

# Discussion Paper

Financial Stability Department



SOUTH AFRICAN RESERVE BANK



File Ref. No.: 1/2/64

## Discussion paper

### **Stays on early-termination rights and resolution moratoria on contracts of designated institutions in resolution**

Note: This discussion paper sets out proposed principles and requirements that will be adapted into a regulatory instrument upon conclusion of the consultative process and after promulgation of the Financial Sector Laws Amendment Bill.

## Contents

1. Definitions .....	3
2. Introduction .....	5
3. Purpose .....	6
4. Statutory stays on early termination rights.....	7
5. Contractual recognition in contracts governed by foreign law.....	8
6. Scope of application .....	8
7. Recognition provision requirements.....	10
8. Overview.....	11
9. Governance .....	12
10. Reporting .....	13

## 1. Definitions

**‘compliant covered contract’** means a contract whose terms and conditions make provision for parties to such a contract to agree to be bound by temporary stays on the exercise of early-termination rights imposed by the South African Reserve Bank (SARB) as part of a resolution process;

**‘covered contract’** means a contract that meets the criteria stipulated under paragraph 5.2 herein;

**‘critical function’** means, as defined in the Financial Sector Laws Amendment Bill (FSLAB), 2018, in relation to a designated institution, a function that is –

- a. essential to, or that contributes substantially to, financial stability and is performed by the designated institution; and
- b. provided to, and essential to the continued operation of, the designated institution;

**‘designated institution’** means, as defined in clause 45 of the FSLAB or section 29A of the Financial Sector Regulation 9 of 2017 (FSR Act) –

- a. a bank;
- b. a systemically important financial institution (SIFI);
- c. the payment system operator and participants of a systemically important payment system;
- d. a company that is a holding company of a bank, a SIFI or a payment system operator of a systemically important payment system; and
- e. subject to any determination in terms of subsection (2), if a bank or a SIFI is a member of a financial conglomerate in terms of section 160 of the FSR Act, each of the other members of the financial conglomerate;

**‘designated institution in resolution’** means, as defined in the FSLAB, a designated institution in respect of which a determination in terms of clause 166J (2) is in force;

**‘holding company’** means a holding company as defined in the Companies Act 71 of 2008;

**‘market infrastructure’** means a market infrastructure as defined in the FSR Act;

**‘orderly resolution of a designated institution’** means, as defined in the FSLAB, the management of the affairs of the designated institution as provided for under Chapter 12A in a way that –

- a. maintains financial stability; and
- b. in the case of a bank, protects the interests of depositors,

including by ensuring that the critical functions performed by the designated institution continue to be performed;

**‘pre-existing contract’** means a covered contract that is already in place prior to the coming into force of the provisions relating to temporary stays on early-termination rights of contracts governed by non-South African law;

**‘resolution authority’** means the SARB as designated in terms of the FSLAB;

**‘stabilisation phase’** the early stage in a resolution process during which the resolution authority will have an opportunity to put in place measures to enable the application of the necessary resolution tools to facilitate the orderly resolution of a designated institution in resolution;

**‘systemically important financial institution’** means a financial institution that has been designated as a SIFI in terms of section 29 of the FSR Act; and

**‘termination rights’** means, in relation to covered contracts, the right to –

- a. terminate, accelerate, close out, set off or net obligations, or any similar right that suspends, modifies or extinguishes an obligation of a party to such contract; or
- b. to prevent an obligation from arising under such contract.

## 2. Introduction

- 2.1. A lesson learnt from the global financial crisis of 2008 (“the GFC”) was that a disorderly termination of a financial institution’s contracts on a mass scale could cause significant contagion effects to the financial markets, posing wider risks to the stability and effective working of the financial system. It has been recognised by global regulators that to address this risk, a resolution authority must be able to resolve a non-viable financial institution without triggering the early termination or close-out of contracts solely because of such financial institution’s entry into resolution.
- 2.2. Prospects for an orderly resolution will be hampered if a failing financial institution’s counterparties terminate their contracts with the designated institution in resolution on a mass scale based solely on such institution’s entry into resolution or the exercise of resolution powers by the resolution authority on the financial institution. In this regard, it is important for the resolution framework to prevent this situation and to ensure that critical functions and shared services can continue, particularly in the case of an open resolution.
- 2.3. Effective stays on early-termination rights (stays) that arise only by reason of, or in connection with, an institution’s entry into resolution is important to prevent the close out of contracts in significant volumes. Such close-out action upon entry into resolution could disrupt the provision of critical functions or critical shared services, lead to the financial institution in resolution having an unbalanced book and undermine the objective of an orderly resolution.
- 2.4. The Key Attributes<sup>1</sup> issued by the Financial Stability Board (FSB) require member jurisdictions to include in their resolution regimes powers for authorities to impose stays, accompanied by appropriate safeguards for counterparties.

---

<sup>1</sup> Financial Stability Board: Key Attributes of Effective Resolution Regimes for Financial Institutions, 2014

### **3. Purpose**

- 3.1. This discussion paper expands on the proposals contained in the SARB's 2019 paper titled "Ending too big to fail: South Africa's intended approach to bank resolution" and should be understood in the context of the SARB's overall arrangements to facilitate the orderly resolution of designated institutions, in line with the provisions of the Financial Sector Laws Amendment Bill (the FSLAB). It aims to provide guidance on the practical application of the provisions of the FSLAB relating to stays and moratoria and sets out proposed requirements for designated institutions to support an orderly resolution.
- 3.2. The discussion paper also sets out proposals for the adoption of contractual recognition provisions, in certain types of contracts that are not governed by South African law, to give effect to the objective and requirements of the FSLAB relating to stays on early termination rights and moratoriums.
- 3.3. It is envisaged that the proposals contained in this paper will be incorporated into a Prudential Standard post the promulgation of the FSLAB.
- 3.4. The paper is divided into three sections. Section A sets out the proposed requirements and guidance on stays on early termination rights. Section B sets out guidance on the moratoria that the SARB may issue on the contracts of designated institutions in resolution. Finally, Section C sets out the proposed general requirements that designated institutions will have to meet to ensure the effective operation of stays and moratoria.

## **A. *Stays on early termination rights***

### **4. Statutory stays on early termination rights**

- 4.1. Clause 166L<sup>2</sup> of the FSLAB provides that the following does not give rise to early termination rights:
- i. the intent to place a designated institution in resolution;
  - ii. placing a designated institution in resolution;
  - iii. the proposal to take a resolution action; and
  - iv. taking a resolution action.
- 4.2. The above section ensures that counterparties to the designated institution that is being placed in resolution may not exercise early termination rights solely on the grounds of the actions set out above.
- 4.3. Clause 166L does not, however, have any impact on the performance of obligations of the designated institutions in terms of its contracts. An institution in resolution must continue to perform its obligations in terms of its contracts. Failure to do so will give rise to the relevant default provisions in the contracts.
- 4.4. Designated institutions regularly enter into contracts with third parties in terms of which the agreement is governed under foreign law. To ensure that the institution's contracts are aligned to the resolution objective, Section 5 sets out proposed requirements to ensure alignment of contracts under foreign law with the statutory stay.

---

<sup>2</sup> 166L.(1) A provision of an agreement is of no effect to the extent that the provision, on the basis that a designated institution has been or is proposed to be placed in resolution, or on the basis of a resolution action or proposed resolution action in relation to a designated institution –

- a. confers a right, or imposes an obligation, on a person; or
- b. accelerates or varies an obligation of a person, whether or not the person is a party to the agreement.

(2) Subsection (1) does not apply in relation to an obligation to give notice to a person.

## **5. Contractual recognition in contracts governed by foreign law**

- 5.1. In the absence of an appropriate statutory framework or contractual recognition provisions, there is a risk that foreign courts could enforce an agreement governed by foreign law and may not give effect to statutory provisions on the exercise of early termination rights imposed under the South African resolution regime, or may take too long to do so.
- 5.2. While the FSB principles<sup>3</sup> emphasise the importance of implementing comprehensive statutory resolution frameworks, they also support contractual recognition approaches to cross-border recognition, which complement and support the statutory frameworks.
- 5.3. To complement the provisions under clause 166L of the FSLAB and in line with the contractual recognition approach promoted by the FSB, the SARB will require designated institutions to adopt contractual recognition provisions for the implementation of stays.
- 5.4. In terms of the contractual recognition approach, designated institutions are required to ensure that the terms and conditions of covered contracts that they enter into contain provisions to the effect that parties to such contracts agree to be bound by temporary stays on the exercise of early termination rights imposed the SARB in terms of the proposals in this Paper (stays requirements).

## **6. Scope of application**

- 6.1. The stays requirements will apply to early termination rights that arise by reason only of entry into resolution or in connection with the use of resolution powers. The requirements do not absolve an institution in resolution from performing any of its other contractual obligations, including payment and delivery obligations.

---

<sup>3</sup> Financial Stability Board: Principles for Cross-border Effectiveness of Resolution Actions, 2015



### *Covered entities*

6.2. The stays requirements apply to all designated institutions as defined by the FSLAB.

### *Excluded counterparties*

6.3. Central banks will be excluded from the proposed requirements set out in this paper. Market Infrastructures (MIs), including payment system MIs, will also be excluded due to the role they play in facilitating the smooth functioning of the financial system.

### *Covered contracts (in-scope contracts)*

6.4. The stays requirements set out in this paper apply to –

6.4.1. contracts entered into by a designated institution, which contracts contain all of the following features:

- a. a contract that is governed under foreign law; and
- b. a contract that contains early termination rights.

6.5. Specifically, the following financial contracts entered into by designated institutions that comply with the features in 6.4.1:

- a. Securities contracts, including:
  - i. contracts for the purchase, sale or loan of a security, a group or index of securities;
  - ii. options on a security or group or index of securities; and
  - iii. repurchase or reverse repurchase transactions on any such security, group or index;
- b. Commodities contracts, including:
  - i. contracts for the purchase, sale or loan of a commodity or group or index of commodities for future delivery;
  - ii. options on a commodity or group or index of commodities; and
  - iii. repurchase or reverse repurchase transactions on any such commodity, group or index;

- c. Futures and forwards contracts, including contracts for the purchase, sale or transfer of a commodity or property of any other description, service, right or interest for a specified price at a future date;
- d. Swap contracts, including:
  - i. swaps and options relating to interest rates; spot or other foreign exchange contracts; currency; an equity index or equity; a debt index or debt; commodity indices or commodities; weather; emissions or inflation;
  - ii. total return, credit spread or credit swaps; and
  - iii. any contracts or transactions that are similar to an agreement referred to in point (i) or (ii) which are the subject of recurrent dealing in the swaps or derivatives markets; and
- e. Master agreements entered into in respect of any of the contracts referred to in points (A) to (D) above.

## **7. Recognition provision requirements**

- 7.1. Contractual recognition of the statutory stay on early termination rights ensures that all the contracts of designated institution are in line with the FSLAB in that parties are not able to exercise any early termination rights based solely on the actions set out in paragraph 4.1.
- 7.2. Designated institutions must ensure that any early termination provisions in contracts that fall within the scope of Section 6 of this paper, do not provide rights to a third party to terminate a contract in the event of an action as provided for in paragraph 4.1.
- 7.3. Designated institutions may not amend existing contracts, or make provision in contracts it enters into, that gives, or may purport to give, a right to a third party that aims to circumvent the operation of Section 166L.

## **B. *Moratoria***

### **8. Overview**

- 8.1. A stay on early termination rights as provided for in Section 166L of the FSLAB does not affect the rights of counterparties that may arise due to the non-performance of obligations by the designated institution. If a designated institution in resolution does not perform its obligations in terms of its contracts, counterparties may exercise their rights in terms of the contracts.
- 8.2. The purpose of an open resolution is to continue with the operations of a designated institutions and to ensure that its critical functions are maintained. This requires the continued performance on its contractual obligations, among other things. However, in certain situations it may be necessary for the success of an orderly resolution to allow the designated institution to, temporarily, not perform on some obligations in terms of its contracts without counterparties terminating the contracts.
- 8.3. Clause 166R (1)(d) of the FSLAB provides that, if the SARB determines that it is necessary to do so for the orderly resolution, the SARB may, among other things, subject to subsection (4), by written notice to the parties to an agreement to which a designated institution is a party, suspend an obligation by the designated institution.
- 8.4. A moratorium may only be issued by the SARB when the conditions for triggering a resolution have been met and the designated institution is placed in resolution. The suspension must, however, only be temporary in nature and subsection (4) requires that the moratorium states the period which must be a reasonable period.
- 8.5. To ensure that moratoria issued by the SARB are in line with international best practice, the suspension of any obligations that may be provided for in moratoria issued by the SARB will not exceed (48) hours. This period will also be set out in the Prudential Standard within which the proposed requirements provided for in this paper will be set out.

8.6. Designated institutions participate in several financial systems and continued performance on contracts by designated institutions, even in resolution, ensures the smooth functioning of these systems. Exceeding the 48-hour period poses a high contagion risk and will have negative consequences for the participation of South African institutions in global markets.

### **C. *General requirements***

#### **9. Governance**

9.1. Designated institutions must have complete information of their exposures in respect of their covered contracts as well as those entered into by their group companies and/or that are guaranteed or otherwise supported by those companies. This includes information about the status of compliance with the temporary stay provisions on an aggregate basis, as well as at an entity level for each of the relevant entities in the designated institution's group.

9.2. Designated institutions must have in place internal system capabilities to maintain a detailed record of covered contracts entered into (or guaranteed or otherwise supported), and to be able to present information on these contracts in a timely manner.

9.3. The detailed record of covered contracts referred to in paragraph 6.2 above should be kept at an individual entity level and should include, but not be limited to, the following key features:

- i. governing law;
- ii. covered contract type;
- iii. details of the termination right provisions;
- iv. counterparty type;
- v. counterparty jurisdiction of incorporation; and

vi. mark-to-market values and notional amounts by number of trades and agreements.

9.4. These capabilities should be established as part of resolution planning obligations, irrespective of whether an actual resolution is foreseen, and should be embedded in designated institutions' internal governance framework and risk management processes.

## **10. Reporting**

10.1. A designated institution will be required to periodically report to the SARB the extent to which the covered contracts that it has entered into complies with the stays requirements.

10.2. At a minimum, a designated institution should be capable of readily producing periodic reports containing a detailed categorisation of covered contracts referred to in paragraph 6.4 above, including for the relevant entities within its group, under the following broad categories:

- i. compliant covered contracts
- ii. non-compliant covered contracts
- iii. pre-existing covered contracts.

10.3. The SARB may request further details on specific contracts during the bilateral resolution planning work programme with designated institutions, on an ad hoc basis.

10.4. While the SARB does not intend to routinely perform due diligence on the legal enforceability or the effectiveness of the contractual provisions on termination rights, the SARB may request sight of legal opinions as evidence of enforceability.

## References

Bank of England: *Contractual stays in financial contracts governed by third-country law*. 2015

<https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2015/ps2515>

Financial Sector Laws Amendment Bill, 2018

<http://www.treasury.gov.za/twinpeaks/Financial%20Sector%20Laws%20Amendment%20Bill.pdf>

Financial Sector Regulation Act, Act 9 of 2017

<http://www.treasury.gov.za/legislation/acts/2017/Act%209%20of%202017%20FinanSectorRegulation.pdf>

Financial Stability Board: *Principles for Cross-border Effectiveness of Resolution Actions*. 2015

<https://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf>

Hong Kong Monetary Authority: *An Effective Resolution Regime for Financial Institutions in Hong Kong - Rules on Contractual Stays on Termination Rights in Financial Contracts for Authorized Institutions*. 2020

<https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/Stay-rules-CP-for-consultation.pdf>

South African Reserve Bank: *Ending too big to fail: South Africa's intended approach to bank resolution*. 2019

<https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/9398/South%20Africa's%20intended%20approach%20to%20bank%20resolution.pdf>