After the crisis:

Implementing the G20 financial sector reforms

National Treasury

27 May 2009

The global financial crisis has highlighted flaws in the global financial system which have been long overlooked

The global financial crisis in brief

- The NICE (non-inflationary continuous expansion) was a long period of economic growth, driven in part by the industrialisation of China
- Over time, structural imbalances between emerging and developed countries developed
- Long-run real interest rates remained too low for too long, consequently rates of return on investments also remained low
- A period of deregulation meant that financial institutions could use complex structured products to attempt to mitigate growing risk (e.g hybrids, derivatives, securitised instruments)
- This led to a boom in global credit extension, which stimulated growth in asset prices, particularly housing
- While macroeconomic imbalances created the crisis, regulatory failures worsened it…

The G20 process addressed the regulatory failures that the crisis exposed

Background to the G20 Working Groups and the London Summit

- **G20 had a series of meetings culminating in the London Summit on 2 April 2009**

- **As part of the process, four technical working groups were formed to consider reforms to the global financial system, with the first two looking at what needs to be done to regulation:**
  - Working Group 1 “Enhancing sound regulation and strengthening transparency”
  - Working Group 2 “Reinforcing international co-operation”
  - Working Groups 3 and 4: IMF and the World Bank reform

- **At the summit, G20 leaders issued a communiqué pledging that G20 countries would do whatever necessary to:**
  - Restore confidence, growth, and jobs;
  - Repair the financial system to restore lending;
  - Strengthen financial regulation to rebuild trust;
  - Fund and reform our international financial institutions to overcome this crisis and prevent future ones;
  - Promote global trade and investment and reject protectionism, to underpin prosperity; and
  - Build an inclusive, green, and sustainable recovery.

The process first identified some of the regulatory flaws that led to the global financial crisis

Flaws identified in previous approach to regulation

- **Macroeconomic and financial stability were generally treated separately,** the former focused on preserving low and stable inflation as well as growth, the latter on firm level supervision of the formal banking sector. Neither set of policymakers saw the wider implications of rising risks in the shadow financial sector; nor did they appreciate that economy-wide trends in credit growth, leverage, and house prices posed systemic risks.

- **Check-box approach –** The approach to financial market regulation has increasingly been an institution-by-institution "check-box" approach, where individual institutions are regulated on the basis of their *compliance* to accepted regulatory standards, rather than the overall *health* of the system.

Flaws ctnd

- **Fragmented oversight.** Limited collaboration among national financial regulators; and ad-hoc bilateral, regional, and multilateral facilities created a co-ordination failure.

- **Regulatory arbitrage –** Similar activities conducted by various types of institutions were regulated differently even when in a single group and subject to the same regulator. The resulting opportunities for regulatory arbitrage fuelled the growth of the shadow banking system, resulting in excess leverage obscured by complexity**.**

- **Regulators did not keep up with innovation, and relied on counterparty surveillance, particularly for complex derivatives.** As financial products became more sophisticated, regulators did not improve their capacity to regulate these products.

In South Africa, we have managed to avoid the worst of the crisis, but we can still learn lessons from our G20 colleagues

Areas of priority

- **Currently there are 24 recommendations under Working Group 1 and over 17 recommendations under Working Group 2**

- **Recommendations cover everything from implementing Basel II (which we have done) to the global regulation of credit agencies (which will take place at a global level)**

- **Clearly we need to prioritise, and five lessons stand out as important:**
  - Increasing the importance of macroprudential regulation
  - Improving global regulatory co-ordination
  - Improving the regulation of innovative financial instruments, structures and funds (e.g. hedge funds)
  - Addressing the procyclicality problem inherent in the current Basel II regulations
  - Improve the financial safety net and improving our crisis-management preparedness

Lesson 1: We need to consider the big picture

1. Macroprudential regulation

- **There is a clear need to adapt financial market regulation to take into account macroeconomic developments, particularly if macroeconomic disturbances can contribute to financial market instability.** A simple example is a sudden depreciation of the exchange rate, which may create substantial stress in the system if a bank's assets and liabilities are in different currencies. Similarly asset price bubbles pose potential risks.

- **The overall financial system needs to be evaluated for risk, not just each individual bank.** For example, even if individual entities have assets and liabilities that are relatively well matched from a liquidity perspective, it is possible for the system as a whole to have unmatched assets and liabilities.

- **But… capturing systemic risks through indicators is very challenging –** any number of variables may warn of a coming crisis, and it may be a combination of factors rather than a specific indicator. For example, the current crisis was a "perfect storm" of sub-prime problems, a rapid expansion of credit fed by global capital flows and imbalances, and a sustained period of above trend growth in household income, consumption and wealth.

Lesson 2: We need to work together better, both domestically and internationally

2. Improving global regulatory co-ordination

- **Almost all modern large banks, including South African banks, operate in more than one country.** During a crisis, regulators across borders need to work closely together. Despite the emphasis in recent years on the importance of crisis management arrangements, global co-ordination of actions also took a while before being implemented. Already there are processes underway to improve the preparedness of global regulators for a financial crisis.
  - Supervisory colleges have been proposed, we need to ensure that these benefit emerging economies as well
  - We welcome the expanded Financial Stability Forum (now called the "Financial Stability Board"), it will give us the platform to advance the interests of emerging economies

- **Strengthening the mandate of the regulators to deal with financial crises.** We need to enhance legislation and approaches to strengthen the mandate of the regulators and improve the co-ordination between regulators. The crisis has highlighted the importance of how regulators interact during a crisis can have a profound impact on how quickly the crisis is resolved.

Lesson 3: We need to keep pace with innovation, even though it takes place at dazzling speed

3. Improving the regulation of innovative financial instruments, structures and funds (e.g. hedge funds)

- **The financial boom was characterised by a sustained period of financial innovation, with new products, new structures and new entities, many of them unregulated**

- **Concentrated and significant risks can accumulate in these unregulated entities, e,g, in hedge funds.** Unregulated entities transferred their losses to regulated entities through off-balance-sheet vehicles, unregulated entities within financial groups, leveraged funds, and other unregulated intermediaries. While it appeared that risk had been transferred from regulated to unregulated entities through these special purpose vehicles, the reality was quite different – the original regulated entity was not insulated.

Lesson 4: We need to address the unintended consequences of some our regulations, particularly the “procyclicality problem”

4. Addressing the procyclicality problem inherent in the current Basel II regulations

- **Currently the Basel II requirements do not explicitly discourage procyclical behaviour –** banks naturally tend to lend during good times, and slow lending during bad times. During good times, thus, banks contribute to unsustainable credit booms; while during recessions, banks cut back on their lending and contribute to the further shrinking of the economy.

- **The Basel Committee on Banking Supervision (BCBS) has already started to assess whether, and the extent to which, regulations and prudential standards reinforce cyclical dynamics and impact on the entire financial system.** There is widespread agreement that capital buffers should be built up in the good times, to ensure that banks survive the inevitable bad times. This not only helps reining in the growth of credit and leverage as financial imbalances build up; it also protects the core of the financial system when such imbalances unwind.

Lesson 5: Prevention is the first prize, but we also need to be ready for any eventuality

5. Improving the financial safety net and improving our crisis-management preparedness

- **In many cases, the legal framework for large scale interventions simply did not exist.** In some cases, legislation had to be rushed through parliaments worldwide in order for prompt action to be taken. Now that some normality has returned, we need to review our legislation to ensure that, if an emergency arises, the authorities have the legal and other tools available to restore stability to the system (Insolvency laws).

- **Globally there has been a strong move to strengthen the institutions of financial stability.** The Bank of England, for example, has had its authority extended in order to improve its ability to respond to financial crises, including creating a Special Resolution Regime. Similarly, the complex arrangements in the United States have been streamlined, giving the Fed a greater role in financial stability.

- **Locally, we continue to improve our crisis readiness** and improve the tools at our disposal (e.g. rethinking Deposit Insurance)

To conclude, the "unfinished agenda" is all about what happens next

What happens next?

- The policy priorities have been established globally
- South Africa has a long tradition of keeping pace with international reforms (e.g. Basel II, IFRS, etc.)
- Our strong regulatory framework is a key part of the strength of our banking system and we will continue to implement reforms to enhance and protect the system from risk

Thank you