South African Reserve Bank

Address by Francois Groepe, Deputy Governor, South African Reserve Bank at the public workshop on the discussion paper titled 'Strengthening South Africa's resolution framework for financial institutions'

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Introduction: addressing 'too big to fail'

After the global financial crisis of 2007/08, and the severe and lingering consequences thereof on the global economy, one of the key items on the agenda of the G-20 (the Group of Twenty Finance Ministers and Central Bank Governors) was to address the 'too big to fail' problem.

During the past couple of decades, financial sectors have outgrown the size of their national economies and have expanded beyond their national borders. The individual balance sheets of large, global financial conglomerates are now larger than those of most economies. For example, the balance sheet of JP Morgan Chase amounted to US$2,6 trillion in 2014 – larger than the gross domestic product, or GDP, of all but the six largest economies in the world[1]. Moreover, the activities of these large financial institutions are highly interconnected, and the services they provide are inseparably integrated into the modern financial system and the global economy. Unlike non-financial corporates, which can be liquidated in the event of failure even if they are large, the failure of a single large financial institution can disrupt the functioning of the whole financial system and the economy so that the ultimate cost of the failure far exceeds the initial losses that caused the failure.

[1] China, France, Germany, Japan, United Kingdom and United States (data from the International Monetary Fund and the World Bank)

This is what had forced governments to intervene in past financial crises, and what came to be known as the 'too big to fail' problem.

The 'too big to fail' problem is not only a global phenomenon. In South Africa, banks' total assets amount to some R4,4 trillion. This approximates to 125 per cent of South Africa's GDP of about R3,7 trillion. The assets of long-term insurers amount to about R2,4 trillion, and those of self-administered pension and provident funds to R1,7 trillion[2]. These are just some examples to show how important financial institutions have become in our own economy, and how exposed the system has become to the consequences of a failure of one of the significant financial institutions, especially since the financial system is highly concentrated and interconnected. Even if government were willing to support these institutions in the event of failure, such an intervention would bring a huge burden on the public purse. We are fortunate that our large financial institutions are all in a healthy financial condition and well managed, with a very low probability of failure. However, this is also the best time to prepare for the unlikely event of failure.

Lessons from the financial crisis for resolution

The global financial crisis as well as the way in which both governments and central banks had to act to contain the effects thereof has taught us important lessons. The list of lessons is extensive, but I will highlight a few that have a particular bearing on resolution and on what we are attempting to achieve with a strengthened resolution framework.

i. Implicit support leads to moral hazard. If banks believe that they will not be allowed to fail (i.e. that they will be 'bailed out'), they tend to take greater risk. Similarly, if bank managers and executives are rewarded on the basis of profitability without facing the consequences of excessive risk-taking, it creates skewed incentives. This did not happen in South Africa on any large

[2] All amounts quoted from the June 2015 *Quarterly Bulletin*

scale, which helped to protect us from the worst of the crisis, but it certainly happened in other parts of the world, with devastating effects.

ii. Implicit support leads to a mispricing of risk. If investors believe that banks will be bailed out and will therefore not be liquidated, they basically believe that their investment risk profile is similar to that of the sovereign. An effective resolution framework should promote market discipline by ensuring that investors and creditors price for the risk of the institution in which they invest, without relying on a government bailout and hence an implicit subsidy.

iii. Markets overreact in a crisis. An effective resolution framework should enable authorities to prevent excessive losses that arise from fire sales, frozen markets, excessive volatility, additional collateral requirements, margin calls and early termination rights.

iv. Early intervention and corrective action reduce the losses resulting from failure. The cost of a failure can be significantly reduced if authorities have the power and the tools to intervene while the financial institution is still solvent. Once the market loses confidence in the ability of an institution to recover, its failure becomes a self-fulfilling prophecy.

v. Planning and preparing for resolution is important. Although the reason for a possible failure cannot be predicted, and although the likelihood of failure could be very small, proper planning always puts authorities in a better position to successfully manage an orderly resolution. Being caught unawares – without the necessary information, resolution tools and/or cooperation agreements – may cause delays during which asset values and market confidence are eroded and possibly destroyed.

vi. It is not only banks whose failure can cause a financial crisis. The failure of non-bank financial institutions can have equally devastating effects on financial stability, as was clear from the failure of Lehman Brothers, AIG and

others. Authorities therefore need tools to deal with the failure of various kinds of financial institutions, as well as of financial groups.

vii. Financial failures cause hardship for ordinary people. Financial crises can result in job losses, financial losses, and an inability to conclude transactions. An effective resolution framework should contain safety net arrangements to protect the most vulnerable citizens from severe hardship as a result of a financial failure.

viii. Cooperation and coordination among regulators and other authorities is essential to achieving an orderly resolution, especially if a financial group operates in various jurisdictions. Coordination arrangements should be supported by appropriate legislation.

The international response

Various international standard-setting bodies, including the G-20 and the Financial Stability Board (FSB), have made significant progress in developing and promoting the implementation of enhanced regulatory standards to increase the resilience of the financial sector to shocks.

South Africa's own regulatory framework is undergoing significant changes as a result of this response, with the introduction of Basel III, … (SAM), over-the-counter (OTC) derivatives market reforms and the Twin Peaks regulatory framework, to name but a few.

However, even the most effective regulatory framework cannot completely rule out the possibility that financial institutions and financial groups may fail. Therefore, significant attention has been given to the development of new standards for resolution.

G-20 member countries have committed themselves to the objective of implementing measures which will allow large financial institutions fail in a way that critical economic and financial functions continue uninterrupted and without taxpayer money

while maintaining the financial stability of the sector. To achieve this objective, the FSB has developed a set of new international standards that G-20 member countries have to implement in order to make it possible to resolve the failure of large, complex and interconnected financial institutions, which often operate in multiple jurisdictions, without having to provide public support and without interrupting the provision of critical functions. Drawing on lessons learnt during the global financial crisis, the FSB developed the *Key attributes for effective resolution regimes* (*Key attributes*), which describe the minimum set of legal powers, processes and governance arrangements that countries should have in place in order to achieve the orderly resolution of failing financial institutions. G-20 member countries have to comply with these *Key attributes* from 2016.

The second thematic peer review on resolution, conducted by the FSB in May 2015, showed that G-20 member countries have made progress in implementing the *Key attributes*. In the European Union (EU), the Bank Recovery and Resolution Directive (or BRRD) was introduced, which contains the full range of resolution powers. The BRRD is being incorporated into national legislation by EU members. In the United States (US), the Dodd-Frank Act introduced all but one of the *Key attributes* powers. Six jurisdictions have all but two or three powers. Most jurisdictions have reported that they are planning and implementing reforms. Significant progress has also been made in the areas of recovery planning and resolution planning, in particular with regard to global systemically important banks (G-SIBs).

South Africa's response

As a G-20 member, South Africa is committed to implementing the framework contained in the *Key attributes*. But this is not merely an exercise to comply with international standards; rather, this is seen as a key element of a resilient financial sector that can withstand shocks and continue to serve the economy and all its stakeholders, even in the event of a systemic disruption or failure.

A thematic peer review conducted by the FSB in 2013 and a comprehensive review of South Africa's resolution framework in 2009/10 under the auspices of the World Bank's First Initiative Programme revealed gaps in a number of areas where South

Africa's resolution powers did not comply with the *Key attributes*. These gaps were confirmed in the findings of the International Monetary Fund (IMF) in its 2014 Financial Sector Assessment Programme (FSAP) for South Africa. Our current framework for dealing with failed financial institutions is fragmented across various pieces of legislation and regulations. In general, there are inconsistencies in dealing with different kinds of financial institutions, inadequate powers for 'business rescue' practices that would be appropriate for financial institutions, and some implicit assumptions and beliefs that drive activities in the financial sector but that would not always be possible or realistic. Table 1 in the paper contains a more complete assessment of South Africa's existing resolution framework against the *Key attributes*, and highlights the gaps that the new framework should address.

The new resolution framework is intended to rectify the inconsistencies; to clarify the position of investors, depositors, policyholders and creditors in the event of a failure; to ensure the fair and transparent allocation of losses with appropriate safeguards; to put measures in place for the funding of resolution actions; to provide protection where it is most needed; and to introduce the tools necessary for maintaining financial stability and ensuring the continuation of critical financial services.

The key elements of an effective resolution framework

The discussion paper sets out the key elements of an effective resolution framework, as it could be applied to South Africa.

It is important to understand that the term 'resolution' is not a synonym for 'liquidation', 'curatorship' or 'administration', the latter terms representing South Africa's current arrangements for dealing with failed financial institutions. Resolution in the context of the *Key attributes* is a new concept that requires a paradigm shift. Going forward, resolution is about earlier intervention, preserving value, restoring confidence, and preventing 'fire sale' losses. Going forward, resolution is about allocating losses where they are due without necessarily having to liquidate, and about being able to rectify malpractices, structural problems and mismanagement while there is still a chance for recovery. Going forward, resolution is focused at maintaining critical functions rather than rescuing legal entities. Going forward,

resolution is about protecting broader financial stability instead of protecting only particular groups of creditors or depositors.

The intention is to establish a new, strengthened framework for resolution by drafting and promulgating a Special Resolution Bill. The main objective of this Special Resolution Bill will be to maintain financial stability in the event of an institutional failure.

I will highlight the main elements of the new framework, each of which is discussed in detail in the paper itself.

i. The paper introduces the concept of a ‘designated resolution institution’, applicable to any financial institution whose failure would disrupt financial stability. The Special Resolution Bill will apply to all banks and to systemically significant non-financial institutions. The Bill will potentially (but not necessarily) apply to financial groups from the level of the ultimate holding company; this will be determined by the structure and operations of each financial conglomerate.

ii. The South African Reserve Bank will be the Resolution Authority, in line with its financial stability mandate. However, appropriate consultation and coordination requirements as well as appropriate governance and accountability arrangements will be in place.

iii. Resolution plans and resolvability assessments will become a legal requirement in terms of the Special Resolution Bill, and the South African Reserve Bank will be able to share these plans or parts thereof with other regulators, if required.

iv. A deposit guarantee scheme will be established as part of the new resolution framework. A panel of experts is currently conducting a research project to finalise detailed proposals on the design features of the scheme.

v. The South African Reserve Bank, as the Resolution Authority, should have the ability to share information with other regulators and enter into agreements to facilitate the execution of an orderly group-wide resolution strategy.

vi. The Special Resolution Bill should provide for pre-resolution powers which should be available to the Resolution Authority in order to facilitate ongoing resolution planning, the operation of the deposit guarantee scheme, and cross-border cooperation. In addition, the powers needed in a resolution process are also needed to implement the resolution strategy. The powers proposed in the paper should be available to all institutions but may not be equally appropriate to all institutions in all circumstances. The powers used should be proportionate to the nature and systemic significance of the institution being resolved.

vii. The point at which an institution is put into resolution (the 'point of resolution' or POR) will be triggered if the institution is no longer able to meet its minimum prudential requirements or is judged to be no longer viable, if recovery options have become depleted or ineffective, and if no private-sector solution seems likely or feasible. These criteria are applicable to all financial institutions, not only to banks.

viii. The paper proposes a number of new stabilisation powers, namely the ability to establish a bridge institution, to transfer assets and liabilities, and to 'bail in' within resolution (the so-called 'statutory bail-in'). The paper also proposes a creditor hierarchy for financial institutions that will facilitate bail-in in a way that no creditor or investor will be worse off in resolution than they would have been in liquidation. Bail-in is the tool available to the Resolution Authority to recapitalise a failed institution or a bridge institution, and to allocate losses to shareholders, creditors and investors outside of liquidation. Bail-in can contribute to greater market discipline and better pricing for risk, provided that the conditions for and the hierarchy of the instruments that are potentially subject to the bail-in are fair, transparent and well understood.

Conclusion

I trust that you will find this workshop interesting and useful to understand what we are aiming to achieve with a strengthened resolution framework. We depend on your valuable input on the proposals presented in the discussion paper to ensure that we design a framework that will serve our financial system better into the future. I foresee likely changes to the policy proposals once we have processed all the comments and inputs. We look forward to receiving your honest and constructive opinions to help us achieve the best possible outcome.