

SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

by

JESSICA FOX

(11027658)

submitted in partial fulfilment of the requirements
for the degree of

MASTER OF LAWS

at the

THE UNIVERSITY OF PRETORIA

PREPARED UNDER THE SUPERVISION OF

PROFESSOR CM VAN HEERDEN

DECLARATION

I declare that this dissertation is my own original work and where other people's work has been used, this has been properly acknowledged and referenced. This dissertation is submitted in partial fulfilment of the requirements for the degree of Masters of Laws in Mercantile Law. It has not been submitted by another student or any other person in any other institution.

Name: Jessica Fox

Student Number: 11027658

Signature: _____

ACKNOWLEDGEMENTS

I would like to express my deepest gratitude to my supervisor, Professor van Heerden for her fruitful insight, patience and guidance throughout this process and to my family and friends for their constant support and encouragement.

SUMMARY

The Global Financial Crisis of 2008/2009 has changed the global perspective of regulating financial institutions and further highlighted the need to pursue financial stability. The monitoring and counteracting of systemic risk was identified as the key to achieving a stable financial system. Although South Africa weathered the Global Financial Crises well in comparison to other jurisdictions like the USA it has, as a G20 member, adopted the movement toward achieving financial stability through the implementation of a Twin Peaks model of functional financial regulation by objective via the Financial Sector Regulation Act 9 of 2017(FSRA). According to this model, the central bank as guardian of financial stability is given the power to designate certain financial institutions as systemically important financial institutions (SIFIs) given their ability to trigger systemic collapse. This research accordingly considers the designation of SIFIs as provided for in the FSRA. Furthermore, a comparative study of Hong Kong's financial regulatory system and designation of SIFIs is considered and analysed. It is concluded and recommended that Hong Kong's proactive approach should be considered and potentially adopted with the aim of effectively regulating SIFIs instead of over-regulating them when giving effect to the FSRA.

INDEX

Chapter 1: General Introduction	7
1. Background.....	7
2. Workable Definitions	13
3. Study Objectives	14
4. Research Questions.....	15
5. Literature Review	15
6. Significance of Study.....	19
7. Hypothesis	20
8. Methodology	20
9. Limitations of Study.....	20
10. Layout of Chapters.....	21
Chapter 2: What Is A Systemically Important Financial Institution?	22
1. Introduction	22
2. Financial Regulatory Bodies	22
3. Workable Definition.....	23
4. Assessment Methodology of G-SIBS.....	27
5. The Indicator-Based Measurement Approach.....	28
6. Assessment Methodology of D-SIBS	31
7. Principles 1 - 7: Assessment Methodology	32
8. Assessment Methodology in South Africa.....	33
9. Conclusion	37
Chapter 3: The Prudential Authority, Prudential Requirements and Higher Loss Absorbency Requirements	39
1. Introduction of the 'Twin Peaks' Model in South Africa.....	39
2. Prudential Requirements Prescribed by the BCBS	41
3. Prudential Requirements in South Africa	42

4. Additional Prudential Requirements in respect of SIFIs	47
5. Sections 30 and 31 of the FSRA.....	49
6. Conclusion	50
Chapter 4: Basel III and the Designation of SIFIs in Hong Kong.....	51
1. Introduction	51
2. Financial Regulation in Hong Kong.....	52
3. Designation of G-SIBs and D-SIBs in Hong Kong: Assessment Methodology	56
4. Hong Kong Prudential and Higher Loss Absorbency Requirements	59
5. Assessment of the Implementation of Regulatory Standards underpinning the Basel III Framework in Hong Kong	62
6. Conclusion	63
Chapter 5: Comparison and Recommendations	64
1. Introduction	64
2. Financial System Regulatory Framework.....	64
3. Assessment Methodology: D-SIBs.....	65
4. Prudential and Higher Loss Absorbency Requirements.....	66
5. Conclusion and Recommendation	67
Bibliography	69

CHAPTER 1

GENERAL INTRODUCTION

1. Background

In 1929, the “Great Depression” resulted in a strict approach to financial regulation across the globe. In the early 1980’s however financial markets underwent regulatory deconstruction in order to allow free market rule and mobility of capital whilst deregulating business and finance. De Jager refers to this process of deconstruction as “...*the phase of evolution of financial markets under the radical financial deregulation process...*”.¹ Crotty states that the financial regulatory systems’ evolution “...*took the form of cycles in which deregulation, accompanied by rapid financial innovation, stimulated powerful financial booms and ended in crisis. Government bailouts in response to these crises caused new expansions, resulting in larger financial markets and larger financial crisis, threatening whole financial systems and societies.*”² The aforementioned statement by Crotty aptly captures the essence of the Global Financial Crisis (GFC) experienced in 2007/2008.

The GFC was the domino result of several occurrences which led to a countrywide recession in the USA and which later spread globally.³ One of the main causes of the GFC could be attributed to the collapse of large financial institutions, which were considered “Too-Big-To-Fail” (TBTF) or Systemically Important Financial Institutions (SIFIs) because their size, complexity and interconnectedness posed severe contagion risk that could trigger the collapse of financial systems, nationally and sometimes even globally⁴. TBTF financial institutions would be bailed-out by government when they experienced financial difficulties. For the purpose of this dissertation a “bail-out” is defined as

¹ De Jager J (2013) SA MercLJ *The South African Reserve Bank: Blowing Winds of Change* (Part 2) at 492.

² Crotty J (2009) *Structural causes of the global financial crisis: a critical assessment of the “new financial structure”*. Cambridge Journal of Economics, Oxford University Press 563.

³ Bartmann R (2017) Causes and effects of 2008 financial crisis, HFU Business School at 3.

⁴ “Too-big-to-fail”(TBTF) means a financial firm “*whose disorderly failure, because of its size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic system*”. See Financial Stability Board (FSB) *Reducing the moral hazard posed by systemically important financial institutions* (2010) at 1.

government provided assistance to a financial institution to prevent it from failing.⁵ These government bail-outs were alleged to have created a moral hazard in that it encouraged even more risk-taking by these TBTF-firms as they were basically guaranteed of bail-outs in case of failure.⁶ In the end, the consequences of this excessive risk taking by these financial institutions were incurred by taxpayers, whose taxes were used by government to bail-out failing TBTF financial institutions.⁷ Some examples of TBTF financial intuitions that played a major role in the 2007/2008 GFC include, *inter alia*, Bear Sterns, Lehman Brothers and AIG.⁸

One of the other major causes of the GFC was the creation of the new lending system in the USA, which encompassed, *inter alia*, a new market for selling securities backed by subprime⁹ mortgages¹⁰. These subprime mortgages offered by banks were particularly risky because banks guaranteed low and flexible interest rates, no or diminished down payments and often more than one mortgage without requiring any proof of income and employment.¹¹ Securitisation is “*the process in which certain types of assets are pooled so that they can be repackaged into interest-bearing securities. The interest and principal payments from the assets are passed through to the purchasers of the securities*”.¹² These subprime mortgages were pooled or bundled by US government-backed agencies into sellable assets which were then sold to other banks and investors in the USA and globally.¹³ The loans sold to other banks

⁵ Labonte M (2017) *Systemically Important or “Too Big To Fail” Financial Institutions*, CRS Report at 7.

⁶ A Moral hazard is where one party is responsible for the interest of another (i.e. a bankers responsibility toward the bank’s clients), but has an incentive to put his or her own interest first (i.e. due to government bail-outs bankers would take excessive risk knowing that it is protected against that risk and that the government will incur the cost). See Dowd K (2013) Moral hazard and the financial crises, *Cato Journal* 29 (1) 144 at 142.

⁷ Financial Stability Board (FSB) *Reducing the moral hazard posed by systemically important financial institutions* (2010) at 1.

⁸ Labonte M (2017) *Systemically Important or “Too Big To Fail” Financial Institutions*, CRS Report at 1.

⁹ Bartmann R (2017) *Causes and effects of 2008 financial crisis*, HFU Business School at 3. A “subprime” mortgage is generally a loan that is meant to be offered to prospective borrowers with impaired credit records, normally higher interest rates are charged in order to compensate for the lender accepting greater risk; see Consumer Financial Protection Bureau (2017) *What is a subprime mortgage?* Available at < <https://www.consumerfinance.gov/ask-cfpb/what-is-a-subprime-mortgage-en-110/>> (accessed on 22 April 2018).

¹⁰ Bartmann R (2017) *Causes and effects of 2008 financial crisis*, HFU Business School at 3. A mortgage is defined as a legal agreement between two parties which transfers the ownership of property to a lender as a security for a loan; see Parkinson D (2006) *Oxford Learner’s pocket dictionary of business English* Oxford: Oxford University Press.

¹¹ Bartmann R (2017) *Causes and effects of 2008 financial crisis*, HFU Business School at 4.

¹² Jobst A (2008) What is Securitization? IMF available at < <https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf>> (accessed on 22 April 2018).

¹³ Bartmann R (2017) *Causes and effects of 2008 financial crisis*, HFU Business School at 4.

and investors were not however only limited to mortgages.¹⁴ The repackaging and selling of, *inter alia*, mortgage loans was considered a positive step as the assets were AAA rated (by rating agencies)¹⁵, required little capital to borrow against and provided banks with a free return. Investment banks like Morgan Stanley, Lehman Brothers, Merrill Lynch and Bear Stearns, were at the time, almost entirely funded by short term borrowing and by the mid-2000s billions of dollars' worth of mortgages were given to individuals with poor credit ratings on adjustable rates.¹⁶

During 2006, the issuing of these mortgages reached its peak and by late 2007 and early 2008 the default rates on subprime mortgages spiked.¹⁷ The defaulting spike was caused by the Federal Reserve of the US increasing interest rates to 5.25% and inflation. As a result, homeowners could no longer afford their monthly repayments and began defaulting. The moment the housing bubble burst, there was an over-supply of and decreased demand for property, which resulted in property prices plummeting. Dramatically, the subprime mortgage crisis quickly became a financial crisis when so called TBTF financial firms started going bankrupt due to the huge losses suffered.¹⁸ The financial sector including the building and real estate sectors, amongst others, were all affected.¹⁹

AIG, one of the largest insurance companies in the world, also played a role in the GFC. It not only sold normal health insurance but also insurance for products (i.e mortgage loans) on the financial market, called Credit Default Swaps (CDS). Investors would purchase a CDS, a short insurance policy and would pay a

¹⁴Jobst A (2008) *What is Securitization?* IMF available at

< <https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf>> (accessed on 22 April 2018).

¹⁵A rating agency is a company that assesses the financial strength of companies and government entities, especially their ability to meet principal and interest payments on their debts. The rating assigned to a given debt shows an agency's level of confidence that the borrower will honour its debt obligations as agreed. During the 2000's the three largest rating agencies consisted of Standard & Poor's, Moody's and Fitch. See CFI *Rating Agency* available at <<https://corporatefinanceinstitute.com/resources/knowledge/finance/rating-agency/>> (accessed on 22 April 2018)

¹⁶WSO Financial Banking Crisis 2008 –Detailed Overview available at <<https://www.wallstreetoasis.com/financial-banking-crisis-2008-overview>> (accessed on 22 April 2018).

¹⁷WSO Financial Banking Crisis 2008 –Detailed Overview available at <<https://www.wallstreetoasis.com/financial-banking-crisis-2008-overview>> (accessed on 22 April 2018).

¹⁸Bartmann R (2017) *Causes and effects of 2008 financial crisis*, HFU Business School at 7.

¹⁹WSO Financial Banking Crisis 2008 –Detailed Overview available at <<https://www.wallstreetoasis.com/financial-banking-crisis-2008-overview>> (accessed on 22 April 2018).

premium to AIG. When the investor's Credit Default Owner (CDO) defaulted AIG had to pay the investor for the losses incurred.²⁰ At the end of 2007 CDSs covered by AIG amounted to more than \$440 billion in bonds. Subsequently, when numerous CDO's began to default, AIG could not adequately cover its investors.²¹ Banks and hedge funds also sold CDSs but with a critical difference to AIG, they also bought CDSs in order to ensure that there was always money coming in.²² AIG ultimately faced financial difficulty and required government assistance in the form of a bail-out.²³

Due to the global financial system's increasing growth and ultimately becoming highly interconnected and interrelated, there was a rapid transfer of the risk between non-bank financial institutions (such as insurance companies and investment companies) and banks worldwide during the GFC.²⁴

It is apparent from the sheer scale of the GFC that the blurring of the boundaries between, banking, insurance and securitisation together with poor credit, inadequate valuation methods and insufficient regulatory oversight lead to the decline in investor confidence and in the value of subprime mortgages which caused a liquidity crises and severely impacted financial stability globally.²⁵

In effect the GFC spearheaded the implementation of the Third Basel Accord (Basel III)²⁶ issued by the Basel Committee on Banking Supervision (BCBS)²⁷

²⁰Bartmann R (2017) *Causes and effects of 2008 financial crisis*, HFU Business School at 7.

²¹Davidson A (2008) *The Big Money: How AIG fell apart* Thomas Reuters available at < <https://www.reuters.com/article/us-how-aig-fell-apart/the-big-money-how-aig-fell-apart-idUSMAR85972720080919>> (accessed on 22 April 2018).

²²Davidson A (2008) *The Big Money: How AIG fell apart* Thomas Reuters available at < <https://www.reuters.com/article/us-how-aig-fell-apart/the-big-money-how-aig-fell-apart-idUSMAR85972720080919>> (accessed on 22 April 2018).

²³Davidson A (2008) *The Big Money: How AIG fell apart* Thomas Reuters available at < <https://www.reuters.com/article/us-how-aig-fell-apart/the-big-money-how-aig-fell-apart-idUSMAR85972720080919>> (accessed on 22 April 2018).

²⁴Americans for Financial Reform (2014) *Background on the Financial Stability Oversight Council* at 1.

²⁵Jobst A (2008) *What is Securitization?* IMF available at < <https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf>> (accessed on 22 April 2018).

²⁶Basel III is an internationally agreed set of measures developed by the BCBS in response to the GFC. The measures aim to strengthen the regulation, supervision and risk management of banks. See Bank for International Settlements (BIS) available at < <https://www.bis.org/bcbs/basel3.htm>> (accessed on 21 April 2018).

²⁷The BCBS is the primary global standard setter for prudential regulation of banks and provides a forum for regulator cooperation on banking supervisory matters. See BIS < <https://www.bis.org/bcbs/>> (accessed 21 April 2018).

which, *inter alia*, required the designation of SIFI's and their tightened prudential regulation in an attempt to achieve financial stability.

Notably, the global focus on banking regulation and supervision began in 1988 with the introduction of the First Basel Accord (Basel I) by the BCBS. Basel I gave life to the Basel Accords and encapsulated the idea that in order to reduce bank exposure to credit risk enough capital should be held in order to offset the risk-weighted assets ²⁸of the bank.²⁹

Subsequently, the BCBS issued a revised version of the Basel Accords, namely the Second Basel Accord (Basel II), referred to above. The Accords were amended to facilitate a more comprehensive, sophisticated and risk-sensitive approach for banks to calculate regulatory capital necessary to protect against various forms of risks.³⁰

However the abovementioned financial crisis of 2007/2008 underlined a number of weak areas in the Basel II rules.³¹ During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking and non-banking institutions and ultimately taxpayers were exposed to large losses as a result of governments having to bail-out failing TBTF financial institutions during the crisis. Given the scope and speed with which the crisis had been transmitted around the globe as well as the unpredictable nature of future crisis, it became critical that all countries raised the resilience of their banking sectors to both internal and external shocks.³²

²⁸Risk-weighted Assets (RWA) represent an aggregate measure of different risk factors affecting the evaluation of financial products. RWAs play an important role in the banking sector as the RWA quantification affects the amount of capital the bank will have to retain to be compliant with the imposed capital adequacy requirements prescribed in the Basel Accords. See E-encyclopaedia of banking, stock exchange and finance, *Risk Weighted Assets (RWA) (Encyclopaedia)* available at < <http://www.bankpedia.org/index.php/en/124-english/r/23632-risk-weighted-assets-rwa>> (accessed on 22 April 2018).

²⁹RiskArticles.com (2017) available at <<http://riskarticles.com/basel-iii-key-updates/>> Magazine Basic (accessed on 12 June 2017).

³⁰RiskArticles.com (2017) available at <<http://riskarticles.com/basel-iii-key-updates/>> Magazine Basic (accessed on 12 June 2017).

³¹RiskArticles.com (2017) available at <<http://riskarticles.com/basel-iii-key-updates/>> Magazine Basic (accessed on 12 June 2017).

³²BCBS (2011) *Basel III: Global regulatory framework for more resilient banks and banking systems*, BIS at 1.

Basel III was designed to address the weaknesses of the recent crisis and to prepare the banking industry for future economic downturns. The BCBS therefore introduced a number of reforms to the international regulatory framework which strengthen bank-level, micro prudential regulation as well as a macro prudential focus to address system-wide risks that can accumulate across the banking sector.³³ The BCBS and the G20 leaders agreed that these reforms should be introduced in a way that does not impede the recovery of the real economy and which allowed for translation of the new internationally agreed standards into national legislation. Therefore, new standards were gradually implemented by the G20 members as of 1 January 2013 and should be fully phased-in by them by January 2019.³⁴

It is no secret that South Africa's economy is at present undergoing a turbulent period in relation to its financial stability which is supported by the recent credit rating downgrade in 2017.³⁵ In dealing with a looming recession it has become increasingly important that the Basel III phase-in objectives are achieved through the regulations proposed by international regulatory bodies, the Banks Act 94 of 1990, as amended ("the Banks Act") and the Financial Sector Regulation Act 9 of 2017 ("FSRA") in order to maintain sound financial regulation, supervision and ultimately financial stability.

This study will take into account the causes of the past financial crisis, whether South Africa has sufficiently met the Basel III phase-in requirements to date, the consequences the stricter regulatory requirements for SIFIs may produce and whether these regulations sufficiently prepare South Africa's banks and other financial institutions for future economic downturns.

³³BCBS (2011) *Basel III: Global regulatory framework for more resilient banks and banking systems* at 2.

³⁴BCBS *Annex 2: Phase-in arrangements* <<http://www.bis.org/press/p100912b.pdf>> (accessed on 12 June 2017).

³⁵Donnelley L (2017) Global credit ratings agency has downgraded South Africa to junk status, Mail & Guardian available at < <https://mg.co.za/article/2017-11-25-global-credit-ratings-agency-has-downgraded-south-africa-to-junk-status>> (accessed on 22 April 2018).

2. Working Definitions

2.1. The Basel Accords

The International recommendations on banking law and regulations, namely Basel I, II and III.

2.2. Too Big to Fail (“TBTF”)

Is the term allocated to financial institutions that relied heavily on government bail-outs when faced with financial difficulties and bankruptcy.³⁶

2.3. Systemically Important Financial Institution (“SIFI”)

SIFI is an umbrella term which, in addition to banks, also includes insurance companies and financial market infrastructure providers deemed systemically important by regulators.³⁷ The sub-categories of SIFIs include, *inter alia*:-

2.3.1. Global Systemically Important Financial Institution (“G-SIFI”);

2.3.2. Global Systemically Important Bank (“G-SIB”); and

2.3.3. Domestic Systemically Important Bank (“D-SIB”).

2.4. Financial Stability Board (“FSB”)

The FSB is an international body that monitors and makes recommendations about the global financial system. It was established after the 2009 G20 London Summit as a successor to the Financial Stability Forum³⁸ in order to represent the G20 leaders’ first major international institutional innovation. The FSB works alongside the IMF,

³⁶FSB (2010) *Reducing the moral hazard posed by systemically important financial institutions* at 1.

³⁷Wikipedia, List of Systemically Important Banks, available at <https://en.wikipedia.org/wiki/List_of_systemically_important_banks> (accessed 20 May 2017).

³⁸The Financial Stability Forum (FSF) was founded in 1999 by the G7 Finance Ministers and Central Bank Governors. The FSF was established to bring national authorities responsible for financial stability in significant international financial centres, regulators and supervisor engaged in developing standards and codes of good practice and experts concerned with market infrastructure and functioning together. Subsequent to the G20 countries calling for a larger membership of the FSF, the FSF was dissolved in 2009 and re-established as the FSB. See FSB *Our History* available at <<http://www.fsb.org/about/history/>> (accessed on 22 April 2018).

World Bank and World Trade Organisation. South Africa is a member of the FSB alongside the other G20 countries.³⁹

2.5. **Basel Committee on Banking Supervision(“BCBS”)**

The BCBS provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding on key supervisory issues and improve the quality of banking supervision worldwide.⁴⁰

2.6. **Basel III**

Basel III is a comprehensive set of reform measures, developed by the BCBS, to strengthen the regulation, supervision and risk management of the banking sector. The implementation of the Basel standards is monitored.⁴¹

3. Study Objectives

The main objective to the study is to point out and emphasize that the stricter regulations are not a mere repeat of past failed attempts to achieve financial stability and that the regulatory bodies have imposed a system that is proactive instead of reactive to possible economic downturns. In doing this, the study shall focus on the following specific objectives:

- 3.1. Briefly investigate and analyse the relevant international standards presently set by the BCBS in respect of prudential regulation and the designation of D-SIBS;
- 3.2. Determine the progress South Africa’s banks have made in implementing the final phase-in of Basel III which is due to be fully implemented by 2019;

³⁹ Wikipedia, Financial Stability Board, < https://en.wikipedia.org/wiki/Financial_Stability_Board > (accessed on 20 May 2017).

⁴⁰BIS, *Basel Committee on Banking Supervision – Overview*, available at < <https://www.bis.org/bcbs/> > (accessed 20 May 2017).

⁴¹BIS, *Basel Committee on Banking Supervision – Overview*, available at < <https://www.bis.org/bcbs/> > (accessed 20 May 2017).

- 3.3. Briefly explore the different methods of financial sector regulation and whether it has succeeded or failed in relation to achieving financial stability; and
- 3.4. Define the assessment methodology used to identify systemically important financial institutions in South Africa and the stricter requirements that will be imposed on these institutions.

4. Research Questions

The study attempts to answer the following research questions: -

- 4.1. What is the historical context in relation to the regulation of banks in South Africa?
- 4.2. What assessment criteria/methodology should be utilised to identify SIFIs?
- 4.3. What is the rationale or objectives behind the designation of SIFIs?
- 4.4. What are the main financial institutions of concern in South Africa from a SIFI-perspective?
- 4.5. What international guidelines or standards have been issued regarding SIFI's/D-SIB's?
- 4.6. What are the potential consequences of the designation as a D-SIB in South Africa?
- 4.7. Are South African banks sufficiently positioned to achieve the Basel III phase-in standards by 2019?

5. Literature Review

The umbrella term 'SIFI' became a priority to international and national financial regulatory bodies as a response to the vulnerability of the banking sector that materialised during the events that led up to the GFC of 2007/2008. The South African National Treasury (Treasury) undertook a review of the South African financial system that began in 2007 and gained momentum post the GFC. In the

policy document “A safer financial sector to serve South Africa better” the Treasury identified the two main causes of the GFC as global macroeconomic imbalances and inadequate financial sector regulation.⁴² The primary focus for the purposes of this dissertation is the role that the ‘inadequate financial sector regulation’ and ‘TBTF’ financial institutions played in the events leading up to the financial crisis and whether the suggested enhanced regulations will assist South Africa in maintaining financial stability.

A financial firm would be considered TBTF when “...*policy makers judge that their failure would cause unacceptable disruptions to the overall financial systems*”.⁴³ ‘SIFIs’ are accordingly defined as financial institutions whose “*distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.*”⁴⁴ According to Thomson ‘systemically important’ entails a “...*risk that an event will trigger loss of confidence in a substantial portion of the financial system that is serious enough to have adverse consequences for the real economy.*” meaning that SIFIs are financial institutions that give rise to systemic risk.⁴⁵ It is thus necessary to have a working definition of the concept ‘SIFI’ to allow for the creation of a workable formula which could include a number of factors that would indicate whether the financial institutions assessed fall within the scope of a SIFI and can consequently designated as such. Any two financial institutions could be designated as systemically important for unrelated reasons therefore it is essential to identify and clarify the criteria utilised to designate various SIFIs⁴⁶.

The importance of identifying SIFIs is, *inter alia*, to prevent the repeat ‘moral hazard’ experienced during the 2008 financial crisis, which is explained by Crotty as follows:

⁴²Gordhan PJ (2011) *A Safer Financial Sector to Serve South Africa Better*, National Treasury Policy Document at 9.

⁴³Labonte M (2015) *Systemically Important or “Too Big to Fail” Financial Institutions*, Congressional Research Service Report R42150.

⁴⁴Deloitte Centre of Regulatory Strategies (2014) *Addressing the Risks Posed by Systemically Important banks: The End of Too Big to Fail?* at 2.

⁴⁵Thomson J (2009) *On Systemically important financial institutions and progressive systemic mitigation – policy discussion paper* at 1.

⁴⁶Thomson J (2009) *On Systemically important financial institutions and progressive systemic mitigation – policy discussion paper* at 2.

“The current financial system is riddled with perverse incentives that induce key personnel in virtually all important financial institutions...to take excessive risk when financial markets are buoyant. For example, the growth of mortgage securitization generated fee income—to banks and mortgage brokers who sold the loans, investment bankers who packaged the loans into securities, banks and specialist institutions who serviced the securities and ratings agencies who gave them the seal of approval. Since fees do not have to be returned if the securities later suffer large losses, everyone involved had strong incentives to maximise the flow of loans through the system whether or not they were sound.”⁴⁷

In essence Crotty explains that TBTF financial firms, due to their size and interconnectedness that gave them systemic prominence in the financial system, expected government bail-outs to protect them from their losses as they were ‘not allowed to fail’. In other words, taxpayer money was exploited in order to ‘rescue’ failing financial institutions from bankruptcy. This expectation created a moral hazard as it lowered the incentive of financial institutions to monitor their risk taking. Thus by increasing the regulation of SIFIs post GFC the importance of the enhanced regulation standards would be to ensure that financial institutions monitor their own risk taking and ensure that they are capable of maintaining their solvency and liquidity without government support or intervention.⁴⁸

Policy makers and government realised that there was a need for coordinated international efforts to secure global financial and economic stability, so a formal review of the financial regulatory system was launched in 2007, which was subsequently expanded on in 2008 after the financial crisis in South Africa. The primary objective for the designation of SIFIs is that of financial stability achieved through a strengthened regulatory framework as proposed by Basel III. The purpose of the co-operative approach is to ensure that the G20 members regularly assess their regulatory system and ensure that they maintain the standards set at an international level.⁴⁹ National Treasury identified further

⁴⁷Crotty J (2009) *CJE* 563 at 565.

⁴⁸Crotty J (2009) *CJE* 563 at 565.

⁴⁹Gordhan PJ (2011) *A Safer Financial Sector to Serve South Africa Better*, National Treasury Policy Document at 4.

objectives for the designation of SIFIs in South Africa which include a stronger regulatory framework, effective supervision, crisis resolution and addressing systemic institutions in order to ensure that the costs of failure is as minimal as possible, that failure does not affect the broader financial system and that regular assessments of the regulatory system are conducted.⁵⁰ These objectives, specifically financial stability, are essential to achieve a safe and sound financial sector in the current economic climate in South Africa.

The rationale provided for these objectives stems from the fact that pre-crisis safety and soundness prudential regulation did not explicitly address the additional moral hazard created by TBTF financial institutions because they were not identified and accordingly not sufficiently regulated and supervised.⁵¹

The South African financial sector is only comprised of Domestically Systemically Important Banks (D-SIBs) and does not have Global Systemically Important Banks (G-SIBS) which means the international guidelines on D-SIBs is a useful point of departure for the designation of D-SIBs in South Africa.⁵² The BCBS issued the rules text on the assessment methodology for G-SIBs and their additional loss absorbency requirements, which has been endorsed by the G20 leaders. The BCBS has required each committee and the FSB to develop models to extend the G-SIFI framework to D-SIBs.⁵³ A D-SIB is defined as “...*a bank whose distress or disorderly failure would have a serious detrimental impact on either the financial system or the real economy within the country in which the bank operates.*”⁵⁴ The set of principles developed by the BCBS provides the assessment methodology and the minimum higher loss absorbency requirements that should be met by the identified D-SIBs. The base requirements must be matched or bettered by the respective G20 countries and South Africa’s requirements will be analysed in comparison with Hong Kong in chapter 4 of this dissertation.

⁵⁰Gordhan PJ (2011) *A Safer Financial Sector to Serve South Africa Better*, National Treasury Policy Document at 4.

⁵¹Labonte M (2015) *Systemically Important or “Too Big to Fail” Financial Institutions*, Congressional Research Service Report R42150 at 8.

⁵²South African Reserve Bank, *Financial Stability Review*, September 2013 at 33.

⁵³BCBS (2012) *A Framework for Dealing with Domestic Systemically Important Banks*, Bank for International Settlements, at 1.

⁵⁴Deloitte Centre of Regulatory Strategies (2014) *Addressing the Risks Posed by Systemically Important banks: The End of Too Big to Fail?* at 2.

In South Africa, during October 2015 the Financial Sector Regulation Bill (FSR Bill) was tabled in parliament⁵⁵. In addition, Treasury published the third draft of the Ministerial Regulations made in terms of the Financial Markets Act (“FMA”). Treasury subsequently passed the Regulations during February 2018.⁵⁶ The aim of these regulations is to progress South Africa’s Commitment to the G20 obligations to implement regulatory and legislative reforms to make financial markets safer. On 6 December 2016 the FSR Bill was passed by the National Assembly and transmitted to the National Council of Provinces for concurrence.⁵⁷ The Financial Sector Regulation Act 9 of 2017 (FSRA) was signed into law on 21 August 2017. Treasury has since detailed the commencement date of each section of the FSRA by way of a government notice.⁵⁸ On 18 December 2017 Treasury published the draft Regulations to the FSRA for public comment, the proposed regulations set out the transitional arrangements for, *inter alia*, the transformation of the existing financial services regulators in South Africa.⁵⁹

6. Significance of Study

This dissertation aims to provide an overview of relevant international standards relating to designation of SIFIs, specifically D-SIBS, and compare it to the South African position on D-SIB-designation in order to determine whether South Africa has aligned itself sufficiently with the international guidelines and further attempts to predict the success rate of achieving financial stability through the enhanced domestic regulation of SIFI’s.

⁵⁵ Government Gazette No.39127, 21 August 2015.

⁵⁶ Government Gazette No.41433 Notice R98, 9 February 2018.

⁵⁷ Parliamentary Monitoring Group, Financial Sector Regulation Bill (B34-2015) <<https://pmg.org.za/bill/608/>> (accessed 17 April 2017).

⁵⁸ South Africa (2018) *Commencement Of Financial Sector Regulation Act, 2017* (National Treasury Notice No. 169 of 2018) Government Gazette No. 41549, March 2018 vol. 633.

⁵⁹ Graham S and King B (2018) Twin Peaks (Financial Sector Regulation Act) moves forward: Transitional Arrangements available at <<https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Finance/finance-and-banking-alert-15-january-twin-peaks-financial-sector-regulation-act-moves-forward-transitional-arrangements.html>> (accessed on 22 April 2018).

7. Hypothesis

This study is based on the premise that in order to prevent a repeat of past failures in maintaining financial stability the latest approach to regulation should be understood to the extent that regulatory and supervisory bodies should be proactively seeking methods to identify and resolve any potential systemic crisis before they arise and therefore preventing the resultant devastating economic consequences as previously experienced. In this context addressing the systemic risk posed by SIFIs is a focal point.

8. Methodology

The bulk of research would consist of desktop research, mainly focusing on the use of secondary research materials such as journals, articles, policies and legislation and other scholarly materials from the internet. The author also relies on a historical analysis of past financial market regulation and a comparison of the adoption of the internationally set standards in respect of financial market regulation in Hong Kong to that in South Africa.

9. Limitations of Study

Due to the complex, dynamic and recent nature of the standards and requirements published in South Africa and internationally, the research is largely based on documents that are subject to public comment and continuous change.

Furthermore, as the standards are in the process of being phased-in in South Africa, it is difficult to analyse the success rate of the stricter regulatory requirements within South Africa's financial market and the long-term consequences of the designation as a D-SIB. Therefore this paper serves merely as a preliminary study of how South Africa should approach the stricter regulations upon comparing it to how D-SIBs are designated in Hong Kong.

10. Layout of Chapters

- 10.1. **Chapter One ‘Introduction’** serves as the proposal to the study, giving the background and objectives of the study. It provides a very brief overview of the research topic, as well as a preliminary literature review.
- 10.2. **Chapter two ‘What is a Systemically Important Financial institution?’** provides for the working definition and the assessment methodology utilised to identify SIFIs within the financial sector.
- 10.3. **Chapter Three ‘The Prudential Authority, Prudential Requirements and Higher Loss Absorbency Requirements’** discusses the Twin Peak Model, the prudential requirements and the higher loss absorbency requirements that will be imposed on D-SIBS in South Africa.
- 10.4. **Chapter Four ‘Basel III and the Designation of SIFIs in Hong Kong’** is a comparative chapter dedicated to discussing the implications of the designation as a SIFI in South Africa in comparison with the Hong Kong.
- 10.5. **Chapter Five ‘Conclusion and Recommendations’** concludes the study by providing a detailed summary of the issues discussed throughout the paper, as well as specific recommendations.

CHAPTER 2

WHAT IS A SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTION?

1. Introduction

SIFIs (otherwise known as banks or non-bank financial institutions that are considered “too big to fail”) have become a global focus since the 2007/2008 GFC negatively impacted virtually all financial markets around the world, some more dramatically than others. In response to the Financial Crisis, international regulatory bodies sought to protect the global financial system through preventing the failure of SIFI’s or preventing a repeat of the extensive adverse impact on the financial system as experienced during the Financial Crisis or worse.¹ It appears that international regulatory bodies, with the aid of domestic financial regulators, intend to proactively rather than reactively respond to possible future financial system distress.

2. Financial Regulatory Bodies

The BCBS introduced prudential regulations, namely Basel I, II and presently Basel III, which prescribes general prudential requirements for banks and additionally prescribes additional prudential requirements for SIFIs. It should be noted however that the FSB and the BCBS are entities that merely perform advisory functions and therefore do not directly establish laws, regulations or rules for any financial institution.² The internal financial regulators and lawmakers of each respective country will be solely responsible for implementing specific laws, regulations and rules that will apply to banks and other financial institutions within their own domestic financial system whilst ensuring that they comply with internationally prescribed standards. This is specifically true for those countries that form part of the Group of Twenty “G20” international forum.

¹ Gordhan PJ (2011) *A Safer Financial Sector to Serve South Africa Better*, National Treasury Policy Document at 9.

² Magnus M & Korpas A (2017) *The role of the Basel Committee on Banking Supervision (BCBS)* European Parliament, Directorate- General for Internal Policies PE 587.390 at 1.

The G20 countries are primarily focused on achieving international financial stability and South Africa is a member thereof.³

3. Workable Definition

In order to understand the implications of a bank or other financial institution being designated as a SIFI it is necessary to appropriately define the term “SIFI”. A single standard definition as alluded to in Chapter One is unsuitable in that it would be unable to encompass every possible bank or financial institution that could possibly hold systemic importance. A workable definition has therefore been developed by the BCBS. The workable definition allows for the creation of thorough assessment methodology in order to appropriately and consistently identify SIFIs.⁴ Due to the systemic risk element that emerged during the GFC it is important to understand its role before discussing what constitutes “systemic importance”.

Systemic risk and economic fluctuations are concepts that have always been present even before the 2007/2008 GFC arose but the extent of their negative effects only became a focus area to international regulatory bodies in light of the aftermath of the Global Financial Crises.⁵ Financial stability and systemic risk are intrinsically linked however prior to the GFC financial regulators had severely underestimated the impact of systemic risks materialising. Credit risk⁶, liquidity risk⁷ and operational risk⁸, *inter alia*, can be directly attributed to a financial institution but systemic risk can only be attributed indirectly. Herein lies one of

³ The G20 is a leading forum of the world's major economics and seeks to develop global policies to address pressing challenges. The G20 is made up of 19 countries and the European Union. The G20's work is divided into two tracks, the Finance Track and the Sherpa Track. The Finance Track focuses on financial and economic issues such as monetary, fiscal and exchange rate policies, infrastructure investment, financial regulation, financial inclusion and international taxation. The Sherpa Track focuses on broader issues. See G20 Website < <https://www.g20.org/en/g20/how-it-works>> (accessed on 6 May 2018).

⁴ Brühl V (2016) *How to Define a Systemically Important Financial Institution (SIFI) – a new perspective* 538, CFS Working Paper Series at 3.

⁵ Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science at 1.

⁶ Credit risk is the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms”. See BCBS (2000) *Principles for the Management of Credit Risk* at 1.

⁷ A liquidity risk is the risk that a business will have insufficient funds to meet its financial commitments in a timely manner. All businesses need to manager liquidity risk to ensure they remain solvent. See CPA Australia, *Guide to managing liquidity risk* at 4, available at <https://www.cpaaustralia.com.au/~/_media/corporate/allfiles/document/professional_resources/business/managing-liquidity-risk.pdf?la=en> (accessed on 6 May 2018).

⁸ Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk but excludes strategic and reputational risk. See BCBS (2011) *Principles for the Sound Management of Operational Risk* at 3.

the main causes of the GFC, the respective risk mentioned above were considered separately by financial regulators and when those separate risks were aggregated with systemic risk undesired and unexpected consequences followed.⁹

Systemic risk can arise from various factors but moral hazard is a major contributor thereto¹⁰ as discussed in Chapter One. The sources of systemic risk in the financial system have also been explained by the SARB. The SARB defined “systemic risk” as follows:-

“ ...the risk of disruptions to the provision of key financial services that is caused by an impairment of all or parts of the financial system, and which can cause serious consequences for the real economy . Systemic risk may arise at certain points in the economic cycle where borrowers exceed their means, when leverage in the financial sector is high, and when maturity transformation is excessive.”¹¹ (Emphasis Added).

The SARB goes on further to state that “*Systemic risks are usually divided into cyclical and structural risks*”¹². In other words, risk which accumulates over time (such as credit booms and asset price bubbles) would be considered cyclical or time dimension systemic risks. However structural or cross-section dimension systemic risks would be how the concentration of risk and the interconnectedness of different parts of the financial system contributes to systemic risk.

In essence the above highlights the fact that the strength and stability of the financial system is dependent on the state of the economy and the state of the economy is dependent on the behaviour of its participants. In other words systemic risk can either result from the collective behaviour of financial institutions or an individual SIFI¹³ and this in turn implies that the stability of the economy is dependent on the rules that regulate its participants.

⁹ Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science at 2.

¹⁰ Crotty J (2009) *CJE* 563 at 565.

¹¹ SARB (2016) *A New Macroprudential Policy Framework for South Africa* Financial Stability Department at 9.

¹² SARB (2016) *A New Macroprudential Policy Framework for South Africa* Financial Stability Department at 9.

¹³ Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science at 5.

Systemic risk consists of macro- and microeconomic dimensions. Macro-systemic risk arises when the financial system becomes exposed to aggregate risk. Micro-systemic risk arises when the failure of an individual institution (a SIFI) has an adverse impact on the financial system as a whole. The materialisation of systemic risks caused by accumulated imbalances not only increases the possibility of a SIFI defaulting but also the extent of its adverse impact on the financial system.¹⁴ Systemic risk however possesses an evolving nature which means that the exposure of financial institutions to systemic risk may depend on their activities alone or on their activities in combination with external factors such as an economic recession.¹⁵ It is therefore difficult to permanently distinguish systemic from non-systemic events and to predict the extent of which a systemic risk will materialise. The potential sources of systemic risk should therefore be periodically reviewed by the macro-prudential authority.¹⁶ This difficulty however has been addressed in the proposed assessment methodology, as discussed below.

Systemic risk from a micro-risk perspective, can be regarded as the degree to which a single financial institution “pollutes” financial stability through the production of negative externalities. Negative externalities caused by systemic risk include firstly, the tendency for the simultaneous increase in credit and liquidity risk exposure during booms. Secondly, from fire sales when overleveraged financial institutions are forced to liquidate an asset at a time when potential buyers are also troubled and thirdly, the negative externalities resulting from a high degree of interconnectedness between financial institutions, particularly between SIFIs, as they serve as shock transmitting channels.¹⁷

As such it is important to identify the participants that could dramatically affect the stability of the domestic economy and subsequently the stability of the global financial market. After the GFC the focus of financial regulation shifted to protecting the financial sector from itself, “[I]n other words systemic risk

¹⁴Dobrzańska (2012) as referenced in Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science at 5.

¹⁵Dobrzańska (2012) as referenced in Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science at 5.

¹⁶Dobrzańska (2012) as referenced in Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science at 5.

¹⁷Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science at 6 and 7.

*mitigation is meant to ensure that if one institution drowns in a liquidity crisis, it does not pull other interconnected financial institutions under the water.”*¹⁸

The systemic risk contribution of an institution, defined as its “systemic importance”, can vary significantly depending on the market conditions at the time. The analysis of a financial institutions’ systemic risk contribution should therefore not solely rely on its size but also other criteria such as, *inter alia*, the degree of interconnectedness, contagion and correlation.¹⁹

The FSB defines SIFIs as “those institutions whose disorderly failure, because of their size, complexity, lack of substitutability and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity”.²⁰ The Board advised that national authorities should impose stricter regulations to counteract the negative externalities that may arise from the failure of a SIFI, the underlying objective being to impose measures that neutralize the systemic risk posed by SIFIs.²¹ However, since no single solution to the externalities posed by G-SIBS exists the Board introduced a multipronged approach with the broad aim to achieve a reduction in the probability of failure of SIFIs by increasing going-concern loss absorbency²² and reducing the extent or impact of failure by improving global recovery and resolution frameworks.²³

¹⁸Liner E (2016) *Understanding SIFIs: What Makes an Institution Systemically Important?* Thirdway <<http://www.thirdway.org/report/understanding-sifis-what-makes-an-institution-systemically-important>> (accessed 29 July 2017).

¹⁹ Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science at 7, 11 and 12.

²⁰FSB (2013) *Progress and Next Steps Towards Ending “Too-Big-To-Fail” (TBTF)*, Report at 2 available at <http://www.fsb.org/wp-content/uploads/r_130902.pdf?page_moved=1>(accessed 14 June 2017).

²¹BCBS (2013) *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* at 3.

²²‘Going concern loss absorbency’ refers to Tier I capital which is available to absorb losses suffered by a financial institution on a ‘going concern’ basis. In other words, it is capital that can be depleted without placing the institution into insolvency, administration or liquidation. Tier II capital however will be utilised to absorb losses on a ‘gone concern’ basis, this means that the capital will absorb losses in insolvency before depositors lose any money. See Jinks A and others (2011) *Overview of Basel III – minimum capital requirements and global liquidity standards*, available at <<https://www.claytonutz.com/knowledge/2011/january/overview-of-basel-iii-minimum-capital-requirements-and-global-liquidity-standards>> (accessed 10 August 2018).

²³BCBS (2013) *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* at 3. See in this regard FSB (2014) *Key Attributes of Effective Resolution Regimes for Financial Institutions*, available at <http://www.fsb.org/wp-content/uploads/r_141015.pdf> (accessed 10 August 2018). This document sets out the core elements that the FSB considers to be necessary for effective resolution regimes and their implementation. The FSB believes this will assist authorities in resolving financial institution issues without taxpayer exposure to loss from solvency support.

4. Assessment Methodology of G-SIBS

In 2011 the Bank for International Settlements (“the BIS”) published a consultative document which set out the proposal from the BCBS on the assessment methodology and additional loss absorbency rules for global systemic importance.²⁴ In 2013 the 2011 text was updated. The 2013 version is titled “Global systemically important banks: revised assessment methodology and the higher loss absorbency requirement”.²⁵ The changes made to the 2013 document were a result of lessons learnt from applying the assessment methodology on certain banks between the year-ends 2009 to 2011²⁶ and sets out measures developed by the BCBS on the assessment methodology for global systemic importance, the higher loss absorbency requirements for G-SIBS, the arrangements by which they will be phased-in and the data that banks above a certain size must publicly disclose.²⁷ The measures are in accordance with the FSB’s request as set out in its document titled “*Reducing the moral hazard posed by systemically important financial institutions- FSB recommendations and Time Lines (20 October 2010)*” wherein the FSB, *inter alia*, requested the BCBS to develop an assessment methodology comprising of both quantitative and qualitative indicators to assess systemic importance of G-SIBS.²⁸

The 2013 version was again updated and replaced in July 2018. The 2018 document is titled “*Global systemically important banks: revised assessment methodology and the higher loss absorbency requirements*”.²⁹ The reason for the revision was due to the BCBS’s agreement that the framework would be

²⁴BCBS (2011) *Globally Systemically Important Banks: Assessment Methodology and the additional loss absorbency requirements Rules text*.

²⁵BCBS (2013) *Globally Systemically Important Banks: Updated Assessment Methodology and the higher loss absorbency requirement*.

²⁶BCBS (2013) *Globally Systemically Important Banks: Updated Assessment Methodology and the higher loss absorbency requirement* at 1.

²⁷BCBS (2013) *Globally Systemically Important Banks: Updated Assessment Methodology and the higher loss absorbency requirement* at 4.

²⁸BCBS (2013) *Globally Systemically Important Banks: Updated Assessment Methodology and the higher loss absorbency requirement* at 4.

²⁹BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement*.

reviewed every three years.³⁰ This provides the Committee the opportunity to continuously enhance the framework, where necessary.³¹

The BCBS's assessment methodology is an indicator-based measurement approach and the chosen indicators reflect different aspects of what generates negative externalities and makes a bank critical for the stability of the financial system.³² The indicator-based measurement approach is advantageous as it encompasses many dimensions of systemic importance in comparison to the current model-based measurement approaches and methodologies which rely on a small set of indicators or market variables.³³

5. The Indicator – Based Measurement Approach

The BCBS has indicated that the global systemic importance of financial institutions should be measured in terms of the impact of the bank's failure on the global financial system and wider economy.³⁴ The BCBS stresses that the probability or risk that a SIFI fails or defaults should not be the focus in this respect.³⁵

The selected indicators reflect the size³⁶ of banks, their interconnectedness³⁷, the lack of readily available substitutes or financial institution infrastructure for

³⁰BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 1.

³¹BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 1.

³²BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 3.

³³BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 3 – 4.

³⁴BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 4.

³⁵BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 4.

³⁶'Size' refers to how large the Bank's share is of the global activity/economy. The larger the bank the more difficult it is for its activities to be replaced by other banks and as such the greater the probability that its distress or failure could cause disruptions to the financial markets within which it operates. See BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 6.

³⁷'Interconnectedness' refers to the network of contractual obligations in which the bank operates and the possibility that the financial distress of one institution can materially increase the likelihood of distress at other institutions within the same network. See BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 6.

the services they provide³⁸, their global (cross-jurisdictional) activity³⁹ and their complexity⁴⁰. These categories are in line with the IMF/BIS/FSB report submitted to the G20 Finance Ministers and central bank Governors in October 2009.⁴¹

To indicate the revisions that have been made by the BCBS to the indicator-based measurement approach it is necessary to compare the 2013 framework to that of 2018. The 2013 framework was constituted as follows:-

Indicator – Based Measurement Approach		
Category (and weighting)	Individual Indicator	Indicator Weighting
Cross-jurisdictional activity (20%)	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Size (20%)	Total exposures as defined for use in the Basel III leverage ratio	20%
Interconnectedness (20%)	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Securities outstanding	6.67%
Substitutability/financial institution infrastructure (20%)	Assets under custody	6.67%
	Payments activity	6.67%
	Underwritten transactions in debt and equity markets	6.67%
Complexity (20%)	Notional amount of over-the-counter (OTC) derivatives	6.67%
	Level 3 assets	6.67%
	Trading and available-for-sale securities	6.67%

Source: BIS (2013)

As it appears from the above table, the indicator-based methodology allocates an equal weight of 20% to each of the five categories used to measure global systemic importance. With the exception of the size category, the BCBS has

³⁸'Substitutability/ Financial Institution Infrastructure' refers to the involvement of the bank in a particular business line or as a service provided in underlying market infrastructure. The greater the involvement the larger the disruption will follow from its failure. See BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 6.

³⁹'Cross-Jurisdictional Activity' refers to the bank's global footprint, in other words the importance of the bank's activities outside its own jurisdiction. See BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 6.

⁴⁰'Complexity' refers to the business, structural and operational complexity of a bank. The more complex the bank the greater the costs and time needed to resolve the bank should it experience distress. See BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 6.

⁴¹BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 4. See also IMF/BIS/FSB report on Guidance to assess the systemic importance of financial institutions, markets and instruments: initial considerations (October 2009).

identified multiple indicators in each of the categories, with each indicator equally weighted within its category. That is, where there are two indicators in one category, each indicator is given 10% overall weight and so on.⁴² If a financial institution exceeds the specified cut-off levels as set out in the above table then it will be classified as a G-SIB.⁴³

The 2018 revised framework is currently constituted as follows:-

Indicator – Based Measurement Approach		
Category (and weighting)	Individual Indicator	Indicator Weighting
Cross-jurisdictional activity (20%)	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
Size (20%)	Total exposures as defined for use in the Basel III leverage ratio*	20%
Interconnectedness (20%)	Intra-financial system assets*	6.67%
	Intra-financial system liabilities*	6.67%
	Securities outstanding*	6.67%
Substitutability/financial institution infrastructure (20%)	Assets under custody	6.67%
	Payments activity	6.67%
	Underwritten transactions in debt and equity markets	3.33%
	Trading volume	3.33%
Complexity (20%)	Notional amount of over-the-counter (OTC) derivatives*	6.67%
	Level 3 assets*	6.67%
	Trading and available-for-sale securities	6.67%

*Extended scope of consolidation to include insurance activities.

Source: BIS (2018).

By comparison of the above two tables, while each category is still given an equal weight of 20%, totalling 100%, it appears that the BCBS has revised the category of substitutability. The trading volume indicator has subsequently been added and has been allocated a weighting of 3.33% and the underwritten transactions in debt and equity markets weighting has been reduced from 6.67% to 3.33%. The split in these indicators reflect the complementary role of the trading volume indicator, which captures potential disruptions in the provision of

⁴²BCBS (2013) *Globally Systemically Important Banks: Updated Assessment Methodology and the higher loss absorbency requirement* at 10.

⁴³BCBS (2013) *Globally Systemically Important Banks: Updated Assessment Methodology and the higher loss absorbency requirement* at 10.

liquidity in the secondary market and the underwriting indicator, which captures liquidity in the primary market.⁴⁴

Furthermore, as the BCBS found that neither the G-SIB nor the global systemically important insurers jurisdictions formally captured insurance subsidiaries of banking groups, the BCBS included insurance activities for the following indicators: total exposures, intra-financial system assets, intra-financial system liabilities, securities outstanding, notional amount of OTC derivatives and level 3 assets in the size, interconnectedness and complexity categories as a further revision.⁴⁵

6. Assessment Methodology of D-SIBS

The G20 leaders did not only wish to deal with the assessment methodology for the designation of G-SIBS but requested that the BCBS and the FSB extend the G-SIFI framework to D-SIBs. The D-SIBS framework, like the G-SIB framework, addresses the negative externalities posed by the systemically important banks on a domestic level in order to assist domestic financial regulators to apply the assessment methodology within their respective financial markets.⁴⁶

As indicated above the G-SIB methodology identifies five broad indicators of global systemic importance, namely size, cross-jurisdictional activity, interconnectedness, substitutability and complexity.⁴⁷ The G-SIB framework however is focused on global financial stability and ensuring a consistent international ranking of G-SIBs. In respect of the D-SIBs framework the detail and emphasis placed on the cross-jurisdictional activity indicator, according to the BCBS, does not find much relevance in considering the domestic importance of a bank.⁴⁸

The principles laid down by the BCBS in respect of the D-SIB framework allows for appropriate national discretion to accommodate structural characteristics of

⁴⁴BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 4.

⁴⁵BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 5.

⁴⁶BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 1.

⁴⁷BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 4.

⁴⁸BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 1.

the particular domestic financial system. The D-SIB framework recognises that the local authorities are in the best position to evaluate and assess the impact of failure on their local financial system and the local economy.⁴⁹ The local authorities would then be able to specify additional indicators unique to their country and banking sector and will have the discretion as to the appropriate relative weights they place on these factors depending on the identified domestic circumstances.⁵⁰ This is in contrast with the G-SIB methodology, which places equal weight on each of the five categories of systemic importance.⁵¹

The D-SIBs framework consists of 12 principles that constitute the D-SIB framework. These principles are broadly categorised into two groups: the first group (Principles 1-7) which focuses mainly on the assessment methodology for D-SIBS while the second group (Principle 8-12) focuses on HLA for D-SIBS.⁵² Principles 8-12 will be addressed in Chapter Three.

7. Principles 1 – 7: Assessment Methodology

National authorities are responsible for establishing a methodology for assessing the degree to which banks are systemically important in a domestic context. The assessment methodology for a D-SIB should reflect the potential impact of, or externality imposed by, a bank's failure and the reference system for assessing the impact of failure of a D-SIB should be the domestic economy. Banks must be assessed at a consolidated group level for their degree of systemic importance as well as each subsidiary within the consolidated group.⁵³

The impact of the D-SIB's failure on the domestic economy should, in principle, be assessed having regard to bank-specific factors such as size, interconnectedness, substitutability or financial institution infrastructure (including considerations as to the concentrated nature of the banking sector) and complexity (including the additional complexities from cross-border activity). National authorities can consider other measures or data that would

⁴⁹BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 1 and 2.

⁵⁰BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 1.

⁵¹BCBS (2013) *Globally Systemically Important Banks: Updated Assessment Methodology and the higher loss absorbency requirement* at 12.

⁵²BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 2-3.

⁵³BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 3.

inform these bank-specific indicators within each of the above factors such as for example the size of the domestic economy.⁵⁴

The BIS advised that national authorities should undertake regular assessments of the systemic importance of the banks in their jurisdictions to ensure that their assessment reflects the current state of the relevant financial systems and that the interval between the D-SIB assessments may not be significantly longer than the G-SIB assessment frequency. National authorities should also publicly disclose information that provides an outline of the methodology employed to assess the systemic importance of banks in their domestic economy.⁵⁵

8. Assessment methodology in South Africa

As indicated, the Financial Sector Regulation Act 9 of 2017 (“the FSRA”), the enabling framework Act, was signed into law on 22 August 2017 and was brought into force from 1 April 2018. The FSRA places South Africa as the first developing jurisdiction to switch to a Twin Peaks model. In the Government Gazette 41548 of 29 March 2018, the Minister was empowered to pass regulations which would enable the SARB to perform functions of the Prudential Authority and for the FSB to perform the functions of the Conduct Authority while new authorities are being established and FSB assets and staff are transferred to the Conduct Authority.⁵⁶

Accordingly, section 11 of the FSRA sets out the SARB’s financial stability mandate by stating that it is responsible for protecting and enhancing financial stability and in the event that a systemic event has occurred or is imminent that SARB is responsible for restoring or maintaining financial stability. As such, the FSRA amends section 3 of the South Africa Reserve Bank Act 90 of 1989, as amended to provide that, in addition to its primary objective of price stability, the SARB is responsible for protecting and maintaining financial stability as envisaged in the FSRA.⁵⁷

⁵⁴BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 3.

⁵⁵BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 3.

⁵⁶Notice 169 of 2018 Government Gazette 41548 of 29 March 2018. See also Regulation Gazette R405 of 29 March 2018 Government Gazette 41550.

⁵⁷Schedule 4, FSRA

In order to assist SARB in realising its new mandate, various powers and functions have been assigned to the SARB and co-operation as well as collaboration are required from the Prudential Authority, the Financial Sector Conduct Authority, other financial regulators and organs of state.⁵⁸ This co-operation entails two aspects, namely: assisting SARB in the execution of its financial stability mandate and facilitating the effective overall functioning of the Twin Peaks Model.⁵⁹ As such, when the SARB exercises its powers in respect of financial stability it must consider the views and information provided by the financial sector regulators as well as the recommendations of the Financial Stability Oversight Committee (“the FSOC”)⁶⁰. In other words the SARB has to act within the consultative parameters imposed by the FSRA and cannot act on its own.

It remains to be mentioned however that while the SARB’s new mandate hinges on the prevention, mitigation and management of systemic risk and the requirement that SARB monitors the financial system closely in order to act swiftly should a potential disruption to financial stability arise, SARB does not have complete control over how it decides to execute its financial stability mandate. The SARB is required to act within a policy framework agreed between the Minister of Finance and the Governor of SARB and to ensure that there is extensive consultation and collaboration between SARB and the National Treasury.⁶¹

In relation to systemic events and risks, in terms of section 14(1) of the FSRA, the Governor, after consulting the Minister, may determine that a specified systemic event or circumstances, or a specified combination of events or

⁵⁸S26(1) of the FSRA in summary states that financial sector regulators must co-operate and collaborate with the Reserve Bank and with each other to maintain, protect and enhance financial stability, to provide assistance and information to the Reserve Bank and Financial Stability Oversight Committee to maintain or restore financial stability, promptly report to the Reserve Bank on any matter which poses or may pose a risk to financial stability and gather information from or about financial institutions that concerns financial stability. S76 of the FSRA in addition states that financial sector regulators and the Reserve Bank must co-operate and collaborate when performing their functions in terms of financial sector laws, the National Credit Act and the Financial Intelligence Centre Act in order to, *inter alia*, strive to adopt consistent regulatory strategies and to minimise duplication of effort and expense.

⁵⁹Van Heerden C & van Niekerk G (2017) Twin Peaks in South Africa: a new role for the central bank, Law and Financial Markets Review, 11:4, 154-162. See also Section 26 and Sections 76 – 86 of the FSRA, respectively.

⁶⁰S26(2) of the FSRA

⁶¹Van Heerden C & van Niekerk G (2017) Twin Peaks in South Africa: a new role for the central bank, Law and Financial Markets Review, 11:4, 154-162.

circumstances, is a “systemic event”. However, such a determination can only be made after the Governor has consulted the FSOC⁶², whether or not the systemic event has already occurred or arisen and after consulting the Minister.⁶³ The FSOC, in fulfilling its functions, is assisted by the Financial Sector Contingency Forum (“the FSCF”), a forum which was established to assist the FSOC in identifying potential risk that systemic events will occur and with the co-ordination of appropriate plans, mechanisms and structures to mitigate those risks⁶⁴

It is also apparent from the FSRA that South Africa has followed suit in respect of the assessment methodology adopted by international financial regulators to designate SIFIs. Section 29(3) of the FSRA provides the following designation criteria:-

- “(3) In deciding whether to designate a financial institution in terms of subsection (1), the Governor must take into account at least the following:-*
- (a) the size of the financial institution;*
 - (b) the complexity of the financial institution and its business affairs;*
 - (c) the interconnectedness of the institution with other financial institutions within or outside the Republic;*

⁶²The FSOC was established to assist the SARB in achieving its new financial stability mandate and to facilitate co-operation and collaboration between the financial sector regulators and the SARB in respect of matters relating to financial stability. The FSOC is a powerful committee comprising of the Governor of SARB, the Deputy Governor, the Chief Executive Officer of the Prudential Authority, the Commissioner of the Financial Sector Conduct Authority, the Chief Executive Officer of the National Credit Regulator, the Director-General of Treasury, the Director of Financial Intelligence Centre and any additional persons appointed by the Governor. In summary, the FSOC’s functions include serving as a forum for representatives of the Reserve Bank and each of the financial sector regulators to be informed and exchange views regarding financial stability, to make recommendations to the Governor on the designation of SIFIs, to advise the Minister of SARB on steps to promote, protect, maintain or to manage or prevent risks to financial stability as well as advising on matters relating to crisis management and prevention, to make recommendations and to perform any other function in terms of applicable legislation. See S20, S21 and S22 of the FSRA.

⁶³S14(1) – (5) of the FSRA.

⁶⁴S25(1) and (2) of the FSRA. The SARB must provide administrative support and other resources, including financial resources for the effective functioning of the FSCF. See S25(6).

- (d) *whether there are readily available substitutes for the financial products and financial services that the financial institution provides or, in the case of a market infrastructure, the market infrastructure;*
- (e) *recommendations of the Financial Stability Oversight Committee;*
- (f) *submissions made by or for the institution; and*
- (g) *any other matters that may be prescribed by Regulation.”*

The specific D-SIB assessment indicators and their respective weighting adopted in South Africa are as follows: Size (20%), Global activity (10%)⁶⁵, Interconnectedness (20%), Substitutability (20%), Complexity (10%) and impact on confidence within the financial sector/social impact (20%).⁶⁶ The impact on confidence within the financial sector/social impact is unique to South African D-SIB methodology and includes sub-indicators that reflect the potential impact a bank’s failure would have on confidence in the South African financial sector.⁶⁷

In terms of section 29(1)(a) of the FSRA the Governor of the SARB may, by written notice to the financial institution concerned, designate the institution as a SIFI after taking into account of the criteria in section 29(3) of the FSRA as set out above, the Governor’s power in this regard may not be delegated⁶⁸. However, before designating a financial institution as a SIFI in terms of section 29(1)(a) the Governor must give the FSOC notice of the proposed designation and a statement of the reasons why the designation is proposed and invite the

⁶⁵Even though global activity is considered less relevant in the BCBS’ D-SIB methodology, it has been deemed relevant by South African banks due to their cross-border activities and the potential spill overs relating to these activities, especially in Africa. See SARB (2013) *Financial Stability Review* at 33, available at <<https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5961/FSR%20September%202013%281%29.pdf>> (accessed on 12 August 2018).

⁶⁶SARB (2013) *Financial Stability Review* at 33, available at <<https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5961/FSR%20September%202013%281%29.pdf>> (accessed on 12 August 2018).

⁶⁷SARB (2013) *Financial Stability Review* at 33 and 34 , available at <<https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5961/FSR%20September%202013%281%29.pdf>> (accessed on 12 August 2018).

⁶⁸S29(1)(b) of the FSRA.

FSOC to provide advice on the proposal within a specified reasonable period.⁶⁹ If, after considering the advice of the FSOC, the Governor proposes to designate the financial institution in terms of section 29(1)(a) of the FSRA, the Governor must invite the financial institution to make submissions on the matter within a reasonable period.⁷⁰ Section 29(4)(a) however states that if the Governor has determined in terms of section 14(4) that a systemic event has occurred or is imminent, the Governor may designate a financial institution as a SIFI without complying, or fully complying with section 29(2) and section 29(3) of the FSRA. If the Governor has acted in terms of section 29(4)(a) of the FSRA the financial institution may make submissions on the designation to the Governor within 30 days after being notified of the designation.⁷¹ The Governor must then consider the financial institution's submissions and must issue a written notice to the financial institution confirming or revoking its designation.⁷² A designation or the revocation of a designation in terms of section 29 must be published.⁷³

Interestingly, in order to counter a repeat of the moral hazard that had emerged during the events leading up to the GFC the FSRA specifically makes provision for the fact that being designated as a SIFI does “not imply or entitle the designated financial institution to a guarantee, any form of credit or other support from any organ of state”.⁷⁴ In other words the government will not “bail-out” the financial institution should it face a liquidity crisis in order to protect financial market stability.

9. Conclusion

In summary, understanding the meaning of “systemic risk” together with “systemic importance” of individual financial institutions has ensured that an open, evolving list of assessment methodology has been utilised in order to identify SIFIs due to the varying indicators that could be taken in account during economic fluctuations, the changing environment or conditions of the financial market. The designation of SIFIs is the first step in the process and this paper

⁶⁹S29(2)(a) of the FSRA.

⁷⁰S29(2)(b) of the FSRA.

⁷¹S29(4)(b) of the FSRA.

⁷²S29(4)(c) of the FSRA.

⁷³S29(7) of the FSRA.

⁷⁴S29(5) of the FSRA.

will deal with the implications following such a designation in respect of compliance with prudential requirements in the next chapter.

CHAPTER 3

THE PRUDENTIAL AUTHORITY, PRUDENTIAL REQUIREMENTS AND HIGHER LOSS ABSORBENCY REQUIREMENTS.

1. Introduction of the 'Twin Peaks' model in South Africa

During 1995, Michael Taylor wrote a Centre for the Study Financial Innovation ("CSFI") Report¹ proposing the Twin Peaks approach to financial regulation.² The premise for Taylor's proposal was that there should be two regulatory agencies, a Financial Stability Commissioner and a Consumer Protection Commissioner, each having a clear objective (i.e. prudential regulation or consumer protection).³ Taylor stressed that focus should shift from the traditional tripartite distinction between banking, securities and insurance and be replaced by a regulatory structure that instead focuses on the objectives of regulation.⁴ Although this approach was first proposed by Taylor for financial regulation in the United Kingdom, it was not adopted by the UK but was actually first adopted during 1998 in Australia and later in the Netherlands. Variations of this model have also been implemented in Spain, France and Canada.⁵

In a 2011 policy document titled "A safer financial sector to serve South Africa better",⁶ the National Treasury of the Republic of South Africa identified that financial regulatory reform was a necessity and committed the Republic of South Africa to adopting the Twin Peaks model of financial regulation modelled broadly on the model currently in use in Australia.⁷ South Africa initially adopted an institutional approach wherein banks, insurers and capital markets were self-regulating but due to lack of coordination this approach was abandoned. Under the then existing institutional model the SARB, specifically the Banking Supervision Department oversaw the banking sector and the FSB oversaw the

¹ Taylor M (1995) 'Twin Peaks': A Regulatory Structure for the New Century, Centre for the Study of Financial Innovation, London.

² Taylor M (2009) *'Twin Peaks' Revisited ... a second change for regulatory reform*, CSFI report 89 at 1.

³ Taylor M (2009) *'Twin Peaks' Revisited ... a second change for regulatory reform*, 89 CSFI report 89 at 1.

⁴ Taylor M (2009) *'Twin Peaks' Revisited ... a second change for regulatory reform*, 89 CSFI report 89 at 4.

⁵ Taylor M (2009 – 2010) *The Road from "Twin Peaks" – and the Way Back*, 16 Connecticut Insurance Law Journal 61 at 63.

⁶ Republic of South Africa National Treasury (2011) *A Safer Financial Sector to Serve South Africa Better*, National Treasury Policy Document, National Treasury, Republic of South Africa.

⁷ Schmulow A (2017) *Financial Regulatory Governance in South Africa: The Move Towards Twin Peaks*, 25 Afr. J. Int'l & Comp. L. 393, 417 at 401.

non-bank financial industry, which are regulated by industry-specific legislation, including their enabling Acts.⁸ The Treasury Report stated as follows:-

“ The twin peaks approach is regarded as the optimal means of ensuring that transparency, market integrity, and consumer protection receive sufficient priority, and given South Africa's historical neglect of market conduct regulation, a dedicated regulator responsible for consumer protection, and not automatically presumed to be subservient to prudential concerns, is probably the most appropriate way to address this issue ... the existence of separate prudential and market conduct regulators may be a way of creating a system of checks and balances, thereby avoiding the vesting of too much power in the hands of a single agency ... the flip side of creating checks and balances is the need to carefully define roles and responsibilities to avoid duplication of work and jurisdictional overlap ... separation of prudential and market conduct regulation does not eliminate the possibility of conflict between them ... consultation between the two bodies would lead to an acceptable compromise. But if not, some external means would need to be found to reconcile objectives. In South Africa, the formal way of resolving conflict will be through the Council of Financial Regulators.”⁹(Emphasis Added).

Although the model adopted in South Africa is referred to as a Twin Peak System it is not a “pure” model as contemplated by Taylor, as the South African model actually comprises of three peaks, which includes the SARB, the Prudential Authority (“PA”) and the Financial Sector Conduct Authority (“FSCA”).

Generally, the PA’s objective will be to promote and enhance the safety and soundness of regulated financial institutions and the FSCA, as market conduct regulator, will be tasked with protecting financial customers through supervising market conduct.

⁸ Schmulow A (2017) *Financial Regulatory Governance in South Africa: The Move Towards Twin Peaks*, 25 Afr. J. Int'l & Comp. L. 393, 417 at 402.

⁹ Republic of South Africa National Treasury (2011) 'A Safer Financial Sector to Serve South Africa Better', in *National Treasury Policy Document*, National Treasury, Republic of South Africa at 28.

2. Prudential Requirements prescribed by the BCBS

As mentioned in Chapter One, the Basel Accords were developed by the BCBS in response to the deficiencies in financial system regulation that were identified as a result of the GFC. Basel III is the latest amendment to the Basel Accords and is intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage. The BCBS has prescribed Basel III phase-in arrangements over an extended period. As of 1 January 2019, all G20 countries have agreed to fully comply with the internationally determined prudential standards.¹⁰

Basel Committee on Banking Supervision
BANK FOR INTERNATIONAL SETTLEMENTS

Basel III phase-in arrangements
(All dates are as of 1 January)

Phases		2013	2014	2015	2016	2017	2018	2019		
Capital	Leverage Ratio		Parallel run 1 Jan 2013 – 1 Jan 2017 Disclosure starts 1 Jan 2015				Migration to Pillar 1			
	Minimum Common Equity Capital Ratio	3.5%	4.0%	4.5%				4.5%		
	Capital Conservation Buffer				0.625%	1.25%	1.875%	2.5%		
	Minimum common equity plus capital conservation buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%		
	Phase-in of deductions from CET1*		20%	40%	60%	80%	100%	100%		
	Minimum Tier 1 Capital	4.5%	5.5%	6.0%				6.0%		
	Minimum Total Capital		8.0%			8.625%	9.25%	9.875%	10.5%	
	Minimum Total Capital plus conservation buffer		8.0%	8.625%				9.25%	9.875%	10.5%
	Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital		Phased out over 10 year horizon beginning 2013							
Liquidity	Liquidity coverage ratio – minimum requirement			60%	70%	80%	90%	100%		
	Net stable funding ratio						Introduce minimum standard			

* Including amounts exceeding the limit for deferred tax assets (DTAs), mortgage servicing rights (MSRs) and financials.
-- transition periods

Source: BCBS Basel III phase-in arrangements¹¹

It is apparent from the above table that by 1 January 2019 the minimum percentage of Risk-Weighted Assets (“RWAs”) of Common equity¹² Capital

¹⁰ BCBS (2011) *Basel III: A global regulatory framework for more resilient banks and banking systems* at 1- 2.

¹¹ Table available at <http://www.bis.org/bcbs/basel3/basel3_phase_in_arrangements.pdf> (accessed 14 October 2017).

¹² ‘Common equity’ is the stock owned by the founders, employees and all other shareholders of a company. It is basically a number of investments held by shareholders in a company. See Tayyab M (2017) Difference between Common Equity and Total Equity, available at <<https://www.linkedin.com/pulse/difference-between-common-equity-total-muhammad-tayyab>> (accessed on 10 August 2018). Tier 1 Common Equity includes, *inter alia*, common shares issued by the bank, stock surplus, retained earnings, accumulated other comprehensive income and other disclosed reserves. See BCBS (2011) *Basel III: A global regulatory framework for more resilient banks and banking systems* at 13.

Ratio should be 4.5%, Capital Conservation Buffers¹³ should be 2.5%, minimum common equity plus capital conservation buffer should be 7.0%, Tier 1 Capital¹⁴ should be 6.0%, Total Capital¹⁵ should be 8.0% and Total Capital plus conservation buffers should be 10.5%.

Capital instruments that no longer qualify as non-core Tier1 Capital or Tier 2 Capital¹⁶ should be phased out over a 10 year horizon from 2013. In respect of liquidity, the Liquidity coverage ratio¹⁷ should be at 100% and a net stable funding ratio¹⁸ will be introduced.

3. Prudential Requirements in South Africa

South Africa has a well-established banking regulatory framework. South Africa implemented the Basel capital framework through a three-tier regulatory structure, namely legislation (tier 1) being the Banks Act 94 of 1990, as amended (“the Banks Act”), the Regulations Relating to Banks (2012), as amended in 2016¹⁹ (“the Regulations”) (Tier 2) which contains the bulk of the Basel capital framework and Directives, Circulars and Guidance Notes issued by SARB authorities and banking associations (Tier 3).²⁰

Section 70 to 75 of the Banks Act provides enabling legislation for the enforcement of the prudential requirements in respect of capital that is

¹³Capital Conservation Buffers’ are designed to ensure that banks build up capital buffers above the regulatory minimum outside periods of stress which can be drawn down as losses are incurred. See BCBS (2011) *Basel III: A global regulatory framework for more resilient banks and banking systems* at 54.

¹⁴Tier 1 capital is the bank’s core capital, which is intended to measure the bank’s financial health and is used when the bank must absorb losses without ceasing business operations. See <<https://www.investopedia.com/ask/answers/043015/what-difference-between-tier-1-capital-and-tier-2-capital.asp>> (accessed on 10 August 2018)

¹⁵ Is calculated by adding Tier 1 Capital to Tier 2 Capital.

¹⁶Tier 2 capital is a bank’s supplementary capital. This capital includes revaluation reserves, hybrid capital instruments and subordinated term debt, general loan-loss reserves and undisclosed reserves. Tier 2 is less reliable than Tier 1 Capital. Available at < <https://www.investopedia.com/ask/answers/043015/what-difference-between-tier-1-capital-and-tier-2-capital.asp>> (accessed on 10 August 2018).

¹⁷The Liquidity Coverage Ratio is the first Basel III liquidity standard and refers to highly liquid assets held by financial institutions to meet short-term obligations. The ratio is a 30-day generic stress test that aims to anticipate market-wide shocks. It ensures that financial institutions have the necessary assets should it experience any short-term liquidity disruptions. Available at < <https://www.investopedia.com/terms/l/liquidity-coverage-ratio.asp>> (accessed on 10 August 2018).

¹⁸The Net Stable Funding Ratio is the second Basel III liquidity standard and aims to promote resilience over a longer time horizon by creating incentives for banks to fund their activities with more stable sources of funding on an ongoing basis. In other words the NSFR tries to prevent banks from expanding their balance sheets quickly by relying on cheap and abundance short-term wholesale funding. See BIS (2018) Net Stable Funding Ratio (NSFR) – Executive Summary.

¹⁹Government Gazette No 35950 dated 12 December 2012 (amended in 2016).

²⁰BCBS (2015) *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III risk-based capital regulations – South Africa* at 7.

stipulated in Regulation 38 of the Regulations relating to Banks²¹. Registered banks must have qualifying capital and reserves as defined in the Banks Act in order to meet the minimum capital requirements calculated for credit risk, market risk and operational risk, including additional capital requirements.²²

South Africa, as a member of G20, has to comply with the new amendments to Basel III but South African domestic banks have already, at this stage, capitalised above the Basel III required levels.²³ Essentially this means that banks in South Africa have not been required to raise capital or deleverage because of their already well capitalised position.²⁴ The banks however have had to refocus their strategies on liquidity requirements²⁵ in order to comply with new global liquidity standards.²⁶

The Banks Act differentiates between banks of which the business consists solely of trading in financial instruments, banks of which the business does not include trading in financial instruments and banks of which the business includes trading in financial instruments and prescribes that the minimum sum of its common equity tier 1 capital, additional tier 1 capital, tier 2 capital and its common equity tier 1 unimpaired reserve funds²⁷, additional tier 1 unimpaired

²¹The Regulations caters for, inter alia, capital disclosure requirements, the calculation of bank's Liquidity Coverage Ratio, requirements to intraday liquidity management and public disclosure requirements related to the Liquidity Coverage ratio. Regulation 38 in particular deals with capital adequacy and leverage and contains the directives and interpretation for the completion of the monthly return concerning capital adequacy and leverage in relation to the measurement of Risk-Weighted Assets, the bank's exposure to counterparty credit risk, market risk and operational risk, calculating common equity tier 1 capital, additional tier 1 capital, tier 2 capital, reserve funds, requirements if a bank has not compiled its risk exposure adequately, adjusting/deducting from capital and reserve funds, external credit assessment conditions, amongst others, in relation to the requirements set out in the Banks Act.

²²BCBS (2015) *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III risk-based capital regulations – South Africa* at 29.

²³Shawe L and Colegrave A (2017) *Banking Regulation in South Africa: overview*, Thomas Reuters at 5.

²⁴Shawe L and Colegrave A (2017) *Banking Regulation in South Africa: overview*, Thomas Reuters at 5.

²⁵In light of banks' extensive reliance on short-term funding, maturity mismatches between assets and liabilities and insufficient liquidity buffers made banks quite susceptible to liquidity risks. As such the BCBS introduced a global minimum liquidity standard which includes a short-term LCR requirement as well as a longer-term structural liquidity ratio (NSFR). The LCR is to ensure that a bank can manage a short-term liquidity crisis while the NSFR's aim is to reduce refinancing risks on the balance sheet of the bank. Available at <<http://financialmarketsjournal.co.za/oldsite/13thedition/printedarticles/basel3.htm>> (accessed on 10 August 2018).

²⁶The Banking Association of South Africa, *South African Bank Sector Overview*, at 8 available at <<http://www.banking.org.za/docs/default-source/publication/banking-sector-overview.pdf?sfvrsn=6>> (accessed on 15 October 2017).

²⁷S1 of the Banks Act defines this as a share premium arising from the issue of instruments or shares constituting common equity tier 1 capital, retained earnings and such a component of, percentage of or component or percentage of accumulated other comprehensive income and other disclosed reserve funds arising from compliance with Financial Reporting Standards, as may be prescribed.

reserve funds²⁸ and tier 2 unimpaired reserve funds²⁹ in the Republic will not amount to less than R250 000 000 or an amount which represents a prescribed percentage of the sum of amounts relating to different categories of assets and other risk exposures.³⁰

The Banks Act further prescribes, as a minimum prudential requirement, that a bank will hold one high-quality liquid asset which does not amount to less than the sum of amounts, calculated as prescribed percentages, but which in no instance may exceed 20 percent, of such different categories of its liabilities.³¹

In addition to the prudential requirements, a bank may not make investments with or grant loans or advances or other credit to any person, to an aggregate amount exceeding 10% of such amount of its capital and reserves as may be prescribed, without first obtaining permission from the relevant body.³²

Since the implementation of Basel III in South Africa in 2013 the BCBS has issued revised requirements which have necessitated amendments to South Africa's existing regulations. The Regulations serve as a backdrop to the risk-based capital requirement and prevent build-up of excessive leverage in the financial system. The Regulations incorporate requirements such as the Basel III framework and the BCBS Core Principles for Effective Supervision.³³

Under the Basel III framework, SARB introduced a leverage ratio³⁴ under regulation 38(15) which provides that every bank and every controlling company must calculate a leverage ratio in accordance with the relevant requirements specified in subregulation (15) to supplement the bank or controlling company's

²⁸S1 of the Banks Act defines this as a share premium arising from the issue of instruments or shares constituting tier 1 capital and such a component of, percentage of or component or percentage of accumulated other comprehensive income and other disclosed reserve funds arising from compliance with Financial Reporting Standards, as may be prescribed.

²⁹S1 of the Banks Act defines this as any premium arising from the issue of instruments or shares that constitute tier 2 capital and a prescribed percentage of general provision, general loan loss reserve or other reserve held against unidentified and unforeseen losses that comply with such conditions as may be prescribed.

³⁰S70(2), (2A) and (2B) of the Banks Act.

³¹S72 of the Banks Act.

³²S73 of the Banks Act.

³³GAA Accounting (2015) *The ins and outs of banking regulation in South Africa* available at <<http://www.gaaaccounting.com/the-ins-and-outs-of-banking-regulation-in-south-africa/>> (accessed 21 October 2017).

³⁴A 'leverage ratio' is used to evaluate a company's debt levels and thereby assessing the ability of a company to meet its financial obligations. The most common leverage ratios are the debt ratio and the debt-to-equity ratio. Definition available at <<https://investinganswers.com/dictionary/leverage-ratio>> (accessed on 11 August 2018).

relevant risk-based capital requirements. Regulation 38(5)(c) provides the leverage ratio formula and Regulation 38(15)(d) and (e) sets out how the formula must be used and how the relevant amounts are determined. During the current period a bank must manage its business in such a manner that its leverage ratio is at no time less than 4% and the bank's leverage multiple (inverse of the bank's leverage ratio) must at no time exceed 25, or such leverage ratio and multiple as may be determined by the Registrar in consultation with the Governor of the SARB, which leverage ratio shall in no case be less than 3%.³⁵

According to regulation 38(8)(b) the percentage, as contemplated in section 70 mentioned above, of the amount of a bank's assets and other risk exposures is 8 % or higher of common equity tier 1 capital and reserve and tier 2 and reserve funds. Banks will continuously maintain the relevant minimum specified percentage of 8% of qualifying common equity tier 1 and reserve funds, additional tier 1 capital and reserve funds and tier 2 capital and reserve funds to risk weighted exposure, provided that the qualifying common equity tier 1 and reserve funds to risk weighted exposure shall at no time be less than 4,5%.³⁶ Qualifying tier 1 capital and reserve funds, that is, a sum of common equity tier 1 and reserve funds and additional tier 1 capital and reserve funds, to risk weighted exposure shall at no time be less than 6%.³⁷

The additional minimum percentage for systemic risk of qualifying common equity tier 1 capital and reserve fund and additional tier 1 capital and reserve funds and tier 2 capital and reserve funds to risk weighted exposure and relevant additional bank specific minimum required percentage specified from time to time for idiosyncratic risk of qualifying common equity tier 1 capital and reserve funds and additional tier 1 capital and reserve funds and tier 2 capital and reserve funds to risk weighted exposure and a capital conservation buffer shall range between 0 to 2,5% of a bank's relevant amount of risk weighted

³⁵Shawe L and Colegrave A (2017) *Banking Regulation in South Africa: overview*, Thomas Reuters at 6.

³⁶Regulation 38(8)(e)(i)(A).

³⁷Regulation 38(8)(e)(i)(B).

exposure in order to build up capital buffers outside periods of stress identified.³⁸

The countercyclical capital buffer³⁹ must ensure that the specified minimum capital requirement for banks take into account the macro-financial environment in which the bank operates. Its primary objective is to use a buffer of capital to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build-up of system-wide risk. This buffer is calculated as the weighted average of buffers in effect in the jurisdictions to which banks have a credit exposure and consists entirely of common equity tier 1 capital.⁴⁰ Should a bank fail to meet the minimum buffer requirements for the capital conservation and countercyclical capital buffers, capital distribution constraints will be imposed on the bank. These constraints however only relate to capital distributions and not the operation of the bank.⁴¹

The buffer regime has been phased-in from 1 January 2016 and will become fully effective on 1 January 2019. The Financial Stability Committee of SARB will be responsible for setting the countercyclical capital buffer rate for South Africa.⁴² This means that if a countercyclical capital buffer was set in South Africa, a buffer of either or between 0 to 0.625% of RWAs could have been set as of 1 January 2016. This percentage of RWAs would then have increased annually until the final value of 2.5% of RWAs is reached by 1 January 2019.⁴³

³⁸Regulation 38(8)(e)(ii),(iii) and (iv)(C).

³⁹The 'countercyclical capital buffer' is a framework that provides macroprudential supervisors with a tool to change capital requirements for banks in order to protect the financial system from the boom and bust phases of the financial cycle. See SARB (2017) Financial Stability Review, 2nd edition at 24, available at < <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8073/Second%20Edition%20FSR%20Oct%202017.pdf>> (accessed on 11 August 2018).

⁴⁰Regulation 38(8)(e)(v)(A) and BIS (2018) Countercyclical capital buffer (CCyb), available at < <https://www.bis.org/bcbs/ccyb/>> (accessed on 11 August 2018).

⁴¹BCBS (2018) Countercyclical capital buffer (CCyb), available at < <https://www.bis.org/bcbs/ccyb/>> (accessed on 11 August 2018). See also BCBS (2010) Guidance for national Authorities operating the countercyclical capital buffer at 1, available at < <https://www.bis.org/publ/bcbs187.pdf>> (accessed on 20 October 2018).

⁴²SARB (2017) Financial Stability Review, 2nd edition at 24, available at <<https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8073/Second%20Edition%20FSR%20Oct%202017.pdf>> (accessed on 11 August 2018).

⁴³SARB (2018) Financial Stability Review, 1st edition at 27, available at < <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8420/FSR%20First%20Edition%202018.pdf>> (accessed on 11 August 2018).

The SARB circular 8/2015 issued in terms of section 6(4) of the Banks Act to banks, branches of foreign institutions, controlling companies, eligible institutions and auditors of banks or controlling companies, clarifies the implementation of the countercyclical buffer in South Africa. SARB stated that in accordance with the provisions of regulation 38(8)(e)(v) and 38(8)(g) of the Regulations relating to Banks, the countercyclical buffer add-on rate will be set in a range from 0% but not more than 2,5% of risk-weighted assets. The main indicator used by South Africa in determining the countercyclical buffer is the credit-to-GDP ratio as set out in the Basel Committees' *Guidance for National authorities operating the countercyclical capital buffer*.⁴⁴ However other indicators may be considered, such as various asset prices, funding spreads and CDS spreads, credit condition surveys and real GDP growth.⁴⁵ The countercyclical buffer could have been applied to South African banks from 2016 however the Financial Stability Committee of the SARB, after considering all relevant information, decided not to activate the countercyclical buffer add-on for banks at this stage, as such the rate was kept at 0%. Currently this position has not changed in South Africa.⁴⁶

Domestic banks in South Africa must comply with the implementation dates of the Basel III framework and should already have begun reporting on how they have positioned themselves for compliance. It is however apparent that South Africa's regulations are on par with international standards and that SARB has conducted annual financial stability reviews in accordance with its mandate.

4. Additional Prudential Requirements in respect of SIFIs

As a point of departure principles 8 to 12⁴⁷ in respect of the D-SIBS framework determines the framework for the Higher Loss Absorbency ("HLA") (alternatively referred to as Additional Loss Absorbency) requirements that must be applied to identified D-SIBS. The HLA requirement has to be phased-in with the capital

⁴⁴Available at < <https://www.bis.org/publ/bcbs187.htm> > (accessed on 11 August 2018).

⁴⁵SARB Circular 8/2015 at 2. See also BCBS (2010) Guidance for national Authorities operating the countercyclical capital buffer at 4, available at < <https://www.bis.org/publ/bcbs187.pdf> > (accessed on 20 October 2018) .

⁴⁶SARB (2018) Financial Stability Review, 1st edition at 28, available at < <https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8420/FSR%20First%20Edition%202018.pdf> > (accessed on 11 August 2018).

⁴⁷BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 3 and 4.

conservation and countercyclical buffers between 1 January 2016 and year-end 2019. The purpose of the HLA requirement for D-SIBS is to “...*reduce further the probability of failure compared to non-systemic institutions, reflecting the greater impact a D-SIB failure is expected to have on the domestic financial system and economy*”.⁴⁸ Furthermore, the HLA requirement is to ensure that the D-SIB is further capable of resilience should it undergo stressful financial periods.⁴⁹

The BCBS has fixed the HLA requirement to respective buckets. The bucketing approach means that once a score produced by the indicator-based measurement of a bank exceeds a cut-off level set by the BCBS and it is classified as a G-SIB it will be allocated into a specified category of systemic importance. Depending on the category (bucket) in which the bank falls, the level of the HLA requirement varies.⁵⁰ The magnitude of the highest HLA requirement in respect of bucket 5 has been set at 3.5% of risk-weighted assets and the magnitude of the lowest HLA requirement in respect of bucket 1 has been set at 1% of risk-weighted assets. The HLA requirements are to be met with Common Equity Tier 1 capital as defined in the Basel III framework.⁵¹

National authorities should document the methodology utilised to determine the level of the HLA requirement that it would require of the D-SIBs in their jurisdiction. The degree of the HLA requirements should correspond to the degree of systemic importance of the Bank in order to address the risk posed by the D-SIB.⁵²

The Regulations in South Africa prescribe that the relevant additional minimum required percentage specified in writing by the Registrar from time to time for systemically important banks will be dependent on factors such as size, interconnectedness, substitutability and financial institution and complexity, which factors may be assigned equal weights.⁵³ In South Africa the additional

⁴⁸BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 7.

⁴⁹BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 7.

⁵⁰BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 7.

⁵¹BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement* at 10 -11.

⁵² BCBS (2012) *A framework for dealing with domestic systemically important banks* (final version) at 4.

⁵³ Regulation 38(8)(b)(vi)(A)(i) to (iv).

loss-absorbency requirement requirements have been phased in from 1 January 2016 and will become a minimum standard with effect from 1 January 2019.⁵⁴

5. Sections 30 and 31 Of The FSRA

In addition to the HLA requirements, section 30 of the FSRA provides for the implementation of higher prudential standards and regulator's directives in respect of SIFIs. The SARB may, after consulting the PA, direct the PA to impose, either through prudential standards or directives, requirements applicable to one or more SIFIs in relation to any of the following matters:-

- Solvency measures and capital requirements, which include requirements in relation to counter-cyclical capital buffers;
- Leverage ratios;
- Liquidity;
- Organisational structure;
- Risk management arrangements;
- Sectoral and geographical exposures;
- Required statistical returns;
- Recovery and resolution planning; and
- Any other matter in respect of which a prudential standard or regulators directive may be made, on the recommendation of the Governor.⁵⁵

The PA however must notify the SARB and the Financial Stability Oversight Committee of any steps taken to enforce a prudential standard that it made or a directive that it issued.⁵⁶

Furthermore, section 31 of the FSRA provides for a special resolution regime for SIFIs as this section deals with winding-up and similar steps in respect of SIFIs. Usually when a financial institution is insolvent its license can be suspended, varied, amended or cancelled, a special resolution to wind-up the financial institution voluntarily can be adopted, a court order can be obtained to wound up that financial institution, an administrator, trustee or curator for the financial

⁵⁴ Regulation 38(8)(b)(vi)(B)(i) and (ii).

⁵⁵S30(1) of the FSRA.

⁵⁶S30(3) of the FSRA.

institution can be appointed, the financial institution can be placed under business rescue, an agreement for amalgamation or merger may be entered into or a compromise arrangement with creditors of the financial institution can be entered into.⁵⁷ None of these steps however may be taken without the concurrence of the SARB if the institution concerned is designated as a D-SIB. Notably if any of the aforementioned steps are taken without the concurrence of the SARB, such a step will be void.⁵⁸

6. Conclusion

It is clear that there has been a concerted effort by the G20 countries to meet the Basel III requirements set by the BCBS by 2019, although only a few of those jurisdictions have moved toward or are moving toward the adoption the Twin Peaks model as proposed by Taylor, albeit in various forms.

South Africa in particular, as the first developing economy to adopt the Twin Peak model, has undertaken the mammoth task of implementing new legislation and aligning already existing legislation in order to achieve the prudential standards adopted internationally. Fortunately, South Africa's regulatory and legal framework is sophisticated and effective and has set standards on par with, if not higher, than those prescribed in Basel III.

Furthermore, it is also apparent from the discussion above that banks designated as a D-SIB will be required to comply with additional prudential requirements such as the higher loss-absorbency requirements by 2019, depending upon its systemic importance in the domestic financial industry. The requirements with which D-SIBS will have to comply, in the various countries, will be different in light of the different domestic economies and remains to be seen.

⁵⁷S31(1) of the FSRA.

⁵⁸S31(2) of the FSRA.

CHAPTER 4

BASEL III AND THE DESIGNATION OF SIFIS IN HONG KONG

1. Introduction

The difficulty in comparing the South African financial regulatory system with that of other countries is that there are many different models with no commonality and the financial regulatory models utilised by various countries would largely be dependent upon, *inter alia*, the size of the financial system, historical influences, politics, the stage of development of a specific economy and the specific objectives of regulation and supervision. As such there is no single “best” regulatory model that can merely be rubber stamped by every country.¹ In essence the regulatory structure for a particular country must be designed to coincide with an economy’s financial structure, as a financial and regulatory mismatch can lead to additional risks arising.²

In light of the various financial regulatory systems adopted around the world, Hong Kong stood out as an interesting comparator. Accordingly, the key reasons for comparing the South Africa regulatory system with that of Hong Kong is due to Hong Kong’s developed economy, the fact that Hong Kong has undergone regulatory consistency assessments conducted by the BCBS and because of Hong Kong’s status as the third top International Financial Centre since September 2017, just below New York and London.³ Hong Kong also has one of the highest concentrations of banking institutions in the world as 70 of the largest 100 banks worldwide have an operation in Hong Kong.⁴

¹ Llewellyn D (2006) *Institutional Structure of Financial Regulation and Supervision: The Basic Issues*, Washington DC at 35.

² Arner *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss. 1, Article 8 at 44, available at < <http://www.bepress.com/asjcl/vol5/iss1/art8> > (accessed on 11 August 2018).

³ A ‘Financial Centre’ is a location that is home to a cluster of nationally and internationally significant financial service providers such as banks, investment managers or stock exchanges. See: The Global Financial Centres Index 23 (2018) at 2. Available at < <https://www.longfinance.net/media/documents/GFCI23.pdf> >. HKMA (2016) *International Financial Centre*, Annual Report at 95. Available at < https://www.hkma.gov.hk/media/eng/publication-and-research/annual-report/2016/13_International_Financial_Centre.pdf > (accessed on 11 August 2018).

⁴ HKMA (2018) available at < <https://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/three-tier-banking-system.shtml> > (accessed on 11 August 2018).

Furthermore, as the GFC also affected Hong Kong, although not as severely as the United States and other parts of the world, Hong Kong had the unique opportunity to address the weaknesses of and to enhance its financial regulatory system.⁵ On a side note, like other financial centres, Hong Kong's financial regulatory systems has developed gradually prior to the GFC in response to other major international financial crisis of 1973, 1987 and 1997.⁶ Although, in response to the GFC, Hong Kong focused its efforts in three main areas: liquidity (expanding the Hong Kong Monetary Authority's ("HKMA") liquidity mechanisms), depositor protection and capital injections.⁷ Hong Kong's experience of the GFC was unusual as there had been no general systemic instability, loss of confidence and there had been no need for state funds for bank recapitalisation. Despite this, consumers appeared to have suffered material losses as a result of the GFC.⁸

In 2018 the HKMA published a half-yearly Monetary and Financial Stability Report in which it stated its concerns about the fact that global financial markets started the year with a return of volatility triggered by a reappraisal of inflation risk in the United States of America. Due to this volatility in the global and local markets, the HKMA held the view that fund flows in Hong Kong could become more volatile. As such the HKMA advised that banks should assess the possible impacts of sharper-than-expected interest rate rises on their asset quality.⁹

2. Financial Regulation in Hong Kong

While it appears that many countries worldwide have adopted various forms of the 'Twin Peaks' Model (in other words objective-based regulation¹⁰), Hong

⁵ Arner *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss. 1, Article 8 at 1, available at < <http://www.bepress.com/asjcl/vol5/iss1/art8>> (accessed on 11 August 2018).

⁶ Arner *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss. 1, Article 8 at 1, available at < <http://www.bepress.com/asjcl/vol5/iss1/art8> > (accessed on 11 August 2018).

⁷ Arner *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss. 1, Article 8 at 20, available at < <http://www.bepress.com/asjcl/vol5/iss1/art8> > (accessed on 11 August 2018).

⁸ Arner *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss. 1, Article 8 at 35, available at < <http://www.bepress.com/asjcl/vol5/iss1/art8> > (accessed on 11 August 2018).

⁹ HKMA (2018) *Half-Yearly Monetary And Financial Stability Report* at 4, available at < https://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb201803/E_Half-yearly_201803.pdf > (accessed on 11 August 2018).

¹⁰ Objective-based regulation entails that regulators are separated by objective and not institution. In other words, one regulator will oversee the safety and soundness of the financial system while another focuses on

Kong has not, although it has been proposed that Hong Kong considers moving toward the 'Twin Peaks' Model. Hong Kong currently follows an institutional approach to financial sector regulation. This means that a firm's legal status, i.e. whether the institution is a bank, broker-dealer or insurance company, determines which regulator oversees its activity.¹¹

Hong Kong's principal regulators consist of the Financial Services and Treasury Bureau ("FSTB") which is responsible for translating policies into regulation, the Hong Kong Monetary Authority ("the HKMA") which regulates banking and banks, the Securities and Futures Commission ("SFC") which regulates the securities and future markets, the Office of the Commissioner for Insurance ("the OCI") which regulates insurance business and the Mandatory Provident Fund Schemes Authority (the MPFA") which regulates the pensions industry.¹² All four regulatory agencies independently supervise their respective sectors however a Cross-Market Surveillance Committee, which is composed of representatives of these agencies, amongst others, was established to exchange market information, to formulate prompt and appropriate actions as well as to facilitate supervision of financial groups.¹³

This section will focus primarily on the HKMA's role in the financial regulatory system in relation to the banking sector. The HKMA has a general objective to promote the safety and stability of the banking system and as such the HKMA, as a supervisory authority, plays a role in safeguarding financial stability by ensuring that banks are resilient to shocks, able to recover their position in response to a crisis and ultimately helping to prevent failure.¹⁴

the conduct of businesses. See Bryane M *Should Hong Kong Adopt a Twin Peaks Model of Financial Regulation?*, University of Hong Kong. Available at

<<https://web.hku.hk/~bmichael/publications/HTML%20Papers/Should%20Hong%20Kong%20Adopt%20a%20Twin%20Peaks%20Model%20of%20Financial%20Regulation2.htm>> (accessed on 11 August 2018).

¹¹Bryane M *Should Hong Kong Adopt a Twin Peaks Model of Financial Regulation?*, University of Hong Kong. Available at

<<https://web.hku.hk/~bmichael/publications/HTML%20Papers/Should%20Hong%20Kong%20Adopt%20a%20Twin%20Peaks%20Model%20of%20Financial%20Regulation2.htm>> (accessed on 11 August 2018).

¹²Group of 30 (2008) *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace* <http://group30.org/images/uploads/publications/G30_StructureFinancialSupervision2008.pdf> (accessed on 15 April 2018) at 66.

¹³Arner *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss. 1, Article 8 at 6, available at < <http://www.bepress.com/asjcl/vol5/iss1/art8> > (accessed on 11 August 2018).

¹⁴HKMA (2017) *Banking Stability* available at < <https://www.hkma.gov.hk/eng/key-functions/banking-stability.shtml> > (accessed on 11 August 2018).

Accordingly, the applicable legislation in this regard is the Banking Ordinance¹⁵ read together with the Capital, Disclosure and Liquidity Rules, the Exchange Fund Ordinance,¹⁶ supplemented by the Companies Ordinance, Bills of Exchange Ordinance¹⁷ and the common law. Section 7(1) of the Ordinance provides that the principle function of the HKMA is to “*promote the general stability and effective working for the banking system*”. In addition, the HKMA seeks to maintain a prudential supervisory system and regulatory framework in line with international standards, being the Basel III standards published by the BCBS and the FSB.¹⁸ In order to achieve these standards the HKMA adopted a risk-based supervisory approach¹⁹ based on a policy of “continuous supervision”, through on-site examinations (periodic inspections of individual institutions to assess how it is managed and controlled), off-site reviews (either a regular analysis of statistical returns or an extensive annual review of the performance and financial position of individual institutions), prudential meetings (with senior management), co-operation with external auditors and sharing information with supervisors with the aim of detecting issues at an early stage.²⁰ In summary, the HKMA performs the functions of both central bank and regulator.²¹

The difference however in Hong Kong’s approach to financial regulation is that it mixes prudential and market conduct objectives and accordingly Hong Kong’s financial regulator does not require inter-agency cooperation.²² For example:-

¹⁵Cap. 155, Laws of Hong Kong.

¹⁶Cap. 66, Laws of Hong Kong. The HKMA is responsible for administering the official monetary policy and manages the exchange fund under powers delegated by the Financial secretary.

¹⁷ Cap. 19, Laws of Hong Kong.

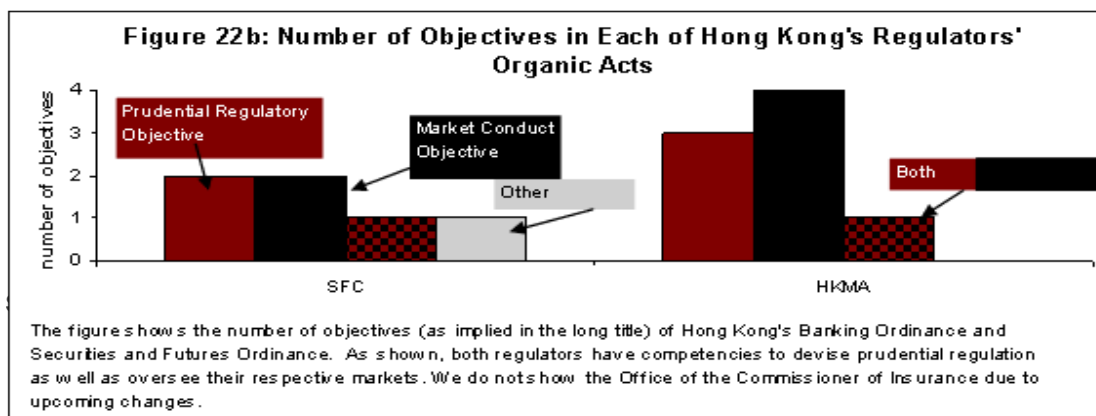
¹⁸HKMA (2017) *Banking Stability* available at < <https://www.hkma.gov.hk/eng/key-functions/banking-stability.shtml> > (accessed on 11 August 2018).

¹⁹A risk based supervisory approach means that the HKMA assesses the risk profile of each institution and ascertains the effectiveness of the institutions systems and procedures to identify, measure, monitor and control risks. This approach enables the supervisory process to focus on areas of greatest risk to an institution and enables the HKMA to be more proactive in taking actions to pre-empt any serious threat to the stability of the banking system. The risks focused on include credit, interest rate, market, liquidity. Operational, reputational, legal and strategic risks. Available at < https://www.hkma.gov.hk/gdbook/eng/r/risk-based_supervisory_app.shtml > (accessed on 11 August 2018).

²⁰HKMA (2017) *Banking Stability* available at < <https://www.hkma.gov.hk/eng/key-functions/banking-stability.shtml> > (accessed on 11 August 2018).

²¹Arner *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss. 1, Article 8 at 6, available at < <http://www.bepress.com/asjcl/vol5/iss1/art8> > (accessed on 11 August 2018).

²²Bryane M *Should Hong Kong Adopt a Twin Peaks Model of Financial Regulation?*, University of Hong Kong. Available at



The HKMA originally issued its Banking (Capital) Rules (“BCR”) and Banking (Disclosure) Rules (“BDR”) in 2006 in order to implement Basel II. Subsequently the HKMA has undertaken several initiatives designed to strengthen the prudential requirements relating to bank capital. The HKMA amended the BCR again in October 2012 to implement the first phase of Basel III taking effect from 1 January 2013. During October 2014 a new set of amendments was made to the BCR to implement the capital buffers and higher loss absorbency buffer for systemically important banks, effective as of 1 January 2015. Given the structural features of the Hong Kong banking system, including the significant presence of subsidiaries of several large G-SIBS these were important steps towards ensuring financial stability in Hong Kong, within the Asia-Pacific region and globally.²³

It has been stated that Hong Kong’s approach to financial regulation is proactive rather than reactionary and emphasises that any regulatory reform should rather focus on more effective regulation than merely *more* regulation.²⁴ This is an important aspect that should be considered in South Africa’s approach to regulating its financial system.

<<https://web.hku.hk/~bmichael/publications/HTML%20Papers/Should%20Hong%20Kong%20Adopt%20a%20Twin%20Peaks%20Model%20of%20Financial%20Regulation2.htm>> (accessed on 11 August 2018).

²³BCBS (2015) *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III risk-based capital regulations –Hong Kong SAR*, BIS at 3.

²⁴Arner DW, Hsu BFC and Da Roza AM 5 (2010), *Financial Regulation in Hong Kong: Time For a Change*, Asian Journal of Comparative Law at 37.

3. Designation of G-SIBS and D-SIBs in Hong Kong: Assessment Methodology

There are over 30 G-SIBS in Hong Kong listed by the FSB. As mentioned above, Hong Kong is one of the major international financial centres and therefore many G-SIBS have a presence in Hong Kong albeit that not all of these institutions have any systemic importance to the domestic financial system and economy of Hong Kong.²⁵

The HKMA is empowered under the BCR²⁶, which were issued pursuant to section 97C of the Banking Ordinance, to designate authorised institutions incorporated in Hong Kong as G-SIBs or D-SIBS and to determine HLA requirements. The assessment methodology used to identify G-SIBs is the same as that adopted by the BCBS' G-SIB framework.²⁷

On the other hand, the D-SIB framework used is complementary to the G-SIB framework which is part of the internationally agreed standards to address the problem of TBTF banks and the moral hazard costs associated with the failure of financial institutions as discussed in Chapter One. Hong Kong is implementing the D-SIB framework in accordance with the Basel III framework and implementation schedule.²⁸

In 2015, the HKMA published a Supervisory Policy Manual which deals with the Designation of Systemically Important Banks in Hong Kong.²⁹ This model sets out the HKMA's framework for assessing the systemic importance of authorised institutions in Hong Kong and for determining the HLA capital requirements to which any locally incorporated authorised institution designated

²⁵HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1, available at <<https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018). See frequently asked questions.

²⁶Cap. 155L Banking (Capital) Rules. These rules deal with the capital adequacy framework for authorised institutions in Hong Kong.

²⁷HKMA (2017) Systemically Important Authorised Institutions (SIBs), available at <<https://www.hkma.gov.hk/eng/key-functions/banking-stability/implementation-of-international-standards/sibs/>> (accessed on 11 August 2018) and See Chapter 2, paragraph 4 "Assessment Methodology of G-SIBS".

²⁸HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1, available at <<https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018). See frequently asked questions.

²⁹HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1, available at <<https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>>(accessed on 17 April 2018).

as a D-SIB or G-SIB under the BCR should be subjected. The HLA requirement will be become effective as from 1 January 2019.³⁰

The key components in the D-SIB framework in Hong Kong is firstly to identify D-SIBS, to reduce their probability of failure by implementing HLA requirements together with intensive supervision and to reduce the impact of failure by improving the D-SIBs resolvability.³¹ The key factors utilised as classification methodology for D-SIBS in Hong Kong is mainly based on four criteria, drawn from the BCBS' D-SIB framework, which includes size, interconnectedness, sustainability and complexity.³²

Under its local D-SIB framework however the HKMA will adopt a two-stage approach in identifying D-SIBS which firstly entails a quantitative measure using an indicator-based approach and then applying a supervisory judgement in order to take into account factors which cannot be captured using quantitative measures. All licensed banks will automatically fall within the scope of regular D-SIB assessments whilst more restricted license banks and deposit-taking companies will only be considered on a case-by-case basis, in the event that they become systemically influential.³³

The quantitative aspect of the first stage entails a weight being assigned to the size, interconnectedness and substitutability factors. No quantitative indicators have been assigned for the complexity factor. The HKMA applies a 50% weight to size and a 25% weight to each of the interconnectedness and substitutability factors. The highest weighting is allocated to size because it is viewed in Hong Kong as the most important measure of systemic importance than the other factors. The factor or indicator weighting is illustrated as follows:-

³⁰HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1 at 4 , available at < <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018).

³¹HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1 at 5 , available at < <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018).

³²HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1 at 8 , available at < <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018).

³³HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1 at 13, available at < <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018).

Factor (and Weighting)	Quantitative Indicator	Indicator Weighting
Size (50%)	Total Assets	50%
Interconnectedness (25%)	Interconnectedness within the Banking system: Balances with and from banks (both components weighted 6.25% each)	12.5%
	Interconnectedness within the financial system: Loans of financial concerns	12.5%
Substitutability (25%)	Deposit from customers	12.5%
	Loans and advances to customers	12.5%
Complexity (no %)	Complexity will be assessed purely by reference to qualitative factors.	

Source: HKMA (2015)³⁴

Once an overall systemic score has been calculated, the HKMA will firstly determine a cut-off threshold above which financial institutions would be considered systemically important and then the HKMA will proceed to stage 2 and make a supervisory judgment as a complement to the quantitative scores. The reasoning for this approach is that a robust assessment approach cannot be solely or mechanically based on quantitative indicators as some factors for assessing systemic importance could also be of a qualitative nature.³⁵ The HKMA intends reviewing the methodology every three years to ensure that developments within the banking sector domestically and internationally are captured³⁶.

³⁴HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1 at 13, available at < <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018).

³⁵HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1 at 14, available at < <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018).

³⁶HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1 at 15, available at < <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf>> (accessed on 17 April 2018).

4. Hong Kong Prudential and the Higher Loss Absorbency Requirements

4.1 Capital

The capital requirements applicable to authorised institutions in Hong Kong are provided mainly in the BCR issued under section 97C(1) of the Banking Ordinance. As such locally incorporated authorised institutions are required to comply with the minimum capital adequacy ratio requirements.³⁷

The capital adequacy ratio refers to three risk-weighted assets namely: Common Equity Tier 1 Capital Ratio, Tier 1 Capital Ratio and Total Capital Ratio prescribed under Basel III. According to the BCR locally incorporated authorised institutions must maintain a Common Equity Tier 1 Ratio of not less than 4.5 %, a Tier 1 Capital Ratio of not less than 6% and a Total Capital Ratio of not less than 8%. The MKHA however may increase these minimums depending on the systemic importance of the authorised institution in Hong Kong.³⁸ This MKHA's authority in this respect is set out from section 97F of the Banking Ordinance.

In addition, local incorporated authorised institutions are also required to maintain capital buffers such as a capital conservation buffer, countercyclical capital buffer and, if considered systemically important, a higher loss absorbency buffer.³⁹

4.2 Capital Conservation Buffer

The capital conservation buffer in Hong Kong is being phased in, in equal annual increments. The capital conservation buffer was set at 0.625 % in 2016 and will reach the upper level of 2.5% of the RWAs in 2019.⁴⁰

³⁷HKMA, *Capital Adequacy Ratio (CAR)*, available at < https://www.hkma.gov.hk/gdbook/eng/c/capital_adequacy_ratio.shtml > (accessed on 11 August 2018).

³⁸S3A and 3B of the BCR set out the minimum CAR requirements. See also: HKMA, *Capital Adequacy Ratio (CAR)*, available at < https://www.hkma.gov.hk/gdbook/eng/c/capital_adequacy_ratio.shtml > (accessed on 11 August 2018).

³⁹HKMA, *Capital Adequacy Ratio (CAR)*, available at < https://www.hkma.gov.hk/gdbook/eng/c/capital_adequacy_ratio.shtml > (accessed on 11 August 2018).

⁴⁰Lake P (2016) *Hong Kong The Banking Regulation Review – Edition 7*, available at < <https://thelawreviews.co.uk/edition/the-banking-regulation-review-edition-7/1136521/hong-kong> > (accessed on 11 August 2018).

4.3 Countercyclical Capital Buffer

As of 1 January 2019, the countercyclical capital buffer will increase to 2.5% from the current 1.875% which was set in 2018.⁴¹ The BCR were amended in 2014 to incorporate provisions for the imposition of capital requirements arising from the operation of the countercyclical buffer as well as the capital conservation buffer.

The HKMA, in setting the countercyclical capital buffer, considered a series of quantitative and qualitative indicators. This included, *inter alia*, bank, corporate and household leverage, debt servicing capacity, profitability and funding conditions within the banking sector and macroeconomic imbalances.⁴²

4.4 Higher loss Absorbency Requirements

As mentioned above, the HKMA is also empowered to determine an HLA requirement for D-SIBS with reference to their degree of systemic importance. In order to achieve this, the HKMA has allocated different HLA buckets to which different D-SIBS with varying systemic importance may be allocated. Once a D-SIB has been allocated to a bucket it must apply the relevant HLA in the calculation of their regulatory capital buffers within 12 months of their notification of their designation.⁴³

Designated D-SIBS will fall into one of five HLA buckets with an HLA ranging between 1% and 3.5% and must be met with Common Equity Tier 1 Capital. The HLA requirements have been phased in from January 2016 in order to reach full implementation by January 2019, as internationally prescribed. This means that the HLA requirement will be phased in with a 25% increment each year beginning at 0.25% to 0.875% until each bucket

⁴¹HKMA (2018) *Monetary Authority Announces Countercyclical Capital Buffer for Hong Kong*, Press Release, available at < <https://www.hkma.gov.hk/eng/key-information/press-releases/2018/20180110-4.shtml> >.

⁴²HKMA (2018) *Monetary Authority Announces Countercyclical Capital Buffer for Hong Kong*, Press Release, available at < <https://www.hkma.gov.hk/eng/key-information/press-releases/2018/20180110-4.shtml> >.

⁴³HKMA (2015) *Designation of Domestic Systemically Important Authorised Institutions (D-SIBS)* <<http://www.hkma.gov.hk/eng/key-information/press-releases/2015/20150316-3.shtml>> (accessed on 14 April 2018).

reaches the aforementioned maximum percentages by 2019. The HLA together with the Capital Conservation Buffer and Countercyclical Capital Buffer are applied to D-SIBS as part of the Basel III implementation. A D-SIB may however be moved from one bucket to another depending on its level of systemic importance.⁴⁴

4.5 Liquidity

In Hong Kong there are two classifications namely “category 1 institutions⁴⁵” which are subject to the Liquidity Coverage Ratio (“LCR”) and the Net Stable Funding Ratio (“NSFR”)⁴⁶. and “category 2 institutions⁴⁷” which are subject to a local liquidity standard, the Liquidity Maintenance Ratio (“LMR”)⁴⁸. The rationale for the distinction is in respect of, *inter alia*, their difference in nature and scale and systemic importance to the Hong Kong banking system.⁴⁹ The LCR implementation in Hong Kong follows the phase-in transitional arrangement proposed by Basel III, a 60% minimum by 2015 and 100% by 2019.⁵⁰

⁴⁴Hong Kong Monetary Authority (2015) *Designation of Domestic Systemically Important Authorised Institutions (D-SIBS)* <<http://www.hkma.gov.hk/eng/key-information/press-releases/2015/20150316-3.shtml>> (accessed on 14 April 2018).

⁴⁵*In determining whether authorised institution should be designated as a category 1 institution, the HKMA takes into account a set of relevant criteria and factors, including whether (i) the AI is “internationally active” or significant to the general stability and effective working of the banking system in Hong Kong; (ii) the liquidity risk of the AI is material; or (iii) there is a risk of regulatory arbitrage if a category 2 institution connected to a category 1 institution is not designated as a category 1 institution. To facilitate the HKMA’s assessment, quantitative benchmarks are used (re: total asset size, and level of international exposures as measured by the sum of an AI’s external claims and liabilities) in conjunction with the review of other relevant “qualitative” factors (such as the nature and complexity of an AI’s business operations, its role in the local banking system and financial markets, and the potential impact of its failure on banking stability in Hong Kong). The high-level criteria for designation of AIs as category 1 institutions are set out in Schedule 1 to the BLR”. See fn 8 of the BCBS (2015) Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III LCR Regulations – Hong Kong SAR at 6. Available at < <https://www.bis.org/bcbs/publ/d314.pdf> > (accessed on 11 August 2018).*

⁴⁶Under the Basel liquidity standards, the NSFR is a ratio, expressed as a percentage, of the amount of a category 1 institution’s “available stable funding” to the amount of the institution’s “required stable funding”.

⁴⁷All institutions which do not fall within category 1 institutions. Definition available at HKMA < https://www.hkma.gov.hk/gdbook/eng/l/liquidity_main_ratio.shtml > (accessed on 11 August 2018).

⁴⁸A ratio, expressed as a percentage, of the amount of a category 2 institutions “liquefiable assets” to the amount of the institution’s “qualifying liabilities (after deductions)” over a calendar month. Definition available at HKMA < https://www.hkma.gov.hk/gdbook/eng/l/liquidity_main_ratio.shtml > (accessed on 11 August 2018).

⁴⁹BCBS (2015) Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III LCR Regulations – Hong Kong SAR at 6. Available at < <https://www.bis.org/bcbs/publ/d314.pdf> > (accessed on 11 August 2018).

⁵⁰BCBS (2015) Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III LCR Regulations – Hong Kong SAR at 9. Available at < <https://www.bis.org/bcbs/publ/d314.pdf> > (accessed on 11 August 2018).

The Banking (Liquidity) Rules (“BLR”)⁵¹ issued by the HKMA under section 97H(1) of the Banking Ordinance is used to implement, amongst other things, the Basel III LCR requirements in Hong Kong with effect from 1 January 2015 and were found to be compliant with the Basel III framework.⁵²

5. Assessment of the implementation of regulatory standards underpinning the Basel III framework in Hong Kong

An assessment team conducted an assessment on the consistency and completeness of the domestic regulations in Hong Kong with the Basel III framework, otherwise known as a Regulatory Consistency Assessment Programme (RCAP).⁵³ The purpose of the RCAP is to assist the BCBS to monitor, assess and evaluate its members’ implementation of the Basel framework.⁵⁴

The assessment was conducted in three phases, firstly a RCAP questionnaire was completed by the HKMA, then an off and on-site assessment of the seven largest banks in Hong Kong was carried out by the assessment team and finally a post-assessment review was conducted. The final step consisted of a two-stage technical review of the assessment findings by a separate RCAP review team and a discussion by the BCBS’ Supervision and Implementation Group, followed by a review and clearance by the RCAP peer review board.⁵⁵

Overall in 2014, the assessment team found that the HKMA’s prudential regulations were largely compliant with the standards prescribed under the Basel framework. Out of 13 components that were assessed the only real issue

⁵¹Cap. 155M, Laws of Hong Kong.

⁵²BCBS (2015) Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III LCR Regulations – Hong Kong SAR at 14. Available at < <https://www.bis.org/bcbs/publ/d314.pdf> > (accessed on 11 August 2018).

⁵³BIS (2015) *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III risk- based capital regulations –Hong Kong SAR* Basel Committee for Banking Supervision at 3. Available at < <https://www.bis.org/bcbs/publ/d314.pdf> > (accessed on 11 August 2018).

⁵⁴BCBS (2015) *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III LCR Regulations – Hong Kong SAR* at 14. Available at < <https://www.bis.org/bcbs/publ/d314.pdf> > (accessed on 11 August 2018).

⁵⁵BIS (2015) *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III risk- based capital regulations –Hong Kong SAR* Basel Committee for Banking Supervision at 5.

was that the HKMA required banks to disclose their capital adequacy ratios on a semi-annual basis rather than quarterly.⁵⁶

On the other hand, the HKMA stated that it considered the RCAP process to be a useful exercise as it was able to correct 17 potential deviations from the international standards which were identified from the process.⁵⁷

6. Conclusion

Recently in 2018, an article addressed the rumour that Hong Kong would be the trigger for the next global financial crises due to the weakening Hong Kong Dollar. It was reasoned however that Hong Kong would not be the epicentre of the next crisis as the difference between the Hong Kong Dollar and US Dollar is the interest rates charged. Hong Kong's interest rates are much lower since its financial system is saturated with money from the Chinese mainland.⁵⁸

It could also be argued that Hong Kong's adoption of the Basel III framework and the identification and regulation of D-SIBS in Hong Kong has aided in maintaining its financial stability. Hong Kong has been extremely focused on the implementation of the Basel III framework in an attempt to secure a competitive advantage over other countries by adopting a proactive financial regulatory system. There appears to be many lessons which can be learnt from the regulatory system adopted by Hong Kong in relation to its financial system.

As a consequence, authorised institutions in Hong Kong which have been identified as D-SIBs, will also be required to comply with additional capital requirements in accordance with the Basel III standards.

⁵⁶BIS(2015) *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III risk- based capital regulations –Hong Kong SAR* Basel Committee for Banking Supervision at 5.

⁵⁷BIS(2015) *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III risk- based capital regulations –Hong Kong SAR* Basel Committee for Banking Supervision at 7.

⁵⁸Holland T (2018) *Hong Kong is about to trigger a global financial crisis...really?* <<http://www.scmp.com/week-asia/opinion/article/2136488/hong-kong-about-trigger-global-financial-crisis-really>> (accessed 17 April 2018).

CHAPTER 5

COMPARISON AND RECOMMENDATIONS

1. Introduction

In summary, there are number of differences in the chosen financial regulatory models adopted in South Africa and Hong Kong, albeit that the same international Basel III minimum standards are being applied. These comparisons can be best illustrated using tables. The various tables will set out the differences in respect of the Financial Regulatory models, the Assessment Methodology of D-SIBS and the Prudential and Higher Loss Absorbency Requirements.

2. Financial System Regulatory Framework

Country	South Africa	Hong Kong
Central Bank with financial stability mandate	South African Reserve Bank	Hong Kong Monetary Authority
Financial Structure	Developing Economy	Developed Economy
Financial Regulatory Model	'Twin Peaks' Model	Institutional Model
Description of Regulatory Model	Objective – Based Regulator	An institutions legal status determines which regulator oversees its activity Risk-based Supervisory Approach
Regulator responsible for ensuring the safety and soundness of the banking sector	Prudential Authority	Hong Kong Monetary Authority

In comparing the chosen financial system regulatory models, it is clear that in implementing the Basel III requirements, the regulatory model chosen may impact upon the success in achieving the international standards set by the BCBS. As discussed earlier, due consideration should be given to the design of a country's regulatory structure as it must coincide with the relevant economy's

financial structure and a financial and regulatory mismatch could result in unforeseen risks arising.¹ In this regard, when deciding on the “best” regulatory structure for a specific country, the responsible authorities should take into account, *inter alia*, the size and strength of a country’s economy, historical influences and politics as not all regulatory structures may be suitable to different economic environments.²

In light of the above, it will be difficult to determine whether a regulatory structure, that is subject to different financial structures and environments worldwide, will be successful in South Africa. At best, South African regulators should continuously develop and adapt the regulatory structure based on lessons learnt from other countries, which have previously faced similar challenges.

3. Assessment Methodology: D-SIBS

	Assessment Methodology	Weighting
BCBS (G-SIB)	Size	20%
	Global Activity	20%
	Interconnectedness	20%
	Substitutability	20%
	Complexity	20%
BCBS (D-SIB)	Should be determined by national regulators, but more or less should be in line with the BCBS’ G-SIB assessment methodology.	
South Africa	Size	20%
	Global Activity	10%
	Interconnectedness	20%
	Substitutability	20%
	Complexity	10%
	Impact on confidence within the financial sector/social impact	10%
Hong Kong	Quantitative Factors:	
	Size	50%

¹ Amer *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss. 1, Article 8 at 44, available at < <http://www.bepress.com/asjcl/vol5/iss1/art8> > (accessed 11 August 2018).

² Llewellyn D (2006) *Institutional Structure of Financial Regulation and Supervision: The Basic Issues*, Washington DC at 35.

	Interconnectedness	25%
	Substitutability	25%
	Qualitative Factors:	
	Complexity	N/A
	Other	N/A

Considering the above table, South Africa and Hong Kong have adopted substantially different approaches in applying the BCBS' G-SIB and D-SIB assessment methodology. This could be attributed to the very different financial systems in the respective countries.

South Africa has expanded upon the quantitative factors in its assessment methodology by including a unique factor relating to the potential impact of a bank's failure on the confidence in the banking sector as well as a factor which speaks to the global activity of its Banks. On the other hand, Hong Kong has limited its quantitative factors to size, interconnectedness and substitutability, the size factor being of most importance with a weighting of 50% and it has included in its assessment a number of qualitative factors. Its reasoning for this was to create a more robust assessment methodology, with the view of consistently reviewing its methodology in order to keep abreast of developments in the domestic and international banking sector.³ Hong Kong's approach speaks to its financial regulators policy to adopt a pro-active and supervisory approach in identifying potential risks within the banking sector before they occur.

It cannot be said, at this stage, which approach to designating SIFIs will be more effective, but the avoidance of a mechanical and rigid approach may be a factor which South African financial regulators should consider in due course.

4. Prudential and Higher Loss Absorbency Requirements

	Prudential Requirement	As at 1 January 2019
South Africa	Common Equity Tier 1 Ratio	4.5%
	Tier 1 Capital Ratio	6%

³HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1 at 14, available at < <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CA-B-2.pdf> > (accessed on 17 April 2018).

	Total Capital Ratio	8%
	Capital Conservation Buffer	2.5%
	Countercyclical Capital Buffer	0%
	Liquidity Coverage Ratio	100%
	Higher Loss Absorbency (SIFIs)	1% (lowest bucket) – 3.5% (highest bucket)
Hong Kong	Common Equity Tier 1 Ratio	4.5%
	Tier 1 Capital Ratio	6%
	Total Capital Ratio	8%
	Capital Conservation Buffer	2.5%
	Countercyclical Capital Buffer	2.5%
	Liquidity Coverage Ratio	100%
	Higher Loss Absorbency (SIFIs)	1% (lowest bucket) – 3.5% (highest bucket)

In light of the above table, South Africa and Hong Kong are on par with the meeting the Prudential and Higher Loss Absorbency requirements as set out in the Basel III implementation timeline by 2019. The only real difference, at this stage, is that the HKMA in Hong Kong has decided to impose a countercyclical capital buffer.

5. Conclusion and recommendation

In conclusion, the financial regulatory framework adopted by any specific country will be determined based on its own financial system's characteristics which, by its very nature, is unlikely to be identical to any other countries financial systems due to various influencing factors. Nevertheless, the assessment methodology adopted to designate SIFIs should seek to be the pro-active, thorough and non-mechanistic.

Past financial crisis', and particularly the GFC of 2008/2009, to a large extent may not have been a result of no regulation or over-regulation but rather a result of adopting a reactive approach to risks which arose in the financial sector whether those risks were, *inter alia*, systemic risks, moral hazard risks, operational risks, market risks or liquidity risks. As emphasised in the risk-based supervisory approach adopted in Hong Kong, the HKMA is attempting to secure a competitive advantage in the banking sector by seeking to identify risks early

and to pro-actively resolve those risks before they arise and have the chance to negatively harm Hong Kong's financial stability. The feasibility of this approach is supported by the designation of D-SIBs, the continuous supervision of those institutions as well as the higher prudential requirements and loss absorbency requirements with which SIFIs must comply. On the other hand, the largely unpredictable nature of the financial sector will remain a challenging aspect to financial regulation. Be that as it may, the extent of the potential impact on the domestic and international financial industry due to a failure of a designated SIFI failing, in most cases, should be lessened due to the adoption of the Basel III framework. Accordingly, the designation, supervision and regulation of SIFIs is a positive movement toward attempting to prevent future financial crisis or devastating economic depressions.

BIBLIOGRAPHY

Legislation: South Africa

Banks Acts 94 of 1990, as amended and the Regulations relating to Banks, 2012, as amended.

Financial Sector Regulation Act 9 of 2017.

South African Reserve Bank Act 9 of 1989, as amended.

Government Gazette No 35950 dated 12 December 2012 (amended in 2016).

Government Gazette No.39127, 21 August 2015.

Government Gazette No.41433 Notice R98, 9 February 2018.

Commencement Of Financial Sector Regulation Act, 2017 (National Treasury Notice No. 169 of 2018) Government Gazette No. 41549, March 2018 vol. 633.

Legislation: Hong Kong

Cap. 155 Banking Ordinance, as amended.

Cap. 155L Banking (Capital) Rules, as amended.

Cap. 155M Banking (Liquidity) Rules, as amended.

Cap. 155D Banking (Disclosure) Rules, as amended.

Cap. 66 Exchange Fund Ordinance.

Cap. 19 Companies Ordinance, Bills of Exchange Ordinance.

Reports, Policies, Discussion Papers and Other

Americans for Financial Reform (2014) *Background on the Financial Stability Oversight*.

BCBS (2000) *Principles for the Management of Credit Risk*, Basel Committee on Banking Supervision, BIS.

BCBS (2010) Guidance for national Authorities operating the countercyclical capital buffer, BIS

BCBS (2011) *Basel III: Global regulatory framework for more resilient banks and banking systems*, BIS.

BCBS (2011) *Principles for the Sound Management of Operational Risk*, Basel Committee on Banking Supervision, BIS.

BCBS (2012) *A Framework for Dealing with Domestic Systemically Important Banks*, BIS.

BCBS (2013) *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement*, BIS.

BCBS (2015) *Regulatory Consistency Assessment Programme (RCAP): Assessment of Basel III risk-based capital regulations – South Africa*, BIS.

BCBS (2015) *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III risk-based capital regulations –Hong Kong SAR* Basel Committee for Banking Supervision, BIS

BCBS (2015) *Regulatory Consistency Assessment Programme (RCAP) Assessment of Basel III LCR Regulations – Hong Kong SAR*, BIS

BCBS (2018) *Globally Systemically Important Banks: Revised Assessment Methodology and the higher loss absorbency requirement*, BIS.

BCBS (2018) *Net Stable Funding Ratio (NSFR) – Executive Summary*, BIS.

BCBS (2018) *Countercyclical capital buffer (CCyb)*, BIS

Brühl V (2016) *How to Define a Systemically Important Financial Institution (SIFI) – a new perspective* 538, CFS Working Paper Series

Deloitte Centre of Regulatory Strategies (2014) *Addressing the Risks Posed by Systemically Important banks: The End of Too Big to Fail?*

FSB (2010) *Reducing the moral hazard posed by systemically important financial institutions*, Report.

FSB (2013) *Progress and Next Steps Towards Ending “Too-Big-To-Fail” (TBTF)*, Report.

FSB (2014) *Key Attributes of Effective Resolution Regimes for Financial Institutions*, Report.

Gordhan PJ (2011) *A Safer Financial Sector to Serve South Africa Better*, National Treasury Policy Document.

HKMA (2015) *Systemically Important Banks*, Supervisory Policy Manual CA-B-2, V1.

HKMA (2016) *International Financial Centre*, Annual Report.

HKMA (2018) *Half-Yearly Monetary and Financial Stability Report*.

IMF/BIS/FSB (2009) *Guidance to assess the systemic importance of financial institutions, markets and instruments: initial considerations*, Report.

Labonte M (2017) *Systemically Important or “Too Big To Fail” Financial Institutions*, CRS Report.

Magnus M & Korpas A (2017) *The role of the Basel Committee on Banking Supervision (BCBS)* European Parliament, Directorate- General for Internal Policies PE 587.390.

Republic of South Africa National Treasury (2011) *A Safer Financial Sector to Serve South Africa Better*, National Treasury Policy Document.

SARB (2016) *A New Macroprudential Policy Framework for South Africa*, Financial Stability Department.

Shawe L and Colegrave A (2017) *Banking Regulation in South Africa: overview*, Thomas Reuters.

Smaga P (2014) *The Concept of Systemic Risk*, Systemic Risk Centre, Special Paper No 5, London School of Economics and Political Science.

South African Reserve Bank, *Financial Stability Review*, September 2013.

SARB (2013) *Financial Stability Review*.

SARB (2018) *Financial Stability Review*, 1st edition.

The Global Financial Centres Index 23 (2018).

Thomson J (2009) *On Systemically important financial institutions and progressive systemic mitigation – policy discussion paper*.

Circulars

SARB Circular 8/2015.

Journal Articles

Arner *et al* (2010) *Financial Regulation in Hong Kong: Time for a Change* Asian Journal of Comparative Law: Vol 5: Iss.1.

Bartmann R (2017) *Causes and effects of 2008 financial crisis*, HFU Business School.

Crotty J (2009) *Structural causes of the global financial crisis: a critical assessment of the “new financial structure”*. Cambridge Journal of Economics, Oxford University Press.

De Jager J (2013) *The South African Reserve Bank: Blowing Winds of Change (Part 2)*. South African Mercantile Law Journal.

Dowd K (2013) *Moral hazard and the financial crises*, Cato Journal 29 (1) 144.

Llewellyn D (2006) *Institutional Structure of Financial Regulation and Supervision: The Basic Issues*, Washington DC.

Schmulow A (2017) *Financial Regulatory Governance in South Africa: The Move Towards Twin Peaks*, 25 African Journal of International and Comparative Law 393 – 417.

Taylor M (1995) *‘Twin Peaks’: A Regulatory Structure for the New Century*, Centre for the Study of Financial Innovation, London.

Taylor M (2009) *‘Twin Peaks’ Revisited ... a second change for regulatory reform*, CSFI Report 89, London.

Taylor M (2009 – 2010) *The Road from “Twin Peaks” – and the Way Back*, 16 Connecticut Insurance Law Journal 61.

Van Heerden C & van Niekerk G (2017) *Twin Peaks in South Africa: a new role for the central bank*, Law and Financial Markets Review, 11:4, 154-162.

Internet Sources

Bank for International Settlements *Basel Committee on Banking Supervision – Overview*, available at: <https://www.bis.org/bcbs/>.

Banking Association of South Africa, *South African Bank Sector Overview*, at 8, available at: <http://www.banking.org.za/docs/default-source/publication/banking-sector-overview.pdf?sfvrsn=6>.

Basel Committee on Banking Supervision, *Annex 2: Phase-in arrangements* <http://www.bis.org/press/p100912b.pdf>.

Bryane M *Should Hong Kong Adopt a Twin Peaks Model of Financial Regulation?*, University of Hong Kong. Available at: <https://web.hku.hk/~bmichael/publications/HTML%20Papers/Should%20Hong%20Kong%20Adopt%20a%20Twin%20Peaks%20Model%20of%20Financial%20Regulation2.htm>.

CFI *Rating Agency*, available at: <https://corporatefinanceinstitute.com/resources/knowledge/finance/rating-agency/>.

Consumer Financial Protection Bureau (2017) *What is a subprime mortgage?*, available at : <https://www.consumerfinance.gov/ask-cfpb/what-is-a-subprime-mortgage-en-110/>.

CPA Australia, *Guide to managing liquidity risk*, available at: https://www.cpaaustralia.com.au/~/_media/corporate/allfiles/document/professional_resources/business/managing-liquidity-risk.pdf?la=en.

Davidson A (2008) *The Big Money: How AIG fell apart* Thomas Reuters, available at: <https://www.reuters.com/article/us-how-aig-fell-apart/the-big-money-how-aig-fell-apart-idUSMAR85972720080919>.

Donnelley L (2017) Global credit ratings agency has downgraded South Africa to junk status, Mail & Guardian available at < <https://mg.co.za/article/2017-11-25-global-credit-ratings-agency-has-downgraded-south-africa-to-junk-status>.

FSB *Our History*, available at: <http://www.fsb.org/about/history/>.

Financial Stability Board, available at: https://en.wikipedia.org/wiki/Financial_Stability_Board.

GAA Accounting (2015) *The ins and outs of banking regulation in South Africa*, available at: <http://www.gaaaccounting.com/the-ins-and-outs-of-banking-regulation-in-south-africa/>.

G20, available at: <https://www.g20.org/en/g20/how-it-works>.

Graham S and King B (2018) *Twin Peaks (Financial Sector Regulation Act) moves forward: Transitional Arrangements*, available at: <https://www.cliffedekkerhofmeyr.com/en/news/publications/2018/Finance/finance-and-banking-alert-15-january-twin-peaks-financial-sector-regulation-act-moves-forward-transitional-arrangements.html>.

Group of 30 (2008) *The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace*, available at: http://group30.org/images/uploads/publications/G30_StructureFinancialSupervision2008.pdf.

Holland T (2018) *Hong Kong is about to trigger a global financial crisis...really?*, available at: <http://www.scmp.com/week-asia/opinion/article/2136488/hong-kong-about-trigger-global-financial-crisis-really>.

HKMA *Capital Adequacy Ratio (CAR)*, available at : https://www.hkma.gov.hk/gdbook/eng/c/capital_adequacy_ratio.shtml.

HKMA (2015) *Designation of Domestic Systemically Important Authorised Institutions (D-SIBS)*, available at: <http://www.hkma.gov.hk/eng/key-information/press-releases/2015/20150316-3.shtml>.

HKMA (2018) *Banking Policy and Supervision*, available at: <https://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/three-tier-banking-system.shtml>.

HKMA (2017) *Banking Stability*, available at: <https://www.hkma.gov.hk/eng/key-functions/banking-stability.shtml>.

HKMA (2017) *Systemically Important Authorised Institutions (SIBs)*, available at : <https://www.hkma.gov.hk/eng/key-functions/banking-stability/implementation-of-international-standards/sibs/>.

HKMA (2018) *Monetary Authority Announces Countercyclical Capital Buffer for Hong Kong*, Press Release, available at: <https://www.hkma.gov.hk/eng/key-information/press-releases/2018/20180110-4.shtml>.

Lake P (2016) *Hong Kong The Banking Regulation Review – Edition 7*, available at: <https://thelawreviews.co.uk/edition/the-banking-regulation-review-edition-7/1136521/hong-kong>.

Liner E (2016) *Understanding SIFIs: What Makes an Institution Systemically Important?* Thirdway <<http://www.thirdway.org/report/understanding-sifis-what-makes-an-institution-systemically-important>.

Jinks A and others (2011) *Overview of Basel III – minimum capital requirements and global liquidity standards*, available at: <https://www.claytonutz.com/knowledge/2011/january/overview-of-basel-iii-minimum-capital-requirements-and-global-liquidity-standards>.

Jobst A (2008) *What is Securitization?* IMF, available at: <https://www.imf.org/external/pubs/ft/fandd/2008/09/pdf/basics.pdf>.

Parliamentary Monitoring Group, *Financial Sector Regulation Bill (B34-2015)*, available at: <https://pmg.org.za/bill/608/>.

Risk Weighted Assets (RWA) (Encyclopaedia), available at: <http://www.bankpedia.org/index.php/en/124-english/r/23632-risk-weighted-assets-rwa>.

RiskArticles.com (2017), available at: <http://riskarticles.com/basel-iii-key-updates/Magazine-Basic>.

Tayyab M (2017) *Difference between Common Equity and Total Equity*, available at: <https://www.linkedin.com/pulse/difference-between-common-equity-total-muhammad-tayyab>.

WSO *Financial Banking Crisis 2008 –Detailed Overview*, available at: <https://www.wallstreetoasis.com/financial-banking-crisis-2008-overview>.