FINANCIAL SECTOR LAWS AMENDMENT BILL [B15 – 2020]

PRESENTATION TO STANDING COMMITTEE ON FINANCE ON 16 MARCH 2021

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NT AND SARB TEAM PRESENT TODAY

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- Ismail Momoniat (DDG: Tax and Financial Sector Policy)
- Vukile Davidson
- Jeannine Bednar-Giyose
- Langelihle Nkabinde

South African Reserve Bank

- Nicola Brink
- Jacques Botes
- Hendrik Nel
- Sabihah Mohamed
- Masenye Masemole
- Pregasen Moodley

The final step in measures to make the Financial system safer.

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BACKGROUND ON TWIN PEAKS REFORMS AFTER 2008 GFC

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- Financial Sector Laws Amendment Bill (FSLAB) part of Twin Peaks regulatory reforms introduced in 2011
- Followed 2008 Global Financial Crisis (GFC), where one million SA lost their jobs despite our banking sector being safe
- 2011 National Treasury (NT) published broad policy paper:

'***A safer Financial Sector to serve South Africa Better***'

  - *Cabinet adopted the policy in 2011*
  - *More Intensive, Intrusive and effective financial regulation*
  - *Given effect by Financial Sector Regulation Bill which was approved by Cabinet in 2014 and 2015*
  - *FSR Bill introduced in Parliament in 2015, enacted 2017*
- Twin Peak Bills introduced Prudential Authority and also a Financial Sector Conduct Authority, established 1 April 2018
  - PA deals with financial health of fin institutions like banks, inc SIFIs (systemically important fin institutions)
  - FSCA deals with market conduct and customer protection

WHAT HAVE WE DONE IN SOUTH AFRICA

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- We have at least 10 Acts covering regulating the financial sector, all except one reporting to Min of Finance, with one Act (NCR Act) to Min of TIC.
- *Other legislation done in 2011 in parallel with Twin Peaks reform*
  - 2012 Promulgation of the Financial Markets Act (19 of 2012)
  - 2015 Banks Amendment Bill – in response to African Bank failure to allow for transfer of assets and liabilities and separate the entity into a good vs bad bank
- Many framework papers published after 2011, including on market conduct, crypto-assets, financial markets
- COFI Bill is the key outstanding Bill that has been published twice for public comment in 2018 and 2020, and will be introduced later this year for consideration of Parliament

- 2015 NT, SARB and FSCA published second specific policy paper '**Strengthening South Africa's Resolution Framework for Financial Institutions**'

- 2017 SARB published discussion paper '**Designing a Deposit Insurance Scheme for South Africa**'

WHY WE NEED THIS BILL?

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- As demonstrated internationally in 2008 GFC, banking risk is closely linked to sovereign risk – "doom loop"
  - Banks hold most of their Government bonds
- Crisis in Eurozone crisis ("PIGGS") in 2009 (Portugal, Ireland, Italy, Greece, Spain)
  - Challenges in refinancing sovereign debt or bailing out banks
- Bank weakness can foreshadow big costs for government budgets
  - Over the past three decades, banking crises have contributed to large increases in public debt. The median cost of direct government intervention in banking crises was 7 percent of GDP. The direct and indirect fiscal costs from post-crisis recessions, are an increase in public debt four years after the beginning of a crisis of 12 percentage points of GDP. And in many countries, public debt increased by more than 20 percentage points of GDP.
  - Pre-crisis bank characteristics, crisis management policies matter

THE IMPACT OF A FINANCIAL CRISIS IS DEVASTATING ON THE ECONOMY

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- Consequences of a banking crisis on government finances (and spending) as a result of a financial crisis, are devastating.

  - A study of 187 banking crises in 126 countries over the period 1970-2009, shows the impact of a crisis not only on the economy and the financial sector, but also on health, education, poverty, and gender issues.

  - The broad-ranging implications for society include declines in average life expectancy, primary school enrolment and considerable short-run worsening of poverty and income equality.

BANK RISKS ARE AS SIGNIFICANT AS NUCLEAR RISKS TO AN ECONOMY

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- Major banks are "Too-big-to-fail"(TBTF) and this is why banks are often compared to nuclear facilities and described as Systemically Important Financial Institutions (SIFI's)
- Failure of a bank has a domino effect on other banks and financial institutions because of interconnectedness, and results in devastating far reaching problems for the entire economic system
- So governments will do whatever it takes to avoid this outcome, including bail-outs of banks
- Problem of MORAL HAZARD must be dealt with, as banks may then take even more risky behaviour to make profits
- Profits are privatised, but losses are socialised

2008 GLOBAL FINANCIAL CRISIS WAS A WAKE UP CALL

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- The 2008 GFC illustrated the devastating effect SIFIs' failures have
- Risk is not only to domestic economy, but affects banks and economies of other countries
- South Africans remained safe, and were not the cause of any domestic crisis, but SA still lost 1 million jobs
- In 2009, former President Zuma and other G20 heads of state, called on the countries to commit to measures to address too-big-to-fail (TBTF) banks and SIFIs
- In 2010 at the Seoul Summit the G20 heads of state endorsed the framework for reducing the moral hazard of SIFIs
- Objective of the SIFI Framework is to address the systemic risks and the associated moral hazard problem for institutions that are seen as TBTF. It does so by making SIFIs stronger and more resilient as well as policy measures to make sure that they can be resolved in the event that they fail.
- Regulators plan for what happens if a bank is in financial stress. This is called **RESOLUTION planning,** or to have a **"living will",** which in USA is a mandatory annual submission that SIFI banks have to make to regulators

BANKS ARE DIFFERENT FROM OTHER COMPANIES

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- Banks are different from other companies, and hence they require a failure management process different to normal insolvency processes – currently curatorship
- Banks work on TRUST, and the moment depositors hear even a rumour of a bank in trouble, they rush to the bank to withdraw their deposits
- It is in the nature of banking that no bank keeps cash to pay out 100% of its depositors
  - Depositor funds are used to make loans
- Bank runs and panics happen very quickly, and a bank failure affects other banks as they have interrelated deposits and loans
- Hence, like almost every country, we have CURATORSHIP for banks BEFORE any insolvency mechanisms are utilised
  - World is going further with RESOLUTION and deposit insurance
  - Also reduces risk to the fiscus to bail-out banks

KEY ELEMENTS OF THE G20 GLOBAL REGULATORY REFORMS

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Cross-Border resolution of SIFIs

SIFIs to develop specific, internationally standardised contingency and resolution plans

Reduction of Systemic Risk and Moral Hazard

Legal Framework for Crisis Intervention

More Intensive supervision of SIFIs

Development of Resolution Tools and Frameworks for SIFIs

WHAT HAVE WE DONE IN SOUTH AFRICA

- 2011 National Treasury (NT) published broader policy paper '***A safer Financial Sector to serve South Africa Better***'
  - *This led to the Twin Peaks regulatory framework, extending the regulatory perimeter and allowing for more intensive and intrusive supervision. It also provided the framework for dealing with SIFI's*

Other work:

- 2012 Promulgation of the Financial Markets Act (19 of 2012)

- 2015 NT, SARB and FSCA published second specific policy paper '**Strengthening South Africa's Resolution Framework for Financial Institutions**'

- 2015 Banks Amendment Bill – in response to African Bank failure to allow for transfer of assets and liabilities and separate the entity into a good vs bad bank

- 2017 SARB published discussion paper '**Designing a Deposit Insurance Scheme for South Africa**'

- 2019 SARB published discussion paper on '**Ending too big to fail: South Africa's intended approach to bank resolution"**

2017 FINANCIAL SECTOR REGULATION ACT (FSRA)

The FSRA gives the Reserve Bank the mandate for financial stability, including:

- Systemic events
- Designation of SIFIs

Established - Prudential Authority & Financial Sector Conduct Authority

WHAT PROBLEMS WILL WE BE ADDRESSING

1. Minimise use of public funds and reduce moral hazard: As outlined, the costs of the failure of a SIFI's are borne by the general public, but the profits are made by the investors.

2. Plan for failure: Make sure we have tools to resolve SIFI's with minimum disruption to the economy.

To do this the Resolution Framework will:

- **Adopt Bail-in, not Bail-out** – need to move from culture of bailouts from tax payer funds, creditors and shareholders who profit in good times need to ***absorb losses in bad times***
- Need for complex SIFIs to plan for the possibility of failure (resolution planning), to make an orderly resolution feasible.
- Need for ***depositor protection*** and recognition in liquidation – vulnerable depositors should be protected and have access to funds
- Need for a legal framework that goes **beyond curatorship/business rescue** due to the economic nature of critical functions provided by financial institutions

CURRENT LEGAL GAPS IN SOUTH AFRICA

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I. Banks Act only provides for curatorship which is limited in scope – does not apply to non-bank financial institutions and inadequate for the failure of SIFIs

II. Companies Act provides for business rescue proceedings – does not give due regard to the nature and complexities of large, complex financial institutions operating across multiple jurisdictions

III. Insolvency Act only applies in liquidation proceedings, does not recognise depositors as preferred in the creditor hierarchy

IV. No pre-identified resolution authority with commensurate powers and functions to deal with group-wide resolution of financial conglomerates

V. Fragmentation of the law, need to have alignment and co-operation provisions between regulators e.g. PA and SARB

CURRENT LEGAL GAPS IN SOUTH AFRICA….CONTINUED

VI. No legal provision for resolution planning for banks, systemically important non-bank financial institutions and holding companies

VII. Bail-outs based on a case by case basis, not in accordance with a uniform standard or principle defined in law

VIII. Lack of depositor protection in resolution and liquidation

IX. South Africa does not have an explicit, privately funded deposit insurance scheme – past compensations were done on an ad hoc basis, funded by government subject to available funds and the budget process

FINANCIAL SECTOR LAWS AMENDMENT BILL

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Key Objectives

- Provide a framework for the resolution of Banks, non-bank SIFIs
- Designate the Reserve Bank as the Resolution Authority with commensurate powers
- Deposit Insurance Fund + Corporation for Deposit Insurance
- Creation of a Creditor Hierarchy to ensure depositor protection in liquidation

STRUCTURE OF THE AMENDMENTS

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Clause 1-50

- Various Technical Amendments
- OTC Insolvency Amendments

Clause 51

Chapter 12A

- Resolution (166A – 166Z)
- Deposit Insurance (166AA-166BH)

Clause 52-61

- Long Title Amendment
- General Amendments

FINANCIAL SECTOR LAWS AMENDMENT BILL: Key Proposals

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Key Proposals

- Bill aims to enhance the Reserve Bank's financial stability mandate and to expand its objective for depositor protection;
- Scope of application will be all banks, systemically important non-bank financial institutions and holding companies;
- Stabilisation powers to include bail-in, transfer of certain assets and liabilities as well as the creation of bridge institutions;
- Resolution Authority (i.e. Reserve Bank) to be responsible for the development of resolution plans for all designated institutions (SIFI's);
- Safeguards to include a new proposed creditor hierarchy (see slide 17) and adherence to the 'no creditor worse off' principle

FINANCIAL SECTOR LAWS AMENDMENT BILL: Framework, Powers and Functions.

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RESOLUTION FRAMEWORK

- MAINTAINING FINANCIAL STABILITY
- DEPOSITOR PROTECTION
- ORDERLY RESOLUTION OF DESIGNATED INSTITUTION
- MANAGEMENT OF AFFAIRS OF DESIGNATED INSTITUTION
- ENSURING CRITICAL FUNCTIONS OF DESIGNATED INSTITUTION CONTINUE
- RESOLUTION PLANNING
- MINISTER OF FINANCE EMPOWERED TO PLACE DESIGNATED INSTITUTION IN RESOLUTION

RESERVE BANK POWERS & FUNCTIONS

- POWER TO REMOVE AND REPLACE MANAGEMENT & RECOVER MONIES FROM THOSE RESPONSIBLE
- POWER TO TERMINATE/ASSIGN CONTRACTUAL AGREEMENTS
- APPOINTMENT OF RESOLUTION PRACTITIONERS WITH DELEGATED POWERS
- POWER TO ESTABLISH BRIDGE INSTITUTION AND TRANSFER SELECTED ASSETS AND LIABILITIES
- POWER TO TAKE BAIL-IN ACTION WHILST RESPECTING HIERARCHY OF CLAIMS IN LIQUIDATION

In Liquidation…..

Creditors have better memories than debtors.

(Benjamin Franklin)

izquotes.com

FINANCIAL SECTOR LAWS AMENDMENT BILL:
Creditor Hierarchy

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Current	***Proposed***
Secured	Secured
Preferred	Preferred
Unsecured	Covered deposits
	Unsecured
	Flac instruments
	Regulatory debt instruments

FINANCIAL SECTOR LAWS AMENDMENT BILL: Creditor Hierarchy

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Policy Rational for new Creditor Hierarchy

i. SA creditor hierarchy does not recognise distinction between ordinary depositors using a bank for transactions, and informed creditors and depositors making an investment in a bank for a return.

ii. Need to align bail-in sequence (for creditor losses) with sequence to be followed in liquidation

iii. Bail-in together with creditor hierarchy should allow for orderly resolution and if necessary winding up of a SIFI and not be restrictive for the Reserve Bank

iv. A creditor hierarchy that gives due regard to sophisticate creditors (i.e. institutional and corporate depositors at wholesale level) allows for appropriate pricing of risk and certainty of ranking

Financial Sector Laws Amendment Bill…..continued

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Policy Rational for new Creditor Hierarchy

v. A definitive creditor hierarchy will ensure transparency and avoid confusion e.g. preferred v ordinary creditors and who bears the loss first which in turn will lead to avoidance of under/over pricing of risk

vi. Need to align SA creditor hierarchy with international standards

Summary of Proposal

- Secured and preferred creditors to retain current ranking
- Depositor preference – covered depositors (up to coverage level)
- Unsecured creditors – currently recognised in Insolvency Act, to rank below covered depositors
- FLAC Instruments – instruments specifically identified as loss absorbing after regulatory capital

Financial Sector Laws Amendment Bill…..continued

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Summary of Proposal Continued….

- Regulatory capital requirements are designed to bear going-concern losses. Lessons from the previous bank failures show that regulatory capital may be insufficient by the time a SIFI enters resolution, additional requirement for large financial institutions to hold instruments, over and above regulatory capital for loss absorption during resolution
- Regulatory capital has to be available to absorb shocks and losses during normal times and prevent failure. If there are any regulatory capital left when a bank fails, the creditor hierarchy should ensure that the instruments identified as regulatory capital are first in line to suffer loss during a failure.

DEPOSIT INSURANCE

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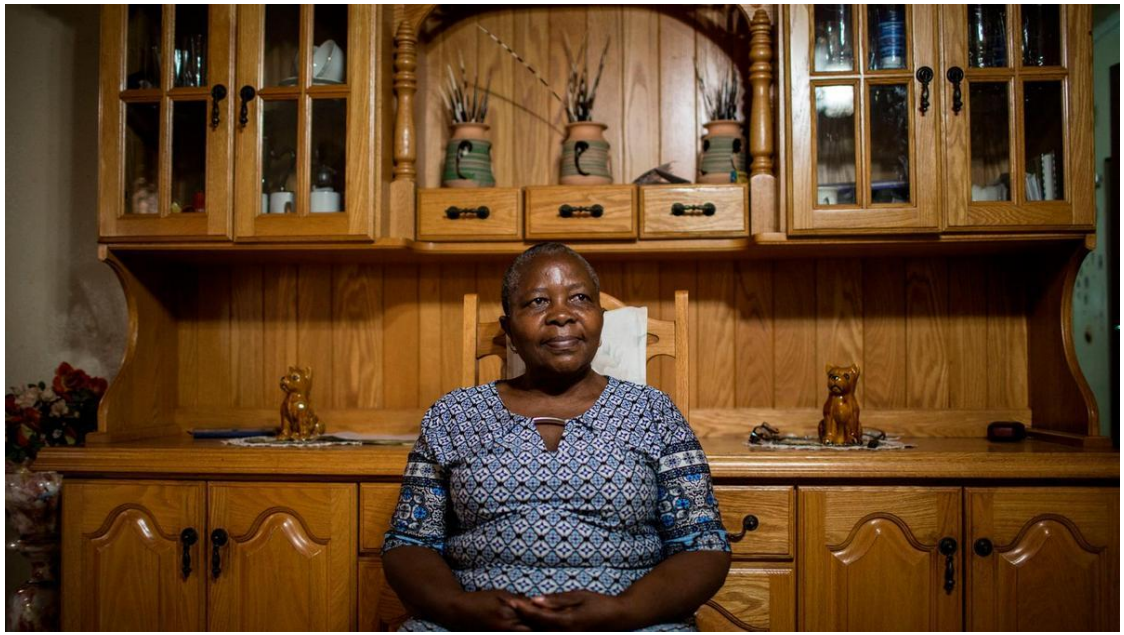
- One of the key features of the Resolution Framework is the introduction of a Deposit Insurance Scheme (DIS).



Annah Muambadzi, a pensioner and treasurer of the 'stokvel', a collective of sixteen people that invested in VBS, at her home in Hamutsha Village in Levubu Limpopo, South Africa.

DEPOSIT INSURANCE SCHEME: why we need it

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ADVANTAGES

- ✓ Eliminates risk of depositors losing funds that deprive them of their livelihood
- ✓ Promote competitiveness of smaller banks
- ✓ Improves confidence and reduces risk of a bank run during a crisis
- ✓ Ensures continued access to funds during a bank failure
- ✓ Minimises the risk of contagion
- ✓ Enhances SA market integrity which in turn ensures investor confidence
- ✓ Smaller bank crises can be managed with minimal disruption
- ✓ Protects the fiscus from bailouts
- ✓ Puts the cost of failure on banks and depositors who benefit, instead of the taxpayers in general
- ✓ Provides certainty on guaranteed depositor pay-out amounts and timing of repayments
- ✓ South Africa is the last G-20 country not to implement an explicit DIS

Deposit Insurance Scheme: Overview

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Policy Objective	Structural Features
Protection for depositors in bank failure e.g. qualifying deposits up to R100 000 per qualifying depositor per bank; Safety net for ordinary depositors Minimise disruption, adverse effects of failures Crisis management tool during systemic event available to Reserve Bank	To be housed within the Reserve Bank Reserve Bank subsidiary – CoDI established to independently administer the fund and manage its affairs Membership comprises registered/licensed banks allowed to hold covered deposits Fund to consists of premiums collected, deposits by banks and investment return on these items

Funding

Deposit Insurance Levy – charged and collected from members of the fund in terms of a Money Bill to fund operations of CODI

Deposit Insurance Premium – charged and collected by the CODI in terms of a Money Bill from Members

Provision of liquidity to CODI – from members, currently this is subject to consultation between banks and the Reserve Bank

DEPOSIT INSURANCE SCHEME: Funding Structure

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As needed	**Emergency Tier (SARB emergency funding)** • Only needed in exceptional cases • First to be repaid by Corporation from proceeds of liquidation • If shortfall, repaid through premiums by banks

Deposit insurance Fund (for coverred depositor payout or to support resolution with funding)

3% of covered deposits per year	**Liquidity Tier (Deposits placed by banks with Corporation)** • Interest-earning asset for banks • Adjusted monthly in line with covered deposit balance • Used for liquidity during payout as an advance against liquidation proceeds • High degree of certainty of recovery from liquidation proceeds due to position of covered deposits in the proposed creditor hierarchy
0.2% of covered deposits per year (0.2%/12 per month)	**Equity Tier (Premiums by banks)** • Funded through premiums (expensed) • Flat premiums of 20 bps per year (paid monthly) • If shortfall in liquidation proceeds, premiums by banks can be adjusted

Annual levy to cover operational costs: 0,015% of covered deposits

DEPOSIT INSURANCE SCHEME: Features

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Proposed Design Feature Continued…

- Establish information requirements (Single Customer View) and efficient payout mechanisms
- Limited support for open resolution strategies subject to conditions:
  - Less costly than payout
  - Viability of the resolution strategy
- Emergency liquidity facility provided by the SARB as a backstop in the event of insufficient funding – to be recovered from liquidation proceeds first, then from membership banks

Summary

- 2008 Global Financial Crisis exposed regulatory gaps in global markets especially for banks which operate on a cross-border basis
  - DOOM LOOP btw sovereign and banking risks
- Large fin institutions SIFIs are 'Too Big to Fail', require more than business rescue/insolvency legal proceedings to ensure orderly resuscitation/winding down process
- Regulatory frameworks require a legal process that entails early intervention, crisis planning, crisis management and orderly wind down
- 2009 South Africa undertook to adopt a resolution framework in line with G-20/FSB principles, this Bill is the culmination of these agreed reforms.
- SA lessons - African Bank and VBS demonstrated the need for additional powers during an intervention and an explicit, privately funded deposit insurance scheme to protect vulnerable depositors

THE END

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QUESTIONS AND ANSWERS