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Further Submissions on the Banks Amendment Bill [B17-2014] to the Standing Committee on Finance

1. **Introduction**

1.1 Pursuant to the hearings on the Banks Amendment Bill held on 4 February 2015, the Tier II Debtholder Committee has been requested to make further submissions to the Standing Committee on Finance on the Banks Amendment Bill [B17-2014] (the **Bill**) and the effect of the proposed amendments on the Tier II Debtholder Committee's broad investor client base in relation to the curatorship of African Bank Limited (**ABL**).

1.2 We set out below:

(a) a brief analysis of the legislative regimes presented by the National Treasury on 4 February 2015, to be read together with the presentation attached hereto as Annexure "A" (the **Appended Presentation**);

(b) a discussion of the applicability of the "No Creditor Worse Off than in liquidation" principle;

(c) an introduction to the views of the Tier II Debtholder Committee on the constitutionality of the Bill, to be read together with the legal opinion of Adv. Alfred Cockrell SC and Adv. Isabel Goodman, attached hereto as Annexure "B" (the **Opinion**); and

(d) our comments and responses to the following matters forming part of the National Treasury's presentation to the Standing Committee on Finance on 10 March 2015 (the **10 March Presentation**):

(i) the appropriateness of the Tier II debt as an investment for pension funds; and

(ii) the impact of the Tier II proposal in relation to the Bill on the South African tax payers and fiscus.

2. A Comparative Analysis

2.1 Submission in relation to precedent bank resolution legislation in other jurisdictions

(b) We refer to the presentation on the Bill given by the National Treasury to the Standing Committee on Finance on 3 February 2015 (the **NT Presentation**). In particular, reference is made to National Treasury's citing of legislation in other jurisdictions which introduced certain resolution regimes for banks, to support the National Treasury's assertions that the Bill should be passed into law in South Africa, in its current form.

(c) While the Tier II Debtholder Committee does not dispute the validity and role of resolution regimes *per se*, it is our submission that the respective statutes and circumstances leading to the enactment of such statutes in the jurisdictions cited by the National Treasury are not analogous to the circumstances surrounding the resolution of ABL. While we do not wish to engage on a case-by-case rebuttal of each point in the Presentation, our main objections are as follows:

(i) **urgency and timing of legislative change**: the apparent urgency indicated by the National Treasury in passing the Bill in its current form is aimed specifically at addressing the issues arising from the ABL case, instead of allowing domestic regulatory authorities to undertake a broader review of what is appropriate for South African banking resolution regimes (outside of ABL-specific requirements). We note that discussions regarding the introduction of a new resolution regime for banks in South Africa have been ongoing since December 2013 and up until now: (i) there has not been any urgency to implement such a regime in South Africa; and (ii) there has been no consultation on the subject by the regulator with the investment committee represented by the Association for Savings and Investment South Africa (ASISA).

(ii) **Basel II vs Basel III frameworks**: with regulators in other countries adopting resolution regimes, banks in those jurisdictions have been encouraged to issue Basel III capital and/or are required to ensure that capital issued is subject to write-down at the point of non-viability. Conversely, the lack of urgency to move to a resolution regime by the South African authorities indicated to local banks that the regulator was comfortable with the status quo of Basel II capital with the view of phasing it out. In particular, we refer to the BCBS statement from 13th January 2011, which explicitly states that (a) new Tier 1 and Tier 2 notes issued must include a provision allowing these to be written off at the point of new viability, unless the governing jurisdiction has laws in place allowing for such a write-off (which is not the case for South Africa), and (b) instruments that no longer qualify as Tier I or Tier II (given that they cannot be written off) should be phased out over 10 years (acknowledging that they are not "bail-in-able" instruments); and

(iii) **differences with ABL case**: where certain jurisdictions identified in the NT Presentation did not previously have a resolution regime, the law was changed retrospectively only to resolve banks in regimes where there was an immediate systemic risk i.e. a risk of collapse of the entire financial system or market. It is our submission that there is no immediate systemic risk in the case of ABL and the examples provided in the NT Presentation demonstrate idiosyncratic differences with the case of ABL.

(d) As further explained below, we consider that, the sole purpose of the introduction of a resolution regime, as proposed in the Bill, is to allow the curator of ABL to implement a restructuring deal without the consent of some of ABL's creditors, who would be deprived of their property rights retroactively.

(e) While we do believe that a long-term bank resolution framework is required, and do foresee a phased implementation of the Basel III regulatory standard as beneficial to the broader financial system in South Africa, it is our submission that the Bill is aimed specifically at addressing the issues arising from the ABL case, and should, therefore, not be implemented retrospectively in order to push through the recapitalisation of ABL at the expense of one group of creditors over and above other groups of creditors.

(f) We also refer to the Appended Presentation in support of our submissions herein.

2.2 **Urgency and timing of legislative change**

(a) As the Standing Committee on Finance is aware, banks have been facing global financial pressure ever since the onset of the global financial crisis in 2008. Immediately after the onset of, and in response to, the global financial crisis, various countries introduced resolution regimes in order to be better positioned to address any future challenges in the financial sector and to better manage the failure of a financial institution in an orderly fashion.

(b) South Africa is a member of the Financial Stability Board (the **FSB**), and the FSB's mandate is that it "monitors and make recommendations about the global financial system". Since 2011, the FSB has been actively promoting changes to local banking regulations in order to develop strong regulatory, supervisory and other financial sector policies. As a result, in 2011, European countries undertook the decision of implementing the Basel III features, such as, the ability for creditors to be bailed-in as well as to write-off certain liabilities in a resolution process, which, in some jurisdictions have been enacted, and in others will be implemented from 2016 (a forward looking and not retrospective change). Despite these initiatives in Europe, South Africa has showed no urgency in taking action to amend its regime and to shift its banking framework to incorporate Basel III or FSB bank resolution mechanics. As is highlighted on page 5 of the Appended Presentation, in contrast to other countries, South Africa does not have any banking resolution measure currently in place. South Africa has had four years to consider implementing new legislation and to decide on any modifications to its banking sector regulations and, despite the previous bank failures in this jurisdiction, the most significant of which was SAAMBOU, there does not seem to have been any urgency in implementing any such legislative changes until the curatorship of ABL.

(c) Therefore, we submit that it is reasonable for the creditors to assume that the governing bodies in South Africa were comfortable with the curatorship proceedings that are currently enacted, which is a well-established procedure that has been used in successfully restructuring financial institutions in the past. The South African authorities have, up until now, shown no urgency in making any amendments to the regulatory and legislative framework within which banks operate, and in particular have not been concerned by the way in which banks hold regulatory capital under the Basel II framework, which does not require write-down at the point of non-viability.

2.3 **Basel II vs Basel III frameworks**

(a) Following the financial crisis in 2008, the members of the Basel Committee on Banking Supervision agreed a new regulatory standard on bank capital adequacy, Basel III, in 2010-2011.

(b) Under Basel III, changes were made to the terms and rights of the regulatory capital held by banks compared to Basel II securities. New Basel III terms will reduce rights of tier 2 noteholders significantly, relative to Basel II.

(c) In particular, under Basel III, regulatory tier II capital can be "bailed-in" and therefore written-off in the event of a bank's insolvency. On the other hand, as stipulated in the BCBS statement from 13th January 2011, Basel II instruments must be phased out over a period of time, given that they cannot be written-off, which acknowledges that Basel II instruments are not "bail-in-able" in the manner envisaged under Basel III.

(d) In 2014, global banks issued $174bn Basel III capital instruments[1]. The rise in debt issuance shows that institutions globally are aware of the different treatment to both types of notes and demonstrates a clear recognition that Basel III notes are different and need to be treated differently to Basel II notes.

(e) The ABL Tier II Notes are issued under the Basel II framework and never contemplated being "bail-in" in their terms and conditions. The Bill seeks to provide the curator with the power, retrospectively, to treat the ABL Tier II regulatory capital as capital held under Basel III rather than the Basel II framework, despite the clear recognition that both types of notes are different forms of capital.

(f) It is our submission that the SARB and the National Treasury did not previously challenge the difference between how Tier II capital was held under the Basel II and Basel III frameworks with any sense of urgency, SARB and the National Treasury only recently did so to support the changes proposed in the Bill at a time when such changes, if implemented, would apply to the specific case of ABL.

2.4 **Differences between bank resolution regimes in other jurisdictions and the ABL case**

2.5 In the NT Presentation, the National Treasury listed a number of examples of previous cases in which national legislation was passed in order to implement a banking resolution. It is our submission that the examples provided differ from the ABL case and demonstrate "idiosyncratic" features that are not applicable to ABL, for example:

(a) **Northern Rock (UK)**: the assets transferred to UKAR (the "bad" bank) hold substantial value, with Tier II notes having been tendered for and redeemed at c.50 per cent. or more of their face value. In addition, the subordinated liabilities have been tendered for and redeemed ahead of the government in recovery; and

(b) **Banco Espirito Santo (Portugal)**: a framework for banking resolution was already in place since 2012, and legislation was passed only in order to establish a bridge bank. Creditors had therefore already been forewarned that they could be bailed-in (comparing this to South Africa, where regulators were comfortable with the Basel II framework remaining in place, with no requirement for Tier II capital to be written-off in the event of bank insolvency).

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[1] Source: Financial Times (date 11th February 2015)

2.6 The majority of other countries in which creditors were "bailed-in" had pre-existing regimes in place for resolving banks. When banks failed, the regulators applied the framework already in place. Creditors were aware of this potential risk prior to the resolution being put in place. This is not the case for ABL, where the regulators have not acted on the 2011 FSB directives and creditors could reasonably assume that the regulators were comfortable with the status quo and legal regime already in place.

2.7 Furthermore, cases in which governments retrospectively changed the legislation were those in which there was a systemic risk to the financial system and governments were unable to remedy such risk due to the size of the exposure (see appended slides). In comparison, ABL's assets comprise only 3 per cent. of South Africa's GDP and as such, there is arguably no systemic risk to South Africa's financial system were ABL to continue in curatorship or to go into liquidation. The Tier II Debtholder Committee would therefore stress that the examples provided by the National Treasury in the NT Presentation each had unique features that distinguish them from the case and circumstances of ABL and its position in the overall financial system of South Africa. Legislation has only been retrospectively applied in situations where there was systemic risk, such as in Iceland and Cyprus.

3. Applicability of "No Creditor Worse Off than in Liquidation" Principle

3.1 As expressed in our previous submission, the "No Creditor Worse Off than in Liquidation" principle does not presently form part of South African law. In addition, it is our view that the principle should not be introduced into our law to apply to curatorship, as it conflicts with certain constitutional principles as set out below.

3.2 Section 69 of the Banks Act, 1990 (the **Banks Act**) does not permit the application of a "No Creditor Worse Off than in Liquidation" principle by a curator. The principle departs from a wholly different premise to that which is applicable in the curatorship process and is in fact inimical to the aims of curatorship as presently set out in section 69 of the Banks Act.

3.3 The curatorship process differs substantially from the liquidation process. It is an alternative to liquidation, and has as its aim the promotion of the interests of all the creditors of a bank. By choosing curatorship, the Registrar, at least temporarily, forgoes the power to liquidate as provided for in section 68 of the Banks Act. Accordingly, it is in our view not legally correct to treat the curatorship process as if it were a liquidation and accordingly to rank the interests of the creditors as they would have been ranked had there been a liquidation of ABL. To do so would remove the very rationale and purpose for the discretion and power which the curator enjoys under section 69(3)(b) and (e) of the Banks Act.

3.4 If at any time the curator is of the opinion that there is <u>no</u> reasonable probability that the continuation of the curatorship will enable ABL to pay its debts and meet its obligations and become a successful concern, the curator is, in terms of section 69(2D) of the Banks Act, required to inform the Registrar of this fact, and the Registrar will then have to consider invoking section 68 of the Banks Act, and effect a winding up of ABL. Section 69(2D) accordingly implies that the object of the curatorship process is to settle all debts and obligations, whether subordinated or not, and not merely some of them, and once it becomes evident that this will not be possible, the curatorship should be brought to an end.

3.5 If the Bill were to be enacted, the proposed section 69(2C) would:

(a) require the curator and the Minister to consider whether the transfer means that creditors will not incur greater losses on the date of the transfer than they would have incurred had the

bank been wound up on that date. This would expand the powers of the curator and the Minister in a manner that will remove existing contractual rights in that unsubordinated Tier II debt will become sub-ordinated, which would be unconstitutional as it violates the rule of law; and

(b) allow the curator and the Minister to implement a transfer by having regard to the counterfactual position that would exist if ABL were to be wound up – but in circumstances where ABL has not been wound up and where the Tier II Noteholders are therefore not afforded the remedies that would be available to them in the case of a winding-up, including for example, the ability to challenge impeachable transactions under the Insolvency Act, 1936, to apply for an enquiry to be convened under section 417 of the Companies Act, 1973, and to seek to extend liability for the bank's debts in terms of section 424 of the Companies Act. This would distort the distinction between curatorship and liquidation and violates the rule of law.

4. **Constitutionality of the Bill**

The Tier II Debtholder Committee is of the view that certain aspects of the Bill are unconstitutional and, accordingly, the Bill cannot be passed into law in its current form. We refer to the Opinion in support of our submissions herein.

Rule of law

4.1 As indicated in the opinoin, currently the contractual provisions of the Tier II Notes read with the Banks Act and Regulations, specifically Regulation 38(14) do not permit the curator to subordinate the claims of the Tier II Noteholders in the absence of dissolution, liquidation or winding-up of ABL.

4.2 Further, as indicated above, section 69(3) of the Banks Act grants the power to the curator to prefer one creditor over another only to advance the objective of the curatorship, which is to return a bank, in this case ABL, to being a successful concern which is able to meet all of its obligations.

4.3 The Bill, if enacted will allow the curator to subordinate the claims of the Tier II Noteholders in situations other than those that are currently allowed, with none of the associated rights that would be available to the Tier II Noteholders in liquidation. This is accordingly a new consequence that the Tier II Noteholders could not have foreseen at the time that the contractual arrangement with ABL was entered into. In our view, this interference with the existing contractual rights of the Tier II Noteholders violates the rule of law.

4.4 The Bill envisages incorporating the "No Creditor Worse Off than in Liquidation" principle into our law. This would allow the curator to treat the Tier II Noteholders as if there was liquidation as long as they are no worse off than if ABL was placed in liquidation. However, by choosing curatorship, the Registrar forgoes the power of liquidation, yet the Bill deprives the Tier II Noteholders of their statutory rights that they would otherwise have enjoyed in circumstances where ABL was wound up. This not only blurs the distinction between curatorship and liquidation but the Tier II Noteholders could not have anticipated the application of the "No Creditor Worse Off than in Liquidation" principle in the event that ABL were to be placed in liquidation. The Bill therefore violates the rule of law for this reason as well.

4.5 The proposed section 69(3)(j) allows the curator to disregard any contractual relationship that prevents ABL from granting security over the assets of the bank. This removes any rights that the Tier II Noteholders have in relation to preventing ABL from providing security over its assets. Again

the alteration to allow the curator to override the vested contractual rights of the Tier II Noteholders violates the rule of law.

Arbitrary differentiation and arbitrary deprivation of property

4.6 The proposed section 69(2C) allows the curator to differentiate between creditors by treating some creditors less favourably than others. Section 9 of the Constitution of the Republic of South Africa, 1994 (the **Constitution**), prohibits arbitrary differentiation between categories of people if such differentiation is not rationally related to a legitimate government purpose – namely to maintain a stable banking sector and public confidence in the banking sector.

4.7 The power granted to the curator to treat creditors differently removes the certainty as to how investors will be treated. Differential treatment of creditors of a bank in curatorship, where the creditors are uncertain as to how they will be treated cannot rationally be argued to promote the maintenance of a stable banking sector.

4.8 Likewise, in terms of section 25 of the Constitution the vested contractual rights of the Tier II Noteholders cannot be removed if the deprivation of these rights is not rationally connected to the purpose of promoting confidence in, or the stability of, the banking sector. A deprivation is arbitrary and unconstitutional if it occurs without sufficient reason (see paragraph 59 of the Opinion). As with arbitrary differentiation between creditors, the uncertainty created by removing these contractual rights is not rational and not proportionate to the end sought to be achieved.

4.9 We therefore submit that the Bill violates the rule of law as well as sections 9 and 25 of the Constitution.

5. Comments and responses to the 10 March Presentation

5.1 Appropriateness of Tier II debt as an investment for pension funds:

(a) During the 10 March Presentation, it was contended that asset managers should never have invested pension money in Tier II instruments. This argument is problematic in two respects:

(i) Firstly, Regulation 28 of the Pension Fund Act (drafted by the National Treasury) allows pension funds to invest up to 75% of assets in the equity of corporates which includes banks regardless of their rating. It is common cause that all the equity investment in African Bank Investments Limited has been lost. But there is a clear prospect of recovery of value for Tier II debt. From a risk perspective equity is always more risky than debt. Therefore if pension funds can invest 75% in equity, how is it that they should not invest in Tier II debt generally? How can it be said that it is prudent to invest pension money in African Bank equity but not in African Bank Tier II debt which ranks above equity? Quite simply, the contention that Tier II debt is inappropriate for pension fund investments is counter-intuitive and fundamentally flawed.

(ii) Secondly, the Tier II debt of all the major South African Banks (i.e. ABSA, Standard Bank, FirstRand and Nedbank) is majority owned by pension funds. Should pension funds now sell all Tier II instruments they hold from other banks, and all equity they hold, and only invest in senior debt going forward? That is clearly not what was intended by Regulation 28. Therefore any contention that pension funds should not have invested in Tier II debt does not hold.

5.2 **Impact of the Tier II proposal in relation to the Bill on SA tax payers and the fiscus:**

(a) There is little risk to the South African tax payers from the resolution of ABL, for two reasons:

(i) Firstly, during the 10 March Presentation National Treasury made it clear that ABL is performing well, and collecting slightly ahead of expectations. Therefore the loans to be advanced to ABL under the guarantees provided by the SARB, and backed by the National Treasury, are expected to be fully repaid with interest from the collections on the Bad Book which the SARB will be taking as security for the loans.

(ii) Secondly, the separation of the "Good" and "Bad" bank creates a structure whereby profits will be reported in Good Bank that would otherwise have been shielded from tax had it accrued in Bad Bank, due to the substantial deferred tax asset which has built up in African Bank (not to mention the benefit the fiscus has derived over the past number of years through the under provisioning of African Bank, and consequent overstatement of taxable income). This will result in Good Bank paying tax to the fiscus in the coming years that would otherwise not have arisen had the profit on the Good assets been earned in the Bad Bank. The deferred tax loss in African Bank currently amounts to between R5bn and R7bn. Therefore the SA tax-payer will gain a tax asset of R5bn to R7bn through the demise of African Bank.

The submissions from the Tier II Debtholder Committee do not change the above position in any way and will not result in any further cost to the South African tax-payers.

6. **Conclusion**

6.1 As indicated above, while we acknowledge and agree that a long-term bank resolution framework is required, we cannot accept the current amendments, as long as they include the "No Creditor Worse Off than in Liquidation" principle.

6.2 We have no objection to the introduction of these amendments to apply prospectively, but we are of the strong view that it is not appropriate, nor constitutional, to include the "No Creditor Worse Off than in Liquidation" principle and apply it retrospectively, based on our submission above.

6.3 Our view is that the curator should be permitted to resolve ABL in a manner that is not intrusive to the constitutional rights of all creditors. In particular, the curator should be allowed to transfer assets subject to the consents of all creditors by way of a scheme of arrangement or compromise, and the Banks Act should be amended to allow for such consent process to be implemented.

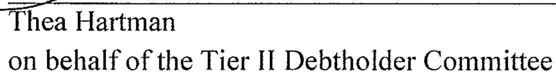
6.4 The Tier II representatives had a meeting with National Treasury where we explained our concerns around the constitutionality of the retrospective introduction of the "No Creditor Worse Off than in Liquidation" principle. National Treasury representatives indicated that this principle is not essential for the resolution of African Bank and that the deletion thereof from the Bill would be considered. Unfortunately, Tier II representatives have been advised recently that due to demands by the other creditors and the curator, the principle will be retained in the next draft of the Bill. These parties have no basis in law to insist on the introduction of this principle in a retrospective manner or at all.

6.5 We believe that if the Bill is promulgated into law without addressing the submission contained herein, it is highly likely that its validity will be challenged at the highest level necessary to safeguard the rights of investors whose rights will be violated by the consequences of the proposed

amendments. In this vein, and in light of the submission contained herein, we request for the formation of a working group, involving the Senior Noteholders, Tier II Noteholders, National Treasury, SARB and the curator of ABL, to debate the way forward on the Bill

7. We request that the Standing Committee on Finance gives due consideration to the submissions contained herein prior to progressing the Bill.

Yours faithfully,



Thea Hartman
on behalf of the Tier II Debtholder Committee