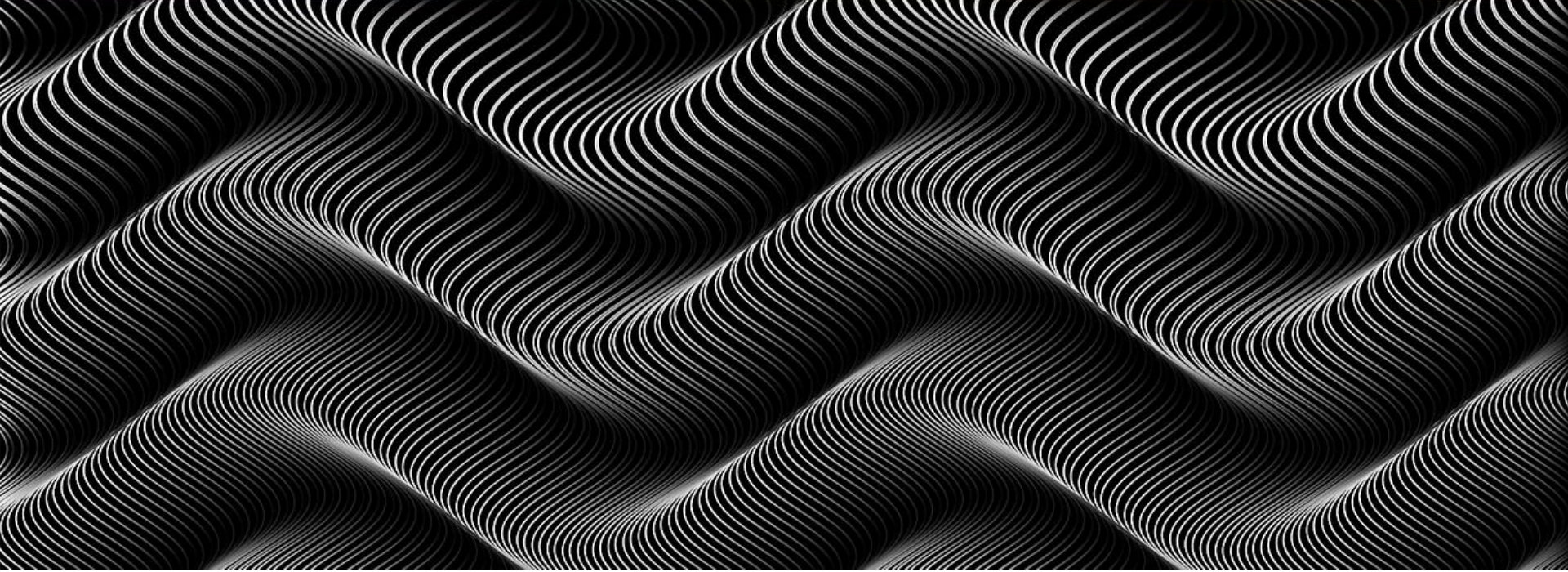


Don't give me FLAC!

FLAC instruments, the SAM standard formula, and systemic risk for South African insurers

David Kirk | Short Term Insurance Seminar 2026

Agenda

1. **What is FLAC?**
   The bail-in framework, international precedent, and the SA context
2. **SAM Technical Treatment**
   Classification, CQS, LGD adjustments, and the capital mismatch
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   Yield pickup, information opacity, and adverse selection
4. **Should Insurers Own These?**
   Wrong-way risk, contagion, and the regulatory gap
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PART 1

What is FLAC?

The bail-in framework, international precedent, and the SA context

The Problem: Too Big To Fail

When systemically important banks fail, governments face impossible choices:

Bail out (taxpayer rescue)

Moral hazard. Privatised profits, socialised losses. Political impossibility post-2008.

Let them fail (disorderly)

Contagion. Depositor panic. Payment system collapse. Broader economic damage.

Negotiate with creditors

Protracted wrangling. Markets freeze while waiting. Counterparties can't value exposures. Uncertainty itself is contagious.

FLAC pre-agrees the loss-absorption mechanism. The resolution authority can act decisively without taxpayer funds and without needing creditor consent.

What is a FLAC Instrument?

First Loss After Capital (FLAC) is a debt instrument issued by a bank holding company, designed to be written down or converted to equity when the bank enters resolution.

Issuer	Bank holding company (e.g. Absa Group Ltd), not the operating bank
Form	Listed, tradeable bond with defined maturity and coupon
In resolution	Written down to zero or converted to equity at the SARB's discretion
Position	SENIOR to the bank's own capital JUNIOR to senior unsecured and depositors

In normal conditions it behaves like a bond. In a crisis, it behaves like equity – or worse.

International Precedent

2011

Financial Stability Board Key Attributes

Global standard for effective resolution regimes

2014

EU BRRD / MREL

Bank Recovery and Resolution Directive; Minimum Requirement for Eligible Liabilities

2015

TLAC Standard

Total Loss-Absorbing Capacity: global systemically important banks to hold 18% of Risk Weighted Assets

2023

Credit Suisse

CHF 16.5bn AT1 write-down; creditor hierarchy inverted

2024

SA Resolution

FLAC framework for 6 South African SIFIs, phased to 2030

The Only Test Case: Credit Suisse (2023)

The framework was tested. It didn't work the way the contracts said it would.

Credit risk

CHF 16.5 billion in AT1 instruments written down to zero. The loss-absorption mechanism worked. Holders lost everything.

Political risk

FINMA acted under emergency powers over a weekend. Equity holders received CHF 3bn through the UBS merger. The creditor hierarchy was inverted.

Legal risk

The Swiss Federal Administrative Court ruled the write-down unlawful (Oct 2025). Appeal pending. But holders are still wiped out.

If you hold bail-in instruments, you are trusting not just the contractual terms, but the political and regulatory process that will execute them under extreme pressure.

South Africa's FLAC Market

3 issuers, 4 auctions by March 2026

Absa Group: ~R3bn issued, R8.4bn in bids (2.65×)
Standard Bank Group: R2.2bn first issuance, R10bn+ bids
Nedbank Group also issued; SBG issued twice

R300bn+
estimated total requirement
phased to 2031

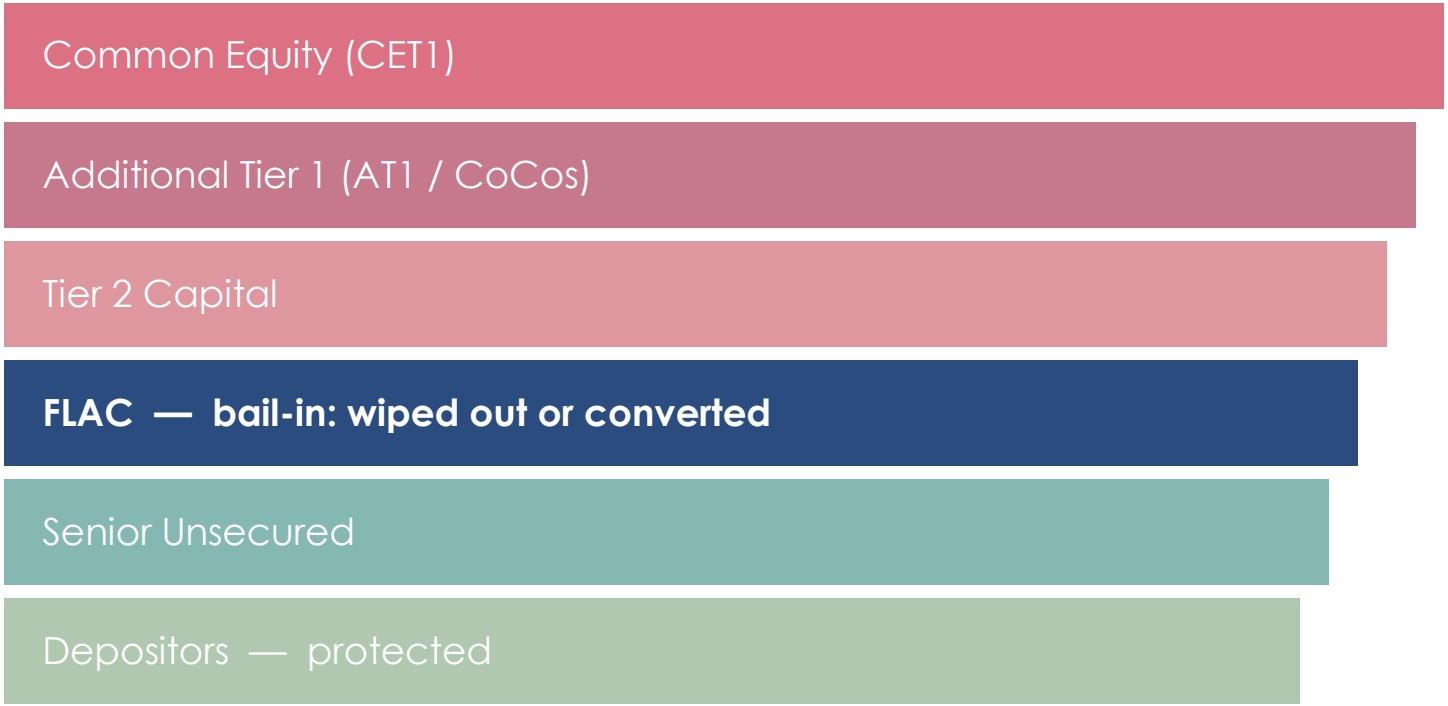
Expected premium
10–42 bps
over senior unsecured

Actual clearing premium
3–4 bps
~8–9 bps adjusted for compression

Source: Futuregrowth Asset Management, Kabir Bedasie, March 2026

Senior bank paper (OpCo) ranks above FLAC (HoldCo). As senior paper transitions to FLAC, investors move down the creditor hierarchy — for very little additional spread.

Loss Hierarchy in Bank Resolution



PART 2

SAM Technical Treatment

Classification, CQS, and the capital mismatch

Spread Risk vs. Type 1 Default Risk

Spread Risk

- Mark-to-market loss as spreads widen
- Holder can trade out – at a loss
- The likely initial path to loss for FLAC
- CQS × duration → spread risk factor
- LGD_adj applied when using issuer CQS

Type 1 Default Risk

- Loss through actual non-payment
- Holder less likely to trade out
- Loss crystallises through default event
- CQS → probability of default
- LGD prescribed at 100% – no discretion

Spread risk may be more appropriate classification – but neither module fully captures the risk of an instrument designed for binary loss in a systemic crisis.

The CQS Question: Issuer vs. Instrument

FSI 4.1 contains an internal inconsistency:

Paragraph 9.10

The CQS should reflect the credit quality of the instrument, not the issuing entity.

Paragraph 9.12

Provides detailed guidance for when an issuer rating is used instead – including the LGD adjustment mechanism.

If 9.10 were always followed, 9.12 would not need to exist.
For most instruments this doesn't matter. For FLAC, it does.

SA FLAC instruments do not currently have instrument-level ratings.

Two Routes, Different Answers

Route A: Issuer CQS + LGD_adj

2.22×

LGD_adj = 100% / 45%

Multiplies the spread risk factor by 2.22. Equivalent to 100% LGD – consistent with Type 1 default treatment.

Route B: Instrument CQS (notched)

1–3

CQS notches, LGD_adj = 1

Rating agencies typically notch bail-in instruments 1–3 steps from the issuer rating (S&P ~2, Moody's up to 3).

These should be two ways of capturing the same risk.
They could produce materially different capital charges.

LGD Ratios and the 2.22× Multiplier

FSI 4.1, paragraph 9.22 and Attachment 4, Part D

Nature of exposure	LGD	LGD_adj
Fully collateralised	35%	0.78
Senior unsecured (baseline)	**45%**	**1.00**
>50% of assets pledged to other creditors	86%	1.91
Equity, junior/mezzanine, structurally subordinated	**100%**	**2.22**

LGD_adj = LGD / 45%. The spread risk factors in Attachment 4 are calibrated assuming a 45% LGD. The 2.22× multiplier scales them up to reflect 100% loss severity.

The Evidence: Notching vs. LGD_adj by Duration

Ratio of spread risk factors at CQS downgrades vs. 2.22 (**starting CQS 11**)

Duration	+1	+2	+3	LGD_adj
1 year	1.33	1.74	**2.44**	**2.22**
5 year	1.23	1.48	1.88	**2.22**
10 year	1.18	1.36	1.63	**2.22**

At typical FLAC durations (5–10 years), even a 2–3 notch downgrade (security CQS) produces a capital charge well below the 2.22× LGD adjustment (issuer CQS)

Source: Spread risk factors from FSI 4.1, Attachment 4, Part A.
Yellow row = typical FLAC duration.

Concentration Risk

FLAC exposures must be combined by issuer **with all other exposures to that counterparty.**

Combine by issuer

Senior unsecured + Tier 2 + FLAC + any other exposures to the same bank group.

Diversification may soften the blow… but too much?

Diversification against other market risk sub-modules and life underwriting risk may make the net impact modest. But this depends on portfolio composition.

Six banks ≠ diversification

South African SIFIs share the same sovereign, macro environment, and depositor base.
Diversifying across six correlated names is not genuine diversification.
Standard formula treats this as diversification

The Standard Formula: Key Takeaways

- Spread risk is arguably the appropriate module.
- Type 1 default risk would give a clean 100% LGD – consistent with the LGD_adj route
- The instrument-CQS route (notching) produces a lower capital charge than the issuer-CQS + LGD_adj route, especially at longer durations
- The common "system-generated" default (issuer CQS, LGD_adj = 1) makes FLAC risk invisible
- Concentration must be assessed by issuer – six correlated banks ≠ diversification

If your FLAC exposures are material, the standard formula offers choices with Potentially materially different results. Address this in the ORSA + Standard Formula Appropriateness.

PART 3

Why Would Insurers Invest?

Yield pickup, information opacity, and adverse selection

The Yield Pickup

FLAC offers a spread premium over senior unsecured debt from the same issuer.

The rational case

- 3* to 42* bps yield pickup over senior unsecured
- Resolution of a SA SIFI is a genuine tail event – low probability
- Expected loss may be low. Spread may be adequate on an expected-value basis
- Deliberate, informed risk acceptance with adequate capital is reasonable

The concern

- Asset managers benchmarked on yield have a direct incentive to accumulate
- The decision to hold may not be deliberate – it emerges from mandates
- Insurer risk teams may not even be aware of the exposure

The Real Danger: Information Opacity

Fixed income funds and CIS vehicles

The blind spot

FSI 4.1 requires look-through for CIS. In practice, this is imperfect. Multi-manager mandates, fund-of-funds, and balanced funds will hold FLAC. The insurer may not know.

The CLN parallel

We have seen this before with Credit-Linked Notes and other structured exposures where CIS providers claim they cannot provide sufficient detail for a proper SAM market risk calculation. If you can't value it properly, you can't risk-manage it.

The adverse selection spiral

If yield-blind capital buys FLAC for the spread, this bids up prices and compresses spreads. Informed investors exit. The market is left with holders who don't understand what they own.

PART 4

Should Insurers Own These?

Wrong-way risk, contagion, and bank subsidiaries

Wrong-Way Risk

FLAC losses crystallise precisely when everything else is failing.

Equity markets	▼ **Falling**
Credit spreads	▲ **Widening**
Yields	▲ / ▼ **Volatile**
Liquidity	▼ **Drying up**
Lapses & surrenders	▲ **Elevated**
New business volumes	▼ **Declining**

The insurer takes a significant FLAC loss at precisely the moment its own solvency position is most strained.

Two Paths

Path A: Conversion to Equity

- FLAC converts to bank equity at resolution
- Insurer now holds bank equity. Equity risk SCR applies
- SCR increases at the worst possible time

Path B: Write-Down to Zero

- FLAC written down completely
- Total loss of invested capital
- Direct reduction in Own Funds
- Credit Suisse precedent

An interesting modelling problem: do you stress this as spread risk, equity risk, or a binary event?

What About Bank-Subsidiary Insurers? #badidea

An insurer subsidiary buying FLAC issued by its parent holding company is buying a bail-in instrument from the entity that controls it.

- In resolution, the parent's FLAC is written down
- The subsidiary insurer takes a capital hit
- Policyholders of the subsidiary bear the cost of the parent's failure
- This is not just wrong-way risk – it's a governance and conflict of interest issue
- FSI provisions not 100% clear (to me) how own-bank-parent FLAC should be treated.

PART 5

Before You Take FLAC

A practical checklist

Before You Take FLAC

1

Know what they are

Understand the bail-in mechanism, the loss hierarchy, and the Credit Suisse precedent. This is not a vanilla bond.

2

Get the capital treatment right

Establish what CQS and LGD_adj your SCR calculation uses.

3

Get the data

Ensure FLAC, CLN, and other non-vanilla instruments are visible in your portfolio data.

4

Think systemically

Wrong-way risk. Contagion. Concentration by issuer. Banking sector exposure. Model a SIFI resolution scenario (in your ORSA).

5

Decide deliberately

Is the yield pickup worth the tail risk, the wrong-way correlation, and the capital uncertainty?