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Presentation to the Select Committee of Finance on funding considerations for the FSR Bill

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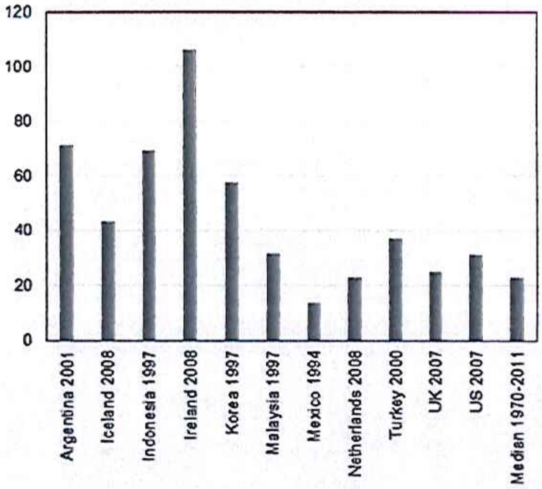
REPUBLIC OF SOUTH AFRICA

Considerations in funding new regulatory model

Banking crises can impose huge economic costs

Selected systemic banking crises:
Cumulative output losses, % of GDP



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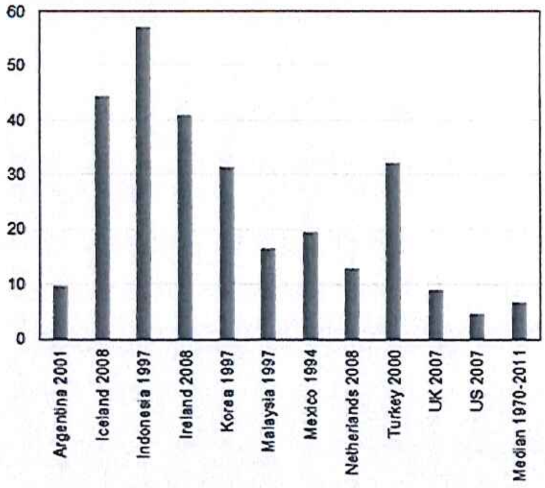

Source: Data from Laeven, L and F Valencia (2012), "Systemic Banking Crises Database: An Update", IMF Working Paper WP/12/16, International Monetary Fund, June 2012

Cumulative output losses are calculated as the sum of the difference between actual and trend real GDP over the period T to T+3 (where T is the first year of the crisis), as % of trend real GDP.

Fiscal cost captures the gross fiscal costs related to the restructuring of the financial sector, mainly in the form of bank recapitalisations, asset purchases and loans.

Costs of crises

- Bank of England in 2010 estimated that the financial crisis cost the British economy up to **£7.4trillion** in lost output
- Hidden cost to the taxpayer of the implicit support offered to the big UK banks at more than **£50bn**
- IMF estimated in 2009 that globally **$11.9 trillion** had been spent dealing with the effects of the global financial crisis
- In the USA, *Better Markets* in 2015 released an extensive Cost of the Crisis Report detailing how the 2008 financial crash and the economic catastrophe it caused will cost the United States more than **$20 trillion.**

UK costs related to Twin Peaks implementation

- Pre global financial crisis, the cost of the FSA (single regulator) was £269mn in 2006/07, increasing to £335mn in 2008/09

- UK estimates on moving to a Twin Peaks model[1]:
– The estimated cost to the BoE and the FSA of creating the PRA: £100 million - £150 million
– The estimated cost of creating the FCA: £15 million - £25 million
– Anticipated that the FCA's and PRA's combined ongoing running costs not materially different (in real terms) in aggregate from FSA budget of about **£500 million** in 2012

- Actual Annual Funding Requirements of PRA and FCA in first year of operation:
– **Combined requirement of £646.3 million** for FCA and PRA in 2013/14, an increase of 15% on the FSA funding requirement in 2012/13

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1. HM Treasury, "A new approach to financial regulation: the blueprint for reform", June 2011

UK costs and consumers

- How is this felt by consumers?
  - **£262 million** paid back to consumers by June 2016 through **redress for PPI** (other redress schemes underway)
  - Single redress agreement this week: CFO Lending to pay back **£34 million to 97000 customers** for predatory lending practices

A more balanced and proportionate approach: firms who do wrong must compensate
Can only identify "bad" firms/practices by intensive regulatory monitoring and scrutiny

- Note that the FCA also collects levies for the Financial Ombuds Scheme and Money Advice Service, based on budgets submitted to the FCA

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Funding requirements of new authorities in UK in first year of operation

Table 4.A Combined AFR across FCA and PRA

£ million	FCA 2013/14	PRA 2013/14	FCA plus PRA 2013/14	FSA 2012/13	Change
Ongoing regulatory activity (ORA)					
FSA twelve months to 31 March 2013				535.5	
FCA twelve months to 31 March 2014	445.7		445.7		
PRA twelve months to 28 February 2014		217.6	217.6		
Total ORA	**445.7**	**217.6**	**663.3**	**535.5**	**127.8**
Year on year change in annual ORA					**24%**
PRA adjustment to eleven months		-18.2	-18.2		-18.2
Total ORA adjusted	**445.7**	**199.4**	**645.1**	**535.5**	**109.6**
Year on year change in adjusted ORA					**21%**
Additions:					
Recovery of scope change costs	3.3		3.3	2.4	0.9
FCA regulatory reform implementation	2.6		2.6	32.5	-29.9
Bank of England transition costs		14.8	14.8		14.8
Subtractions:					
Surplus in previous year[a]	-19.5		-19.5	-10.6	-8.9
AFR	**432.1**	**214.2**	**646.3**	**559.8**	**86.5**
Year on year change in AFR					15%
Financial penalty discount	**-40.6**		**-40.6**	**-70.7**	**30.1**
Percentage year on year change in chargeable fees taking account of financial penalties discount					24%

(a) To be finalised on completion of the statutory audit

Other jurisdictions

USA

- In July 2010, Congress passed and President Obama signed the Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act created the Consumer Financial Protection Bureau (CFPB). The CFPB receives a mandatory transfer of funding from the Federal Reserve System in an amount determined by the Director of the CFPB

- Total cost of CFPB operations in 2011 was $142mn, increasing to $329mn in 2012. The cost for 2016 is budgeted at **$605.9mn**

AUSTRALIA

- APRA budget for 2015/16 → AUS$ 184mn

  (Budgeted expenses for APRA pre-crisis in 2007/08 → AUS$ 9.3mn)

- ASIC budget for 2015/16 → AUS$ 562mn

  (Budgeted expenses for APRA pre-crisis in 2007/08 → AUS$ 23.1mn)

Socio Economic Impact Assessment

Socio-Economic Impact Assessment System

- **Socio-Economic Impact Assessment System (SEIAS)**
  - Problem statement
  - Impact assessment
  - Managing risks
  - Summary, including impact on national priorities

- **Methodology**
  - SEIAS template: provides core questions about the impact of legislation
  - Review of FSRB and associated public consultation documents
  - Review of unpublished commissioned research
  - Preliminary estimates of initial costs at Twin Peaks institutions
  - Questionnaire on compliance costs at financial institutions

Who will benefit?

- **Intended outcome: A safer financial sector that works in the interests of a broader base of financial consumers**
- **Society in general:**
  - Protecting from the substantial costs associated with systemic crises
  - Improving access to good quality financial products and services
  - Supporting the efficient channelling of savings into investment and growth
  - Impact flows through to SEIAS groups: poorest households; black people, youth and women; small and emerging enterprises; and rural development
- **Retail financial consumers:**
  - Strengthened market conduct framework
  - Strategies on financial capability and inclusion
- **Financial institutions (and their shareholders):**
  - Competitive playing field with sound standards of conduct and integrity
  - Protection from the risks of systemic instability
  - Harmonised and consistent approach across financial sector regulators

Illustration: Banking crises can impose huge economic costs…

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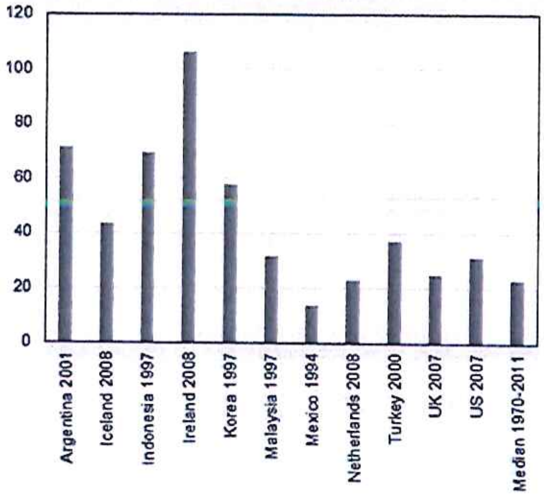
Cumulative output losses, % of GDP



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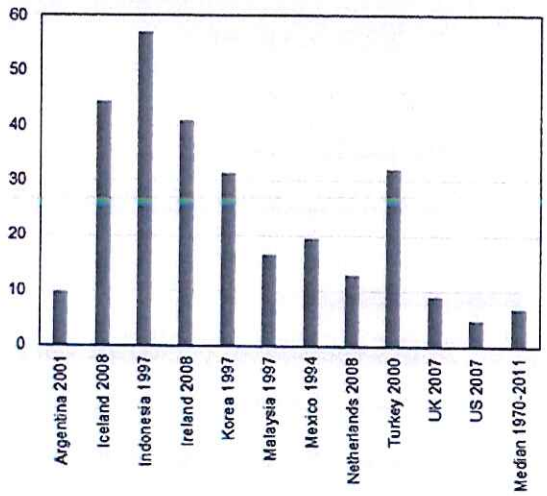

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Who will face a cost?

- **Costs at the South African Reserve Bank, Prudential Authority and FSCA**
  - Preliminary estimate based on forecasts and current costs at SARB and FSB
  - To be funded by fees on regulated financial institutions
- **Compliance costs at financial institutions**
  - Questionnaire sent to small group of financial institutions - 16 responses
  - Compliance costs have been increasing and most respondents expect regulatory challenges and costs to increase further under Twin Peaks
  - Scope for potential benefits of reforms is also identified by several respondents
  - Impact assessment: increasing costs of regulatory compliance must be taken into account in implementing Twin Peaks and further legislative change
- **Costs for financial consumers**
  - Some part of regulatory costs may be passed on through fees and similar charges
  - Difficult to predict response, including net impact of *Treating Customers Fairly*

Putting costs of regulation into perspective...

South Africa's financial regulators cost around R907m in 2015/16

This is expected to rise initially to around R1,033m in 2016/17 under Twin Peaks

It's the direct cost to government and the financial sector of delivering a safer financial sector that works in the interests of financial consumers...

... That's less than the R1,243 million* in combined remuneration packages in 2015 for Directors and senior executives of some of SA's largest financial sector companies.

** Based on total fees and remuneration reported for Directors and other senior executives in the following companies: Barclays Africa, FirstRand, Nedbank, Standard Bank, Discovery, MMI, Sanlam, and the JSE. Source: Annual Reports 2015*

Putting costs of regulation into perspective...

South Africa's financial institutions contributed around R325 billion* to the economy in 2015...

** Gross value added (GVA) of financial corporations, SARB Quarterly Bulletin*

Preliminary estimates and scenarios suggest that the total direct and indirect costs of financial regulation could be between 1.3% and 1.8% of the sector's contribution to the economy

Projections of costs at the SARB, Prudential Authority and FSCA and scenarios for compliance costs at financial institutions based on current costs reported by respondents to the questionnaire conducted for the Impact Study

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Preliminary estimates of direct and indirect costs under Twin Peaks

	Rand, in millions	% of GVA of financial corporations[1]
Benchmark of costs under the current regulatory framework, 2015-16:		
Direct costs of financial regulation and supervision at SARB and FSB[2]	907	0.27%
Indirect costs of compliance functions at regulated financial institutions[3]	3,266	0.97%
Total direct and indirect costs for 2015/16	**4,173**	**1.24%**
Total costs held constant for 2016/17[4]	**4,424**	**1.24%**
Projected costs under Twin Peaks for 2016-17		
Direct costs at SARB, Prudential Authority and FSCA[2]	1,033	0.29%
Indirect costs of compliance functions at regulated financial institutions:[5]		
Scenario 1: overall costs unchanged in real terms	3,462	0.97%
Scenario 2: overall costs increase by 10%	3,808	1.07%
Scenario 3: overall costs increase by 25%	4,328	1.21%
Scenario 4: overall costs increase by 50%	5,193	1.46%
Illustrative range for total direct and indirect costs	**4,495 to 6,226**	**1.26% to 1.75%**

Notes:

1. Gross value added of financial corporations, from South African Reserve Bank Quarterly Bulletin (March 2016).

2. Derived from forecasts provided by SARB and FSB

3. Derived from questionnaire. Aggregate rand costs of compliance functions reported by the questionnaire group scaled up to the industry level. The scaling factor is based on the approximate share of combined assets of institutions in the questionnaire group in the total assets of financial institutions.

4. Total direct and indirect costs for 2015/16 increased for inflation at an assumed rate of 6%. GVA of financial corporations is also adjusted for inflation at a rate of 6%.

5. Four scenarios are used to illustrate the potential scale of increases in costs. The lower bound (scenario 1) assumes that costs remain unchanged in real terms, where an inflation rate of 6% is assumed relative to costs in 2015/16. Scenarios 2 to 4 apply further increases to the costs under scenario 1. GVA is held constant in real terms and thus does not include any net change in the value of the sector arising from regulatory reform.

Managing risks

Identified risk	Mitigation measures
Conflicts between financial sector regulators and the South African Reserve Bank arise in meeting different objectives and fulfilling responsibilities, leading to inconsistent application of regulation.	The FSR Bill establishes mechanisms for consultation, collaboration and cooperation to deal with the risk of conflicts that might arise between the regulators. The FSR Bill further aims to clearly define the powers and responsibilities of each regulator and the Reserve Bank, taking into account the need for cooperation and the mandate to maintain financial stability.
Complexity of the regulatory framework creates uncertainty within the financial sector regarding changing compliance obligations in respect of the different regulatory entities and different requirements under financial sector legislation.	The public consultation process has helped to identify concerns within the financial sector regarding complexity of the framework and to clarify powers and responsibilities of the new regulators to limit uncertainty. Ongoing consultation will be needed as the reforms are implemented. The phased approach to implementation of the Twin Peaks regulatory framework reflects a cautious approach to limit disruption, within a long-term agenda of developing a more harmonised and consistent regulatory approach that should support regulatory certainty for the financial sector.
The new regulatory system creates a substantial increase in the compliance burden for financial institutions, raising costs for consumers and stifling the development of new financial products and services.	The FSR Bill requires the Prudential Authority and FSCA to take into account the need for a risk-based and outcomes-focused approach when performing their functions. Furthermore, the FSR Bill requires the Prudential Authority and the FSCA to regularly review the perimeter and scope of financial sector regulation, and take steps to mitigate risks identified to the achievement of objectives. The Bill also requires a consultation process in making regulatory instruments. These requirements should take into account the compliance processes and costs faced by financial institutions and the implications for achieving policy objectives.

Managing risks *(continued)*

Identified risk	Mitigation measures
Regulatory standards fail to achieve their intended objectives in terms of prudential soundness of financial institutions and better outcomes for financial consumers.	Regular review of the perimeter and scope of financial sector regulation by the Prudential Authority and FSCA, as required under the FSR Bill, should provide a mechanism for identifying and assessing gaps or weaknesses in regulatory standards. The requirement for the Reserve Bank to monitor strengths and weaknesses in the financial system should also contribute to the identification of risks to these objectives.
Mechanisms for responding to major financial shocks fail to prevent a systemic crisis.	The FSR Bill sets out mechanisms and responsibilities relating to systemic events. The South African Reserve Bank is required to monitor the risks to financial stability, including the risk that systemic events will occur. The Financial Stability Oversight Committee and Financial Sector Contingency Forum will assist in the identification of systemic risks and the coordination of measures to mitigate those risks. These pre-emptive measures will strengthen the crisis management framework. The Bill sets out the intervention powers of the South African Reserve Bank that are triggered by a systemic event or the risk of a systemic event, requirements to consult with the Minister of Finance, and the responsibilities of the financial regulators.

Summarising impact on national priorities

Priority	Impact
Social cohesion	Social cohesion will be supported by broadening access to appropriate and affordable financial products and services. The FSCA will have a mandate to deliver better outcomes for financial consumers through promoting fair treatment of financial customers and supporting financial education and financial inclusion. The market conduct framework should enable more people to undertake economic transactions on a daily basis, to save for retirement and long-term goals and to manage major risks to well-being.
Security (Safety, Food, Financial and etc.)	Financial security is one aspect of the objectives of the Twin Peaks reforms through the emphasis on financial stability and financial inclusion. The FSR Bill also makes provisions for financial sector regulators to act and cooperate on combating financial crime, thereby further contributing to security.
Economic growth and investment	Economic growth and investment are supported by a stable and inclusive financial sector, in particular through encouraging higher levels of saving and channelling funds efficiently into productive forms of investment.
Economic inclusion (employment creation and equity)	Financial inclusion is an important aspect of economic inclusion through providing access to affordable and appropriate financial products and services to facilitate participation in the economy. To the extent that a stable and inclusive financial system also supports the funding and financial management of small businesses, then economic inclusion will further be enhanced.
Environmental sustainability	There are no direct implications for environmental sustainability arising from the Twin Peaks reforms. One potential area to monitor, however, would be the extent to which the regulatory framework is able to support appropriate financial instruments for investing in environmental technologies and strategies.

Budgets for the PA and FSCA

Current prudential budgets

SARB Banking Supervision Department

- Total BSD budget 2016/2017 : **R 201m**
  - Personnel costs: R 133m
  - Operational costs: R 68m

FSB Insurance Prudential

- Total budget 2016/17: **R98mn**
  - Personnel costs: R44mn
  - Operational costs: R54mn

Prudential Authority Budget Estimate

- 2016/17 Budget (estimate)

– Bank supervision:	R201m
– Insurance supervision:	R98m
– Additional supervisory functions:	R37m
– FSB transferring personnel alignment:	R 42m
Total	**R378m**

- SARB additional indirect costs – Facilities (Office Space, Parking, IT, other support, etc.)

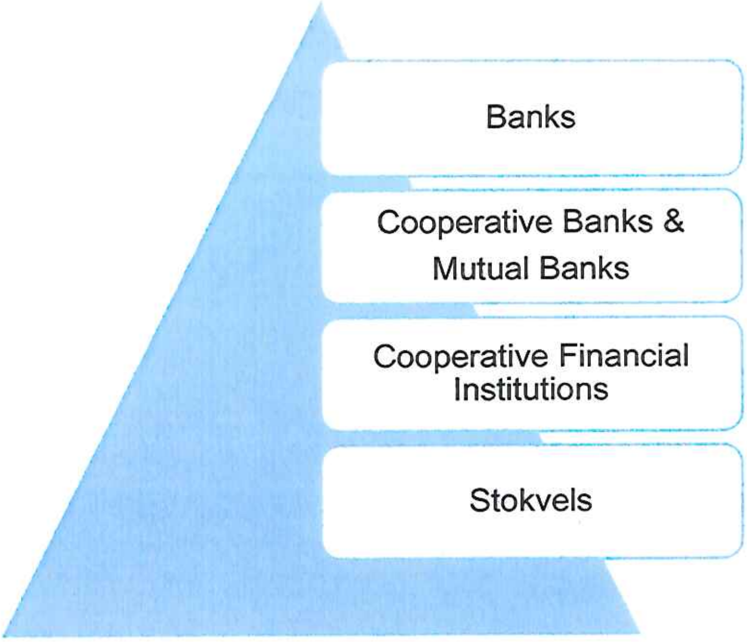
Current approach to setting charges

- Charges/fees are determined ito Banks Act and Regulations, generally linked to time & effort of BSD
  - Examples
    - Review of decisions of the Registrar – S9 – R12 000
    - Granting or refusal of application for Registration – S17 – R18 000
    - Branches of foreign institutions - S18A – R18 000
    - Annual licence fee – S35 Minimum R6 000 – Maximum R300 000
    - Granting or refusal of application for registration as controlling company – S44 – R6 000
    - Amalgamations, mergers and arrangements – S54 – R40 000
    - Alteration of Memorandum of Incorporation and change of name – S56 – R4 800
    - Inspection, copies and keeping of documents – S86 Varies between R60 to R1 200

General approach & factors in setting fees

- Factors taken into account when setting fees
  - International standards:
    - Capital requirements to establish and maintain a bank, linked to risks in the bank
  - Annual licence fees
    - Based on total capital and liabilities, calculated by formula in Regulation 60
    - Minimum R6 000
    - Maximum R300 000
  - Internal costs of the SARB: BSD
    - Specific fees and charges apply per task, published in Regulations Relating to Banks

Inclusion - Prudential



Going forward

- Formula = Total cost of PA X Total Liability of Bank/Total liabilities of all banks
- Example
  - R 289 million X 1 180/4610 million = R 73 million
  - Perhaps capped at R50m, minimum R100 000
- Top 5 banks will contribute 88.92%
- Top 5 insurers will contribute 57%

Current FSB budget

- **Total budget** **R 744 million**
  - Personnel costs: R 451 million
  - Operational costs: R 293 million

FSCA Budget Estimate

• **Current budget:**	**R 744m**
Less: Insurance prudential supervision	(R 98m)
• **Adjusted base:**	**R 646m**
Add: Banking conduct supervision	R 20m
Add: Proactive market/customer research	R 10m
Add: Financial inclusion focus	R 10m
Add: Specialist supervisory support	R 50m
Add: Expanded financial market supervision	R 20m
Add: More intensive conduct supervision	R 20m
Add: Expanded investigation/enforcement capacity	R 10m
• **Provisional FSCA budget estimate:**	**R 786m**

(Plus: capex on integrated regulatory system, new branding, etc.)

Proportionate approach to fees

- **Currently, annual supervisory fees set according to following criteria:**
  - Base amount: Captures cost (time spent) of basic level of supervision needed for all entities, regardless of size
  - Variable amount: Proportionate to nature, size and complexity of entity (according to variables like asset size)
  - Special dispensation to support financial inclusion/transformation: Lower annual supervisory fees for entities serving the low-income sector
- **Examples:**
  - Life insurers: R106,000 (base amount) + 0,0079% of liabilities
  - Assistance business insurers: R10,600 (base amount) + 0,0079% of liabilities
  - Friendly Societies: zero supervisory fee
- **Future approach:**
  - Proportionate approach to continue
  - Cost increases will be carried by entities subject to new regulation (e.g. banks) and larger, more complex entities which pose higher risk to the achievement of supervisory objectives

Considerations for regulator funding process

- **Transparent process** important
  - Regulators should **consult on the intended fees to be charged** and increases thereto annually i.e. apply Chapter 7; if above CPI-linked threshold require Minister approval

- **Strong oversight** required – more onerous that regulatory instruments
  - Regulators should face oversight on **how funds are raised/fees are set** PLUS **actual expenditure** PLUS if money spent is **achieving regulatory objectives (strategy)**
  - Oversight important on particular matters of expenditure, eg remuneration

- Differentiate between 1) costs related to holding a licence, 2) the "lesser" fees and 3) capital adequacy (reserving) requirements

- Propose consumer education, Ombud council and Tribunal included in licence fee as costs of doing business

- **Redrafted Chapter 16** of the FSR Bill sets out process