UNIVERSITY OF THE WESTERN CAPE

FALCULTY OF LAW

DEPARTMENT OF MERCANTILE AND LABOUR LAW

AN EVALUATION AND DISCUSSION OF A DEPOSIT INSURANCE SYSTEM: SHOULD SOUTH AFRICA ADOPT SUCH A SYSTEM?

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A mini-thesis submitted in partial fulfilment of the requirements for the LLM Degree in the faculty of law, University of the Western Cape

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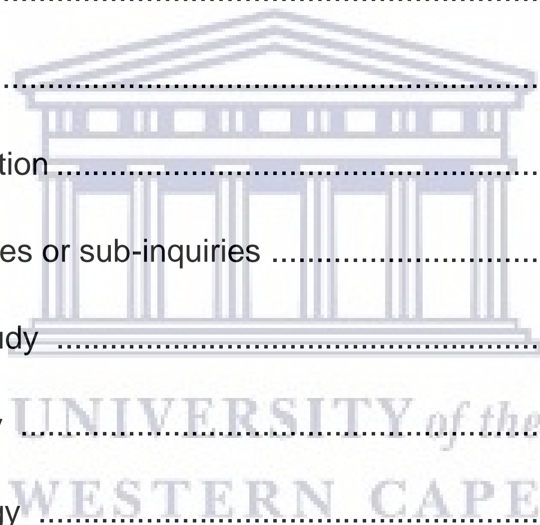
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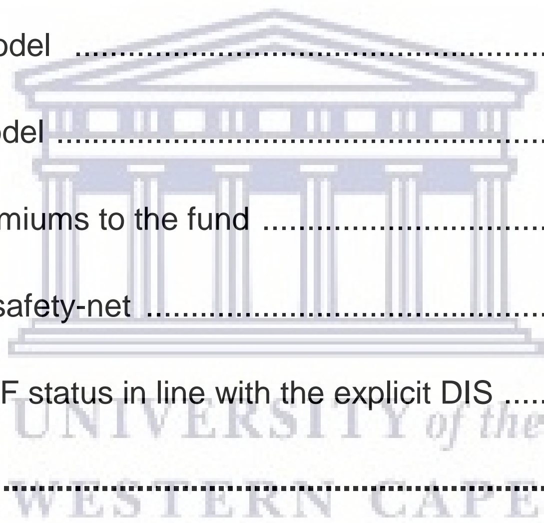

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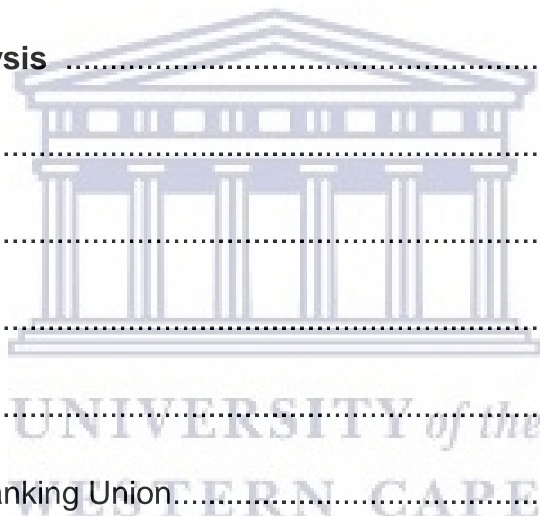
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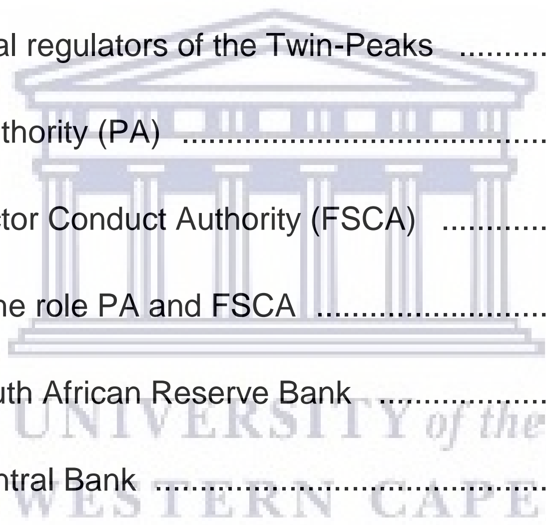

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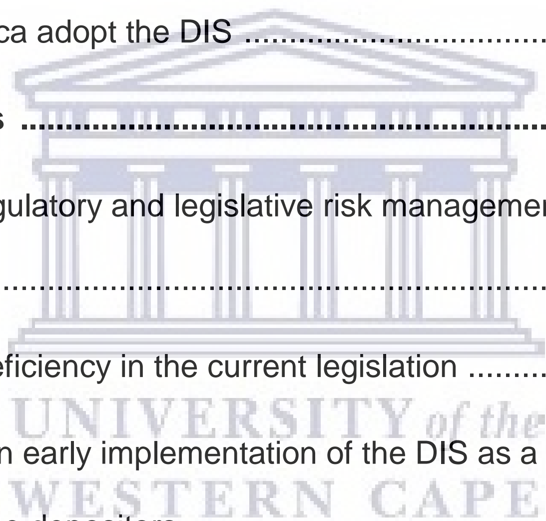

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PLAGIARISM DECLARATION

I declare that '**An evaluation and discussion of a Deposit Insurance System: Should South Africa adopt such a system'** is my own work, that it has not been submitted before for any degree or examination in any other university, and that all the sources I have used or quoted have been indicated and acknowledged as complete references.

Student: Bongani Terrence Khoza

Supervisor: Prof. Riekie Wandraag

SEPTEMBER 2019

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DEDICATION

I dedicate this work to my parents, **Hector Khoza** and **Getrude Mnisi**; to my **siblings**; to the **ZCC** and **ZCCsf family**; to my friends; to my maternal grandmother **Duduzile Chrestina Mnisi**; and my late paternal grandmother, **Rolina Batsepiye Khoza**. I most appreciate the opportunity for allowing me to further my studies. I would not get this far if it was not for your support and encouragements.

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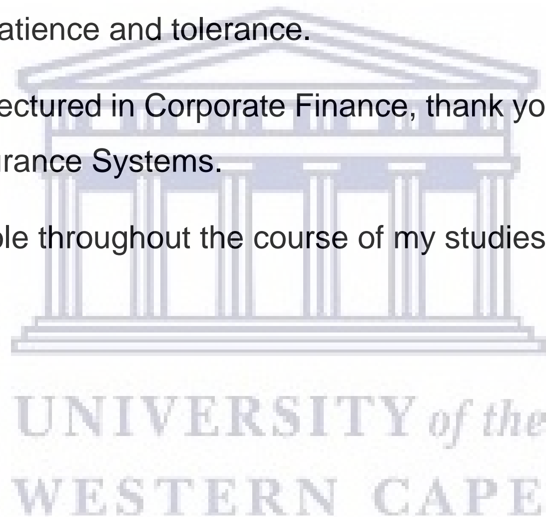

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KEY WORDS

Deposit Insurance System (DIS)

Federal Deposit Insurance Corporation

Moral hazard

South African Reserve Bank

Safety-net

Bank runs

Moral hazards

Best practices

Regulatory frameworks

Coordination

South Africa

United States (US)

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Chapter 1

Deposit Insurance Systems in the banking and financial sector

1. Introduction

The research will evaluate and discuss the importance of Deposit Insurance Systems (DIS) and the necessity of having this system. Important to the evaluation is an analytical consideration of how the South African Reserve Bank (SARB), the National Treasury (NT) and other global financial bodies proposed the approach thereof. Insofar as most jurisdictions had already adopted the DIS as encouraged by the international financial institutions, the study shall determine whether it is plausible for South Africa to derive guidance in her approach taking into account the potential risks posed by the safety-net.

The evaluation of the study will also probe whether any need persists for the adoption of the DIS and the extent to which this system could be beneficial to depositors without burdening the banking sector.

2. Research problem

2.1 Background study

A deposit insurance entails a guarantee extended to the principal that a limited or all amounts of the principal or deposit accounts that accrued interests would be reimbursed if a financial institution could fail.[1] Deposit insurances are traceable in the historical context of the United States' (US) financial sector. The US implemented the system as a response to the 1930s Great Depression (GD) and the unprecedented instability in the banking sector.[2] The GD briefly had its manifestation from the stock crash of 1929 and the bank panics of the 1930s whereby the economy took a drastic downturn and many banks failed.[3] The collapse of the largest banking chains became

[1] Blair C, Carns F & Kushmeider R 'Instituting a deposit insurance system: Why? How?' (2006) 8 *JBR* 6.
[2] Calomiris C & White E 'The origins of Federal Deposit Insurance' available at *https://pdfs.semanticscholar.org/8c13/028561d279951c7473701cfa574271002ffe.pdf (accessed on 5 May 2018)* (Hereinafter referred to as 'Calomiris & White (05 May 2018)').
[3] Calomiris & White (05 May 2018).

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the last straw whereby many banks subsequently suspended their operations, especially after Nashville banking operations had failed.[4]

Soon after Franklin Roosevelt assumed presidency, the Federal Deposit Insurance Corporation (FDIC) was established to remedy the aforesaid factors by extending protection to bank customers and maintain confidence in the American banking sector.[5] Since then, a handful number of countries have already implemented explicit deposit insurance systems, with others moving away from the implicit system to the explicit DIS so as to instil confidence in the financial sector, prevent bank runs and also protect small depositors in instances of bank liquidation and insolvency.[6]

A DIS can either be implicit or explicit. The latter refers to a guarantee that is often privately based and able to stabilize a bank, ultimately compensating depositors if a bank could be in a financial difficulty.[7] This system heavily rely on regulations established on the basis of central bank law or banking law which explains inter alia the purpose and the integral components of the system.[8] On the contrary, where there are no regulations, the assumption is that the system is implicit whereby the rescue and compensation would then come from the government.[9] The guarantee of coverage is inferred rather than legislated whereby collapsing banks are rescued, thus creating an impression of a future rescue. In that sense, it becomes the discretion of the government whether or not to rescue a collapsing bank.[10] If the failure heralds a drastic economic downturn, the government often face external pressure to revive

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[4] Makhubela S *Causes of bank failure in the post democratic South Africa* (Published Maters in Business Administration, University of KwaZulu-Natal, 2006) 18 (Hereinafter referred to as 'Makhubela (2006)').
[5] Calomiris & White (05 May 2018).
[6] According to a comprehensive database, 14 new countries adopted the DIS since 1999. The countries include but not limited to Albania (2002), Bolivia (2001), Nicaragua (2001), Paraguay (2003), Russia (2003), Serbia and Mantanegro (2001), Slovenia (2001) and Zimbabwe (2002). 12 others countries had adopted the DIS as of 1999 which are; Algeria, Bahamas, Belarus, Bosnia and Herzegovina, Gautemala, Honduras, Indonesia, Isle of Man, Kazakhstan, Malaysia and Thailand. See Dermiguci-Kunt A, Karacaovali B & Laeven L 'Deposit insurance around the world: A comprehensive database' Available at *http://hdl.handle.net/10986/8226* (accessed 09 June 2018).
[7] Lucy C & Cole R 'Does Deposit Insurance Improve Financial Intermediation? Evidence from the Russian Experiment' Available at *https://mpra.ub.uni-muenchen.de/29186/1/MPRA_paper_29186.pdf* (accessed on 10 June 2018)
[8] European Credit Research Institute *'Options for reforming Deposit Insurance Schemes in the EU'* (2011) 3.
[9] European Credit Research Institute *'Options for reforming Deposit Insurance Schemes in the EU'* (2011) 3.
[10] Posner E & Casey A 'A Framework for Bailout Regulation' Available at *https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=12151&context=journal_articles* (accessed on 19 February 2020)

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the 'Too-Big-To-Fail' (TBTF) banks for fear of systemic risks.[11] However, systemic risk is characterised as a risk that the failure of a particular financial institution may affect other financial institutions.[12] This lead to a broader financial difficulty in the financial system.[13]

Most of the study in this research focused heavily on an explicit DIS albeit making reference to an implicit DIS. In that vein, banks are either voluntarily or obligatorily insured against a possible financial crisis wherein the banks pay a specified premium for a determined coverage.[14] The premium is levied in accordance to the agreement between the insurance scheme and the banks which then goes to the fund.[15] To a certain extent, a bank has to qualify to be covered and the SARB proposal shows a limit of up to R100 000 coverage per qualifying depositor per bank.[16] This type of safety-net is used as an attempt to strengthen a sound banking system and shields bank depositors from sustaining losses owing to a bank's failure.[17] The system further initiates a proper incentive structure while espousing clear rules.[18] The rationale for the implementation is put forward with the discernment of ensuring public benefit by intensifying confidence in the financial market.[19] Against this backdrop, confidence in banks and the banking system remains an essential pillar, hence without confidence a bank may be exposed to vast risks such as bank runs.

Confidence is mostly guaranteed through observed and enforceable regulatory frameworks reinforcing a sound banking sector and by guaranteeing depositors that their deposits or savings will be safe.[20] Turkey, for instance, lost confidence from foreign institutions due to

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[11] Okeahalam C 'The Political Economy of Bank Failure and Supervision in the Republic of South Africa' (1998) 3 *AJPS* 33 (Hereinafter referred to as 'Okeahalam (1998)').

[12] Csiszar E ''Systemic risks and the insurance industry' Available at *http://www.oecd.org/dataoecd/29/58/1939448.pdf* (accessed on 19 February 2020).

[13] Csiszar E ''Systemic risks and the insurance industry' Available at *http://www.oecd.org/dataoecd/29/58/1939448.pdf* (accessed on 19 February 2020).

[14] South African Reserve Bank '*Designing a deposit insurance scheme for South Africa*' (2017) 31 (Hereinafter referred to as 'SARB (2017)').

[15] South African Reserve Bank '*Designing a deposit insurance scheme for South Africa*' (2017) 31 (Hereinafter referred to as 'SARB (2017)').

[16] Joop A, Christa H & Carla A 'Deposit Insurance: System Design and Implementation Across Countries' Available at *https://www.econstor.eu/bitstream/10419/199058/1/dice-report-2019-1-50000000005878.pdf* (accessed on 19 February 2020).

[17] Dermiguci-Kunt A, Karacaovali B & Laeven L 'Deposit insurance around the world: A comprehensive database' Available at *http://siteresources.worldbank.org/INTRES/Resources/469232 1107449512766/DepositInsuranceDatabasePaper_DKL.pdf* (Accessed 09 April 2018).

[18] Mogyl'nyy O *Establishing effect deposit schemes in Ukrain* (Published Master of Arts in Economics, National University 'Kyiv-Mogyla Academy, 2001) 4.

[19] Ellyne M & Cheng R '*Valuation of Deposit Insurance in South Africa Using an Option-Based Moddle'* (2014) 26 ADR 149 (Hereinafter referred to as 'Ellyn & Cheng (2014)').

[20] Ketcha N 'Deposit insurance system design and considerations' available at *https://www.bis.org/publ/plcy07o.pdf* (Accessed on 09 February 2019) (Hereinafter referred to as 'Ketcha (09 February 2019)').

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weak regulations in the banking sector which never instilled confidence pertinent to the stability and healthy operations of the banks.[21] Furthermore, the fear of a potential financial crisis in a bank gives rise to the issue of bank runs which could be systemically contagion regardless of the soundness of other unaffected banks.[22] This further creates a serious banking crisis wherein the accessibility of credit is critically restricted; depositors forfeit access to their funds; and the economy becomes severely burdened.[23] The confidence could be maintained or sustained in a form of depositors having trust in, amongst other things, the services, ethics and skills of the banking institution which depositors conferred their deposits.[24]

In brief, a run on a bank is a serious economic phenomena which happens when depositors lack confidence in the banking institution whereby the depositors collectively withdraw their deposits from the distrusted bank.[25] The depositor's psychological contagion on one bank has a likelihood of spreading to another bank. The contagions thus affect the operations of banks on the basis that a large number of depositors ultimately withdraw their deposits even from the unaffected banks.[26] When these collective withdrawals are made the banks struggle to meet them since banks possess illiquid assets, this thus "gives rise to a liquidity crisis".[27]

An international point in reference can be drawn from Russia when FK Otkrytie bank faced a major deposit run owing to the uneasiness caused by an outcry of possible concealed losses on their balance sheet.[28] The United Kingdom (UK) also faced the same predicament when it suffered the worst run in 140 years.[29] The event sparked when Northern Rock was in severe financial crisis thus needed a rescue from the Bank of England.[30] Further financial calamity ensued when Lloyds bank and the Royal Bank of Scotland (RBS) had partial segments of their

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[21] Dermiguci-Kunt A & Kane E 'Deposit insurance across the globe: where does it work?' (2002) 16 *JEP* 175 (Hereinafter referred to as 'Dermiguci-Kunt & Kane (2002)').

[22] Mogyl'nyy O *Establishing effect deposit schemes in Ukrain* (Published Master of Arts in Economics, National University 'Kyiv-Mogyla Academy, 2001) 1.

[23] Esmail S Protecting depositors in Palestine: Is there any need for deposit insurance? (Published Masters in Business Administration, Birzeit University) 10.

[24] de Rothschild 'Banking must pursue the holy grail of confidence' available at *https://www.ft.com/content/d9d7b490-dcbb-11e2-b52b-00144feab7de* (accessed 22 May 2018).

[25] Centre for European Policy Studies *'The banking Crisis: Causes, Consequences and Remedies'* (2008) 1.

[26] Kollman R & Malherbe F 'Financial Contagion: the Role of Banks' available at *https://mpra.ub.uni-muenchen.de/69888/1/MPRA_paper_69888.pdf* (accessed on 20 February 2020)

[27] Centre for European Policy Studies *'The banking Crisis: Causes, Consequences and Remedies'* (2008) 1.

[28] Smith G 'A big Russian bank, a key player in Russia's 2014 crisis, Is having problems' available at *http://fortune.com/2017/08/17/russia-bank-otrkytie-problems/* (Accessed 10 April 2018).

[29] Chakravarty S, Fonseca M & Kaplan T 'An experiment on the causes of bank run contagion' (2013) 26 *European Economic Review* 50.

[30] SARB (2017) 12 – 13.

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operation taken over by the government.[31] In essence, the government acquired 68% of voting rights at RBS and 83% of the rights to cash flows.[32] The London Scottish Bank operating in the UK received an exorbitant capital injection to enable the bank to repay depositors despite the insolvent state of the bank.[33] Countrywide financial institutions in the US was also affected by the global financial meltdown.[34] A conventional run also affected financial institutions like Bear Sterns as well as other countries such as Iceland and Greece.[35] The cost of this financial crisis was immense in Iceland leading to a decline of their Gross Domestic Product (GDP) by more than 10%, and their disposable income also declined.[36] The bank run in Greece has compelled the imposition of capital controls, bank closures and restrictions on deposit withdrawals.[37]

It is axiomatic that banks are widely exposed to a wide range of risks posing a threat to their existence. The risks could be internal as will be discussed later in the study, or external happening in a form of bank runs as detailed above. South Africa alone has experienced a number of small bank failures since 1990.[38] The paper will briefly highlight some of the failures. Amid all the failures, no explicit DIS has been adopted to protect depositor's savings. It follows that South Africa still operates under the implicit insurance system whereby, in the event a bank fails, the government will rescue the collapsing bank using taxpayer's money.[39] It has been a norm in the South African financial sector that government, almost always, bailed out banks that were on the brink of collapse.[40] This simply entails that South Africa prefer to rescue failing banks than rescuing any other line of business since a bank is deemed as a fundamental pillar of an economy.[41] Although South Africa has a well-developed regulatory framework in the banking sector, it remains a fact that bank failures have a potential to badly

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[31] Eley J, Moore E & Powley T 'Rock collapse left many in hard place' available at *http://ig-legacy.ft.com/content/2abdeb34-fda8-11e1-8e36-00144feabdc0#axzz5D1evB74X* (Accessed 13 April 2018).
[32] Morrison A 'Systemic risks and the 'too-big-to-fail' problem' (2011) 27 (3) *Oxford University Press* 498 (hereinafter referred to as 'Morrison (2011)).
[33] Morrison (2011) 498.
[34] Bexley J , James J & Haberman J 'The financial crisis and its issues' Available at *https://www.aabri.com/manuscripts/10500.pdf* (accessed on 22 February 2020).
[35] Chakravarty S, Fonseca M & Kaplan T 'An experiment on the causes of bank run contagion' (2013) 72 *European Economic Review* 39.
[36] Benediktsdóttir S, Eggertsson G & Þórarinsson E 'The Rise, Fall, and Resurrection of Iceland: A Postmortem Analysis of the 2008 Financial Crisis' Available at *https://www.brookings.edu/wp-content/uploads/2018/02/benediktsdottirtextfa17bpea.pdf* (accessed on 22 February 2020)
[37] Sibert A "Greek debt crisis: Lessons from Cyprus and Iceland' Available at *https://www.bbc.co.uk/news/world-europe-33354036* (accessed on 22 February 2020)
[38] Makhubela (2006) 46.
[39] SARB (2017) 2.
[40] SARB (2017)
[41] Makhubela (2006) 6.

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cripple the economy which then leads to most banks being branded as being 'Too-Big-To-Fail' (TBTF) at the expense of taxpayers.[42]

Against the above backdrop, the SARB proposed the implementation of the DIS under the discussion paper titled *'Designing a deposit insurance system for South Africa'.*[43] The SARB paper is considered in conjunction with the resolution framework of the National Treasury (NT) published under the paper titled *'Strengthening South Africa's resolution framework for financial institutions'.*[44] The two papers are intended to operate as a comprehensive regulatory foundation of a DIS with the aim of minimizing the social and economic cost of bank failures.[45] The study will attempt to give an analytical consideration of the proposal.

The proposed DIS does not only seek to address the vulnerability of depositors but goes further than stabilizing South Africa's financial system.[46] The further aim is to bring South Africa on par with the international best practices of the Financial Stability Board (FSB). These practices ranges from the Basel Acord III, the Key Attributes of Effective Resolution Regime for Financial Institutions (Key Attributes) and the Core Principles of Effective Deposit Insurance of the International Association Deposit Insurers (AIDI).[47] Furthermore, South Africa is the only Group of Twenty (G-20) member without a safety-net of this nature in comparison with other members in this international forum.[48] The significance of the DIS further seeks to exonerate the government from resorting to public funds to rescue or stabilize banks that are on the brink of collapse since the rescue will, upon inception, come from a privately based DIS serving as a subsidiary of the SARB.[49]

However, the SARB and NT proposal have been severely criticized. Insofar as the DIS plays its foremost goal, it would be folly to overlook the fact that the system also encourage banks to take excessive risks which gives rise to the issue of moral hazards because of the guaranteed cover.[50] This problem is inevitable because even depositors tend to lack incentives to monitor the activities of the banks leading to the banking sector partaking in riskier activities.[51] The criticisms further consider prevailing factors which include but are not limited

[42] Morrison (2011) 500 – 501.
[43] This policy document has not yet been formerly adopted.
[44] This policy document has not yet been formerly adopted.
[45] SARB (2017) 1.
[46] SARB (2017) 7.
[47] The international best practices shall be discussed in depth in chapter three.
[48] SARB (2017) 3.
[49] SARB (2017) 10.
[50] Dermiguci-Kunt & Kane (2002) 176.
[51] The issue of moral hazards and lack of incentives would be discussed in depth in the following chapters.

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to the funding mechanisms, administrative costs and determination of a fair premium.[52] The study shall explore how the proposal seeks to mitigate and address some of these factors.

In the midst of the outcry against the establishment of an explicit DIS, the ultimate question needing an honest answer is whether South Africa should continue with the implicit approach wherein banks are rescued as detailed above or the explicit proposed safety-net should be incepted? Does the comprehensive regulatory foundation of the NT and SARB give rise to an adequate safety-net without prompting any hurdles while attempting to comply with international standards? These questions are imperative because they intrinsically determine the extent to which depositor's vulnerability could be addressed without burdening the banks nor the financial market of South Africa.

2.2. Key Research question

The integral issue the research seeks to address in its evaluation is whether, amid the concerns against the DIS, South Africa should continue with the adoption of the proposed DIS to protect small depositors and comply with international standards.

2.2.1 Research objectives or sub-inquiries

The importance of the DIS will be evaluated against criticisms levelled against it in the South African context, international best practices and academic writing. The following sub-inquiries are relevant to the central question:

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2.2.1.1 Is it important to implement the DIS to cover depositors and disburden the government?

2.2.1.2 Is South Africa obliged by international best practices to adopt the proposed safety-net?

2.2.1.3 If adopted, how will issues such as inter alia moral hazards and the lack of incentives among depositors be mitigated?

2.2.1.4 Will the safety-net place a burden unto the banks?

2.2.1.5 Does the benefit outweigh the heightened disadvantage?

3. Significance of the study

[52] Ellyn & Cheng (2014) 149.

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The call for a privately funded DIS is still at standstill with no official consideration by the South African parliament despite calls made by both national and international bodies that South Africa need to incept the system.[53] When contrasted with South Africa, other jurisdictions with a DIS show their commitment to adhering to international best practices by amongst other things protecting vulnerable depositors against bank failures and disburdening taxpayers from rescuing failing banks.[54] The study therefore becomes significant as it provides groundbreaking approach in which the issue of DIS could be determined in South Africa taking into account its accompanying advantages and disadvantages.

Moreover, the study is distinct because it provides clarity regarding the current position of DIS in South Africa and further propose an alternative towards the adoption of the safety-net. The alternative is advanced through considering the guidance of international financial institutions and how other jurisdictions surged towards the implementation thereof. The study also highlights some of the concerns raised by the banking sector, and goes beyond proffering groundbreaking alternatives.

4. Limitation of the study

An implementation of a DIS by government gives hope to vulnerable depositors that their deposits would be safe during bank failures. Stabilizing the banking sector is also an objective the system aims to achieve. So much factors are influential toward attaining the foremost goals of the DIS. This include but not limited to a robust banking sector which is effectively regulated. Therefore, the focus of the study is a critical evaluation of a DIS imperative to determine whether South Africa is in a better position to surge towards the adoption of the safety-net. The study will only be limited to aspects necessary to answer the question intended to be solved by carrying out the research. Furthermore, the success of this research can enable the SARB and NT to be in a better position to decide whether the DIS should be established to meet the needs of the banking sector. This

5. Research methodology

The research shall heavily rely on both primary and secondary sources. In the context of primary sources this will include but not be limited to legislation enacted in South Africa and other jurisdictions, and the recommendations and practices enforced by international organizations. The primary sources gives guidance insofar as establishing an adequate and robust DIS is concerned. Another purpose pertains to the regulation and supervision of financial institutions upon the adoption of the DIS. The secondary sources comprises of books,

[53] SARB (2017) 2.
[54] SARB (2017) 15.

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journal articles, internet sources and reports or proposals advanced by various organizations across the globe which also gives a detailed analysis of what entails a DIS, the advantages and disadvantages.

6. Chapter outline

Chapter 1 introduces the study by giving a background and statement of the problem required to be solved through conducting the research, the justification of the study and the methodology that will be used to answer the research question. The section further expounds on the sub-inquiries that will serve as guideline in addressing the issue throughout the study.

Chapter 2 gives an overview of South Africa's banking sector, an overview of the proposed comprehensive regulatory framework of the DIS, and that of the collapse of VBS Mutual bank. The chapter further explores the essential design features of the DIS. Moreover, the researcher further review the TBTF status in line with the DIS.

Chapter 3 gives an international overview of the DIS as proposed by international financial bodies. Important to this chapter analyses of the importance of the system as well as the risks posed thereof. There is a comparative analysis of how other jurisdictions adopted the system in juxtaposition with the approach proposed in South Africa.

Chapter 4 gives explore on the adequacy of the South African regulatory framework through determining whether they can withstand the risks stemming from the proposed DIS. There shall further be a discussion of the role of the safety-nets established by the regulatory framework which aims to mitigate the risks attracted by the DIS. The chapter also explore other alternatives proposed by international bodies aimed at mitigating the risks thereof.

Chapter 5 Ultimately answer the question of whether South Africa should proceed with the inception of an explicit DIS in purview of the critical evaluation of the DIS. Moreover, the study will also recommend alternatives to exhaust for the adoption of a robust DIS. This chapter further gives a conclusion of the entire research on whether South Africa is ready is ready for the inception of the DIS.

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Chapter 2

The current status of bank rescues and an overview of the explicit DIS in the South African context

2.1 Introduction

South Africa is no exception to the global bank failures, given the historical bank failures the country has experienced since 1994. These failures triggered a call for the adoption of an explicit Deposit Insurance System (DIS).[55] However, the call received minimal attention because the banking sector is considered safe, and the previous failures only concerned small banks which the government could easily rescue.[56] The predominantly advanced argument is that the explicit DIS gives rise to moral hazard. Moral hazard entails an instance where banks engage in excessive risk taking with the knowledge that the DIS will rescue them should they run into financial difficulty.[57] Linked to that argument is that the 2008 Global Financial Crisis (GFC) had not adversely crippled the South African banking sector, indicating there is adequate regulations to instil soundness, stability and repel any crisis in the financial sector.[58] Indeed, South Africa reinforced her banking system since the 1990s setting her apart from major market economies but the reinforcement has never been a panacea to circumvent bank failures. Above all, the major banks had adamantly opposed the explicit DIS around 2004/2005.[59]

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The anti-explicit DIS proponents appear oblivious to the fact that the inception of the DIS is not limited to guarding against financial crisis.[60] However, the system further address key issues related to systemic risks, bank runs, the vulnerability of depositors and enhanced confidence in the financial sector despite the inevitable risks the system poses to the sector.[61] The risks stemming from the explicit DIS system could be

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[55] Okeahalam C & Maxwell T 'Deposit Insurance design and bank regulation in South Africa' (2001) 9 *JFRC* 142 (Hereinafter referred to as 'Okeahalam & Maxwell (2001)').

[56] South African Reserve Bank '*Public workshop on proposals to establish a deposit insurance scheme in South Africa'* (2017) 2.

[57] The risk of moral hazards serves as an introductory remark in this chapter. Chapter three shall give a holistic overview of the risks stemming from the explicit DIS. For the purpose of the definition thereof. See Dermiguci-Kunt & Kane (2002)176.

[58] Banking Association of South Africa *'South African Banking Sector Overview'* (2014) 1

[60] SARB (2017) 1-2.

[61] SARB (2017) 1-2.

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interpreted to mean the disadvantages which, to a greater extent, has to be weighed against the advantages of the system simply to determine its suitability.

Given the above-mentioned background, this chapter briefly details the current implicit method of bank rescue in South Africa. There is also an overview of the banking sector and its recent bank failures. The study further gives an overview of the explicit DIS as proposed by the South African Reserve Bank (SARB) in collaboration with the National Treasury (NT). This is done by way of discussing the key design features of the DIS needing special attention prior to implementation. The Too-Big-To-Fail (TBTF) doctrine is analysed in purview of the DIS. The examination, overview and discussion herein is aimed at offering a practical approach that may lead to the implementation of the DIS.

2.2 The current position of bank rescue in South Africa

It is important to note that South African banks currently does not have an explicit DIS albeit expressing intentions to adopt one. The intention has been expressed in the comprehensive regulatory framework which is a proposed architecture of both the SARB and NT.[62] To this end, the system in place to mitigate bank failures is the implicit system, hence the aim of the policy consideration is to successfully replace the implicit system with the explicit DIS.

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In iteration, the implicit system entails that the government impliedly takes the responsibility of bailing-out financially distressed institutions, banks included.[63] However, the implicit system is not well endorsed because fundamental arguments are raised against its operation. An argument that received much attention is that the system disturbs the standard of competition between small and large banks,[64] an aspect that will be discussed later in the study. On the other hand, Burger argued that the implicit system offers no absolute guarantee that failing banks would be rescued hence it is easy for bank customers to engage in a bank run once they have knowledge that their bank is in financial difficulty.[65] Furthermore, Avgouleas and Goodhart argue

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[62] This comprehensive regulatory framework is the foundation of the DIS South Africa.
[63] Demirguc-Kunt A, Kane E & Laeven L ‘Deposit insurance around the world: A comprehensive analysis and database’ (2015) 20 *JFS* 156.
[64] Moosa I *The Myth of Too Big to Fail* (2010) 1-2.
[65] Burger B *Bank Rescue in South Africa* (Published LLM in Mercantile Law, University of Pretoria, 2017) 7.

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that the implicit system has a negative impact on public finances and sovereign debt because there is an instant demand and diversion of finances to revive the failing banks.[66] A practical instance of such was demonstrated by the 2008 GFC, and the 2010-2013 Eurozone sovereign crisis whereby governments injected exorbitant amounts of money to prevent runs and rescue distressed banks.[67]

2.3 Developed assumptions

The essence of the above arguments should be considered in light of three assumptions. The first assumption is that most financial institutions in South Africa are interconnected and considered TBTF. The second assumption is that both the interconnectedness and TBTF standards stifles competition in the banking sector resulting in small banks being competitively disadvantaged. The third and last assumption concerns the fiscal ability of the government to bailout collapsing firms, especially because South Africa is a developing nation faced with so many socio-economic factors.[68] These assumptions are significant because they unveil the negative side of the implicit system that is currently overlooked. The assumptions further gives an impression that, while the implicit system is seen as a solution to banking problems, the system indirectly aggravates the banking problems and socio-economic factors because of its inadequacy. However, these arguments and assumptions would be influential in the evaluation of whether South Africa should implement the DIS.

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2.4 Overview of the South African banking sector and analysis of recent bank failures

As a point of departure, the statistics released in 2018 by the Bank Supervision Department (BSD) of the SARB revealed that the banking sector in South Africa comprised of 19 registered banks, 15 local branches of foreign banks, 3 mutual banks, 3 cooperative banks and approximately 41 foreign banks with an endorsement of local

[66] An aspect that shall be deeply discussed in the next chapter. See Avgouleas E & Goodhart C 'Critical Reflections on Bank Bail-ins' (2015) 1 *JFR* 4.
[67] Toader O 'Qualifying and explaining implicit public guarantees for European banks' (2015) 41 *International Review of Financial Analysis* 137.
[68] Bakari S 'Why is South Africa still a Developing Country?' available https://mpra.ub.uni-muenchen.de/80763/1/MPRA_paper_80763.pdf (Accessed on 14 February 2019).

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representative offices.[69] However, the collapse of VBS Mutual Bank[70] led to a decrease of both the total number of banks and mutual banks. Figure one below is an extract of the data collected by Makhubela[71] which details the failure of a number of banks in the South African banking sector since 1994.

Figure one: Bank failures from 1994 – 2018.[72]

Name of bank	Year of failure	Reason(s) for failure
Prima Bank	1994	Credit risk liquidity crisis
Sechold Bank	1994	Market risk
Community Bank	1996	Credit risk liquidity crisis
Islamic Bank	1997	Credit risk liquidity crisis
New Republican Bank	1999	Credit risk liquidity crisis Reputational risk
FBC Fidelity Bank	1999	Credit risk liquidity crisis Reputational risk

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[69] Bank Supervision Department *'Selected South African Banking Trends*' (2018) 2.
[70] VBS Bank was a South African Mutual Bank that was established in 1982. The bank was placed under curatorship on the 11 March 2018. This followed after the bank faced liquidity challenges which proliferated on account of the bank's reliance on illegal municipal deposits. See the Mail&Guardian 'SARB: VBS Mutual bank is not being punished because its black owned' available *at* *http://mg.co.za/article/2018-03-11-sarb-vbs-mutual-bank-is-not-being-punished-its-black-owned* (Accessed 28 July 2018).
[71] Makhubela (2006) 69.
[72] Makhubela (2006) 69.

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Regal Treasury	2001	Credit risk liquidity crisis Operational risk
Saambou	2002	liquidity crisis Operational risk
BEO Bank	2002	Liquidity risk
African Bank	2014	Credit risk liquidity crisis Operational risk
VBS Mutual Bank	2018	Liquidity risk Market risk

The figure above gives an impression that the same risks appear to be the reason for most of the failures. There is a further indication that the running of banking business has an exposure to a number of risks and as a result, banks are prone to fail. Linked to that, the risks have been considered by Apatachioae to form part of banking risks, and the author defines banking risk as a phenomenon that takes place during the running of a bank thus result in a negative impact on the operations of the bank.[73] This aspect also takes into account that the banking business involves a number of financial risks further affecting the bank's performance.[74]

It is of interest to further note that, though all the risks became a factor of the bank failures, liquidity risk had been a dominant factor. Empirical evidence suggests that Saambou bank, as an example, suffered a destructive liquidity crisis such that a run

[73] The identified risks have been grouped in terms of their respective categories while also ascribing a definition of each of them. Apătăchioae A 'The performance, banking risks and their regulation' available at *https://www.sciencedirect.com/sdfe/reader/pii/S2212567115000441/pdf* (Accessed on 03 August 2018)

[74] See Apătăchioae A 'The performance, banking risks and their regulation' available at *https://www.sciencedirect.com/sdfe/reader/pii/S2212567115000441/pdf* (Accessed on 03 August 2018)

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on the bank was triggered, subsequently compromising its existence.[75] It further accords that a run on a bank is caused by the depositor's perception that their bank would be unable to pay their deposits on demand.[76] Banking crises tend to be contagious if not well managed through explicit or implicit guarantees. In general, the collapse of one bank instills the fear of potential losses among bank customers on the basis that all other banks are therefore perceived unsafe. Kaufman has identified two potential losses that can be assumed by depositors and creditors in accordance to their legal priority; (i) credit losses, and (ii) liquidity losses.[77] It is in the same vein that the collapse of Saambou bank also compromised the confidence and credibility of BOE bank such that liquidity had been pressurized because of vast withdrawals.[78] However, some of the distressed banks in figure one have been saved through the implicit system whereas most of them were allowed to fail. VBS is added as the latest bank to fail hence a slight digression will be made in the study to conduct an analysis concerning the failure of VBS.

In essence, there may not be a condemnation of the implicit method of bank rescue offered to the distressed banks because of the understanding that the existence of banks plays a pivotal role in the financial system and economy.[79] Banks plays the intermediation function role whereby there is an allocation of financial resources from savings to investment.[80] Banks further carry out maturity transformation roles for the facilitation of financing for long-term basis, provide liquidity and facilitate amongst other things a payment and settlement function in the broader economy.[81] Therefore, bank failures are not desirable insofar as financial and economic reasons are

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[75] Steyn E et al 'Enron and Saambou Bank in South Africa: a case study of insufficient relationship management' (2004) 30 (1) *Public Relations Review* 76.
[76] Lukhele T *A critical assessment of the funding structure of South Africa's proposed bank Deposit Insurance Scheme* (Published Masters of Business Administration, University of Cape Town, 2017) 10 (Hereinafter referred to as 'Lukhele (2017)').
[77] "Credit losses is defined as the prorata shortfall of the proceeds of the assets from the par value of the deposits and other claims made, and liquidity losses refers to the delays in receiving proceeds of realized recovery amounts because of delays in selling the bank's assets to attempt minimize or avoid fire-sales or the existence of legal stays that prohibit..." See Kaufman G 'Too Big to fail in banking: What does it mean' (2014) 13 *JFS* 215-216 (hereinafter referred to as 'Kaufman (2014)').
[78] Makhubela (2006) 103.
[79] Bank Supervision Department *'Bank Supervision Department Annual Report'* (2016) 1.
[80] Burger B *Bank Rescue in South Africa* (Published LLM in Mercantile Law, University of Pretoria, 2017) 6.
[81] Burger B *Bank Rescue in South Africa* (Published LLM in Mercantile Law, University of Pretoria, 2017) 6.

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concerned. At the same time, it should not be ignored that the presence of one or more of the identified sources of banking risk has a potential to disturb the efficient running of the banking business. As mentioned, the implicit system or explicit DIS have been identified as mitigating mechanisms, while the latter system is preferred for policy considerations in South Africa and for the purposes of the study.

Given the preference thereof the salient question therefore is whether the explicit DIS could have prevented the failure of the banks under figure one. The study draws a preliminary conclusion similar to that of Dermiguc et al,[82] and it is submitted that the DIS could have played a vital role by preventing much of the systemic crisis and ultimately rescue a number of banks because the DIS is considered as a plausible tool of preserving the economic health and soundness of financial systems.[83] Linked to the preliminary conclusion, Moyer and Lamy[84] have also traced the essential role of the DIS under the auspices of the Federal Deposit Insurance Corporation (FDIC) during the Great Depression (GD) whereby the system has successfully restored depositor's confidence and reduced bank failures in the banking system. Despite the detractions concerning the DIS, empirical studies similar to that of Bergbrant et al further recognizes the distinct role of the DIS, thus points out that the system circumvent a run on a bank.[85] By so repelling bank runs, deposits of vulnerable bank customers remains uncompromised. However, the above preliminary conclusion does not project the DIS as a panacea of all related banking crises, denoting that the system should only be viewed as a tool that forms part of the safety-net setting aimed at protecting vulnerable depositors and mitigate bank runs or banking crises. To this end, a number of jurisdictions have since implemented the DIS for the purpose of providing liquidity to banks experiencing bank runs.[86]

[82] The authors carried a comprehensive database of a DIS arrangements of 188 countries through the end of 2013 whereby their preliminary assessment considers that the DIS fulfilled its integral purpose of circumventing open runs on bank deposits especially during the 2007-2008 GFC. See Demirguc-Kunt A, Kane E & Laeven L 'Deposit Insurance Database' available at *http://siteresources.wolrdbank.org/INTRES/Resources/469232-1107449512766/Deposit_insurance_database_preWP.pdf* (Accessed on 02 February 2019).
[83] Ketcha (09 February 2019).
[84] Moyer R & Lamy R 'Too Big to Fail: Rationale, Consequence, and Alternatives' (1992) 27 *PGJ* 20.
[85] Bergbrant M et al 'Does deposit insurance retard the development of non-bank financial markets' (2016) 66 *JBF* 106.
[86] Laevan L 'Bank Risk and Deposit Insurance' (2002) 16 (1) *The World Bank Economic Review* 110

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Since South Africa operates under the implicit system, a system that is selective in nature, some of the banks under figure one could not be rescued. The selective nature of the implicit system became evident when the crisis at Saambou bank was not repelled whereas a subsequent rescue was offered to BOE Bank when it was on the brink of collapse.[87] Moreover, African bank[88] recently received a bailout whereas VBS bank has been overlooked.

2.5 Brief overview of the collapse of VBS Mutual Bank

VBS Mutual Bank is the latest bank to collapse in the South African banking sector.[89] The bank was also exposed to the same risks that led to the failure of the banks depicted in figure one above. According to the presentation made by SARB at parliament, VBS had already established six branches with its head office found in Makhado and corporate office in Johannesburg respectively, thus offered products and services on inter alia savings, mortgage, short-term loans and contract finance.[90]

In essence, VBS Mutual Bank was placed under curatorship on March 2018 preceding the bank's fragility in respect of market risk and liquidity crisis as detailed above, precariously caused by poor corporate governance practice by management of the bank.[91] The liquidity distress stems from inter alia the 'maturity of a large concentration of deposits from municipalities' whereby VBS accepted short-term deposits from the municipalities and have lent them on a long-term basis resulting in the bank's inability to repay such deposits on demand.[92] The bank also failed to come up with a financial resolution plan to accumulate funds so as to circumvent the liquidity crisis. VBS bank was registered under the Mutual Banks Act,[93] but took municipal deposits. The

[87] South African Reserve Bank *'2002 Annual Report'* (2002) 7-8.
[88] African Bank had a near bank run after it experienced serious banking crisis, and the bank was eventually placed under curatorship with a rescue plan crafted and sponsored by the SARB AND government. See Bartra S 'African Bank goes under central bank's curatorship amidst mounting credit losses' available at *https://rmicri.org/media/static/images/thumbnail-pdf/WCBAUG05AUG112014.pdf* (Accessed on 27 January 2019).
[89] National Treasury 'Treasury's response to the VBS Mutual bank matter' available at *http://www.treasury.gov.za/comm_media/press/2018/2018031401%20TREASURYS%20RESPONSE%20TO%20THE%20VBS%20MUTUAL%20BANK%20MATTER.pdf* (accessed 17 February 2020)
[90] This is a presentation made to parliament by the South African Reserve Bank. The presentation was made in March 2018.
[91] See SARB (2018) 7.
[92] South African Reserve Bank 'Embargoed against delivery' (2018)
[93] See the Mutual Banks Ac 124 of 1993.

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Municipal Finance Management Act of 2003 prohibits that exercise.[94] Therefore, VBS Bank has been taking deposits illegally.

The irregular banking practices at VBS bank pressurized the liquidity crisis.[95] There has been no funding mechanisms to repel the crisis. The shareholders could also not be able to extemporaneously provide the money needed and this became a stronghold to eventually put the bank under curatorship.[96] In brief, South African banks are placed under curatorship in accordance to the Banks Act of 1990[97] whereby once the curator is appointed, the curator has to conduct the management envisaged in section 66 (2A)(a) of the Act in a manner that the Registrar may consider to be in the best interest of the creditors of the bank and the banking sector at large.[98] However, many people believe that the taking of municipal deposits became a last straw on the basis that the bank has since been embroiled in controversial governance malpractices prior to its collapse.[99]

However, the collapse of VBS bank raises the question of equitability that has to be accorded to depositors. Imperative to the question is a determination of whether the depositor's deposits would be guaranteed in the event of the failure, and assume the depositors are to receive their deposits, to what extent does the failure affect them. This takes into account that the failure has a direct negative impact on the depositors albeit not extensively affecting the economy. However, the ultimate resolution crafted by the SARB cannot be deemed as being equitable because, despite the guarantee extended to depositors with less than R50 000, the other depositors were inconvenienced as their deposits were not instantly available since the curator highly prioritized the interests of the creditors of the bank.[100] The collapse of VBS should

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[94] See the Municipal Finance Management 56 of 2003

[95] Motau T 'How VBS was looted: The full report' Available at ***https://www.politicsweb.co.za/documents/how-vbs-was-looted-the-full-report*** (accessed on 18 February 2020).

[96] See SARB (2018) 7.

[97] Act 94 of 1990, section 66.

[98] Act 94 of 1990, Section 66 (2A)(a).

[99] Despite the unconscionable action accepting municipal deposits, in 2017 the bank has been fined for poor control measures necessary to preclude money laundering and fight financing of terrorism. See Bonorchis R 'South Africa's VBS Mutual Bank fails amid severe liquidity crisis' available at *http://www.bloomberg.com/news/articles/2018-03-11s-africa-s-vbs-mutual-bank-fails-amid-severe-financial-crisis* (Accessed 26 August 2018).

[100] SARB (2018) 8.

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therefore be viewed as an awakening call despite the imminence of South Africa's proclaimed 'robust financial sector'. Though the banking sector may not easily succumb to collapse but certain banks are still prone to collapse probably due to lack of enforcement of the regulatory frameworks. An honest truth is that these failures always come as a fatal blow to the vulnerable depositors.

2.6 Dominance in the South African bank sector

Despite the detailed historic failures, the South African banking sector is still considered safe and sound, and well capitalized because of the presence of the robust financial regulatory framework and macroeconomic fundamentals.[101] Until 2018, the banking sector has been ranked – number two in terms of soundness and number 27 for offering cost-effective services.[102] In the same light, the 2017 presentation by the NT has unveiled that the financial sector assets makes up to three times the Gross Domestic Product (GDP) wherein the ratio exceeds that of the commonwealth market economies.[103] The banking sector alone manages 4.8 trillion Rand in assets, making the sector to account for more than 100% of the country's GDP.[104] Of great interest, a large portion of these assets is owned by the big five banks.[105] Thus raising the issue of dominance and concentration embedded in the banking sector. The researcher is of the view that the dominance and concentration poses a huge risk to the sector as will be demonstrated along the study.

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The concentration of the big banks has been calculated by the World Bank whereby there has been an increase from 94.8% in 2000 to 98% in 2015.[106] In a similar vein, the 2016 BSD report has shown the big five to hold a 90.7% of total assets in contrast

[101] Foggit G, Heymans A, Van Vuuren G et al 'Measuring the systemic risk in the South African banking sector' available at *http://www.scielo.org.za/pdf/sajems/v20n1/43.pdf* (Accessed on 26 February 2019).

[102] Economic Research Africa *'An analysis of competition, efficiency and soundness in the South African banking sector'* (2018) 3.

[103] A presentation by the National Treasury to the Standing Committee on Finance & Portfolio Committee on Trade and Industry. See the National Treasury '*Transforming the financial sector to make it serve SA better and be transformative: presentation to the standing committee on Finance and Portfolio committee on and industry'* (2017) 6.

[104] National Treasury '*Transforming the financial sector to make it serve SA better and be transformative: presentation to the standing committee on Finance and Portfolio committee on and industry'* (2017) 13.

[105] SARB (2017)

[106] Moyo B 'An analysis of competition, efficiency and soundness in the South African banking sector' (2018) 21 *SAJEMS* 3.

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with foreign banks and other banks operating in the country.[107] Despite the statistical data excluding amongst other things the cooperative banks and mutual banks, the researcher still argue that the inclusion of the latter category of banks would not impact the dominance and concentration by the big banks. To support that claim, the researcher relies on the *Financial Stability Review* paper of the SARB which shows a consistent increase of the total assets of the big banks.[108] The assets increased from the 80% held between the periods 1994 to 2002 to the currently held 90% thus making the concentration to be the highest in the sector.[109] In light of the data thereof, the impression exhibited therefore is that the small banks suffers a competitive disadvantage.[110] This is because the dominance and concentration of the big banks is an intrinsic issue in the sector.[111] This issue has also been identified as a key constraint to the adoption of the DIS in South Africa.[112]

In the context of risk, Dube and Kaya,[113] designed the first systemic ranking model in South Africa which revealed that the large banks contribute a systemic risk of 64.11% in the banking sector. This simply entails that the large banks would have the greatest impact on small banks should they fail.[114] Added to that, Khan find these banks to mount a 60% of the sample size, and further argues that the banks expose the sector at greater risk because of carrying a high percentage of market share in contrast with other banks.[115] Considering the above findings, the research argues that the likelihood of risk cannot be entirely ruled out even in the midst of the strong prudential regulations in the sector. This argument further takes into account that a large portion of loans is

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[107] Bank Supervision Board *'Annual Report'* (2016) 3.
[108] South African Reserve Bank *'Financial Stability Review: First edition'* (2017) 7
[109] SARB (2017) 7.
[110] SARB (2017).
[111] SARB (2017).
[112] SARB (2017) 9.
[113] Dube Q & Kaya T 'New ranking shows which SA Banks contribute most to systemic risk' available at *http://www.aifmrm.uct.ac.za/newsroom/new-ranking-shows-sa-banks-contribute-systemic-risk/* (Accessed on 28 February 2019).
[114] Dube Q & Kaya T 'New ranking shows which SA Banks contribute most to systemic risk' available at *http://www.aifmrm.uct.ac.za/newsroom/new-ranking-shows-sa-banks-contribute-systemic-risk/* (Accessed on 28 February 2019).
[115] Khan N *Risk Factors in the South African Banking Industry: The Role of Capital, Bank Size, Leverage and Franchise Value* (Published Masters of Management in Finance and Investment, Wits University 2016) 6.

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offered by these big banks thereby presenting a risk management implication because the loan portfolios cannot be properly diversified in the banking sector.[116]

2.7 Advanced hypothesis

Upon closely examining the implicit system, the researcher holds that the rescue under the system cannot be construed to accrue automatically as there are opaque qualitative measures the banks need to satisfy to be eligible for a capital injection as will be shown in the study. In respect of these measures, the researcher is of the opinion that they indirectly result in the exclusion of some banks devoid of the legible standards, especially the small banks.

The researcher has therefore developed a hypothesis which used as an attempt to demonstrate the selective nature of the implicit system. In that sense, the researcher provides that if the nature of the collapse concerns a small bank, rescuing such a bank appears cheap compared to rescuing a large bank albeit the collapse of small banks not posing a serious threat to the financial system. In a similar context, rescuing a large bank with a TBTF status or that is systemically important, although costly, appears significant because the rescue prevents economic downturns, systemic runs and the loss of deposits.[117] Therefore, it is less likely that the government can simply let the large banks be liquidated because the liquidation of banks caused by bank failure or liquidity problems can adversely impact the economy.[118] The least can be said about small banks because though it is cheap to revive them as hypothesised. They are seldom rescued probably due to their small sample size and lack of integration as per the advanced assumption.

The expounded hypothesis by the researcher therefore shows that, in one way or the other, the government is forced to rescue the big banks. On the other hand, small banks are easily overlooked in the same way as those depicted under figure one above. This therefore makes it necessary for South Africa to consider an explicit DIS so as to further extend the same advantage to small banks.

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[116] Okeahalam & Maxwell (2001) 141.

[117] Grossman E & Woll C 'Saving the banks: The political economy of bailouts' Available *at https://hal-sciencespo.archives-ouvertes.fr/hal-00972960/document* (Accessed on 11 May 2019).

[118] National Treasury *'Strengthening South Africa's Resolution Framework for Financial Institution'* (2015) 33 (Hereinafter referred to as 'National Treasury (2015)').

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Furthermore, South Africa highly prioritizes bank failures by way of government rescues as opposed to any other line of business because of economic reasons.[119] Taking into account the advanced assumptions, and the overview on dominance, risk and concentration, the researcher finds it puzzling as to why the government is so ardent to hold a large uninsured risk. This is because serious bank failures often become too expensive for any government to bear and sometimes there is a huge uncertainty empirical to amongst other things the criteria of depositors that ought to be compensated and the extent of monetary compensation.[120] Since banks expand their growth and sample size in pursuit of the TBTF status it should be brought to light that systemic size also renders the bailout too exorbitant for a country resulting in a bank being 'Too-Big-To-Save' (TBTS) because of insufficient funds.[121]

2.8 A brief overview of the explicit DIS and how South Africa proposed its implementation

The DIS, as a protective measure, has been the cornerstone of the American banking sector implemented to repel banking panics caused by the Great Depression (GD).[122] To this end, many countries have already implemented the DIS with the aim to enhance confidence in the banking system, replace implicit systems, protect vulnerable depositors and repel banking risks.[123]

The research above identified confidence as an imperative pillar that could determine the profitability of a bank. For instance, bank customers put their money in a bank they can trust with confidence and the deposited money helps the bank to perform its functions.[124] The deposits boost the liquidity standards of the bank whereby the bank is able to convert the liquid deposits into liquidity loans which therefore becomes a

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[119] Erasmus C & Makina D 'An Empirical Study of Bank Efficiency in South Africa Using the Standard and Alternative Approaches to Data Development Analysis (DEA)' (2014) 6 *JEBS* 310.
[120] SARB (2017) 2.
[121] European Banking Sector '*Are banks too big to fail or too big to save? International evidence from equity prices and CDS spreads*' (2010) 14.
[122] Hogan T & Johnson K 'Alternatives to the Federal Deposit Insurance Corporation' (2016) 20 (3) *The Independent Review* 435.
[123] Lambert C, North F & Schüwer U 'How do insured deposits affect bank risk? Evidence from the 2008 Emergency Economic Stabilization Act' (2017) 29 *JFI* 81.
[124] di Lorenzo V 'Public confidence and the banking system: The policy basis for continued separation of commercial and investment banking' (1986) 35 *American University Law Review* 648.

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profitable asset to the bank.[125] Based on that method, the introduction of a DIS into the banking system is presumed to enhance the sector because of retaining depositor’s confidence by way of assuring depositors that their deposits are safe, and this further contributes to the higher economic growth rates.[126] Put simply, the DIS assumes the responsibility of honouring the deposits on demand during bank failures thus exonerating the government from footing the bill.[127]

While the DIS system stabilizes the financial sector and mitigates bank runs, the explicit rules of the system further gives transparency and certainty concerning the resolution processes for failed banks.[128] The rules also define the protective measure of deposits held in banks up to a certain limit.[129] South Africa proposes a limit of R100 000 per qualifying depositor per insured bank with exclusionary rules on who qualifies to be covered.[130] Of great advantage, in the event a bank runs into financial difficulty, such a bank would not be compelled to instantly convert its assets into liquidity simply to honour deposits on demand because the DIS shall initiate the reimbursements.[131]

While studies have found that the DIS increases banking crisis, the findings made by Demirgüc-Kunt and Detriage[132] do not negate the disadvantages of the system. The authors differently consider the crises to be most likely when the DIS is poorly designed whereby amongst other things the DIS makes membership to be voluntary, the system has an unlimited coverage and not independent from government administration.[133] In a similar vein, Khan and Dewan had evaluated the impact of

[125] Lukhele (2017) 16.
[126] Cull R, Lemma W & Sorge M ‘Deposit Insurance and Financial Development’ (2005) 37 *JMCB* 45.
[127] Ketcha (09 February 2019).
[128] IADI ‘Deposit Insurance System’ Available at *https://www.iadi.org/en/deposit-insurance-systems/* (accessed on 14 February 2019).
[129] Khan A & Dewan H ‘Deposit insurance scheme and banking crises: a special focus on less-developed countries’ available at *https://link.springer.com/content/pdf/10.1007%2Fs00181-010-0438-8.pdf* (accessed on 07 February 2019).
[130] SARB (2017) 4.
[131] Diamond D & Dybvig P ‘Bank Runs, Deposit Insurance, and Liquidity’ (1983) 91 *JPE* 404.
[132] Demirgüc-Kunt A and Detriage *‘Does deposit insurance increase banking system stability? An empirical investigation’ (2001) 49 JME* 1402**.**
[133] See Demirgüc-Kunt A and Detriage E *‘Does deposit insurance increase banking system stability? An empirical investigation’* (2001) *49 JME* 1402.

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introducing a DIS in the context of underdeveloped jurisdictions.[134] The authors finds it undesirable to implement the DIS if the financial market is not robust, and similarly considered the design features to be instrumental to either instigate or circumvent banking crisis.[135] Put differently, an adequately designed DIS would comprise of robust design features to mitigate the likelihood of risks and banking crisis. Ketcha also endorses the clear reimbursement procedures encompassed by the DIS during bank failures while not ignorant of the risks stemming from the system.[136] In that sense, the author also considers the DIS as the most useful and plausible policy in the entire safety-net setting compared to other safety-nets because it primarily strengthens the banking sector.[137]

2.9 The key design features of South Africa's DIS regulatory framework

South Africa's DIS is sought to address the aforementioned factors while also complying with international standards.[138] Despite many people believing that the South African banking system cannot easily succumb to failure, others believe there is excessive political risk posing unforeseeable difficulties which could be destructive to the financial sector.[139] Furthermore, the recent bank failures are a sufficient indication that banking reformations must be implemented. The goal should be to preserve the enhanced sector and protect vulnerable depositors, and that can be guaranteed by introducing the DIS in the sector. This aspect is important because even the 2008 GFC unveiled anomalies in most banking operations thus led to the failure of many banks because of amongst other things poor corporate governance and unenhanced regulatory frameworks.[140] However, Cut et al reckoned that the

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[134] Khan A & Dewan H 'Deposit insurance scheme and banking crises: a special focus on less-developed countries' available at https://link.springer.com/content/pdf/10.1007%2Fs00181-010-0438-8.pdf (accessed on 07 February 2019).
[135] Khan A & Dewan H 'Deposit insurance scheme and banking crises: a special focus on less-developed countries' available at https://link.springer.com/content/pdf/10.1007%2Fs00181-010-0438-8.pdf (accessed on 07 February 2019).
[136] Ketcha (9 February 2019).
[137] Ketcha (9 February 2019).
[138] SARB (2017) 14.
[139] AIFMRM 'On the financial wish list for 2017' available at http://www.aifmrm.uct.ac.za/newsroom/financial-wish-list-2017/ (Accessed 17 July 2017).
[140] Demirgüc-Kunt A and Detriage 'The determinants of banking crisis: Evidence from developed and developing countries' available at https://www.jstor.org/stable/3867330 (Accessed on 08 February 2019)

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variations in the design features is an essential determinant of the likelihood of banking crisis.[141] The analysis in the earlier study has unveiled that the design features of the DIS are a yardstick to determine the success of the system. This study acknowledges that the DIS has a number pivotal design features. However, the discussion shall only be limited to the key design features, also construed as robust features, which requires careful consideration when establishing a DIS in South Africa.

a. Scrutiny of the funding models

An important purpose of the DIS is to ostracize systemic runs and to give certainty that it would be able to pay out claims during bank failures.[142] For this purpose to be realised, a proper and stable funding model must be put in place. Questions centred on the funding model also came under scrutiny when South Africa's comprehensive regulatory framework was proposed. However, there is an understanding that the banking sector should bear the cost of funding the DIS on the basis that banks and their customers derive a direct benefit from the system.[143] Three models of funding have been propounded namely; post-funding, hybrid and pre-funding models respectively.[144] Despite the preference given to the pre-funding model, all the models give rise to a question of when to gather funds to meet the guaranteed payments amid financial crisis - prior or after the funds have been paid subsequent to the failure of a bank, and whether any of the models would be adequate enough to achieve the purpose of the DIS. To clarify the question of funding models, each model will be scrutinised with the objective of trying to understand why the SARB opted for the pre-funding model over the other models because each funding model has a substantial bearing on the DIS.[145]

i. <u>The Ex-post model</u>

The ex-post, also known as the post-funding model, entails that funds are acquired subsequent the failure of the bank whereby the government or central bank would inject the funds.[146] Put differently, the funds are gathered after the bank has failed

[141] Cull R, Senbet L & Scorge M 'Deposit insurance and financial development' (2005) 37 *JMCB* 44
[142] International Monetary Fund *'Deposit Insurance Database'* (2014) 7
[143] National Treasury (2015) 37.
[144] See SARB (2017) 32-33.
[145] International Association of Deposit Insurers *'Funding of deposit insurance system: Guiding paper'* (2009) 5 (Hereinafter referred to as 'IADI (2009)').
[146] SARB (2017) 32

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which then boost the liquidity the liquidity standards of the bank to continue operating.[147] This model is not well endorsed because the repayment of the injection would only be the duty of the banks that survived the crisis whereas those that collapsed would be relinquished.[148] Furthermore, the method lacks an explicit obligation regarding the apportionment of costs among the banks simply to compensate the depositors.[149]

An endorsement of any model is attributable to the advantages and disadvantages it yields in the entire DIS setting hence a close consideration of such warrants to be done in respect of each of the models. On the disadvantageous part, an ex-post poses a question centred on the equitability of burdening surviving banks with the costs of failing banks, especially if poor governance has been the cause of failure. At the same time, it would be folly to issue a penalty to an insolvent bank that failed to adhere to the principles of good governance. This is part of the prevailing reasons why the SARB considers the model less effective because the DIS body would further be required to often seek for excessive money from the government in the instance of many bank failures therefore rendering the "contingent liability on the fiscal balance sheet" immutable.[150] The anchored advantages of the model concerns the disburdening of banks with ongoing premiums and the mitigation of moral hazards due to the lack of a standing fund.[151] It therefore accords that the disadvantages of the post-funding model outweighs the advantages, hence the model has been overlooked by the SARB as a mechanism of funding the explicit DIS in the South African context.

ii. Ex-ante funding

An ex-ante, commonly known as the pre-funding model, is an opposite of the post-funding model, literally denoting that the DIS becomes maintained, with premiums paid prior the occurrence of a financial crisis.[152] The DIS paper also points out that the funds should be collected to cover claims and other expenses in anticipation of a financial crisis.[153] In essence, the funds are accumulated through the payment of

[147] Ketcha (9 February 2019).
[148] IADI (2009) 7.
[149] IADI (2009) 7.
[150] SARB (2017) 32
[151] Lukhele (2017) 23.
[152] Ketcha (9 February 2019).
[153] See SARB (2017) 33.

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premiums at the time the economy is still sound.[154] Confidence will thus be enhanced because the collection of funds as a precautionary measure reassures the safety of deposits during bank failures. Lukhele has pointed out that the ex-ante is not appropriate to cover for depositors of large banks,[155] by implication the model may best suit customers of small banks because of their vulnerability during bank failures. The ex-ante funding model essentially maintains trust and confidence in the DIS because the availability of funds entails that the system would be able to cover depositor losses when they happen.[156]

The advantageous part of the ex-ante is that all member banks will contribute towards the maintenance and accumulation of funds irrespective of collapsing or not. It broadly exonerates efficiently managed banks from directly subsidizing poorly managed banks because, in the event of bank crisis, there will be a dip in the pool of funds paid by all banks.[157] However, anyone can postulate that there is a burdening of costs imputed to banks considered immune to insolvency. At the same time it should be understood that although the DIS is unlike other ordinary insurances but the fundamental principles of insurance cannot be ignored. These are the principles that insurance guards against an uncertain future event whereby upon the occurrence of the event, the insurer would step in to remedy the devastations caused by the event insured against.[158] For instance, not everyone anticipated the stock-market crash which adversely affected the banking sector in the US and at the time, depositors were not insured. Therefore, the purpose of this proposed model is to ensure that funds would be available when needed. The pre-funding model is adopted by many jurisdictions as it accords with the Core principles of effective DIS.[159]

iii. Hybrid model

A hybrid model is comprised of both the pre-funding and post-funding models. The essence is that the two models operate on an equal footing. The guiding paper of the

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[154] Bank for International Settlement 'Bank failure management – the role of the deposit insurance' available at https://www.bis.org/fsi/publ/insights17.pdf (accessed on 20 February 2020).
[155] Lukhele (2017) 23.
[156] Federal Deposit Insurance Corporation *'Deposit Insurance Funding: Assuring confidence'* (2015) 3
[157] IADI (2009) 6.
[158] *British Oak Insurance Co Ltd v Atmore* 1939 TPD 9.
[159] The principles will be briefly examined and discussed in chapter three as part of international best practices.

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International Association of Deposit Insurers (IADI) reckons that this model has features of an ex-ante mechanism premised on the payment of premiums and contributions thereof, and further incorporates a strategy to acquire funding ex-post especially from the member banks, done in the context of special 'premiums, levies or loans, should they be needed'.[160]

However, the benefits of both the post-funding and pre-funding models accrue in a hybrid manner while attempting to ostracize the disadvantages.[161]

b. The payment of premiums to the fund

The ex-ante funding mechanism is given preference over the other mechanisms of funding.[162] This preference requires to be considered in purview of the premium payable to the fund. However, there is a general understanding that the banks are vested with the responsibility to pay the premiums, and this is despite the DIS protecting the depositors' deposits.[163] In a similar vein, Ellyne and Cheng[164] hold that setting a fair premium for the insured banks is a very difficult task. Allen et al[165] held that a DIS could precipitate moral hazard if not fairly priced and well risk-adjusted. In that sense, the researcher is of the view that the pricing of premiums should not be costly such that the banks may be burdened, and it has to reflect fairness between the banks while minimizing moral hazard.

The methods of payable premiums are propounded in two respects - risk-based and flat rate premiums.[166] The former is viewed as a more equitable method wherein the risky financial institutions are expected to pay higher premiums.[167] Simply put, the more the bank exhibits high risk on its profile, the higher the premium. It thus accords that the risk-adjusted method would incentivise the banks to actively engage in less risky activities to avoid the occurrence of moral hazard, and the less risky banks will not carry the burden of subsidizing risky banks. Contrary to the above stated, risk-

160 IADI (2009) 8.
161 See the National Treasury (2015) 37.
162 Ketcha (9 February 2019).
163 Grundy T 'Practical aspects of the Deposit Insurance System' (1988) 44 (1) *The American Bar Association* 177.
164 Ellyn & Cheng (2014) 148.
165 Allen F, Carletti E & Leonello A 'Deposit insurance and risk taking' (2011) 27 (3) *Oxford Review of Economic Policy* 465.
166 Ketcha (20 February 2020).
167 Rochester D & Walker D 'A risk-based Deposit Insurance System' (1986) 9 *JIIP* 2.

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based is considered impracticable because of requiring the risk of each of the insured banks to be quantified with precision in accordance to realistic data, which in itself, is a difficult task.[168] On the other hand, the flat rate premium method appears to put all banks on par whereby the pricing of premiums is the same for all banks, and it is considered not sophisticated to administer compared to the risk-based.[169] Under this method, the DIS, however, is widely interested only in accumulating enough funds as opposed to addressing moral hazard.[170]

c. Membership of the safety-net

The explicit DIS is not meant to operate in isolation nor does it substitute other regulatory frameworks.[171] The idea is to ensure the system works complementarily with other safety-nets to circumvent systemic runs and protect depositors,[172] denoting that it should be considered to form part of the entire safety-net setting and cross resolution tools for banks. This notion is endorsed by principle four of the Core principles[173] requiring the deposit insurance to coordinate with other financial safety-net participants in protecting depositors and stabilizing the financial market.

Furthermore, Principle Nine of the Core principles of effective DIS recommends for a compulsory membership for all financial institutions taking deposits from those considered worthy of protection, done so to preclude an 'adverse selection'.[174] This is not to say jurisdictions do not have a choice between the automatic membership and the compulsory membership because everything boils down to the needs of each jurisdiction's financial market. However, it accords that the recommendation remains pertinent to jurisdictions intending to adopt a DISN, South Africa included. In brief, the concept 'adverse selection' entails the propensity of higher-risk banks to opt for

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[168] Ronn E & Verma A 'Pricing Risk-Adjusted Deposit Insurance: An Option-Based Model' (1986) 41 *JF* 872.
[169] Lukhele (2017) 25.
[170] Blair C, Carns F & Kushmeider R 'Instituting a deposit insurance system: Why? How?' (2006) 8 *JBR* 10.
[171] SARB (2017) 42.
[172] SARB (2017) 42.
[173] The core principles are aimed at guiding the efficient implementation of an adequate explicit DIS. The principles will be briefly examined and discussed in chapter three as part of international best practices.
[174] Basil Committee on Banking Supervision/ International Association of Deposit Insurers '*Core principles for effective deposit insurance systems'* (2009) 12 (Hereinafter referred to as 'BCBS/IADI (2009)').

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deposit insurance and of lower-risk banks to opt out of deposit insurance in instances where the DIS provides for membership on a voluntary basis.[175] The South African proposed DIS seeks to comply with principle nine while limiting membership to banks complying with domestic laws.[176]

In the context of domestic laws, if a bank wants to be considered for membership under the proposed DIS in South Africa, such a bank has to be legally registered under the Banks Act 1990,[177] Mutual Banks Act 1993[178] and Coorporative Banks Act 2007.[179] In other words, a bank operating outside the prescripts of the detailed legislation would not qualify for membership even if the membership could be offered either on a compulsory or voluntary basis because adherence to the legislation becomes a point of departure for coverage. It therefore remains imperative to understand how banks are registered simply to dispel any confusion related to membership. However, the study does not deeply delve into the contents and interpretation of the legislations. Instead the focus is narrowed on the contents necessary to give analysis of the legal framework concerning the registration of banks. It is worth noting that chapter three of the Banks Act of 1990, part one of Chapter two of the Cooporative Banks Act of 2007 and chapter three of the Mutual Banks Act of 1993 respectively details the process and procedures for the authorisation to establish a bank, the circumstances under which the registration can be permitted, and the cancellation of registration thereof. The legislations are further supplemented by regulations aimed at giving effect to their respective objectives. However, out of the approaches meant to determine membership, the DIS proposal recommends 'an automatic membership' which takes place when a bank is registered on condition that the DIS is consulted when a new banking licence is sought thus allowing the DIS to put further conditions meant to be effective in conjunction with the licensing conditions put by the Prudential Authority (PA).[180]

2.10 Review of the TBTF status in line with the explicit DIS

[175] SARB (2017) 26.
[176] SARB (2017) 26.
[177] See the Banks Act of 1990.
[178] See the Mutual Banks Act of 1993.
[179] See the Cooporative Banks Act of 2007.
[180] SARB (2017) 26-27.

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The Too-Big-To-Fail (TBTF) phrase was coined by a Congressman, Steward McKinney, after a bailout was offered to Continental Illinois bank subsequent arguments that the failure of the bank would be systemic to American banking system.[181] The phrase is now used as a status that is attached to large banks that are considered systemically important to fail or whose failure could have a disruptive external implication to the economy.[182] In that sense, the disorderly collapse of a big bank which may have collateral damages or significant contagion implications in the financial market may not be easily neutralized,[183] therefore the government prevents the collapse through capital injection irrespective of the amount needed. The impression drawn therefore is that, during a banking crisis, the big banks becomes a priority leading to the affixing of the TBTF status to them. It is in a similar vein that Morrison[184] and Strahan[185] respectively hold that the uninsured depositors and creditors thus receive unfair protection through this regulatory resolutions of the authorities, ultimately transcending to taxpayers.

In light of the above, a salient question therefore is, who should be allowed to fail and who should not, since the fate of survival is dependent on a governmental financial injection.[186] This question essentially probes what exactly are the qualitative measures needed to be met by a bank simply to qualify as a TBTF bank. To this end, a bank is considered legible if the failure would spark unacceptable economic instability in both the domestic banking system and the economy at large.[187] For instance, small banks are devoid of the status of TBTF because of the perceptїon that their failure presents a minor systemic risk if any systemic risk at all, and the contagion impact has a low probability of adversely affecting the financial system, hence regulators are least likely

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[181] Gorton G & Tallman E 'Too Big to Fail Before the Fed' (2016) 106 (5) *The American Economic Review* 528.
[182] Barth J & Wihlborg 'Too Big To Fail and Too Big To Save: Dilemmas For Banking Reform' (2016) 235 *National Institute Economic Review* 27.
[183] This document is a publication of a report compiled by the Congressional Research Services. It was published in May 2017, a report prepared for Members and Committees of Congress in 2017.
[184] Morrison A 'Systemic risks and the "the too-big-too-fail" problem' (2011) 27 (3) *Oxford Review of Economic* Policy 500.
[185] Strahan P 'Too-Big-To-Fail: Causes, Consequences, and Policy Responses' available at https://www.jstor.org/stable/42940401 (Accessed on 09 February 2019).
[186] Kaufman (2014) 214.
[187] Okeahalam (1998) 30-31.

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to apply the TBTF doctrine unto such banks.[188] The flip side is in respect of core banks which easily meet the standards or barometer thereof.

Barth et al[189] examined the TBTF policy and how it is applied, thus argued that the bailout should not be merely justified by the size of the bank rather the systemic importance of the bank and its interconnectedness in the sector. The authors' argument exhibit a notion that some banks are too systemic to fail, and not TBTF because it is the systemic risk stemming from a bank that justifies a bailout.[190] It further accords that the TBTF and the 'Systemically Important Financial Institution' (SIFI) concepts do not express the same meaning, hence Morrison[191] argued that though size may render a bank big, but size alone cannot be a yardstick to consider a bank SIFI. In line with these analysis, the researcher is not credibly against the rescues offered to the big banks, but only raise an inquiry as to whether the TBTF policy is the sole option available to rescue the big banks. This inquiry is essential because amongst other things the reliance on the TBTF policy detracts ex ante discipline since the government implicitly commits to offer bailouts to the big banks.[192] The government's approach further frustrates the equitability standards because the big banks are given special preference over small banks.[193] Of great concern, this big banks tend to deliberately engage in riskier activities to expand their sample size and increase profit knowing should things go bad, the government will quickly rescue them because of their significant role in the economy.[194]

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The researcher further submits that the extent to which bailouts are invoked becomes controversial and renders the TBTF doctrine a misnomer. This argument takes into

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[188] Okeahalam (1998) 34.

[189] Barth A et al 'Why banks are not too big to fail-evidence from the CDS market' (2013) 28 (74) *Economic policy* 339-340.

[190] See Barth A et al 'Why banks are not too big to fail-evidence from the CDS market' (2013) 28 (74) *Economic policy* 337

[191] Morison A 'Systemic risks and the 'too-big-to-fail' problem' (2011) 27 (3) *Oxford Review of Economics Policy* 500.

[192] Strahan P 'Too-Big-to-Fail: Causes, Consequences, and Policy Responses' available *https://www.jstor.org/stable/42940401* (Accessed on 10 February 2019)

[193] The fairness of treatment between small and large banks came under scrutiny, and was severely criticized when a resolution was adopted to rescue the Continental Bank after a number of small banks were not saved wherein their uninsured depositors could not be protected. See Kaufman (2014) 426.

[194] Mohan T 'How do we resolve the Too-Big-to-Fail problem?' (2012) 47 (35) *Economic and Political Weekly* 10.

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account that the decision to bailout the proclaimed 'TBTF banks' is often politically motivated without any economic justification, especially because the banks often use their resources to acquire political connections simply to inter alia default with being penalized and receive rescues when the banks are distressed.[195] Even if there may be economic reasons justifying a bailout, due to political factors at play some banks may still be overlooked for rescue irrespective of being relatively small or big banks respectively. The study supports this claim by deriving empirical evidence from two jurisdictions. The first being the United States (US) whereby the government deviated from applying the TBTF policy on Lehman Brothers in contrast with its counterparts on the Wall Street.[196] It is axiomatic that there were obvious economic reasons to revive the Lehman Brothers because its collapse eventually resulted in serious financial contagion. Therefore, the deviation impulsively ignored the fact that Lehman Brothers was one of the systemically important banks and TBTF Wall Street firms that deserved equal treatment.[197] South Africa is another example, despite the evidence derived within the confines of small banks. In that regard, the subsequent rescue offered to BOE Bank and the reasons for the rescue, altogether raised criticism because other banks were not saved, especially Saambou which was the seventh largest bank.[198]

The TBTF issues becomes pertinent insofar as it promotes concentration in the banking sector, thus hindering competition between small and large banks respectively. South Africa's proposed DIS noted this issue and further attempt to put in place preventative measures since the smaller banks are considered competitively disadvantaged owing to the misleading impression created that the larger banks are always implicitly guaranteed a bailout should they be distressed on account of their TBTF status, thus projecting these banks safer than small banks.[199] In its redress, the explicit DIS further seeks to dispel this fallacy by fortifying the 'development and entry of new banks with specific target markets' necessary to put these new entrants on a competitive edge with the well-established banks, done to further boost diversification

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[195] Banerji S, Duygun M & Shaban M 'Political connections, bailout in financial markets and firm value' (2016) 50 *JCF* 388.
[196] Public Citizen *'Too big: The mega banks are too big to fail, too big to jail and too big to manage'* (2016) 9.
[197] Public Citizen *'Too big: The mega banks are too big to fail, too big to jail and too big to manage'* (2016) 9.
[198] Makhubela (2006)103.
[199] SARB (2017) 11.

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in the banking enterprise.[200] Kazandjieva had similarly argued that the TBTF banks are given a competitive advantage through informal bailouts, and further discourages this practice because the larger banks monopolize the capital market funding to be at lower prices in contrast with that of small banks and further establishes a complex integration.[201] These banks continuously expand their sample size with a goal of attaining the TBTF status resulting in an increase of their implicit claims in instances of banking crisis.[202] However, Sriram et al[203] hold that the small banks should also be rescued when distressed irrespective of their sample size, thus the financial policies should embrace equitability as an explicit objective. The understanding is that the explicit objective is sought to consider the interests of small banks' stakeholders equally to the interests of big banks' stakeholders despite the big banks being interconnected in the banking sector.

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[200] See SARB (2017) 11.

[201] Kazandjieva Y 'Does the Too-Big-To-Fail Doctrine Have a Future' (2017) 1 *Economic Alternative* 51-52.

[202] European Banking Sector *'Are banks too big to fail or too big to save? International evidence from equity prices and CDS spreads'* (2010) 2.

[203] Sriram M, Vaibhav C & Neti A 'Too big to fail versus too small to be counted' available at *https://www.bis.org/publ/bppdf/bispap62j.pdf* (accessed 10 February 2019).

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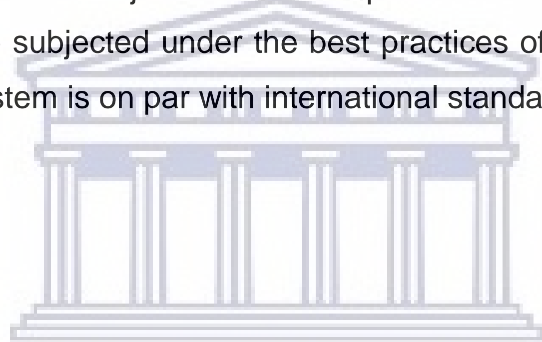
2.11 Conclusion

This chapter has unveiled that South Africa is without a safety-net in a form of a DIS. South Africa currently relies on the implicit system to rescue financially distressed firms, including banks. However, a mere adoption of the DIS cannot be construed as a panacea of resolving all banking crises or cure a poorly regulated banking sector. Design features similar to those discussed in the above study also need to be carefully chosen to ensure they are compatible with the banking environment. However, the DIS has been preferred by this chapter as a plausible form of safety-net that could mitigate bank runs, protect vulnerable depositors, and balance the standards of competition between small banks and big banks while enhancing the banking sector. The findings made in this chapter would further be examined in chapter three, especially in light of how other jurisdictions adopted the DIS. The DIS regulatory framework shall also be subjected under the best practices of international financial bodies to ensure the system is on par with international standards and innovations.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Chapter 3

International best practices concerning the Deposit Insurance System

3.1 introduction

The subject of a Deposit Insurance System (DIS) has gained popularity in the international community, precisely among governments across the globe and international financial bodies.[204] This is because jurisdictions prefer to adopt this particular system than preserving the implicit system. Therefore, so much is constantly done to assist countries to adopt an adequate deposit insurance that is compatible with the global standards. In that sense, this chapter gives an overview of the DIS from an international point of view, focusing on the recommendatory frameworks (hereinafter referred to as best practices) established by international financial institutions as a foundation of financial reformation and innovation. The aim is to determine the extent to which the best practices promotes the DIS aspect and the enhancement of the banking system. This chapter further gives an analysis of the risks posed by the DIS, and a comparative analysis concerning the stability and fragility of the DIS in other jurisdictions. The endmost result is to establish that South Africa is obliged to adopt the DIS. Most importantly, the adoption has to be guided by the best practices while learning from the lessons of other jurisdictions so as to mitigate the risks attracted by the system.

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3.2 International overview of the DIS

Since the 2008 Global Financial Crisis (GFC), the debate on a DIS gained momentum. Of great interest, jurisdictions that had a poorly designed DIS were exposed to devastating repercussions whereas other jurisdictions faced pressure to replace their implicit systems with the DIS.[205] The surge towards the adoption of the DIS has since marked the commitment of jurisdictions to uphold international best practices.

An argument therefore accords that the aftermaths of the 2008 crisis served as a sufficient proof that innovations were essentially needed in both the banking and

[204] This is because the DIS has been adopted by many jurisdictions as guided by international financial institutions. This aspect will be expounded further in the research.
[205] International Monitory Fund *'Deposit Insurance Database'* (2014) 3.

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financial system. This compelled international bodies to reinforce their global position by way of revamping financial regulatory frameworks. The bodies issued best practices aimed at stabilizing the financial sector, ultimately protecting bank depositors and minimize banking crises.[206] The presumption therefore is that South Africa is no exception to comply with the best practices, especially on the adoption of the DIS. The presumption is also supported by the stance of the South African Reserve Bank (SARB) and National Treasury (NT) which unveiled that South Africa is a member of a number of international forums, and these forums expect their member states to legislate the DIS.[207] In light of this presumption, the research now explores the specific best practices that should be complied with for the purposes of establishing a robust DIS in the South African context.

3.3 Overview of international practices and principles

3.3.1 Discussion of the Key Attributes

In November 2011, the G20 leaders endorsed the Key Attributes (KAs) as a new international measure for resolution regime.[208] The concept 'resolution regime' refers to the methods put in place to manage the failure of a systemically important financial institution while avoiding economic disruption and the reliance on taxpayer's money.[209] To ensure an effective resolution regime, the Financial Stability Board (FSB)[210] therefore promotes the KAs as part of its mandate. The aim is to cover institutions of all types whose failure could be systematic.[211] Put broadly, the implementation of the KAs is expounded to create an environment that allows the authorities to resolve

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[206] These global bodies includes but not limited to the Financial Stability Board, Basil Committee on Banking Supervision, International Association of Deposit Insurers and the International Monetary Fund.
[207] See SARB (2017) 3-5.
[208] Lai A & Mordel A 'The resolution of Systemically important financial institutions' available at *https://www.bankofcanada.ca/wp-content/uploads/2012/06/fsr-0612-lai.pdf* (Accessed on 09 November 2018).
[209] World Bank 'Resolution regimes: Dealing with failing financial institutions' available at *http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1303327122200/VP336-Resolution-Regimes.pdf* (Accessed on 09 May 2019).
[210] The FSB is an international body that promotes international financial stability.
[211] Financial Stability Board 'Guidance on the implementation of the Key Attributes' available at *https://www.fsb.org/work-of-the-fsb/policy-development/effective-resolution-regimes-and-policies/understanding-the-key-attributes/* (Accessed on 9 May 2019).

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financial institutions without compromising the sector's stability and public funds.[212] The 2014 updated version serves as a guideline of interpretation aimed at ensuring an effective enforcement of the KAs, more specifically on the aspect of sharing information.[213]

There are Twelve essential KAs aimed at strengthening financial institutions, including the banking sector. Jurisdictions have a choice to adopt KAs suiting the standards of their financial sector hence the study will only discuss the KAs that encourage and promotes the goal of the DIS as a form of enhancing the banking sector. This would be the KAs that South Africa should observe. In that vein, the significance of having a DIS cannot be overemphasized, but the idea is to have the system built on the foundation of the resolution regime for productivity purposes. This therefore translates to crafting a resolution plan for the firms in the event recovery plans do not suffice. A distinction is drawn between recovery plans and resolution plans. The former entails the avenue exhausted by a firm to avoid any form of collapse by ensuring the firm is well-capitalized and properly funded.[214] The latter denotes the plans established to facilitate actions by way of ensuring a firm does not reach the point of non-viability (PoNV).[215] In an instance where a bank is faced with a financial crisis and such a bank is without a recovery plan, it has become a government norm to generally implement a resolution plan to protect the bank from reaching the point of collapse.[216] This essentially means the government institutes expensive bailouts, especially when the financial institutions are interconnected, and considered systemically important or Too-Big-To-Fail (TBTF). Giving context to the assumptions detailed in chapter two, one further understands that the government's approach of bailing out failing institutions has a likelihood of putting a country under acute austerity. Therefore, the KAs find the government's approach undesirable thus expect other measures, in a form of a DIS, to be exhausted.

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[212] Financial Stability Board *'The Key Attributes of Effective Resolution Regimes for Financial Institutions'* (2014) 3 (Hereinafter referred to as 'FSB (2014)').

[213] See FSB (2014).

[214] Bank for International Settlement 'FSB Key Attributes - Executive Summary' Available at *https://www.bis.org/fsi/fsisummaries/fsb_key_attributes.htm* (accessed on 18 February 2020).

[215] This is a presentation made by the National Treasury in 2014. The presentation was titled as an update on the curatorship of African Bank Ltd and was published in March 2014.

[216] Bank for International Settlement 'FSB Key Attributes - Executive Summary' Available at *https://www.bis.org/fsi/fsisummaries/fsb_key_attributes.htm* (accessed on 18 February 2020).

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The NT in South Africa recently raised concerns that part of the resolution regime in the country do not meet the standards of the KAs.[217] This gap was further confirmed by the SARB and international bodies, thus specifically concerned the absence of a DIS in South Africa's banking sector.[218] As an attempt to close the gap, the starting point of discussion shall begin with KA 6[219] which is an essential best practice for the purposes of this study, and South Africa's proposed DIS is sought to comply with this KA. In that vein, the researcher finds that KA 6.1[220] encourages jurisdictions to legislate policies aimed at absolving the government from bailing-out financially distressed firms. KA 6.1 is read with KA 6.3[221] which expounds for the implementation of a DIS or resolution fund whereby the costs of the temporary funding will be recovered ex post. Many interpretations can be ascribed to the wording of the KAs, but the study chooses an interpretation that favours the implementation of a privately funded DIS which shall be responsible to contain and address banking crises. This approach closely aligns with the statement by the International Monetary Fund (IMF) advising South Africa to adopt the DIS subsequent to the collapse of African Bank (AB).[222] Accordingly, the IMF held that the interventions made at the African Bank begged for the inception of a resolution regime compatible with the KAs, hence the DIS has been preferred as a plausible management crisis framework.[223]

In line with the explanatory note for KA 6,[224] the funds for the resolution plan should, as a point of departure, stem from the insurer and creditors, and only to the extent that is necessary could the funds come from the financial institutions. Of great importance, if the government is to be exhausted as a measure of funding, the injected funds should be recoverable ex post from amongst other things the insurer and financial system participants. Seemingly, the government has a duty to play an active and oversight role in the resolution of financial institutions in times of financial crises. However, the significance of these roles does not justify the institution of expensive

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217 National Treasury (2015) 4.
218 SARB (2017) 14-15.
219 KA 6 of the Financial Stability Board (hereinafter referred to as 'K.A 6 of the FSB)').
220 KA 6.1 of the FSB.
221 KA 6.3 of the FSB.
222 International Monetary Fund *'South Africa: Financial System Stability Assessment'* (2014) 8.
223 See International Monetary Fund *'South Africa: Financial System Stability Assessment'* (2014) 8.
224 See the Financial Stability Board '*Key Attributes Assessment Methodology for the Insurance Sector'* (2017) 45.

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bailouts because a pre-funded DIS is legible enough to repel the crises. The importance of KA 6 as a legislative reform, requires to be considered in light of the researcher's view that financially distressed institutions do not always recapitalize after going through a severe financial crisis. This view is further acknowledged by the Bank for International Settlements (BIS) which provides that many banks had continuously faced low profitability problems because of struggling to adjust to the structural changes post the 2008 GFC.[225] Therefore, it is unwise to think the injected funds would be recoverable.

The KAs are also crafted in a manner that also promotes accountability in the financial sector. The aspect of accountability is realised by KA 3.2.[226] Accordingly, KA 3.2 vests the resolution authority with the power to effect, amongst other things, a removal or replacement of executives that poorly manages a financial institution, and to ensure that revival methods are put in place.[227] The further aim of this power is to prevent the perpetuation of poor governance standards prevalent in the financial sector. In that vein, the researcher argues that the lack of accountability is an issue that affects the global financial system. For instance, many people who were complicit in the 2008 GFC were not held accountable.[228]

Furthermore, the existence of foreign financial institutions in jurisdictions like South Africa makes it pivotal to consider the KAs that encourages corporation in the financial sector. This aspect is advanced by KA 7[229] which promotes a cross-border cooperation whereby the domestic authorities should cooperate with the authorities of foreign financial institutions simply to contain the effects of bank failures and moral hazards. The FSB document on cross-border resolution further expands on crisis management under KA 8[230] whereas KA 9[231] deals with the aspect of agreements on institution-

[225] Bank for International Settlements *'Committee on the Global Financial System: CGFS Papers No 60 Structural changes in banking after the crisis'* (2018) 1
[226] KA 6.3 of the FSB.
[227] KA 6.3 of the FSB.
[228] Lack of accountability for poor governance in the banking sector is an issue that besets a substantial number of jurisdiction across the globe. Chapter 4 shall give context to KA 3.2 by discussing how the domestic regulatory frameworks seeks to hold the executives of financial institutions accountable. See Sorell T 'Responsibility in the Financial Crisis' available at *https://onlinelibrary.wiley.com/doi/epdf/10.1111/misp.12081* (accessed on 10 November 2018)
[229] KA 6 of the FSB.
[230] KA 8 of the FSB.
[231] KA 9 of the FSB.

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specific cross-border cooperation. Added to that, there are pillars for cross-border effectiveness resolution actions such as the statutory supportive measures, statutory and contractual recognitions which assists with the strengthening of the authorities.[232] The significance of enhancing this aspect comes with the lessons learned from the 2008 GFC. During that period, amongst other things, the lack of adequate cross-border cooperation and mechanisms for resolution had essentially contributed to the fiscal costs of the crisis which resulted in a disorderly resolution.[233] To close that gap, these KAs advances the significant aspects of coordination and sharing of information between the domestic and foreign authorities, and that is essential for the effectiveness of the DIS.[234]

a. Briefly assessing the KAs

The above discussion shows that the FSB members are obliged to adopt the KAs, South Africa included. The KAs plays an important role in respect of legislating a robust DIS for a banking sector. The integral element of these KAs is aimed at addressing the issue of moral hazards and systemic risks exhibited by financial institutions. Most importantly, the KAs discourages the use of public funds to bailout distressed banks. To achieve that goal, they ensure there is an orderly resolution of financial institutions, and enhances the banking system while protecting depositors. The protection comes in a form of adopting a privately funded DIS aimed at dispelling panics among depositors. Moreover, having a privately funded DIS built on the KAs precludes any political hurdles associated with the acquiring of funds when they are needed to advance the objectives of the DIS.

3.3.2 Overview of pertinent Core Principles

The Core principles (hereinafter referred to as principles) are an architecture of both the International Association of Deposit Insurers and Basel Committee on Banking Supervision (IADI-BCBS). Both AIDI and BCBS merged to craft the core principles as a revamp subsequent the aftermaths of the 2008 GFC. These principles also form

[232] Guo S 'Cross-border resolution of financial institutions: Perspective from international insolvency law' available at https://www.iiiglobal.org/sites/default/files/media/Submission%20for%20the%20III%20Prize%20in%20International%20Insolvency%20Studies%202018_Shuai%20Guo.pdf (Accessed on 11 May 2019).
[233] International Monitory Fund *'Cross-border bank resolution: Recent developments'* (2014) 1.
[234] The subject of coordination is broadly discussed in the following section of study.

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part of the international best practices aimed at prudentially regulating and supervising banking institutions.[235] Similarly to the KAs, the robustness of a DIS is also influenced by the observance of the core principles. However, jurisdictions can voluntarily adopt the principles simply to embolden the DIS thus effectively redressing banking crises and protecting depositors.[236] Like the KAs, all FSB members, South Africa included, are strongly encouraged to establish a DIS founded on the robust tenets of the core principles.[237] The encouragement does not necessarily supplant the choice jurisdictions have on how they want to avoid financial crisis and protect vulnerable depositors.

While there is a general agreement that each jurisdiction should adopt a DIS fitting its economic and financial needs, Okeahalam[238] reckons that robustness should be equated to the type of DIS design and its administration not solely on the DIS per se. Some of the detractions concerning robustness have been identified by Demirgüc-Kunt and Detriage as was expounded in the previous chapter. [239] In the context of the research, the analysis thereof denotes that a DIS with adequate design features complements the key tenets of the core principles, coupled with a competent administration suiting the banking sector.

Of great importance, the AIDI-BCBS document encompass a variety of principles which address different key matters concerning the DIS. The research will only focus on the principles that endorse the implementation of the DIS. These principles are read with preconditions aimed at strengthening the robustness of the DIS framework structure.[240] The preconditions embraces a consistent evaluation of the economy and banking system, prudential governance of agencies having the system, robust

[235] IADI-BCBS (2009) 1.

[236] The voluntary nature of Core Principles embraces the fact that they are not crafted to meet all needs and circumstances of every banking system. Therefore, jurisdictions assumes the principles compatible with their financial sectors. BCBS-IADI (2009) 5.

[237] Financial Stability Board '*Thematic Review on Deposit Insurance Systems: Peer Review Report'* (2012) 6.

[238] Okeahalam & Maxwell (2001) 138.

[239] *Demirgüc*-Kunt A and *Detriage E 'Does deposit insurance increase banking system stability? An empirical investigation' (2001) 49 JME 1402.*

[240] BCBS-IADI (2009) 2.

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prudential regulation and supervision, and a robust legal framework, accounting and disclosure regime.[241]

a. Principle one;[242] addresses the public policy objectives of the DIS in that, the policy framework of the system should explicitly state the objectives for which the system was established. The key attributes and essential components of the DIS should be determined in the context of the powers and mandates vested in the DIS, and the role needed to be played by the DIS in the safety-net setting.[243] While South Africa's system aims to enhance the financial sector, the integral goal is to protect vulnerable bank customers who are exposed to the asymmetry of information and least likely to protect themselves in the event of a bank failure.[244] Through the protection of the deposits, the DIS further plays a role towards the development of a less concentrated banking sector while supporting new entrants and the transformation of the sector.[245] However, principle one further gives an illustration that the scope of activities of the DIS should be clearly identified simply to exclude unnecessary activities. On the basis of a similar analysis, Ketcha[246] argues that, by clearly identifying the scope of the DIS, the likelihood of government interference will be avoided. The general understanding is that this interference skews the choices of market members from the most profitable decisions.

b. Principle five;[247] requires that the DIS operate independently and transparently in accordance to its legal framework, and the DIS body should preclude any external influences attempting to deviate its operation as per the DIS regulatory framework. In a similar vein, Katcha[248] paints a picture that financial crisis may give rise to an unnecessary political pressure wherein hasty decisions are made to the disadvantage of the productivity of the banking system, therefore the presence of an independent authority can significantly repel such pressures. The independence of the DIS further

[241] See BCBS-IADI (2009) 2.
[242] Core Principle 1 of BCBS-IADI.
[243] Financial Stability Board '*International Guidance on Deposit Insurance: A consultative process'* (2000) 3.
[244] South African Reserve Bank *'Public workshop on proposals to establish a deposit insurance scheme for South Africa'* (2017) 2.
[245] SARB (2017) 1.
[246] Ketcha (09 February 2019).
[247] Core Principle 5 of BCBS-IADI.
[248] Ketcha (09 February 2019).

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denotes that it should not be government-administered or be prone to undue industry influence. Seemingly, South Africa's proposed DIS resonates with Ketcha's analysis because the DIS is instilled with the key tenets of this particular core principle. In brief, the proposed DIS is expected to operate as a separate legal entity with its own legislative framework albeit its location in the SARB.[249] By the same token, banks are excluded from forming part of the administration of the DIS simply to maintain transparency. The researcher believes that the expounded independency and transparency would ensure that the DIS does not succumb to any political pressure as argued by Ketcha. Most importantly, banks would not be rescued selectively as it has been the case with the implicit system expounded in the previous chapter.

c. Principle six;[250] is also fundamental because of introducing the idea of coordination between the DIS and other safety-nets in the financial sector. For the realisation of this goal, a formal and conclusive framework is expected to be adopted to maintain a close coordination of activities and the sharing of information. The principle infers that the duty to address banking crisis is not limited to the DIS, but all financial safety-net participants are obliged to be effective in the course and the costs thereof would be apportioned to all participants.[251] In that vein, an enhanced coordination and sharing of information among the safety-net participants shall be an integral factor.

There is another aspect of coordination that is of utmost importance. It is in the context of the DIS of other jurisdictions covering foreign banks in the country, thus a form of agreement should be made regarding amongst other things reimbursements and determining levies.[252] This aspect compliments the goals of the discussed KAs, especially KA 7, KA 8 and KA 9 – promoting the notion of cross-border cooperation by way of agreements simply to have an effective crisis management system. The significance of this form of coordination and sharing of information is advanced with the understanding that South Africa's financial sector is integrated with the global economy, thus likely to be impacted in event of financial crises.[253] This form of coordination has been lacking during the 2008 GFC hence the localized crisis in United

[249] SARB (2017) 24.
[250] Core Principle 6 of BCBS-IADI.
[251] BCBS-IADI (2009) 1.
[252] SARB (2017) 42.
[253] South African Reserve Bank *'Financial Stability Review: Second edition'* (2018) 1-2.

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States' financial sector rapidly spread to other financial markets in the world.[254] Through a sample of assessment, the World Bank Group considered the aspect of coordination and sharing of information difficult to manage, especially when deposit insurers do not play an active role in the information flow for bank-level data until a bank is seriously distressed.[255] Therefore, South Africa would have to carefully prioritize these aspects because her financial sector is at the helm of a number of safety-nets.

In line with the coordination pillar among the safety-net participants, the International Association of Deposit Insurers (IADI)[256] has identified and clarified a number of issues that could detract the operation and productivity of the DIS. The researcher further believes that South Africa would need to take these issues into account.

i. The first issue is in respect of the conditions that may give rise to reimbursement and the notifying of the DIS body. The idea therefore is that the regulatory framework should clearly specify when the DIS will initiate reimbursements.

ii. The second issue pertains to a clear delineation of obligations between the DIS and other safety-nets, especially in the context where the DIS body does not have control over the failed banks, and would need reimbursements to be effected with the assistance of the liquidator or bank's personnel.

d. Principle twelve; insofar as the objective of the DIS is concerned, this principle becomes important to explore. The nature of the principle creates an impression that public awareness is one of the fundamental pillars of the DIS for a proper realisation of the objectives of the system. In a nutshell, the public should be informed and made aware of the existence and importance of the system as well as the accruing benefits simply to preserve confidence. Public awareness has to encompass an essential component of financial inclusion, especially an inclusion underpinned on financial innovation and non-banks. Furthermore, public awareness ensures that depositors

[254] Laevan L 'Banking Crises: A Review' (2011) 3 *Annual Review of Financial Economics* 17.
[255] World Bank *'Deposit insurance system'* (2013) 3
[256] International Association of Deposit Insurers *'Enhanced guidance for effective Deposit Insurance Systems: Reimbursement systems and processes'* (2012) 21

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are well informed of the coverage offered by the DIS, the coverable products and what entails coverage.

The previous study has unveiled how the lack of confidence can be disruptive in the banking system and the efforts made by the DIS to preserve confidence. Public awareness can therefore be a driving factor in the course because a public that is well informed will be least susceptible to rumours concerning the stability of a bank, and the aspect of public knowledge becomes instrumental to circumvent bank runs in the event of financial crisis. Şafakli and Güryay also emphasise the importance of public awareness in that it is a pertinent bedrock for the effectiveness of the DIS. While the DIS contributes to the confidence through guaranteeing assurance of deposits, the extent of awareness thus remains part of the driving factors.

e. Principle fourteen[257] – for the purposes of enforcing good governance, this principle resonates with KA 3.2 thus aims to hold accountable those who deliberately put a bank at the state of insolvency, and this will be done through legal redress. This is not meant to diminish the incentives given for good conduct, statutory immunity for the DIS and an indemnification in the employment agreement. [258] However, accountability should be enforced to the extent that is necessary despite protection accorded to decisions taken in good faith in the carrying out of obligations. This principle is significantly concerned that banking malpractices goes unpunished in most instances.[259] Therefore, the principle's enforcement intends to ensure that the culprits account in that respect. However, this does not automatically take away the protection accorded to banking directors as will be shown later in the research.

f. Brief assessment of the Core Principles

The set of core principles are fundamental insofar as designing a robust DIS is concerned. They are used by countries as a standard for sound prudential regulation and supervision of banks and the banking systems.[260] In the same light, FSB made it clear that all of its members should legislate a DIS built on the set of core principles

[257] Principle 14 of BCBS-IADI.
[258] BCBS-IADI (2009) 16.
[259] Motau T 'How VBS was looted: The full report' Available at *https://www.politicsweb.co.za/documents/how-vbs-was-looted-the-full-report* (accessed on 18 February 2020).
[260] See BCBS (2009) 1.

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simply to enhance the robustness of the DIS. Key to this argument is that a robust DIS is a vital element for a proper functioning of the banking system. It is in that sense that the DIS preserves confidence in the banking system, guards against financial shocks while guaranteeing the safety of the system and its depositors.[261] The core principles further ensures there is a proper balance between designing a DIS compatible with the country's banking environment, and repelling the fear of moral hazards.[262]

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[261] World Bank *'Deposit insurance systems: Addressing emerging challenges in funding, investment, risk-based contributions and stress testing'* (2017) 3.
[262] Lukhele (2017) 21.

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3.3.3 The role of the Basel III Accord

The Basel framework comprises of a full set of standards of the Basel Committee on Banking Supervision, which is the international standard setter for prudential regulation of banks.[263] Weaknesses of Basel I and Basel II have been exposed by the recent financial crises, thus led to the adoption of Basel III which is aimed at the advancement of resilience in the banking sector so as to avoid economic crisis stemming from the banking system.[264] Basel III is simply build on the foundation of Basel II, but with further innovations to remedy the shortcomings of Basel II.[265] The objectives of the G-20 leaders on banking reformations are aimed at discouraging governments from bailing out financially distressed firms through their implicit systems.[266]

Given the above backdrop, it therefore becomes important to give an examination of Basel II as a foundation of Basil III. In essence, Basel II replaced Basel I, and further advanced objectives such as (i) to uphold the already existing capital levels in the banking system while promoting safety and soundness, (ii) embolden equal competition and (iii) adopt a method that will be entirely adequate to address risk.[267] Basel II has further been premised on three fundamental pillars - the minimum capital requirement (pillar one), it also furnished supervisory directives to the national regulators (pillar two), and established disclosure standards for banks (pillar three).[268]

However, to allow banks to support the real economy through economic cycles, the initial phase of Base III sought to enhance regulatory framework in the context of amongst other things increment of capital requirements. [269] This comes as an attempt

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263 Bank for International Settlement 'Background to the Basel Framework' Available at https://www.bis.org/baselframework/background .htm (accessed on 22 February 2020)
264 Bank for International Settlement 'Background to the Basel Framework' Available at https://www.bis.org/baselframework/background .htm (accessed on 22 February 2020)
265 Basil Committee on Banking Supervision *'A brief History of the Basel Committee: Commitment on Banking Supervision'* (2015) 4.
266 Barfield R 'A practitioner's guide to Basel III and beyond' available at https://www.pwc.com/gx/en/financial-services/pdf/introduction-and-chapters-final.pdf (Accessed on 04 March 2019).
267 Lall R 'From failure to failure: The politics of international banking regulation' (2011) 19 *RIPE* 612.
268 Roy D, Kohli B & Khatkale S 'Basel I to Basel II to Basel III: Risk management Journey in Indian Banks' available at https://apps.aima.in/ejournal_new/articlesPDF/Dr.BindyaKohli.pdf (accessed 18 November 2018).
269 Basil Committee on Banking Supervision *'High-level summary of Basel III reforms'* (2017) 1.

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to ensure that banks are resilient to withstand financial shocks, add macroprudential aspects to the regulatory framework and introduce a global framework.[270] Altogether, aimed at mitigating liquidity and maturity through the liquidity coverage ratio and net stable funding ratio.[271]

Furthermore, it has recently been pointed out that this regulatory framework has enhanced the banking sector, ultimately protecting retail deposits. In his keynote, Carsten,[272] the General Manager of the Bank for International Settlement, has considered the regulatory buffers to form the basis of capital and liquidity regulations under the Accord. Carsten also considered the countercyclical capital buffer to be very instrumental in mitigating losses during systemic events.[273] He further holds that the aim of the liquidity coverage ratio is to contain liquidity mismatches.[274] While the Basel accord also strengthens microprudential regulation and supervision, it further instils a macroprudential overlay comprising of the capital buffers thereof.[275]

According to Nkopane's[276] findings, the regulations advanced by Basel III are considered as best practices because of enhancing capital framework by way of raising quantity and quality while boosting risk coverage, and the liquidity buffer guarantees the resilience of banking by mitigating the risk of bank runs. Contrary to this view, the Deloitte believes that Basel III inevitably brings further implication to the banking industry on the basis that the firms will have a huge challenge to feasibly comply with the standards set thereof.[277] Further detractions points out that, despite Basel III aimed at effecting changes across the global banking system, there is a further concern that, it is a challenge to feasibly implement the reforms timeously and the method of implementation across jurisdictions poses a risk of regulatory

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[270] Basil Committee on Banking Supervision *'High-level summary of Basel III reforms'* (2017) 1.
[271] See Basil Committee on Banking Supervision *'High-level summary of Basel III reforms'* (2017) 1.
[272] This was a Keynote address by the General Manager of BIS, Agustin Carstens during the 17th IADI Annual General Meeting and Annual Conference on 'Deposit insurance and financial stability: recent financial topics' available at *https://www.bis.org/speeches/sp181024a.pdf* (accessed 8 March 2019)
[273] Carstens A 'Deposit insurance and financial stability: recent financial topics' available at *https://www.bis.org/speeches/sp181024a.pdf* (accessed 8 March 2019).
[274] Carstens A 'Deposit insurance and financial stability: recent financial topics' available at *https://www.bis.org/speeches/sp181024a.pdf* (accessed 20 February 2020).
[275] BCBS 'Basel Committee on Banking Supervision reforms – Basel III' available at *https://www.bis.org/bcbs/basel3/b3summarytable.pdf* (Accessed on 19 November 2018).
[276] Nkopane T *The Relevance of The Basel III Accord Within The South African Banking System* (Published thesis, Wits University, 2016) 26.
[277] See Deloitte '*Basel III Framework: The butterfly effect*' (2015) 11-12.

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arbitrage.[278] However, the researcher does not intend to overlook the shortcomings of Basil III. As an international framework assumed voluntarily, the researcher is of the view that South Africa would simply have to adopt the robust key tenets compatible with her financial sector, especially those that will boost resilience, macroprudential and microprudential supervision in the banking sector to the benefit of the DIS.

3.4 Analysis of the risk posed by the DIS

So many advantages have been identified to accrue from the DIS. However, the researcher does not overlook the disadvantageous part of the system because it is not an absolute remedy for all bank panics. In that sense, Hogan et al[279] unveiled the disadvantages of the DIS by arguing that the system gives rise to two conflicting factors contributing to bank failures. Firstly, the system removes incentives among depositors to monitor the activities of the banks.[280] Secondly, the removal of the incentives encourages the banks to engage in excessive risk taking which perpetuates moral hazard.[281] In the banking system, moral hazard exist when decision makers (banks) take risks that they would otherwise not take, on the basis that the adverse effect of their decisions is felt or transferred to a third party (DIS body).[282] IADI had similarly highlighted that the DIS perpetuates moral hazard, especially if it is not adequately designed and well regulated.[283] There seems to be a general consensus that moral hazards is a major hindrance for an effective DIS. At the same time mitigating strategies in a form of the discussed adequate design features and best practices are attempted to better enhance the DIS. For instance, principle two of the core principles read with the preconditions of the core principles essentially attempt to contain moral hazards and the lack of incentives.[284]

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[278] Perera O 'Basel III: To what extent will it promote sustainable development' available at *https://www.iisd.org/pdf/2012/basell3.pdf* (accessed on 09 March 2019).
[279] Hogan T & Johnson K 'Alternative to the Federal Deposit Insurance Corporation' (2016) 20 (3) *The Independent Review* 435.
[280] Hogan T & Johnson K 'Alternative to the Federal Deposit Insurance Corporation' (2016) 20 (3) *The Independent Review* 435.
[281] Hogan T & Johnson K 'Alternative to the Federal Deposit Insurance Corporation' (2016) 20 (3) *The Independent Review* 435.
[282] Ely B 'Regulatory moral hazard: The real moral hazard in the Federal Deposit Insurance' (1999) 4 (2) *The independent Review* 241.
[283] International Association of Deposit Insurers ''*IADI Core Principles for Effective Deposit Insurance System'* (2014) 11.
[284] BCBS-IADI (2009) 2.

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Demirgiic-Kunt and Kane [285] had correctly pointed out that the consequences of a DIS remains a vexed question because of the conflicting views that arises. The first view, as emphasised in the chapter, highlights that an adequately designed DIS is pivotal to stabilize the banking sector, thus preventing bank runs. The second view, is rather a detraction because it propounds for a careful supervision concerning risk taking otherwise the DIS will be counterproductive. The latter view, however, takes into account that banks are in a business venture of generating a profit in an uncertain market, they are therefore susceptible to taking uninformed decisions or acting imprudently.[286]

However, the excessive risk taking by the banks occurs because the depositors often lack the incentives to monitor the banks, especially during non-crisis events thus contributing to the high possibility of bank failures.[287] In a similar vein, Okeahalam and Maxwell[288] submit that the scale-back to monitor the banks among the depositors is likely to occur in instances where the DIS consists of coverage of limited deductibles in the context of co-insurance. The empirical understanding therefore is that moral hazards would be instigated and there will further be an issue of adverse selection and the weakening of financial stability.

On a broader scale, the DIS is considered as a detraction of market discipline while giving an edge to excessive risk taking because depositors tend to lack the incentive to make a better judgement concerning a bank's stability.[289] Demirguc-Kunt and Huizinga[290] had further unveiled that financial authorities find it challenging to ascertain that the established DIS functions consistently with market discipline standards. The authors further provides that the risk of moral hazards could be worsened in instances where there is a regulatory forbearance policy coupled with an excessive generosity offered by the DIS.

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[285] Dermiguci-Kunt & Kane (2002) 184.
[286] International Monetary Fund *'Protecting Bank Deposits'* (1997) 1 (Hereinafter referred to as 'IMF (1997)')
[287] Boyle G, Stover R, Tiwana A et al 'The impact of deposit insurance on depositor behaviour during a crisis: A conjoint analysis approach' (2015) 24 *JFI* 591.
[288] Okeahalam & Maxwell (2001) 137.
[289] Ume K & Chioma O 'Deposit Insurance and Moral Hazards: A Theoretical Discourse' (2017) 3 *JSMP* 38.
[290]Demirgu-Kunt A and Huizinga H 'Market discipline and deposit insurance' (2004) 51 *JME* 376

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Some anti-DIS proponents prefer a deregulated financial system as a viable measure for the preservation of incentives amongst bank customers. [291] This rather comes as a measure to advance a theory of an unregulated banking system devoid of a DIS. Those arguments are founded on the notion that the sector could still maintain efficiency and stability by way of disciplining the market. [292] There is a further notion closely linked to the advanced theory. This notion holds that the DIS can cause negative regulatory externalities whereby the authentic risk partaken by banks could be discovered ex-post, and the moral hazards estimates could be theoretically entrenched with no practical use.[293] These arguments band the DIS as a detrimental measure for the banking sector. However, Dow[294] holds a different view which considers regulation and supervision as crucial pillars to the banking sector because of forming part of the economic network. It accords that stability and efficiency could be maintained when the identified two pillars could be prioritized. This approach is also necessary even in the presence of the DIS.

Zhou has identified two instances wherein moral hazard can be instigated.[295] The first instance concerns an explicit government guarantee thus argue that the insured banks would deeply engage in riskier activities to maximize profit knowing the risk will be shifted to the government.[296] Secondly, the preventative risk measures may not be implementable because the banks lacks the incentives of compliance as they know the government will offer a bailout should they be distressed.[297] On the other hand, it is generally believed that experts who recommend and support the adoption of a DIS do so under the misconception that jurisdictions have strong prudential regulations or they merely overlook the 'impact of imperfection' in their contracting environments hence most jurisdictions risk severe consequences. [298]

The research does not ignore the identified detractions against the DIS. In fact, the research further acknowledges that moral hazard may be exacerbated if the DIS could

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[291] IMF (1997) 2.
[292] See IMF (1997) 2
[293] Okeahalam & Maxwell (2001) 137.
[294] Dow S 'Why the banking system should be regulated' (1996) 106 *EJ* 699-700.
[295] Zhou 'Establishing a Deposit Insurance System in China: A Long-Awaited Move Toward Deepening Financial Reform' (2016) 16 *CKJICL* 88 (Hereinafter referred to as 'Zhou (2016)').
[296] Zhou (2016) 88.
[297] Zhou (2016) 88.
[298] Dermiguci-Kunt & Kane (2002) 177.

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comprise of an interest rate liberation because, it is under those circumstances that the banks acquire an incentive to pursue an increased investment comprising of an increased risk.[299] To that end, it is also puzzling to note that academics and policymakers have distinct views concerning the risk of moral hazard where there is a DIS. The former believes that moral hazard are inevitable because regulatory frameworks are insufficient whereas the latter holds contrary to that view, thus considers the regulatory frameworks adequate enough to withstand risks.[300] Though it is difficult to reconcile these conflicting views, and despite the DIS having its fair share of disadvantages, it cannot be denied that the other methods of stabilizing the banking sector are not perfect either. For instance, the implicit system introduces the TBTF issue which affects competition and encourages concentration in the sector as highlighted previously. At the same time, the researcher discourages the misconceptions held by policymakers who thinks an explicit DIS is immune to any risks. The researcher unequivocally states that the issue of moral hazard is a reality and if it is not prudently regulated or supervised, the banking sector may be severely affected.

However, the study avers that both the design features of the DIS and robust regulatory frameworks[301] should be used as a yardstick to determine the degree to which moral hazards could be mitigated. The observance of international best practices also carries a significant weight because of encouraging jurisdictions to design an adequate DIS with plausible design features.

3.5 Comparative analysis

The number of countries adopting the DIS keeps on increasing. A recent cross-country database by Sun and Yamori[302] shows that by the end of 2015 113 jurisdictions out of the 189 jurisdictions recognized by the World Bank had already established the system. At least 76 jurisdictions, mostly developing nations, had been without the

299 Zhou (2016) 88.
300 Dermiguci-Kunt & Kane (2002) 177.
301 South Africa's regulatory frameworks will be discussed under chapter four.
302 Sun J & Yamori N 'How did the introduction of Deposit Insurance affect Chinese banks? An Investigation of its wealth effect' available at *http://www.rieb.kobe-u.ac.jp/academic/ra/dp/English/DP2016-20.pdf* (Accessed on 01 March 2019).

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DIS.[303] The previous chapter highlighted that the absence of an explicit DIS implies the reliance on government bailouts. To this end, G-20 countries like China[304] and Saudi Arabia[305] legislated the DIS, yet South Africa still relies on the implicit system. In as much as a DIS favours a robust banking sector governed by strong regulatory frameworks similar to those present in South Africa, the salient question therefore remains why does South Africa fail to adopt the system in view of her advantageous position? To postulate an affirmative answer raises a huge doubt concerning South Africa's willingness to enhance the banking sector in a form of a DIS, and also be on par with her G-20 counterparts. The question and answer are brought forth taking into account that the FSB and G-20 members have a duty to adopt the DIS as discussed previously.

Demirguc-kunt and Kane[306] were the first to develop a cross-country database that sought to characterise deposit insurance arrangements in different countries. The database has shown a variance concerning deposit designs, and these authors reckoned that the account coverage differs from unlamented coverage to tight coverage to depositors. For that reason, Japan and Mexico promise an absolute coverage to depositors in contrast with other jurisdictions that offer an unlimited guarantee not exceeding their per capita Gross Domestic Product (GDP).[307] It is against this backdrop that the subsequent countries are explored as way of giving a comparative analysis concerning the DIS.

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3.5.1 African countries

[303] See Sun J & Yamori N 'How did the introduction of Deposit Insurance affect Chinese banks? An Investigation of its wealth effect' available at *http://www.rieb.kobe-u.ac.jp/academic/ra/dp/English/DP2016-20.pdf* (Accessed on 01 March 2019).

[304] The State Council of China passed the DIS Regulations in February 2015 that began to operate on 1 May 2015. The regulatory framework came into effect after decades of controversial debates. See Zhou (2016) 48.

[305] Saudi Arabia introduced the DIS on 1 January 2016 as a measure to comply with globally agreed standards. See Financial Stability Board *'Peer Review of Saudi Arabia: Review Report'* (2015) 9.

[306] Demirguc-kunt A and Kane E 'Deposit Insurance: Handle With Care' available at *http://si2.bcentral.cl/public/pdf/banca-central/pdf/v7/345_358Demirguc-Kane.pdf* (Accessed 24 September 2018).

[307] Demirguc-kunt A and Kane E 'Deposit Insurance: Handle With Care' available at *http://si2.bcentral.cl/public/pdf/banca-central/pdf/v7/345_358Demirguc-Kane.pdf* (Accessed 24 September 2018).

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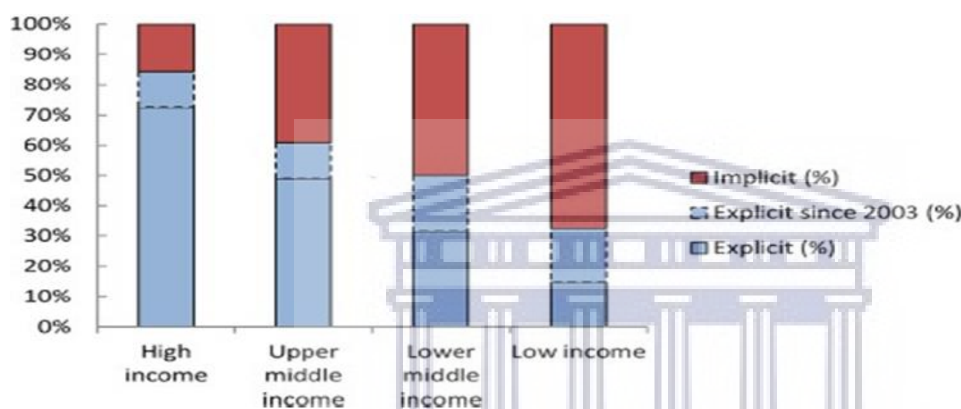
Africa has few countries that adopted the DIS. The rationale is similar to the one of protecting small depositors and minimizing the risk of systemic crisis.[308] This is presumably considered necessary to neutralize doubts prevalent among depositors concerning both the ability and stability of the banking industry to pay out claims on demand. Figure Two below relies on the survey carried out by Demirguc-kunt et al[309] which shows that many lower-income countries, mostly in Africa, are devoid of the DIS. The Figure also shows that only 24% of the African countries have legislated the system irrespective of the fragility of their banking systems.

Figure Two: Explicit deposit insurance by income group, 2013.[310]



Analogous to the figure, the researcher thus advance three assumptions as to why most African countries shun to adopt the system. Firstly, their banking systems are relatively weak, with no strong regulatory frameworks.[311] The second assumption closely links with the first such that, despite the system enhancing the sector, it is also not a cure for a relatively weak banking sector. Thirdly, the countries may be well informed of the difficulties related to designing a credible DIS that precludes banking crisis.[312] These assumptions are carefully advanced because they are also a yardstick to measure the successes or failures of a DIS. On the other hand, the researcher holds that these assumptions may not have an impact on South Africa albeit the country being considered as a developing country. Supporting that claim is the fact that South

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[308] Cull R, Senbet L & Sorge M 'Deposit Insurance and Financial Development' (2005) 37 *JMCB* 44
[309] Demirgüç-Kunt A, Kane E & Laeven L 'Deposit insurance around the world: A comprehensive analysis and database' (2015) 20 *JFS* 176-177.
[310] Demirgüç-Kunt A, Kane E & Laeven L 'Deposit insurance around the world: A comprehensive analysis and database' (2015) 20 *JFS* 176-177
[311] SARB (2017) 15.
[312] Mwenda K *Legal Aspects of Banking Regulation: Common Law Perspectives from Zambia* (2010) 73.

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Africa's banking sector is robust, and the introduction of the 'Twin-Peaks' by the Financial Sector Regulation Act of 2017 (FSRA)[313] sets South Africa apart.

a. Zambia

Zambia has something in common with South Africa albeit Zambia's financial sector not being robust.[314] Similarly to South Africa, Zambia's expressed intention to have the DIS is still at standstill.[315] Though it is emphasised that jurisdictions with relatively weak regulatory frameworks should not have the DIS, an exception persists in that the effectiveness of the DIS is dependent on the design features compatible with the financial market. Therefore, the Bill intended to implement the DIS in Zambia should be construed as a milestone despite the Bill still being under review to ensure there is sufficient compliance with internationally recommended design standards.[316] According to the assessments carried out by the IMF on Zambia's financial sector,[317] Zambia also battles with the issue of dominance whereby the banking sector owns more than 67% of assets in financial sector whereas the remainder is shared amongst the microfinance and nonbank financial institutions. Zambia's problem of bank dominance is similar to the one present in South Africa.

b. Zimbabwe

The researcher now turns to Zimbabwe, a country that adopted the DIS in 2003 despite having a poor banking sector.[318] This essentially entails that Zimbabwe's banking regulations are not as robust as those found in the South African banking sector as was shown earlier in the research. The DIS therefore operate in a very fragile banking environment. The same operation is weakened because the Zimbabwean DIS does not have skilled personnel to form part of the administration, and further lacks the

[313] This Regulation and other legislations will be discussed in chapter.
[314] Bank of Zambia '2019 in Focus' Available at *https://www.boz.zm/Zambanker-December-2018-Edition.pdf* (accessed on 20 February 2020).
[315] Bank of Zambia '2019 in Focus' Available at *https://www.boz.zm/Zambanker-December-2018-Edition.pdf* (accessed on 20 February 2020).
[316] International Monetary Fund *'Zambia Financial Sector Assessment Program and Financial System Stability Assessment'* (2017) 26.
[317] International Monetary Fund *'Zambia Financial Sector Assessment Program and Financial System Stability Assessment'* (2017) 14.
[318] World Bank Group 'Financial Safety Nets and Bank Resolution Frameworks in Southern Africa: Key Issues and Challenges' Available at *http://documents.worldbank.org/curated/en/255991554269112963/pdf/Key-Issues-and-Challenges.pdf* (accessed on 23 February 2020).

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technical capacity to be effective during banking crises.[319] This is the reason why the DIS becomes unable to make prompt reimbursements to depositors or facilitate purchase and assumption transactions.[320] The researcher is of the view that this may have resulted in the continuous failure of banks in Zimbabwe. In that vein, Munoangira and Kaja[321] argue that those failures forced the banks to rebrand themselves simply to restore the lost confidence among the depositors. Contrary to the rebranding, the researcher is of the view that their approach yielded no positive results because, for instance, banks like the Zimbabwe Allied Banking Group (ZABG) has been continuously distressed and the bank went insolvent after the Supreme Court found that ZABG had acquired its assets unlawfully.[322] The unlawful actions of ZABG directors triggers the question of good governance, and the effectiveness of the

3.5.2 Europe

Given the influence of the European nations to the world economy, it is essential to give an overview of the European methods of safeguarding depositors and their banking system. The overview is limited to the methods established by institutions like the Banking Union (BU)[323] which was founded for the benefit of its member states in the Eurozone, and also the Federal Deposit Insurance Corporation (FDIC)[324] established in the United States (US). Both the BU and FDIC are essentially aimed at protecting the interests of bank customers while stabilizing the banking system. It will be established the following research as to what entails the BU and FDIC respectively. In doing so, there would be a discussion centred on the key components of both the BU and the FDIC.

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319 World Bank Group 'Financial Safety Nets and Bank Resolution Frameworks in Southern Africa: Key Issues and Challenges' Available at *http://documents.worldbank.org/curated/en/255991554269112963/pdf/Key-Issues-and-Challenges.pdf* (accessed on 23 February 2020).
320 World Bank Group 'Financial Safety Nets and Bank Resolution Frameworks in Southern Africa: Key Issues and Challenges' Available at *http://documents.worldbank.org/curated/en/255991554269112963/pdf/Key-Issues-and-Challenges.pdf* (accessed on 23 February 2020).
321 Munoangira A & Kaja P 'Strategies to Enhance Public Confidence in the Zimbabwean Banking Sector' (2016) 8 *EJBM* 202.
322 Zimbabwe Independent 'ZABG faces collapse' available at *https://www.theindependent.co.zw/2007/09/07/zabg-faces-collapse/* (accessed 26 November 2018).
323 The BU has about 28 member states, but non-member states are also allowed to derive a benefit from the BU to the extent that is permitted by the BU.
324 The FDIC of the US is selected by the study because it has been in existence for many years.

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a. The European Banking Union

The European government instituted expensive bailouts to bank failing liquidity crisis during the 200 GFC, and this affected the fiscal of the thus led to the 2010 – 2013 European Sovereign Debt crisis (ESDC).[325] The unfolding of these crises disturbed the proper functioning of the financial system in the Eurozone whereby a number of banks had failed.[326] For instance, the collapse of the Spanish and Irish banks added vast liabilities, whereas Greece had its banking system endangered.[327] This disruption called for the reformation of the financial sector regulation and supervision within the euro area.[328]

The European leaders responded to the call by committing to a European BU as a necessary tool to address the financial and banking related problems in the Eurozone.[329] The BU is underpinned on three pillars – the Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM) and the European Deposit Guarantees Scheme (DGS) - all advanced for the benefit of the BU member states.[330] With these pillars as a bedrock, the BU is sought to break the link between the debt-burdened governments and their distressed banks because this link intensified the sovereign crisis.[331] There also had to be a prevention of an instance where the sustainability of public debt is jeopardized by distressed banks and also ensure that a stable banking sector is not put at risk by the unsustainability of public debt.[332] In light of the narratives, the specific aims of the BU pillars are discussed in the following study.

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[325] Allegret J, Raymond H & Rharrabti H 'The impact of the European sovereign debt crisis on banks stocks. Some evidence of shift contagion in Europe' available *at https://hal.archives-ouvertes.fr/hal-01589269/document* (Accessed on 13 May 2019).
[326] Allegret J, Raymond H & Rharrabti H 'The impact of the European sovereign debt crisis on banks stocks. Some evidence of shift contagion in Europe' available *at https://hal.archives-ouvertes.fr/hal-01589269/document* (Accessed on 13 May 2019).
[327] Elliot D 'Key issues on European banking union: Trade-Offs and some recommendations' available at *https://www.brookings.edu/wp-content/uploads/2016/06/11-european-banking-union-elliott.pdf* (Accessed on 14 May 2019).
[328] Gordon J & Ringe W 'Bank resolution in the European Banking Union: A transatlantic perspective on what it would take' (2015) 115 (5) *Columbia Law Review* 1303 (Hereinafter referred to as 'Gordon & Ringe (2015)').
[329] The Banking Union has been established.
[330] Gordon & Ringe (2015)1303.
[331] Gordon & Ringe (2015)1342.
[332] European Commission *'Towards a European Deposit Insurance Scheme'* (2015) 1 (Hereinafter referred to as '(EC (2015)').

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i. The Single Supervisory Mechanism (SSM)

The SSM, as the first pillar, expounds the notion of supervision concerning large financial institutions and banking groups in the euro area.[333] The goal is to ensure there is a robust institution, the European Central Bank (ECB), which supervises the European banks.[334] The ECB remains an independent institution entrusted with the supervisory responsibilities, but the national supervisors are not entirely divested of their national supervision powers. However, the responsibilities entrusted by the SSM are exercised by way of, amongst other things, enhancing the safety and soundness of the banking system while also strengthening financial integration and stability in the euro zone.[335] Under the SSM, the distressed banks are therefore managed in a manner that minimizes systemic risk.

The positive side of the SSM currently pertains to the successful implementation of a central supervisor, the ECB, for the systemically important banks.[336] This resulted into a unified and harmonized supervisory principles which essentially stabilized the banking sector.[337] These successes have also been confirmed by the European Commission (EC) which saw no need to amend the SSM regulation. Accordingly, the EC commended the SSM for enhancing the supervision of banks in the euro zone.[338]

ii. Single Resolution Mechanism (SRM)

The SRM is the second pillar of the BU, and it complements the other pillars, especially the SSM.[339] The SRM ensures that the losses stemming from the banking sector are internalized, by way of imputing them to the shareholders and creditors through the

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333 Pennisi G 'The impervious road to the Single Resolution Mechanism (Srm) of the European Banking Union' available at https://www.jstor.org/stable/43580745 (Accessed on 12 May 2019).
334 Avaro M & Sterdyniak H 'Banking Union: A solution to the Euro zone crisis?' available at https://www.ofce.sciences-po.fr/pdf/dtravail/WP2013-20.pdf (Accessed on 14 March 2019).
335 Federal Ministry of Finance *'The Single Supervisory Mechanism: Lessons learned after the first three years'* (2018) 3.
336 Donnelly S 'Advocacy coalitions and the lack of deposit insurance in Banking Union' (2018) 21 *JEPR* 210.
337 European Commission *'Report from the commission to the European Parliament and the Council'* (2017) 19
338 See the European Commission *'Report from the commission to the European Parliament and the Council'* (2017) 19
339 Beranger A & Scialom L 'Banking Union: Mind the gaps' Available at https://www.sciencedirect.com/science/article/pii/S2110701715000633?via%3Dihub (accessed on 14 May 2019).

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'bail-in' mechanism.[340] The 'bail-in' concept entails an instance where a failing bank relies on the money of, inter alia, creditors and bondholders to restructure the bank's capital so as to keep it afloat.[341] That aspect can be construed as a resolution mechanism of the banks. Conlon and Corter argued that this form of resolution aims to preserve stability while restoring the viability of the distressed financial institution.[342] In other words, the bail-in strategy dismantles the tradition of offering bailouts to ailing banks.

In the absence of a bail-in mechanism, the government is forced to institute bailouts, especially for the systemically important banks. Since the European financial system is characterized on, amongst other things, international regulatory agencies and globally connected financial institutions, the bailouts therefore undermines the importance of enforcing bail-ins.[343] In essence, bailouts had recently burdened public funds in the Eurozone leading to the occurrence of the aforesaid crisis. To remedy that deficiency, the resolution mechanism seeks to transfer the costs of bailouts from the government to the private sector while efficiently managing the distressed banks.[344]

iii. Deposit Guarantee Scheme (DSG)

The European DSG is the third and last vital pillar of the BU.[345] With this type of pillar, the goal is to preserve depositor's confidence and safeguard the banking sector against banking risks.[346] Put simply, the DSG is similar to the traditional DIS proposed in South Africa, albeit advancing goals in a different manner. Membership to the DSG is not strictly limited to the BU member states since the non-member states can still

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[340] Beranger A & Scialom L 'Banking Union: Mind the gaps' Available at *https://www.sciencedirect.com/science/article/pii/S2110701715000633?via%3Dihub* (accessed on 14 May 2019).
[341] Avgouleas E & Goodhart C 'Critical Reflections on Bank Bail-ins' (2015) 1 *JFR* 3
[342] Conlon T & Cotter J 'Anatomy of a bail-in' (2014) 15 *JFS* 258.
[343] Koetter M, Krause T & Tonzer L 'Delay determinants of European Banking Union implementation' 2018 *EJPE* 1-2.
[344] Wickens M 'Is there an alternative way to avoid another Eurozone crisis to the Five President's Report?' (2016) 39 *JEF* 162.
[345] European Central Bank 'Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?' Available at *https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op208.en.pdf* (accessed on 25 February 2020).
[346] Beranger A & Scialom L 'Banking Union: Mind the gaps' Available at *https://www.sciencedirect.com/science/article/pii/S2110701715000633?via%3Dihub* (accessed on 14 May 2019).

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derive a benefit on a voluntary basis.[347] In that vein, the DSG attempts to diversify the risks and costs associated with financial shocks, which essentially benefits the participating states.[348] The ultimate aim is to expand resilience so as to avert the occurrence of future crises while preventing a loss of deposits.[349]

However, the DSG is relatively new in the Eurozone, thus has not yet been tested against financial shocks. Despite the DSG repelling the effects of the 2007 GFC and 2011-2013 ESDC, this framework has been met with fierce resistance whereby some jurisdictions opposed the idea of a harmonised DSG for the Eurozone countries. For instance, Finland was concerned that the banking regulation and risks of the jurisdictions are different, therefore would result to an asymmetry of the distribution of the costs and benefits of the DSG.[350] In a similar vein, Germany, in particular, rejected the creation of the DSG because of the fear of cost implications and moral hazards.[351] The reality of those arguments remains to be seen, but one is prone to argue that the DSG is a plausible system to avert financial crises hence it has been preferred to underpin the BU. Added to that, the system is more viable because it is able to efficiently mobilize the financial resources better than the national schemes. [352] But the components that will influence the successes of the DSG further pertains to the extent of participation by the financial institutions in the euro area, adequate coverage and timely reimbursements in the event a bank fails.[353] Under the system, depositor's deposits are protected for up to 100 000 euros, protected through their national deposit insurances.[354]

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b. Brief consolidation of DSG, SSM and SRM

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347 European Central Bank 'Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?' Available at *https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op208.en.pdf* (accessed on 25 February 2020).
348 European Commission (2015) 2.
349 See the European Commission (2015) 3.
350 This has been cited from a speech. Rossi S 'The Banking Union in the European integration process' available at *https://www.bis.org/review/r160413d.pdf* (accessed on 15 March 2019).
351 Rossi S 'The Banking Union in the European integration process' available at *https://www.bis.org/review/r160413d.pdf* (accessed on 15 March 2019).
352 Howarth D & Quaglia L 'The difficult construction of a European Deposit Insurance Scheme: a step too far in Banking Union?' (2018) 21 *JEPR* 193.
353 Pagliacci A 'The three pillars of the European Banking Union: An evolution road' (2014) 6 *IJPL* 304
354 European Union 'Completing the Banking Union by 2018' available at *http://www.europarl.europa.eu/RegData/etudes/IDAN/2019/574392/IPOL_IDA(2019)574392_EN.pdf* (Accessed on 13 May 2019).

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The DSG, SSM and SRM pillars are important insofar as preserving the financial stability of the Eurozone is concerned. The SSM and SRM pillars serves as a preventative measure whereas the DGS and SRM serves as crisis management.[355] Against this backdrop, the researcher is of the view that these pillars of the BU could have circumvented part of the disruptive effects of the recent crises in the Euro zone.

3.4.3 The FDIC of the United States

As a point of departure, the United States (US) is not a member of the BU, albeit having a deposit insurance as advanced by the FDIC.[356] So much can be learned from the US since it is the first jurisdiction to legislate the DIS, and it has a rich history of what entails the deposit insurance, the advantages and disadvantages thereof.[357] In that vein, the US is worth being considered for the purposes of discussion. However, their policy response to banking crisis came in a form of the FDIC established by the Glass-Steagall Banking Act 1933[358] with the aim of protecting depositors, preserving both stability and confidence in America's banking sector.

Furthermore, the FDIC promotes three missions comprising of strategic goals which goes farther than protecting depositors. These missions and strategic goals includes,[359]

(i) Cinsurance - advancing the goal of protecting depositors without resorting to public funds,

(ii) supervision – aimed at safeguarding the rights of customers while encouraging the supervised firms to invest in the society, and

(iii) receivership management - ensuring an orderly resolution and effective management of receiverships.

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355 Schoenmaker D & Gros D 'European Deposit and Resolution in the Banking Union' (2014) 52 *JCMS* 530.

356 356 See European Central Bank 'Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?' Available at *https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op208.en.pdf* (accessed on 25 February 2020).

357 Calomiris & White (05 May 2018).

358 Banking Act 1933.

359 Federal Deposit Insurance Corporation *'FDIC Strategic Plan 2018-2022'* (2018) 8.

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Based on those fundamentals, the FDIC is therefore construed to play an active role in respect of the resolution of banks and the supervision of institutions.[360]

South Africa's R100 000 coverage per depositor compares favourably with the 100 000 euros guaranteed by the BU meanwhile the US capped coverage at 250 000 dollars per deposits per bank.[361] Depositors may further qualify for a coverage exceeding the capped amount if their funds are in different ownership categories, and subject to meeting further FDIC requirements.[362] When one of the sixth largest banks, Washington Mutual bank, and other financial institutions suffered the loss of confidence resulting in liquidity crisis,[363] the Dodd-Frank Wall Street Reform and Consumer Protection Act[364] was passed, thus widening the duties of the FDIC to include regular risk assessments of all insured institutions, and the increase of coverage to the 250 000 dollars was simply a strategic measure to restore the lost confidence. The enactment of the Act may have been done through the prism of the variety of factors that detracts from banking stability. These factors include but are not limited to the inadequate assessments and the inadequacy of banking regulation.[365]

The FDIC had successfully dispelled the uncertainties concerning bank solvencies. Cooley provides that this has been done in the context of acknowledging "the contradictions and risks inherent in fractional reserve banking by making those responsible for the risks pay for insuring against them".[366]

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Now the study attempts to determine the firmness of the FDIC in times of financial or banking crisis. That shall be done in line with the stability and resolution maintained by the FDIC in the event of a financial crisis, especially the 2008 GFC. The figure

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[360] Beck T & Laevan L 'Resolution of failed banks by Deposit Insurers: Cross-country evidence' available at *https://www.researchgate.net/publication/23723323* (Accessed on 05 March 2019).

[361]

[362] Federal Deposit Insurance Corporation 'Deposit insurance at glance' available at *https://www.fdic.gov/deposit/deposits/brochures/deposit-insurance-at-a-glance-lp-english.pdf* (Accessed on 05 March 2019).

[363] United States Senate permanent Subcommittee on Investigations '*Wall Street and The Financial Crisis: Anatomy of a financial collapse'* (2011) 48.

[364] Dodd-Frank Wall Street Reform and Consumer Protection Act.

[365] Vedder R 'The impact of the Federal Deposit Insurance Corporation on banking stability' available at *https://www.jstor.org/stable/43894449* (Accessed 05 March 2019).

[366] Cooley T 'A Captive FDIC' available at *https://www.forbes.com/2009/04/14/sheila-bair-banks-insurance-opinions-columnists-fdic.html#40492c9a7ebe* (Accessed on 12 March 2019).

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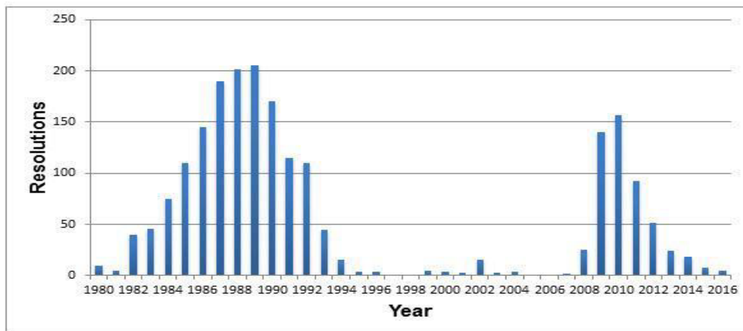
below is imparted as a way of not negating other FDIC resolution activities between years 1980 to 2016.

Figure three: FDIC Resolution of 1980 – 2016.[367]



The financial stability sought by the FDIC entails the capability to resist a financia shock, internally or externally, without any impairment to the economic function, and without the broader economy being severely affected.[368] The researcher therefore holds a view that stability is prioritized in purview of the interest of depositors. That notion resonates with the analysis made in the 2009 FDIC annual report, [369] illustrating that when the FDIC successfully closed 140 failed institutions as depicted by figure two, the body made it plausible for depositors to have access to their insured deposits at the most convenient time. The report further highlighted the final rule that was adopted in light of the largest insured institutions. Accordingly, these institutions had to ensure that in the event of failure – (i) the institutions shall furnish the DIS with pivotal information i.e standard deposit accounts, and (ii) allow the placement and release of holds on liability accounts as well as deposits.[370] Coupled with the final rule is a form of Temporary Liquidity Guarantee Program (TLGP) to restore the diminished

[367] Oliver Wyman 'Post-crisis changes in the stability of the UC banking system: Evidence from UC bank holding companies from 2004 to 2014' available at https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/Post_Crisis_Changes_in_the_Stability_of_the_US_Banking_System_Final_1.pdf (Accessed on 10 March 2019).

[368] Oliver Wyman 'Post-crisis changes in the stability of the UC banking system: Evidence from UC bank holding companies from 2004 to 2014' available at https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/Post_Crisis_Changes_in_the_Stability_of_the_US_Banking_System_Final_1.pdf (Accessed on 10 March 2019).

[369] Federal Deposit Insurance Corporation *'2009 Annual Report: Performance Results Summary'* (2009) 58.

[370] See the Federal Deposit Insurance Corporation *'2009 Annual Report: Performance Results Summary'* (2009) 58.

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confidence and mitigate the spill over, and further offered targeted support for the bank debt markets and deposit funding.[371]

a. Criticisms of the FDIC

The FDIC, like any insurance system, attract vast criticism. Authors like Hogan and Johnson[372] holds that the FDIC is complicit in the 2008 GFC because, by its nature, the federal deposit insurance instigated moral hazard and removed incentives hence the rate of bank failures increased rapidly. This is a substantial argument because based on the figure above, the total number of bank failures were as high as 500 between the years 2008 to 2013.[373] The FDIC may have faced more pressure if the failure concerned large banks, Washington Mutual bank for instance, with a substantial number of depositors or large amounts of uninsured deposits belonging to public institutions because, according to Horvitz,[374] such a failure has undesirable effects to the general public confidence. In a similar vein, Kaufman[375] submits that the FDIC makes it plausible for banks to replace government capital with private capital wherein the government benefits nothing from the undertaking yet assumes the losses in the costs. While the author had further considered enough capital to be the solution to banking crisis, he contrarily bands the FDIC as tainting the adequacy of capital.[376]

b. Assessment of the FDIC

The one argument reiterated throughout the study, often neglected by economists and other anti-DIS proponents highlights that the financial safety-net is "not failure-free and

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[371] Krimminger M 'Response to the Global Financial Crisis: What we did and why we did it' available at *https://www.brookings.edu/wp-content/uploads/2018/08/05-Debt-Guarantee-Program-Prelim-Disc-Draft-2018.09.11.pdf* (accessed on 11 March 2019).
[372] Hogan T & Johnson K 'Alternatives to the Federal Deposit Insurance Corporation' (2016) 20 *The Independent Review* 435.
[373] See Oliver Wyman 'Post-crisis changes in the stability of the UC banking system: Evidence from UC bank holding companies from 2004 to 2014' available at *https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/Post_Crisis_Changes_in_the_Stability_of_the_US_Banking_System_Final_1.pdf* (Accessed on 10 March 2019).
[374] Horvitz P 'Failures of large banks: Implications for banking supervision and Deposit Insurance' (1975) 10 *JFQA* 594.
[375] Kaufman G 'Make FDIC Insurance Redundant' available at *https://www.jstor.org/stable/40721122* (accessed on 11 March 2019)
[376] Kaufman G 'Make FDIC Insurance Redundant' available at *https://www.jstor.org/stable/40721122* (accessed on 11 March 2019)

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is not designed to be".[377] This narrative takes into account that the FDIC or any form of DIS elsewhere involves the shifting of a risk. Therefore, the previously expounded principles of insurance applicable to medical or legal malpractice insurances will also apply to the DIS. In that vein, White finds this insurances' analogous because of the promise made by the insurer (deposit insurance) to reimburse the insured (depositor) in the event the depositor's bank runs into financial difficulty.[378] In his address at the *16th Annual IADI General Meeting and Annual Conference*, Hoenig, the Vice chairman of the FDIC and President of IADI, acknowledges that the system attracts its own abuse of risks, but he further unpacked the mitigating steps that can be taken.[379] These steps encapsulate the oversight role of both the insurers and supervisors simply to, amongst other things, instil a sound supervision and reliable capital measures. Consistent with this view, Anginer et al consider better bank supervision to restrict a bank's engagement in risk taking activities, especially when there is a DIS.[380]

Furthermore, there is a general consensus among some academics that the FDIC has been complicit in the 2008 GFC.[381] These academics went as far as banding the FDIC as a proximate cause of the GFC because of the lack of supervision as stated above.[382] Since the US deposit insurance is state-mandated in contrast with other jurisdictions, Calomiris[383] assumes that many depositors feel entitled to a government bailout in times of crisis. On the basis of a similar analysis, Demirguc-Kunt and

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377 Schich S 'Financial crisis: Deposit Insurance and related financial safety net aspects' available at *https://www.oecd.org/finance/financial-markets/41894959.pdf* (Accessed on 12 March 2019)
378 White L 'The reform of Federal Deposit Insurance' (1989) 3 *JEP* 17.
379 Hoenig T 'Deposit insurance: Addressing its Moral Hazards Effect' available at *https://www.fdic.gov/news/news/speeches/spoct1117.pdf* (Accessed on 11 March 2019).
380 Anginer D, Demirguc-Kunt A & Zhu M 'How does deposit insurance affect bank risk? Evidence from the recent crisis' (2014) 48 *JBF* 319.
381 Oliver Wyman 'Post-crisis changes in the stability of the UC banking system: Evidence from UC bank holding companies from 2004 to 2014' available at *https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/Post_Crisis_Changes_in_the_Stability_of_the_US_Banking_System_Final_1.pdf* (Accessed on 10 March 2019).
382 See Oliver Wyman 'Post-crisis changes in the stability of the UC banking system: Evidence from UC bank holding companies from 2004 to 2014' available at *https://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/Post_Crisis_Changes_in_the_Stability_of_the_US_Banking_System_Final_1.pdf* (Accessed on 10 March 2019).

383 Calomiris C 'The decline of private deposit insurance in the United States' available at *https://www0.gsb.columbia.edu/faculty/ccalomiris/papers/Decline%20of%20Private%20Deposit%20Insurance.pdf* (Accessed on 12 March 2019).

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Detragiache[384] had researched extensively on the topic of government-administered deposit insurances and ultimately concluded they are undesirable because of presenting stronger adverse impact on banking stability. While this analysis is important to consider, the researcher is of the view that there have been so many factors that led to the 2008 GFC as opposed to only blaming the FDIC.[385] This is not meant to completely exonerate the DIS, but it has been argued by academics like Demirgüc-Kunt et al[386] that the system played its foremost role expected of any financial safety-net. This happened when the system mitigated the risk of bank runs as provided in the previous chapter. However, the initial number of failures of FDIC-insured institutions is an aspect the supervisors should have prioritized through establishing a timely redress measure to circumvent most banking problems.[387] The researcher thus argues that contemporary financial sectors should learn from this lessons for the purpose of having a sound DIS.

3.5 Conclusion

This chapter has demonstrated that the DIS policy is now strictly endorsed by international financial bodies. Financial bodies like the FSB makes it obligatory for their member states to adopt the safety-net. By so adopting the DIS, the jurisdictions would be upholding the best practices issued to that effect. The chapter further unveiled that South Africa still need to realise that duty the same way some of its FSB and G-20 counterparts did. Of great importance, the best practices gives guidance on how the analysed risk of moral hazards can be mitigated. However, the purpose of the best practices and the lessons of the comparatively discussed jurisdictions shall be considered in light of the domestic regulatory frameworks which would be discussed in the next chapter. The ultimate aim is to ensure that both the international and domestic regulatory frameworks becomes instrumental in containing the feared risk of

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[384] Demirguc-Kunt A & Detragiache E 'Does deposit insurance increase banking system stability? An empirical investigation' (2002) *JME* 1386-1389.
[385] Ellis L 'The Global Financial Crisis: Causes, Consenquences and Countermeasures' available at https://www.rba.gov.au/publications/bulletin/2009/may/pdf/bu-0509-4.pdf (accessed on 12 March 2019).
[386] Demirgüc¸ -Kunt A, Kane E & Laeven L 'Deposit Insurance around the world: A comprehensive analysis and database' (2015) 20 *JFS* 155.
[387] Federal Deposit Insurance Corporation *'Crisis and Response: An FDIC History, 2008-2013'* (2017) 107.

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moral hazards while making sure there is a proper implementation of the DIS in the South African context.

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Chapter 4

The position of South African law in respect of a Deposit Insurance System

4.1 Introduction

A well-functioning banking system is important and influential to the broader economic growth of a country.[388] That is why jurisdictions constantly reform their financial regulations to preserve the stability and credibility of their banking systems.[389] The reformations simply strengthens the supervision and regulation of the banking sector. In a similar vein, a robust financial sector safety-net, in a form of a Deposit Insurance System (DIS) is a pivotal instrument for stability purposes. In essence, the DIS plays the role of guaranteeing the safety of the banking sector by protecting depositors and inspiring confidence in the system while mitigating financial shocks.[390]

To this point, the research has established that the adoption of the DIS favours a healthy banking sector that is backed by robust regulatory frameworks like those present in South Africa. Against that background, this chapter is aimed at discussing the essential regulatory and legislative frameworks implemented to embolden South Africa's banking system. The frameworks are also important for the enhancement of the DIS upon inception. The ultimate goal is to explore how the domestic frameworks can mitigate the risk of moral hazards by way of coordination, supervision and regulation in the banking sector. The discussion herein is made in light of the previously explored best practices and the duty imposed on South Africa to establish the DIS.[391] Most importantly, the discussion does not construe the frameworks as an absolute remedy of all banking problems, rather as a good foundation upon which the DIS can be established and effectively operate.

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[388] Ellyne & Cheng (2014) 149.

[389] Godwin A 'Introduction to special issue – the twin peaks model of financial regulation and reform in South Africa' 11 (4) *Law and Financial Markets Review* 152.

[390] World Bank *'Deposit Insurance Systems: Addressing emerging challenges in Fun ding, Investment, Risk-based Contributions & Stress Testing'* (2017) 3.

[391] The duty is imposed to all member states of the FSB.

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4.2 Gaps in South Africa's proposed DIS.

It has been established earlier in the research that the South African banking sector was not directly impacted by the 2008 Global Financial Crisis (GFC) because the sector effectively regulated.[392] This justifies why there has been an increase of profitability and capitalization levels in both the banking and insurance industry.[393] The current capital and reserve cushions are also considered sufficient to take on the large financial shocks.[394] However, the researcher cautions against becoming complacent and argues that further reformations are needed in the banking sector so as to prevent the failure of small banks. This is because the small banks sell a substantial portion of their products to the majority of vulnerable customers whose safety is least prioritized in the financial sub-sectors,[395] hence the DIS is sought to close that lacuna.

The previous chapters have reviewed the proposed policy framework of the DIS. The framework does not clearly detail how the risks attracted by the DIS would be avoided. There is only a focus on the design features as key mitigant measures of moral hazard. There is also a weighing of the advantages against the disadvantages so as to ensure a constructive implementation. Furthermore, stronger emphasis is made on the essence of coordination between financial safety-nets in the safety-net setting. The study therefore views the coordination as a bedrock pillar to stabilize the banking sector while realising the broader objectives of the DIS. By virtue of most of the safety-nets founded on their respective regulatory frameworks, that saliently begs for a discussion of the regulatory and legislative frameworks which enhances the aspect of coordination while enforcing accountability in the banking sector.

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[392] Moyo B 'An analysis of competition, efficiency and soundness in the South African banking sector' (2018) 21 *SAJEMS* 3.
[393] International Monitory Fund *'South Africa: Financial System Stability Assessment'* (2008) 1.
[394] See the International Monitory Fund *'South Africa: Financial System Stability Assessment'* (2008) 6.
[395] This point has been expounded in the essay written by de Beer J, titled 'Consumer protection in the financial sector in South Africa: a review of recent developments' available at *http://www.essa2013.org.za/fullpaper/essa2013_2727.pdf* (Accessed on 31 March 2019)

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4.3 Overview of South Africa's regulatory framework

4.3.1 Brief outline of the Financial Sector Regulation Act 2017

The study now turns to the Financial Sector Regulation Act 2017[396] that introduced the Twin-Peaks model of financial regulation in South Africa. The Twin-Peaks model of regulation was firstly proposed by Michael Taylor in 1994, who believe that retaining the regulatory divide between banking, insurance and securities is significant.[397] In essence Taylor was of the view that only two regulatory agencies should be adopted as will be shown later in the study. The idea was to enforce a regulatory structure that focuses on the objectives of regulation, with clear and unambiguous mandate for which it can be held responsible.[398] Australia was the first jurisdiction to adopt the Twin Peaks in 1997, and the model has been exported around the globe.[399]

However, the discussion about the Twin-Peaks is not concerned with whether it was necessary to implement this kind of framework in South Africa. The focus is, rather, on the distinct nature of the Twin-Peaks which has been considered by the Finance Ministry as a plausible regulatory instrument that could guarantee *'a safer financial sector to serve South Africa better'.*[400] The Twin-Peaks Model is malleable in a sense that it can play a huge role in containing the risk of moral hazards given rise by the presence of the DIS. This is vital because the regulators established by the Twin-Peaks are vested with the responsibility to oversee the behaviour and activities of the banks.[401]

In essence, the Twin-Peaks introduced fundamental changes and innovations into the financial sector of South Africa, while advancing indistinguishable objectives from the

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[396] The Financial Sector Regulation Act 9 of 2019 (Hereinafter referred to as 'Act 9 of 2019)'.
[397] Taylor M 'Twin Peaks Revisited: a second chance for regulatory reforms' Available at *http://static1.squarespace.com/static/54d620fce4b049bf4cd5be9b/t/55241044e4b03769e017208a/1428426820095/Twin+Peaks+Revisited.pdf* (accessed on 23 February 2020).
[398] See Taylor M 'Twin Peaks Revisited: a second chance for regulatory reforms' Available at *http://static1.squarespace.com/static/54d620fce4b049bf4cd5be9b/t/55241044e4b03769e017208a/1428426820095/Twin+Peaks+Revisited.pdf* (accessed on 23 February 2020).
[399] Godwin A & Ramsay I 'Twin Peaks – the legal and regulatory anatomy of Australia's system of financial regulation' Available at *https://core.ac.uk/download/pdf/51343229.pdf* (accessed on 23 February 2020).
[400] Minister of Finance *'Implementing the Twin-Peaks Model of financial regulation'* (2013) 6.
[401] See the Minister of Finance *'Implementing the Twin-Peaks Model of financial regulation'* (2013) 3.

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DIS.[402] These objectives pertains to the enhancement of both the financial and banking sectors so as to address the system-wide macro-prudential risks while protecting the vulnerable bank customers against any form of loss. [403] To achieve the objectives, the sector is overseen by two distinct regulators established by the Twin-Peaks – the Prudential Authority (PA) and the Financial Sector Conduct Authority (FSCA),[404] and their key responsibilities shall be discussed later in the study.

a. Twin-Peaks replacing the Silos Model

Before the advent of the Twin-Peaks, South Africa followed the Silos approach of financial regulation which is different from the Twin-Peaks. The distinction is drawn by Botha who provides that the Silos Model entails the appropriation of financial regulation in accordance to its financial lines which includes inter alia insurance, securities and banking.[405] On the other hand, the Twin Peaks entails a separation of regulatory duties between two regulators (PA and FSCA) on the basis that one regulator assumes the duty of safety and soundness supervision, whereas the other regulator only focuses on the conduct of business regulation.[406] Mwenda raise a significant point insofar as regulatory framework is concerned. He illustrate that prior to drafting a regulatory framework, drafters need to understand the nature of the industry, and the role of the regulator in that country.[407] In light of the Silos Model, the impression therefore is that each segment of the financial sector had its own authority to regulate, thus presupposing a clear demarcation of each of the financial services.[408] Thus the researcher is of the view that the replacing of the Silos Model with the Twin

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[402] See Taylor M 'Twin Peaks Revisited: a second chance for regulatory reforms' Available at *http://static1.squarespace.com/static/54d620fce4b049bf4cd5be9b/t/55241044e4b03769e017208a/1428426820095/Twin+Peaks+Revisited.pdf* (accessed on 23 February 2020).

[403] National Treasury *'Twin Peaks in South Africa: Response and Explanatory Document'* (2014) 7 (Hereinafter referred to as 'National Treasury (2014)').

[404] National Treasury 'New Twin Peaks Regulators Established' available at *http://www.treasury.gov.za/twinpeaks/Press%20release%20Twin%20Peaks%20implementation%20March2018_FINAL.pdf* (Accessed on 28 March 2019).

[405] Botha E & Makina D 'Financial Regulation and Supervision: Theory and Practice in South Africa' (2011) *IBERJ* 30 (Hereinafter referred to as 'Botha & Makina (2011)').

[406] Botha & Makina (2011) 30.

[407] Mwenda K *Legal Aspects Of Financial Services Regulation And The Concept Of A Unified Regulator* (2006) 6.

[408] Chimbombi R *Regional integration of financial services regulation and supervision in the Southern African development community* (Published LLM, University of the Western Cape, 2015) 12 (Hereinafter referred as 'Chimbombi (2015)').

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Peaks closely aligns with Mwendas' analysis insofar as adopting a suitable model for the banking industry is concerned.

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b. The inadequacy of the Silos Model

The Silos Model has been fraught with regulatory shortcomings. The dominant shortcoming being that the model gives rise to the fragmentation and complexity of the financial market which posed a risk of regulatory arbitrage.[409] Regulatory arbitrage entails the financial transactions designed to decrease costs or capture profit opportunities created by different regulations.[410] The financial institutions therefore act beyond the reach of regulators thus threatening sovereignty of nation-states and the stability of national economies.[411] This specifically pertained to the regulation of conglomerates regulated by the three lines of financial regulations, thus created levels of inconsistency, and made regulatory arbitrage an inevitable reality.[412] Concentration in the banking sector is another factor whereby, by virtue of the big banks owning large assets, they further instilled concentration and hegemony in the banking sector.[413] Therefore, the Twin-Peaks, by way of establishing the PA and FSCA as regulators, was aimed at redressing these shortcomings and ensuring an enhanced financial sector while safeguarding vulnerable bank customers.[414]

4.4 The two fundamental regulators of the Twin-Peaks

4.4.1 The Prudential Authority (PA)

The PA is the first regulator thus exist independently despite its location at the SARB. The key functions of the PA concerns a microprudential supervision whereby the PA has to, amongst other things, instil safety and soundness in banks and other financial institutions, and also safeguard the protection of depositors by ensuring the institutions operate within the confines of the law.[415] However, the United Kingdom (UK) model gives an understanding that having the PA within the SARB is nothing new. This is

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409 Van Niekerk G & Van Heerden G 'Twin peaks in South Africa: A new role for the central bank' (2017) 11 *LFMR* 154.
410 Riles A 'Managing regulatory arbitrage: A conflict of laws approach' Available at *https://www.lawschool.cornell.edu/research/ILJ/upload/Riles-final.pdf* (Accessed on 24 February 2020).
411 Riles A 'Managing regulatory arbitrage: A conflict of laws approach' Available at *https://www.lawschool.cornell.edu/research/ILJ/upload/Riles-final.pdf* (Accessed on 24 February 2020).
412 Botha & Makina (2011) 30.
413 Godwin A 'Australia's Trek towards Twin Peaks_ Comparisons with South Africa' (2017) 11 *LFMR* 183.
414 See Banking Association of South Africa '*Twin Peaks: Regulations for a safer financial sector'* 18.
415 National Treasury (2014) 7.

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because the UK also adopted the system whereby its Prudential Regulatory Authority (PRA) is considered to form part of the Reserve Bank, thus assumes duties similar to those of the PA.[416]

The safety and soundness has its centrepiece on the institution's financial strength and prudential management.[417] Knowing that financial crises are caused by financial or banking institutions, the integrated role of microprudential supervision is appropriately guided because of targeting institutions such as banks, insurers to mention a few.[418] In essence, moral hazards may result in a bank being unable to further the obligations owed to the depositors, therefore the PA safeguard the banking system by way of strengthening banking stability to preserve trust and confidence in the system.[419] Since the DIS attracts moral hazards, the viewpoint is that the PA can be fully leveraged as a mitigant regulatory instrument. That aspect is similarly endorsed by Ketcha[420] who argues that the scope of the prudential supervision and the DIS has a correlative goal because, to a large extent, the presence of a DIS begs for a strengthened supervision and regulation of banks by the government. Barth et al[421] similarly propound that the regulatory and supervisory mandates of the PA potentially attenuates moral hazards. Under the stewardship of the PA, the banks are further required to have a framework that effectively manage their liquidity risk which captures the full range of liquidity risks to which a bank is exposed and to stress test these risks.[422]

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416 Journal Regulation Compliance 'Prudential Regulation Authority (PRA)' Available at https://thejournalofregulation.com/en/article/prudential-regulation-authority-pra/ (Accessed on 20 February 2020).
417 National Treasury (2014) 28.
418 South African Reserve Bank 'Prudential Authority' available at https://www.resbank.co.za/AboutUs/Departments/Pages/Prudential-Authority.aspx (accessed 27 October 2018).
419 Minister of Finance *'Implementing the Twin-Peaks Model of financial regulation'* (2013) 43.
420 Ketcha (09 February 2019).
421 Barth J, Lee C & Phimiwasana T 'Deposit insurance schemes' Available at Https://www.springer.com/cda/content/download/cda_downloaddocumnet/99781461453598-c1.pdf?SGWID=0-0-45-1372839-P174735940 (accessed 27 October 2018).
422 Prudential Authority 'Bank Licensing in the Republic of South Africa' available at https://www.resbank.co.za/PrudentialAuthority/Deposit-takers/Documents/Banking%20licencing%20in%20the%20Republic%20of%20South%20Africa.pdf (accessed on 29 October 2018).

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The duties of the PA pertain to the promotion of the safety of depositors' deposits, and the interest of the beneficiaries of the financial institutions.[423] By implication, the PA ensures that the financial institutions do not operate beyond the demarcation point of what is sensibly accepted by the law.[424] An argument thus accords that the structures implemented to advance these objectives significantly ensure that banks do not take excessive risk that may tamper with the stability of the banking system and the broader economy. This aspect is imperative because, by further implication, the DIS would not be compelled to make exorbitant reimbursements and revive multiple of banks which is a task that could potentially strain the operation of the DIS. The impression created therefore is that the PA promotes the fundamental objectives of the DIS. This is the reason why the study construes both the DIS and PA as essential financial safety-nets aimed at stabilizing the banking sector in the best interests of customers. The operation of these safety-nets can be stimulated by a high probity of coordination.[425]

4.4.2 The Financial Sector Conduct Authority (FSCA)

The FSCA is another regulator that has been introduced by the Twin-Peaks. The FSCA is commonly known as a stand-alone market conduct regulator conferred with the role of supervising the conduct of the financial institutions in pursuance of business while ensuring an equitable treatment of customers in the sector.[426] In essence, the FSCA execute its responsibilities taking into account how the financial products are, inter alia purchased and traded by way of enforcing equitability and allegiance pertinent to the provisions of the financial products.[427] The further designs are aimed at stimulating financial inclusion and protecting customers of financial institutions. This is achieved through the enhancement of awareness whereby financial education programs are considered pivotal to promote financial capacity and literacy.[428]

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[423] South Africa Reserve Bank 'Prudential Authority' available at https://www.prudentialauthority.co.za/Deposit-takers/Banks/Resolution/Pages/default.aspx (accessed 28 October 2018).
[424] Chimbombi (2015) 32.
[425] Minister of Finance *'Implementing the Twin-Peaks Model of financial regulation'* (2013) 15.
[426] Van Niekerk G & Van Heerden G *'Twin peaks in South Africa: A new role for the central bank'* (2017) 11 *LFMR* 155.
[427] Van Niekerk G & Van Heerden G *'Twin peaks in South Africa: A new role for the central bank'* (2017) 11 *LFMR* 155.
[428] Financial Sector Conduct Authority *'Regulatory strategy of the FSCA'* (2018) 4.

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The pillars of the FSCA further stimulates integrity and efficiency in the financial market, with the ultimate goal of curbing market abuse.[429] Regulation on market integrity and efficiency guarantees the promotion of equitability in the capital market whereby, amongst other things, financial institutions should act fair and ensure there is adequate access to information concerning their products.[430] This aspect comes in a form of attempting to ostracize the poor services offered by the financial institutions, together with the opaque and complex products sold to customers at higher prices. The financial education is thus construed by the study as a vehicle to raise awareness concerning the sophisticated products of the banking sector offered to vulnerable depositors. Ultimately, the researcher submits that, with the knowledge accruing from the financial education, the bank customers can be put in a position which would encourage them to incentivise the banks not to engage in excessive risk taking. This aspect is vital because the issue of lack of incentives in the presence of a DIS has been identified by the previous study as a genuine fear that is held by academics and regulators.

4.5 An assessment of the role of the PA and FSCA

It has clearly been established that the PA and FSCA forms part of the safety-net setting. Therefore the distinct roles of these regulators are not an obstruction of coordination as propounded by the previously discussed Key Attributes (KAs) read with the Core Principles. In fact, but for the slight title difference, the PA and FSCA seem to be modelled on the PRA or Financial Conduct Authority (FCA).[431] In the same vein, the aspect of regulatory coordination does not mean the regulators would be susceptible to external directives other than those encapsulated in the Financial Sector Regulation 2017.[432] But the FSCA, PA and other safety-net participants have an equal standing with the DIS for the purposes of information sharing and the coordination of activities.[433] The coordination between the regulators is further aimed at establishing

[429] Address made by the Ministry of Finance to the staff at the launch of the Financial Sector Conduct Authority. 'Financial Sector Conduct Authority' available at *http://www.treasury.gov.za/twinpeaks/Minister's%20speech%20-%20Launch%20of%20FSCA.pdf* (Accessed on 29 March 2019).

[430] Financial Sector Conduct Authority *'Regulatory Strategy of the FSCA'* (2018) 11.

[431] See Godwin A 'Introduction to special issue – the twin peaks model of financial regulation and reform in South Africa' (2017) 4 *Law and Financial Markets Review* 151-153.

[432] See Act 9 of 2017.

[433] SARB (2017) 42.

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an integrated view of risks in the sector and implement coordinated initiatives.[434] In light of the coordination pillar, the understanding is that the mandate of all financial safety-nets would be carried out in the broader context of strengthening the DIS to mitigate moral hazards and enhance depositor's confidence in the banking system. This scope embraces the reforms of the G-20 pertaining to dealing with the systemically important financial institutions (SIFIs) and TBTF institutions. The reforms are a centrepiece of the stability objective which aims to discard the reliance on government support to revive failing institutions and embolden the banking sector.[435]

The awareness, financial literacy and knowledge promoted by the PA and FCSA is therefore construed by the study as a yardstick of raising awareness concerning the sophisticated products of the banking sector offered to the depositors. By solely looking at public awareness, the researcher is of the view that it remains a fundamental pillar for an effective DIS, hence the DIS requires to be regularly publicized to constantly strengthen public confidence.[436] This point resonates with the essence of Core Principle 12 which considers public awareness as an imperative pillar of a well-functioning DIS as discussed in the previous chapter. In essence, a positive awareness disseminates the appropriate message, instils a positive perception and behaviour while constructing a credible foundation simply to maintain a healthy financial sector.[437] Generally put, education about the system is important insofar as incentivising the banks is concerned.

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The coordination between the regulators is in a sense that the market conduct regulator dispels market misconduct, whereas the PA ensures that the selling of the products is within the prescripts of the required principles.[438] On the other hand, the National Credit Act of 2005 is also included in the picture by virtue of ensuring that banks and other service providers do not encourage consumers to take on loans they

[434] Minister of Finance *'Implementing the Twin-Peaks Model of financial regulation'* (2013) 19
[435] National Treasury (2014) 7.
[436] International Association of Deposit Insurers *'Public awareness of Deposit Insurance Systems'* (2009) 2.
[437] International Association of Deposit Insurers *'Public Awareness of Deposit Insurance Systems*' (2009) 5.
[438] Hargarter A & Van Vuuren G 'Assembly of a conduct risk regulatory model for developing market bank' available at *http://www.scielo.org.za/scielo.php?script=sci_arttext&pid=S2222-34362017000100011* (accessed on 01 November 2018).

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cannot afford as it leads to the consumers being over-indebted.[439] As part of holding the banking institutions accountable for any banking malpractice, the regulators are empowered rescind or revoke banking licenses or fine the directors for their lack of compliance with the law.[440] On the other hand, revoking or rescinding a banking license often become challenging because of the Too-Big-To-Fail doctrine, and also the importance of banking institutions in the broader economy. This lead to the regulators to only issue fines, which most banking institutions would rather pay than have their banking licenses revoked.[441]

4.6 Overview of the South African Reserve Bank

4.6.1 The role of the Central Bank

The fact that many of the financial safety-nets are housed within the South African Reserve Bank (SARB) is a justified ground to give an overview of the role of the SARB. This is aimed ensuring that there is no meddling of responsibilities concerning the regulation and supervision of banks.

In his address, the former governor, Tito Mboweni[442] highlighted that, by virtue of the SARB functioning as the central bank of the Republic of South Africa, its mission is to maintain financial stability, oversee, regulate and supervise South Africa's banking sector for the sustainability of efficiency and soundness in the banking system while issuing notes and coins. It can be gathered from the address that the SARB scope of mandate is broad. This justifies why the SARB operates differently from any other ordinary bank. Other writers have considered the SARB to operate on a 'non-profitable' and 'non-competitive' basis, but operating in the best interest of the general public.[443]

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[439] See Hargarter A & Van Vuuren G 'Assembly of a conduct risk regulatory model for developing market bank' available at *http://www.scielo.org.za/scielo.php?script=sci_arttext&pid=S2222-34362017000100011* (Accessed on 01 November 2018).

[440] Ernst & Young *'Financial Sector Regulation Act: Implementing Twin Peaks and the impact on the industry'* (2018) 5.

[441] Issing O 'Central bank independence – economic and political dimensions' (2006) 196 *National Institute Economic Review* 67.

[442] This was an address made by the former governor of the SARB, Tito Mboweni at the Pretoria Counsil for Businesswomen held on 14 March 200. Available at *https://www.bis.org/review/r000321a.pdf* (Accessed on 20 March 2019)

[443] Van Niekerk G & Van Heerden 'Twin Peaks: The Role of the South African Bank in promoting and maintaining financial stability' available at

http://etd.uwc.ac.za/

The SARB was established in terms of section 9 of the Currency and Banking Act 1920,[444] and it is currently governed by the South African Reserve Bank Act 1989 as amended.[445] At the moment, both Bank Act 1990[446] and the South African Bank Act 1989 and the regulations established in terms of the legislations – provide a legislative framework for the operation of the SARB. This legislative framework gives context to the Constitutional mandate of the SARB as envisage by section 224 of the Constitution of the Republic of South Africa.[447] Accordingly, section 224(a) of the Constitution provides that the duties of the SARB concern the protection of the value of currency, done in the best of a balanced and sustainable economic expansion.[448] These obligations are aimed at sustaining a consistent financial and price stability while stabilizing the banking system. In light of the oversight role, stability is guaranteed by effectively enforcing global and domestic regulatory and supervisory standards.[449] This aspect makes it necessary for the PA to be effective in the global financial landscape to ensure a domestic implementation of the international frameworks.[450] Despite the safety-nets being housed at the SARB, the independence and autonomy of the Reserve Bank is still guaranteed as envisaged by section 224(2) of the Constitution.[451]

The SARB has a sub-structure known as the Bank Supervision Department (BSD), which is entrusted with the responsibility to execute regulatory responsibilities on behalf of the general public.[452] Furthermore, the BSD promotes the stability and soundness of the banking system while assuming duties similar to those of the PA.[453]

https://repository.up.ac.za/bitstream/handle/2263/64057/VanNiekerk_Twin_2017.pdf?sequence=1&isAllowed=y (accessed 02 November 2018)

444 Currency and Banking Act 31 of 1920

445 See the South African Reserve Bank Act 90 of 1989.

446 Act 94 of 1990.

447 The Constitution of the Republic of South Africa, 1996.

448 The Constitution of the Republic of South Africa, s224(1).

449 Shawe L & Colegrave A 'Banking regulation in South Africa' Available on *https://uk.practicallaw.thomsonreuters.com/w-007-6934?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1* (accessed on 02 November 2018).

450 Shawe L & Colegrave A 'Banking regulation in South Africa' Available on *https://uk.practicallaw.thomsonreuters.com/w-007-6934?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1* (accessed on 02 November 2018).

451 See The Constitution of the Republic of South Africa, s224(2).

452 South African Reserve Bank *'Bank Supervision Department Annual Report 2016'* (2016) 1.

453 South African Reserve Bank *'Bank Supervision Department Annual Report 2016'* (2016) 1.

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This aspect significantly takes into account that robust regulatory oversight empirical to banking activities justifies the necessity to maintain the economic soundness and stability of the banking system.[454]

Guaranteeing a clear demarcation of duties between the safety-nets and the Reserve Bank is essential for the purposes of the study because that dispels the fear of interference of duties. At the same time, a convergence of the duties should be guided by the goal of effectively managing the banks. The goal does not negate the importance of independence and autonomy, especially for the Reserve Bank. This study is also not oblivious to the general concerns levelled against the independence of the Reserve Banks.

4.6.2 Concerns about the independence of the SARB

The concerns pertains to the excessive powers vested in the central bank which makes the Bank least susceptible to accountability while also paving a path for political influence.[455] In that sense, Goodhart and Lastra argue that central bank independence entails the freedom from political authority and from financial markets.[456] The authors further consider these two aspects to go hand in hand with their dual mandate of government's bank and banker's bank.[457] However, there are conflicting views insofar as the issue of independence is concerned. The first view is advanced by authors like Issing[458] submitting that the central bank independence embraces the notion of institutional independence whereby the presence of the set of legal frameworks ensures the Bank execute its mandate without external interference. The other view is held by Okeahalam[459] who departs from Issing's view, thereby perceiving the

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[454] See South African Reserve Bank *'Bank Supervision Department Annual Report 2016'* (2016) 1.
[455] Balls E, Howat J & Stansbury A 'Central bank independence revisited: After the financial crisis, what should a model central bank look like?' available at *https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/working.papers/x87_final.pdf* (Accessed on 20 March 2019).
[456] Goodhart C & Lastra R 'Populism and Central Bank Independence' Available at *https://link.springer.com/content/pdf/10.1007/s11079-017-9447-y.pdf* (accessed on 24 February 2020).
[457] Goodhart C & Lastra R 'Populism and Central Bank Independence' Available at *https://link.springer.com/content/pdf/10.1007/s11079-017-9447-y.pdf* (accessed on 24 February 2020).
[458] Issing O 'Central bank independence – Economic and political dimensions' (2006) 196 (1) *National institute Economic Review* 67.
[459] Okeahalam (1998) 40.

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independence of the SARB as a misnomer since central banks are not entirely immune to external directives in the event certain banks fail. The author's view is more concerned with an instance where there is no DIS to effectively manage bank failures. Accordingly, the SARB approach of bank failure management has been driven by political factors as opposed to pure central bank ethics.[460] This has been proven by the previous methods of bank rescues implemented when a number of small banks failed in South Africa. The arguments further resonate with the narratives expounded in the previous chapter which pointed out that the selective nature of rescuing banks begs for the adoption of a DIS with a clearly stated mandated.

4.7 Overview of the legislative framework

The legislative overview is essential insofar as the issue of corporate governance is concerned in the banking sector. For instance, the occurrence of the 2008 GFC has been attributable to the aspect of poor governance standards which is implicated as the dominant of contributor.[461] In the South African context, the breakdown in good governance has led to the failure of a number of small banks as depicted under figure one in chapter two.

The assumption therefore is that, the greater a bank is managed by way of upholding the principles of good governance, the lesser the banking risks may occur and threaten the existence of banks. This denotes that reasonable risk taking would always be guided by the principles of good governance which will be discussed in the following study. Ultimately, banking stability would be preserved whereby banking risks and the loss of depositors' deposits would be circumvented. A benefit would therefore accrue to the DIS because the system favours a banking system that is effectively managed. This does not take away the freedom of directors to run their corporation only to the extent that the freedom is within the boundary of good governance and effective accountability as guided by the regulatory and legislative frameworks.[462]

Understanding that good governance is instilled by directors or those in senior managerial positions, it is imperative for the study to explore the Companies Act 2008,

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[460] See Okeahalam (1998) 38.
[461] Kumar N & Singh J 'Global Financial Crisis: Corporate Governance Failures and Lessons' (2013) 4 *JFAM* 21-22.
[462] Kiadó A 'The ethical principles determining the contents of corporate governance rules and systems' (2005) 27 (2) *Society & Economy* 197.

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the Banks Act 1990 and King IV[463] which are a comprehensive framework aimed at ensuring that directors and executives of banks adhere to good governance principles. The essence of the frameworks takes into account that good governance stimulates efficiency in the functioning of the banking system such that, any breakdown or weaknesses thereof, may result in the transmission of problems in both the banking system and the economy.[464]

The study acknowledges that the concept 'corporate governance' does not have a universal definition. For the purposes of this research, corporate governance simply refers to the manner in which a corporation is directed and controlled,[465] done to safely secure the interest of those on whose behalf the corporation is managed and those who may be affected by how the corporation is managed.[466] The rationale of the control and management is further aimed at promoting and instilling proper behavioural standards while acquiring a maximum efficiency.[467]

The good governance propounded by the study pertains to the reasonable risk taking standards as pointed out earlier on. This is necessary because excessive risk taking gives rise to moral hazards that can inevitably tamper with banking stability and affect the operation of the DIS.[468] To this point, it is clear in the research that international bodies are committed to improve the standards of good governance while ensuring there is accountability in the banking sector. The commitment has been demonstrated by the previously expounded best practices such as Key Attribute (KA) 3.2 read with Core Principle 14 - all advancing the notion of good governance while directing for appropriate measures to be taken against culprits of poor governance.[469] Against this background, the following study explores the domestic legislative frameworks resonating with the best practices.

4.7.1 Position of South Africa's legislative frameworks

[463] King IV Report is a voluntary policy framework. See Institute of Directors in Southern Africa 'King *IV Report on Corporate Governance for South Africa* (2016) (Hereinafter referred to as 'Institute of Directors in Southern Africa (2016)').
[464] Basel Committee on Banking Supervision *'Guidelines: Corporate governance principles for banks'* (2015) 3.
[465] Rossouw G, Van der Wat A & Malan D 'Corporate governance in South Africa' (2002) 37 *JBE* 289.
[466] Wiese T *Corporate governance in South Africa, with international companies* 2 ed (2017) 2
[467] Wiese T *Corporate governance in South Africa, with international companies* 2 ed (2017) 2.
[468] Ketcha (09 February 2019).
[469] See KA 3.2 read with Core Principle 14.

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The Companies Act 2008 is significant insofar as it stresses the need for directors to be responsible and accountable, thus instilling a standard of behaviour to the directors.[470] The Banks Act 1990 operates alongside Companies Act 2008 for a better enhancement of good governance in the banking sector. As a matter of interpretation, the Banks Act does not supersede the application of the Companies Act 2008 and the provisions of other legislations. However, if the provisions of the Companies Act 2008 conflicts with the provisions of other legislations, both provisions of the legislations will prevail with an exception in the context of the Banks Act 1990 whereby if the conflict is irreconcilable, the provisions of the Banks Act 1990 takes precedence.[471]

The relevance of the legislations on the issue of corporate governance have their centrepiece on the regulation of the conduct of directors in the banking sector. In light of the codified duties under the Companies Act 2008, the banking directors are required to adhere to the standards of care, knowledge and skill generally applicable to all corporate directors as envisaged by section 76(3)(c) of the Act.[472] Since the banking business is given special attention because of carry a significant public profile in contrast with ordinary corporations,[473] the banking directors are therefore subjected under additional and specific requirements as codified by the Banks Act 1990, particularly under section 60(1A)[474] read with Regulation 40.[475] In essence the directors need to, amongst other things, act bona fide for the benefit of the bank, uphold a particular kind of care, skill and possess the knowledge expected of directors of banks in the performance of their duties.[476] The duties would essentially denote the banking director's care and skill to take reasonable risks without putting the sector at risk, and also being informed of the accompanying consequences and benefits. The 'standard of care' is particularly determined on the basis of a diligent person in a similar position as the director.[477] In essence, a director's conduct that is contrary to the spirit

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[470] Deloitte *'Duties of Directors''* (2013) 4.
[471] Act 71 of 2008 s5.
[472] Act 71 of 2008 s76*(3)(c).*
[473] Deloitte *'Duties of Directors''* (2013) 76.
[474] Act 94 of 1990 s60(1A).
[475] This regulation is part of the Banks Act 94 of 1990 regulations. The regulation specifically requires directors to have basic knowledge concerning the banking business, and the directors are further obliged to carry their duties with care and diligence. Banks Act regulations in GN 1029 OF *GG* 35950 of 12/12/2012.
[476] See Act 94 of 1990 s60(1A) read with GN 1029 OF *GG* 35950 of 12/12/2012, reg 40.
[477] See Act 94 of 1990 s60(1A).

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of these provisions constitutes a breach of duties in accordance to the provisions of the Companies Act that will be detailed later in the study.

The process of corporate governance has to be effectively consistent with the nature, complexity and risks embedded in the bank's balance sheet activities, while also flexible to the changing environment of the banking sector.[478] The risk management strategy comes as an attempt to promote good governance expected of the directors in the running of the banking business. This aspect resonates with regulation 38[479] which confers a responsibility on the directors to implement a potent corporate governance structure for the banks. The structure is aimed at ensuring that the bank's risk, complexity and nature of operation does not go beyond the point of good governance because, the banking business is significantly based on a proper and adequate handling of distinct risks having a negative impact on the banking system.[480]

To ensure there is compliance with the variety of legislative and regulatory frameworks, the banking directors have to implement and internal compliance function so as to attenuate the risk of non-compliance and regulatory arbitrage.[481] Put broadly, compliance with the prescripts of the law remains a vital pillar, albeit appearing as a burden to the banks. In that vein, Marx and Mynhardt affirmed the complexity of cost implications associated with regulatory compliance, and proposes that the banks be assisted with the calculations, and in the reduction of such costs.[482]

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4.7.2 Overview of King IV Report

The above legislative framework is supplemented by the King IV Report on Corporate Governance in South Africa (King IV) as established by the Institute of Directors in Southern Africa (IoDSA).[483] The concept corporate governance believed to have been improved and broadened under King IV because of promoting the notion of ethical leadership and effective leadership simply to achieve, inter alia, ethical culture, good

[478] Global Legal Insight 'Bank governance and internal controls' available at https://www.globallegalinsights.com/practice-areas/banking-and-finance-laws-and-regulations/south-africa (Accessed on 18 November 2018)
[479] GN 1029 OF *GG* 35950 of 12/12/2012, reg 38.

[481] See GN 1029 OF *GG* 35950 of 12/12/2012, reg 47.
[482] Marx J & Mynhardt R 'The cost of compliance: The case of South African banks' (2011) 8 *COCJ* 8.
[483] See Institute of Directors in Southern Africa (2016) 1.

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performance and effective control.[484] The concept further gives a novel impetus that corporate governance is not only concerned with merely running a company. While management concerns itself with the running of the corporation, governance ensures that the corporation is ran properly.[485] The ultimate understanding, however, is that corporate governance is all about the sustainability of companies.[486] To achieve the goal of sustainability as expected by King IV, pillars such as leadership, oversight management, ethical conduct, transparency and accountability remains the driving factors so as to advance the interests of the stakeholders.[487]

King IV has [a] universal application. This means corporations of all kind, banks included, can adopt the framework to enhance good governance. The universal application is enforced taking into account that the framework is voluntarily assumed with an exception on the companies listed in the Johannesburg Stock Exchange (JSE) which are obligated to comply with King IV.[488] Accordingly, the obligation has been established by section 3 of the 2017 amended JSE listing requirements whereby the JSE listed companies are mandated to comply with King IV.[489] This mandatory application entails that King IV is applied with the legislative frameworks, thus creating a shift towards a hybrid approach of instilling good governance.

A bank's compliance with the requirements, despite their voluntary nature, can essentially contain the risk moral hazard because both King IV and the legislations are the bedrock principles of good governance. However, King IV and its application further dispenses a distinct impetus concerning the enforcement of adequate leadership that is underpinned by the observance of good governance of all kind,[490] hence banks need to observe the principles simply to maintain the status of responsible 'corporate citizenship'. To qualify this claim, the study relies on the argument advanced by IoDSA that – it has become acceptable that corporations

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[484] Padayachee V 'King IV is here: Corporate governance in South Africa revisited' (2017) 2017 *SAJSEP* 17.
[485] Tricker R Corporate Governance (2000).
[486] Amned M *Corporate governance in the Southern African development community* (Published LLM, University of the Western Cape, 2016) 21
[487] Amned M *Corporate governance in the Southern African development community* (Published LLM, University of the Western Cape, 2016) 21
[488] LexisNexus '*The JSE Listings Limited Listings Requirements'* Bulletin 1 of 2017
[489] LexisNexus '*The JSE Listings Limited Listings Requirements'* Bulletin 1 of 2017
[490] Institute of Directors in Southern Africa (2016) 6.

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operate within the dimension of the environment, society and economy, and their methods of generating a profit impacts these three dimensions.[491] On the basis of a similar analysis, Benston[492] believes that the ultimate result of a bank's failure negatively impact the banks' stockholders, employees, customers and the communities wherein they are located. The significance of the social responsibility of directors and their corporations has been considered in the *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Company Limited and others* 2006 (5) SA 333 (W).[493] The court emphasized on the broader responsibilities of directors and the corporation, and had directly referenced King Code which is contemporarily interpreted as being *de facto* part of the director's duties.[494]

In light of the above arguments, the researcher maintains that the bank's engagement in risk taking unguided by the principles of good governance can cause a disruption in a number of aspects. In fact, excessive risk taking creates a banking business that is unsafe whereby the trust of depositors and the public is undermined.[495] Taking it a step further, the idea of responsible 'corporate citizenship' is the pillar of the SARB which is aimed at ensuring that banking business is conducted with transparency necessitated by ethical values, and the respect for the law and the environment.[496] The SARB's approach resonates with the Code of Banking Practice of South Africa which strengthens both the services and conducts of the banking business when dealing with customers – all guided by amongst other things transparency, accountability and fairness.[497]

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4.8 Evaluating the legislative frameworks

To this point, it can be understood that regulation and supervision is key to a healthy functioning banking sector. On the other hand, the legislative frameworks, and the

[491] Institute of Directors in Southern Africa (2016) 4.
[492] Benston G 'Is government regulation of banks necessary' (2000) 18 *JFSR* 190.
[493] *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Company Limited and others* 2006 (5) SA 333 (W)
[494] See *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Company Limited and others* 2006 (5) SA 333 (W)
[495] Brown M 'Report by the chairman' available on *https://www.banking.org.za/news-media/publications/reports/2019-report-by-the-chairman* (accessed on 22 March 2019).
[496] South African Reserve Bank 'Corporate Citizen' Available at *https://www.resbank.co.za/AboutUs/CorporateCitizenship/Pages/CorporateCitizenship-Home.aspx* (accessed on 1 November 2018).
[497] Banking Association of South Africa *'Code of Banking Practice'* (2012) 3.

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Twin-Peaks, create an impression that banks would be strictly regulated or 'overregulated' to a point that generating a profit would be a cumbersome task. Strict regulation is considered to be a cause of unintended consequences by virtue of diminishing creativity among the banking directors, resulting in exorbitant compliance costs and vast capital requirements.[498] On the other hand, the stringent regulation is aimed at preserving the trust that has been attained through sound governance, transparency and good conduct.[499] This is the reason why Marx and Mynhardt affirmed the complexity of cost implications associated with compliance, and proposes that the banks be assisted with the calculations, and in the reduction of such costs.[500]

To closely examine the aspect of overregulation, a strong argument persist that the compliance with a variety of legislation or regulations cannot be equated to overregulation insofar as the ultimate goal of regulatory measures is aimed addressing prudential and conduct of business regulation.[501] In a similar vein, the growth and finance literature also propounds that regulation, compliance and enforcement are essential tools to instil a sound operation of the financial system, ultimately the banking sector.[502] Despite other academics supporting a deregulated system, the study assumes that banks cannot be trusted to prudently act on their own, and this has been proven by the 2008 GFC.[503] Regulatory weaknesses such as inadequate capital, insufficient liquidity and poor governance were viewed as contributory factors that led to the 2008 GFC, therefore regulatory supervision has been preferred by the BCBS to address these systemic inadequacies.[504] The preference gives credence to the strict

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498 Financial Times 'Too much regulation creates bank brain drain' Available at *https://www.ft.com/content/4dfc4190-719f-11e5-9b9e-690fdae72044* (Accessed on 28 November 2018).

499 Brown M 'Report by the chairman' available on *https://www.banking.org.za/news-media/publications/reports/2019-report-by-the-chairman* (Accessed on 22 March 2019)

500 Marx J & Mynhardt R 'The cost of compliance: The case of South African banks' (2011) 8 *COCJ* 8

501 Chimbombi (2015) 37.

502 Centre for Economic Policy Research *'The causes and consequences of banking regulation: The case of Sweden'* (2011) 2.

503 Reichwald H 'Does Overregulation Lead to Underperformance' Available at *http://ww2.cfo.com/regulation/2016/10/does-overregulation-lead-to-underperformance/* (Accessed on 28 November 2018).

504 Zairis A & Zairis G 'The effects of banking regulation and supervision on the banking system overall stability: the case of Greece' available at *https://www.europeanbusinessreview.eu/page.asp?pid=2397* (Accessed on 30 November 2018.

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regulation of banks as a way of preserving their reputation in the domestic and global banking system simply to avoid another financial meltdown.

However, the duties outlined by section 76 of the Companies Act 2008 read with section 60 (1A) of the Banks Act 1990 raise the bar for the directors, and they are a foundation for good governance. In fact, when directors accept their appointment, they commit to perform their duties to a certain standard, and it is a reasonable assumption that they shall apply their skills, experience and intelligence for the benefit of the corporation.[505] On the other hand, it cannot be overlooked that directors are not perfect, therefore not all judgment would be accurate. The salient question is what happens to the decisions that were made with a high degree of honesty, but turned out wrong. This question is vital because if a decision turns out wrong, adverse financial impact may result in a corporation. Statutorily, that constitutes a breach of directors' duties which further attracts liability insofar as the Companies Act is concerned. Put differently, should the director's conduct not satisfy the standard of care, skill and knowledge as expected by both the Banks Act and Companies Act, or carries banking business in a reckless manner, liability will be attracted in a manner shown herein;

(i) Firstly, the director may be civilly liable in terms of section 77(2)(b) for the losses sustained by the bank caused by the breach of the duties.[506]

(ii) Secondly, the banking director may also be civilly liable in terms of 77(3)(b)[507] and 218[508] for the loss, damage and costs sustained by the bank if the director deliberately carry the business in a reckless manner that is prohibited by section 21 (1) of Companies Act.

(iii) Lastly, section 26(6), known as the catchall section, ensures that shareholders have a claim for damages against any person's intentionally causes a bank to do anything contrary to Act.[509]

[505] Deloitte *'The Companies Act: Implications for directors and prescribed officers'* (2013) 3.
[506] Act 71 of 2008 s77(2)(b).
[507] Act 71 of 2008 s77(3)(b).
[508] Act 71 of 2008 s218.
[509] Act 71 of 2008 s26(6).

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Furthermore, section 60(1B)[510] of the Banks Act present a fundamental inconsistency because of drawing a distinction between the banks that are in liquidation and the banks that are not in liquidation. In that vein, the provision empowers the Registrar of the SARB to invoke section 77 of the Companies Act 2008 to hold accountable the directors of banks that in liquidation. On the hand, the Registrar can enforce section 424 of the Companies Act 1973[511] against the directors of banks that are either in liquidation or not in liquidation. The implication of the inconsistency gives rise to the process of decriminalizing the directors' misconduct which is adopted by of the Companies Act 2008.[512] The next chapter shall briefly discuss the inconsistency with further recommendations.

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[510] Act 94 of 1990 s60(1B).
[511] Companies Act 61 of 1973.
[512] Hogan Lovells 'Criminal liability for bank directors? A look at the United Kingdom and South Africa' Available at *https://www.hoganlovells.com/publications/criminal-liability-for-bank-directors-a-look-at-the-united-kingdom-and-south-africa* (Accessed on 29 November 2018).

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4.9 Shielding banking directors against liability

This section of study is sought to dispel the fear of liability among banking directors. It must nonetheless be noted that, the success of a company is deeply based on the director's ability to take reasonable, yet risky business decisions.[513] Banks are not an exception to this aspect. The Business Judgement Rule (BJR) is a judicially established legal principle aimed at protecting directors of companies against the exposure of liability for their error in judgement or lapse of ordinary care wherein the error in judgement or business making decision turns out bad.[514]

The aim is to ensure that directors are not prevented or threatened to take bold decisions to maximize profit because, the business is about risk, and sometimes the best laid plans do fail.[515] Only when the decision is within the confines of section 76(4)(a) of Companies Act 2008 would the allegation of breach fall short. According to this provision, the director satisfies his/her obligations under section 76(3)(b) and (c) if he/she;[516]

i. takes reasonable and diligent steps to become sufficiently informed of the specific matter under consideration by the board,

ii. had no material personal financial interest regarding the matter of the decision taken, or discloses his/her interest to the board, and

iii. Rationally believes that the taken decision was in the best interest of the company.

The King Report also recommends the protection of directors against liability for the breach of care and skill to the extent that the directors' exercise of business judgement was within the confines of 76(4).[517] This approach came as a need to expand business

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[513] Cassim et al *Contemporary Company Law* 2ed (2012) 572.
[514] Branson D *'Business judgment rule for incorporation jurisdictions in Asia'* (2011) 23 *SAcLJ* 688.
[515] Institute of Directors in South Africa 'Director's duties and liability' Available at https://www.iodsa.co.za/news/378187/Directors-duties-and-liability.htm (accessed on 29 November 2018).
[516] Act 71 of 2008, s76(4)
[517] Joubert D *Duty of care: A legal analysis of the Business Judgment Rule and the liability of directors of directors for environmental damage in the South African mining industry* (Published LLM, University of Pretoria, 2017) 45

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development whereby individuals who possess the necessary expertise are not discouraged to accept appointments, and be innovative in the business industry.[518]

However, the BJR is not a fortress for any fraudulent and shady business dealings.[519] Put simply, the banking directors cannot rely on the BJR in instances where the directors took risky decisions falling outside the prescripts of section 76(4). The rule furthers the objectives of the Companies Act 2008 because directors are responsible for the day to day activities of corporations, not regulators or judges who may not be at best position to balance the interests of parties in the operation of the business.[520] This is not to say reckless misconduct should be condoned because it is equated to gross negligence strictly prohibited under section 22(1) of the Companies Act 2008.[521] For instance, excessive risk taking by the banking directors can inevitably give rise to moral hazards as was shown earlier in the study. Moral hazards are not desirable for both the banking and financial systems. In light of that, the researcher submits that moral hazard goes beyond the demarcation point of the BJR, therefore banking directors may not be protected for putting the banking system at risk.

4.10 Conclusion

It has been established in the study that the DIS favours a healthy banking sector that is governed by robust regulatory frameworks. To a large extent, South Africa's banking system is the safest insofar as the regulatory frameworks are constantly reformed. This argument strongly persist since the reformation saw the introduction of the Twin-Peaks that introduced the PA, which guarantees the prudential safety and soundness of the banking system and the FSCA, which promotes the consumer protection.[522] The consumer protection and stability of the banking system is similarly advanced by the DIS. Therefore, a coordination between these safety-nets has been propounded for the realisation of those goals, especially the goals of the DIS so as ensure a profound implementation of the system while mitigating moral hazards.

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[518] See Joubert D *Duty of care: A legal analysis of the Business Judgment Rule and the liability of directors of directors for environmental damage in the South African mining industry* (Published LLM, University of Pretoria, 2017) 46

[519] Cassim F *The practitioner's guide to the Companies Act 71 of 2008* (2011) 92

[520] Muswaka L 'Directors' duties and business judgment rule in South African law: An analysis' (2013) 3 *IJHSS* 92.

[521] Act 71 of 2008 s 22(1).

[522] Minister of Finance *'Implementing the Twin-Peaks Model of financial regulation'* (2013) 6

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The legislative frameworks has been expounded for the purposes of enhancing good governance, accountability, and ensuring there is liability for engaging in moral hazards. Directors are also guaranteed protection upon meeting the prescripts of section 76(4) of the Companies Act of 2008. However, the regulatory and legislative frameworks are not an ultimate arbiter of moral hazards. They are simply aimed at containing the feared risk of moral hazards by way of instilling the pillar of good governance in the banking. However, the expounded legislative and regulatory frameworks shall be used as a yardstick in the next chapter to determine whether South Africa is ready to have a safety net in a form of the DIS.

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Chapter 5

Conclusion and recommendations

5.1 Introduction

This research aimed to evaluate and discuss the significance of a Deposit Insurance System (DIS) as a form of financial safety-net for the protection of bank customers, and reforming the regulatory stability in the South African banking sector. The advantages and disadvantages of the DIS have been weighed against those of the implicit method of bank rescue. In that sense, it has been shown that the current implicit system is a government policy framework whereby banks are rescued using taxpayer's money. To that end, the qualitative measures for a bank to qualify for a rescue under the implicit system have been considered to be inequitable. Thereby, working against small banks and stifling competition by way of promoting the concentration and dominance of the big banks in the banking sector. However, the DIS has sought to discard the aforesaid factors, and to ensure that the small banks could compete on an equal footing with the big banks.

In light of the discussion and evaluation done in the research, this chapter gives a conclusion by answering the research question of 'whether South Africa should adopt the DIS'. The chapter further makes recommendations on how to achieve an effective and feasible implementation of the system. However, the answer and recommendations herein are imperatively influenced by the sub-inquiries expounded under chapter one which, in turn, influenced the findings made in the research.[523]

5.2 Conclusion

5.2.1 Brief findings about the DIS

The findings in the research has essentially shown that the DIS plays a huge role in the economic and banking stability by way of safeguarding against financial shocks and protecting depositors. The extended protection significantly preserves the pillar of trust and confidence in the banking system. In the research, it has been shown that

[523] See paragraph 2.2.1 of chapter one which dispensed the sub-inquiries.

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the system has long been the cornerstone of the American banking sector since the Great Depression (GD), adopted to mitigate banking panics, and had, seemingly, restored confidence in the banking system.[524]

It can be inferred from the study that interest in the DIS had dissipated over time until the 2008 Global Financial Crisis (GFC) occurred. In essence, the aftermaths of the 2008 GFC exposed the weaknesses of the existing regulatory frameworks and methods of circumventing banking crisis.[525] To remedy this deficiency, the adopted best practices such as the Key Attributes (KA), Core Principles and Basil Accord III, became pivotal instruments that gave guidance towards the implementation of a robust DIS to protect banking systems and relinquish the government from bearing the burden of rescuing banks. The international financial institutions that issued the best practices had further imposed a duty on their member states to adopt the DIS. Many jurisdictions attempted to align their deposit insurances with the best practices, with others simply replacing the implicit system with the DIS. Since then, the role of the DIS as a measure of preserving financial stability has evolved, and the role of the system in the financial safety-net has been enhanced and clarified.[526]

5.2.2 Expressed intentions to have the DIS in South Africa

South Africa has since acknowledged the significance of the DIS albeit the implementation of the system still being in the pipeline. This has been highlighted in the proposed policy frameworks as a comprehensive regulatory foundation of the DIS aimed at achieving the fundamental objectives of an ordinary DIS which conforms to the needs of the South African banking sector. These needs ordinarily pertains to, amongst other things; the assurance of vulnerable depositors that their deposits are safe; minimizing systemic risks during bank failures and assuring bankers not to wind-up their assets to meet deposits on demand since the deposits are guaranteed by the DIS. The assurance given to the bankers and depositors is aimed at preserving trust and confidence in the operations of the South African banking business.[527] Most

[524] See paragraph 2.1 of chapter one insofar as the historic background of the DIS is dispensed.
[525] See paragraph 3.2 of chapter three giving an indication that interest in the DIS resurfaced in 2008 since the 1930s Great Depression (GD).
[526] See paragraph 3.3 of chapter three giving an overview of the best practices many under compliance.
[527] See paragraph 2.1 of chapter one read with paragraph 2.5 of chapter 2 giving a brief overview of the proposed framework of the DIS, the rationale and the banking pillars sought to be enhanced.

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importantly, the DIS is aimed at addressing the existing gap in South Africa's financial safety-net by bringing South Africa on par with international best practices and innovations, and other G-20 members that have already implemented the system.[528]

5.2.3 Inadequacy of the current system

The inadequacy of the current implicit method of bank rescue has been of serious concern in the research. Under this system, small banks have continuously failed leading to the inconveniencing of vulnerable depositors. This is because the implicit system does not have a clear policy framework, thereby rescuing banks selectively as per the demonstrated case of BEO bank and Saambou bank as well as the case of African Bank and VBS mutual bank.[529] The small banks continuously suffered a competitive disadvantage because of the concentration and hegemony implanted by the big banks leading to the latter banks being considered safer than the former banks because of their 'Too-Big-To-Fail' status. The research then relied on empirical evidence which projected the big banks as putting the banking sector at greater risk because of having a high systemic risk percentage, coupled with a large market share percentage.[530] The absence of the DIS therefore entails that the risk is made the responsibility of the government as per the uncertainty of the implicit policy of bank rescue. In light of this analysis, the researcher ultimately contend that the implicit system is disadvantageous, therefore undesirable. Thereby, making it significant to consider the DIS simply to disburden the government from bearing the costs of the risks imposed by the banking sector.[531]

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[528] See paragraph 2.2.2.1 of chapter one insofar as sub-inquiry 2.2.1.2 is concerned, considered in conjunction with paragraph 3.3 of chapter three wherein South Africa attempts to comply with its international obligation of adopting the DIS as imposed by the Financial Stability Board.
[529] See paragraph 2.2 and 2.3 in conjunction with 2.5 of chapter two insofar as the advanced hypothesis and the demonstration have shown that the implicit system is inadequate, which is the reason why small banks have failed in abundance since 1994.
[530] See paragraph 2.4 and 2.10 which clearly unveiled the risks posed by the big banks and the extent to which small banks are disadvantaged by the dominance of the big banks.
[531] See paragraph 2.2.1 of chapter one on account that this narrative covers the aspects of sub-inquiry 2.2.1.1 and the examples made thereto.

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5.2.4 Risks of the DIS and mitigant strategies

The research has conceded that the risk of moral hazards and the lowering of depositors' incentives are a perverse effect created by the DIS, thus becoming formidable hurdles for the implementation or operation of the system. However, there are measures that can be put in place to mitigate the identified risks for the purposes of achieving a robust and effective DIS. The regulatory frameworks, especially the Core Principles, gives clear guidance on how to avoid the risks. The opinions of academics are also imperative insofar as crafting a robust DIS is concerned. Amongst other things, there has to be sufficient public awareness of the system; the system should be built on a robustly regulated and supervised banking sector; the system should be carefully designed, thus equipped with robust design features and a proper administration; and there has to be an enhanced coordination among the financial safety-net participants – pillars considered to be a bedrock in order for the DIS to achieve its foremost goals.[532] The aspect of moral hazards has been construed to disadvantageously occur when banks partake in excessive risk taking knowing they will be rescued in the event the bank is distressed. On the other hand, the diminishing of depositors' incentives stimulates moral hazards because of the scale-back by depositors to monitor the activities of the banks since the DIS guarantees the reimbursement of their deposits in the event of bank failure.[533] The risks are not taken lightly by the research and it would be imprudent of any regulator to undermine the reality of their existence because they can be disadvantageous if not carefully taken into consideration when designing a DIS.

5.2.5 The explored domestic regulatory and legislative frameworks

The existing South African legislative and regulatory frameworks and best practices have also been identified as key instruments for the mitigation of the indicated risks, thereby ensuring an efficient operation of the DIS.

In essence, the regulatory framework, in the form of the Twin-Peaks, vest the Prudential Authority (PA) and Financial Sector Conduct Authority (FSCA) with the role

[532] See paragraph 2.8 and 2.9 of chapter two in conjunction with paragraph 3.3.2 of chapter three insofar as proposed mitigating the risks attracted by the DIS is concerned.
[533] See paragraph 3.4 for a better understanding of how the risk of moral hazard and the undermining of depositors' incentives manifest in the presence of the DIS.

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of stabilizing the banking sector while protecting bank customers. By virtue of the PA and FSCA being part of the safety-nets for financial stability, the coordination pillar under Core Principle 6 is applicable, thus transcends to an integrated role of all financial safety-net participants to stimulate the functioning of the DIS to contain moral hazards. In the coordination setting, the PA solely promotes prudential soundness and stability, meanwhile the FSCA ensures that the bank's conduct is within the confines of the law.[534]

On the other hand, the legislative frameworks comprising of the Banks Act 94 of 1990 and the Companies Act 71 of 2008 read with King IV significantly focus on enhancing corporate governance by prescribing a standard of behavior to the banking directors. It has been shown that the Banks Act strictly enhances the standard of behavior prescribed by section 76(3) of the Companies Act. In essence, section 60(1A) of the Banks Act expects the banking directors to uphold a particular kind of behavior, thus prescribing additional requirements for the directors. To attempt a delineation of the provisions, the research propounds that the banking directors need to aim for a high probity of effective and ethical leadership for the attainment of components such as good performance, ethical culture and effective control. The ultimate notion therefore is that the director's will to comply with the prescribed duties would be equivalent to taking banking risks reasonably. This significantly refers to the risk that is consistent with the pillar of good governance which is a driving factor in the banking system. The identified banking directors' duties on good governance further encompasses the idea of effective board oversight, robust internal controls, compliance and effective risk management. In a slightly different vein, the research takes into account that yielding high profitability is premised on the taking of risks, and sometimes the risks are taken without malice, yet they turnout wrong. The presumption therefore is that the banking directors have breached their duties. This is because the failure of the banking directors to live up to their duties of directorship as prescribed by the legislation constitutes a breach of duties, thereby attracting liability as was detailed in the previous chapter.[535]

[534] See paragraph 4.4 of chapter four which details the role of the existing financial safety-nets for the purposes of mitigating the identified risks.
[535] See paragraph 4.7 of chapter four which identified and discussed the legislative frameworks that guides the actions and behaviour of the banks in the context of good governance so as to avoid putting the banking sector at risk.

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However, the approach of the regulatory and legislative frameworks is consistent with the Core Principles and KAs, altogether enforcing accountability, regulation and supervision to achieve better standards of corporate governance. The research thus interpreted the sought-after governance standards as a yardstick to contain the risks attracted by the DIS.[536] This partly dispels much of the detractions advanced by the anti-explicit DIS proponents that the DIS attracts risks, therefore should not be implemented. The research also acceded to the genuine concerns that the DIS detracts from directors' creativity because of the fear of potential liability for breaching section 76(3) of the Companies Act read with section 60(1A) of the Banks Act. However, that concern has simply been addressed by exploring the Business Judgment Rule (BJR) which affords protection to the banking directors for decisions that have been taken honestly, yet turned out wrong. But only to the extent that the decisions are within the confines of section 76(4)(a) of the Companies Act will the banking director find protection.[537]

5.2.6 Should South Africa adopt the DIS?

Whether South Africa should adopt the DIS remains a central question which is at the heart of the research. Prior to answering the question, and despite some people opposing the system's implementation, the researcher has made significant findings that the concern of moral hazard and detraction of depositors' incentives are sometimes levelled without heeding the expounded legislative and regulatory frameworks that have successfully safeguarded the South African banking sector. The strong finding on the robust frameworks led to the research agreeing that South Africa's banking sector is among the safest and healthiest banking sectors across the globe.[538] On the other hand, the trendy failure of the small banks gives an impression that the sector may not be safe enough for the survival of small banks and their vulnerable depositors. This is because the regulator has always been reluctant to rescue the small banks because of the perception that these banks do not pose a systemic risk to the banking stability, therefore are not TBTF as per the advanced hypothesis in chapter two.[539] The perception is peculiar because the collapse of these

[536] See paragraph 4.7 of chapter four dealing in-depth with the enhancement of good government.
[537] See paragraph 4.9 of chapter four insofar as protecting the directors against liability is concerned.
[538] See paragraph 2.1 of chapter two highlighting the adequacy of the banking sector.
[539] See paragraph 2.7 insofar as the hypothesis are concerned.

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banks have always exposed the vulnerable depositors to a severe vulnerability, and this vulnerability appears to be of no concern to the regulators.[540]

Given the fact that the advantages of the DIS outweighs the disadvantages of the system; the DIS is more favorable than the implicit system; and given that the DIS favors a well-regulated and supervised banking sector like that of South Africa, the researcher therefore submits that South Africa is in a better position to adopt a safety-net in the form of a DIS. The perceived robustness of the banking sector gives firm hope that the DIS will have a strong foundation which is a significant aspect that determines the effectiveness of a DIS. By virtue of adopting the DIS, the safety of vulnerable depositors would be guaranteed, the banking sector would be reformed and banking stability would be emboldened.

Most importantly, guidance can be derived from the international best practices and lessons can be learned from the jurisdictions in the Eurozone and the United States (US) which have distinctly designed theirs as shown in chapter three.[541] The ultimate goal should be to implement a DIS that furthers its objectives without burdening the banking sector.

5.3 Recommendations

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The research has discussed and evaluated the importance of a DIS, ultimately contending that it is safe for South Africa to implement the system. The risks posed by the DIS have also been explored together with the legislative and regulatory frameworks sought for mitigation purposes. However, to achieve a feasible implementation of the DIS, its effectiveness and adequacy without tampering with the banking sector while enforcing good governance standards, the following recommendations are proposed:

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[540] See paragraph 2.4 of chapter two whereby the small banks and their vulnerable customers have always been given minimal attention amidst their collapse.

[541] See paragraph 3.5 of chapter three giving a comparative analysis of how the jurisdictions adopted the DIS.

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5.3.1 The discussed regulatory and legislative risk management tools should be constantly reformed

The research has shown that the 2008 GFC unveiled anomalies in the existing regulatory risk management mechanisms of the global banking system. On the other hand, South Africa's regulatory and legislative mechanisms of risk management have been construed to be robust such that they can mitigate the risks attracted by the DIS. Despite the perceived robustness of the existing risk management mechanisms, the research recommends that these mechanisms should be constantly reformed simply to be compatible with the growing need of risk taking in the banking business. This aspect is imperative because, in this era of technological advancements, the risk taking standards of the banks will inevitably evolve like they did during the GD leading to the 2008 GFC. The constant reformation will allow the risk management instruments to be consistent with the evolution of the contemporary kinds of risks which are stimulated by the technological innovations.[542]

The essence of this recommendation dismisses the notion of some scholars endorsing a deregulated banking sector because the dispensed narratives in the study showed that banks cannot be trusted to prudently act on their own. Therefore, the risk management mechanism in a form of the legislation and regulations are pivotal insofar as preserving the standards of good governance is concerned.

5.3.2 Remedying the deficiency in the current legislation

There is a deficiency in our law which has been identified under chapter four. The deficiency specifically concerns the application of section 60(1B) of the Banks Act 1990. This provision draws a differentiation insofar as it mandates the application of section 424 of the Companies Act 1973 against directors of banks that are in winding-up, and section 77 of the Companies Act 2008 against directors whose banks are not in liquidation. This creates an inconsistency because the latter Act substitutes the criminal sanctions with civil liability insofar as the banking directors' misconduct is concerned.[543]

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[542] See McKenzy&Company *'The future of bank risk management'* (2015) 3

[543] See paragraph 4.8 of chapter four in that regard.

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The recommendation therefore is that the old Companies Act should not at all apply to banks when they are in liquidation. In a nutshell, section 424 of this Act imposes criminal sanctions against banking directors who knowingly carry the banking business in a reckless manner. Previous experience has unveiled the shortcomings of this provision wherein many banking directors have not been prosecuted because of the lack of skills and the reluctance to prosecute technical corporate offense leading to directors going scot-free.[544] The recommendation also takes into account that the approach of section 424 has been differently incorporated in section 76 of the Companies Act 2008 which prescribes for the banking directors' standard of conduct. The breach of section 76 allows for the institution of civil liabilities as empowered by section 77(2)(b), section 76(3)(c) and section, and section 20(6) of the new Companies Act. This would allow depositors to have a recourse for any damages suffered as a result of the directors' reckless conduct. In essence, section 60B of the Banks Act 1990 should be amended to align with section 76 of the Companies Act 2008.

5.3.3 There has to be an early implementation of the DIS as a precautionary measure to safeguard the depositors

An early implementation of the DIS is also recommended as opposed to implementing the system in times of financial crises. This recommended approach is vital insofar as it allows for a robust DIS to be designed. This DIS can be fairly instilled with credible and adequate design features in anticipation of any banking crises. The essence is that an early implementation of the system will inevitably instill assurance in the adequacy of the DIS and the banking system. As it has been emphasized in the research, assurance significantly strengthens confidence and trust which are imperative pillars for an effective running of the banking business. The most recent 2008 GFC has also proven that implementing the DIS in times of financial crisis is not desirable because crises are panic-based events, as a result they can be circumvented by an early and credibly designed DIS.[545] This recommendation is advanced in light of the fact that South Africa's financial economy is strongly integrated to the global economy on the basis that South Africa is a member of a number of

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544 See Hogan Lovell 'Criminal liability for bank directors? A look at the United Kingdom and South Africa' available at *https://www.hoganlovells.com/en/publications/criminal-liability-for-bank-directors-a-look-at-the-united-kingdom-and-south-africa* (Accessed on 27 June 2019)

545 See paragraph 2.5.1.2 chapter two above.

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international financial forums and these forums expect their member states to implement the DIS.[546]

Following the narratives of chapter two, the research provides that if the integrated global economy could be in a financial calamity, South Africa would be directly affected. As a result, only small banks' customers would be severely affected given the fact that these small banks are least prioritized by the regulator.[547] Therefore, South Africa need not wait for another GFC to occur simply to realise the importance of the system. Lessons should be learned from other jurisdictions while being guided by the explored best practices in chapter three.

5.3.4 The plausible mitigant strategies should be considered

In accords that the robustness of a DIS is dependent on how the system has been designed and its administration. It is worth considering that, amongst other things, making membership compulsory, limiting coverage and privately administering the DIS are key designs features that that emboldens the robustness of the DIS, and these features should be maintained. A DIS with design features contrary to the aforementioned constitutes to a poorly designed system.[548]

On the other hand, the research strongly believes in the pillar of coordination among the safety-net participants as proposed by domestic and international regulatory frameworks. Therefore, the existence of the DIS as a separate juristic person need not trump the pillar of coordination. In essence, coordination strengthens stability, and also guarantees the protection of the depositors' interests. The enhancement of this pillar should be done in two forms; the first being the coordination among the domestic safety-nets in the financial sector whereby the integrated duties of all financial safety-nets should be carried out in a manner that mitigates the risk of moral hazards. Thereby, stimulating the productivity of the DIS. The second aspect of coordination assumes the form of coordination across country borders whereby agreements should be effected between the domestic DIS and foreign DIS insuring its banks in South Africa. This simply transcends to having a cross-border crisis management tool which

[546] See paragraph 3.3 of chapter two which identified this international bodies.
[547] See paragraph 2.7 of chapter two which advanced fundamental hypothesis in that regard.
[548] See paragraph 2.6 of chapter two above.

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shall stimulate the sharing of information between the jurisdictions simply to guard against banking risks.

All these forms of coordination should not be used as an opportunity to interfere with the mandate of the DIS such that its policy objective would be reduced to redundancy. As per the research, the policy objectives of the DIS pertains to amongst other things, the protection of vulnerable depositors while stabilizing the banking sector simply to achieve a less concentrated banking sector whereby small banks could fairly compete with the big banks. This policy objective must be well understood by all financial safety-net participants as well as the public simply to avoid the distortions that may result in the occurrence of moral hazards.

Final comments

The aim of the research was a significant 'evaluation and discussion of a Deposit Insurance System' so as to determine whether South Africa is ready to implement a system of this nature simply to, inter alia, protect vulnerable depositors and strengthen the banking.

The conclusion of the research essentially acknowledges the significance of the DIS, thus South Africa should adopt the system given the fact that she is in an advantageous position. Arriving at this conclusion has been as a result of the discussion undertaken throughout the research. To that end, the researcher believes that the DIS is the most plausible system that can safeguard the interest of small depositors, strengthen the banking sector and achieve a less concentrated banking sector wherein all banks will compete equitably. Given the presence of robust regulatory and legislative frameworks, the proposed design features and recommended approach, the DIS is most likely to operate without much hurdles. Thereby achieving the identified policy objectives while also disburdening the government from bailing out the collapsing banks.

However, the recommended approach has to be implemented to the extent that achieving the objectives of the DIS is concerned. Thus should not unnecessarily stifle profitability in the banking sector. Most importantly, the implementation of the DIS should not be construed as a panacea of all systemic risks since effectiveness is premised on its coordination with other financial safety-net participants.

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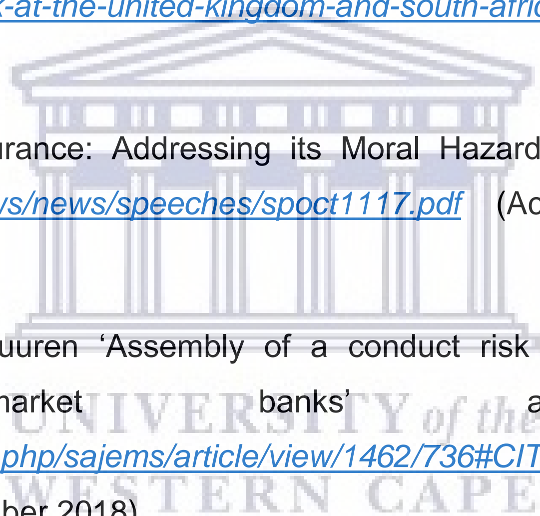
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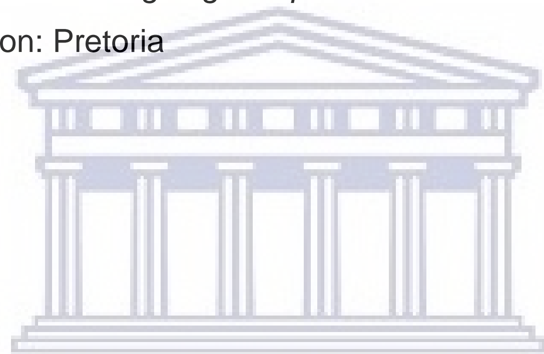
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