

**DESIGNATION OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS IN
TERMS OF THE FINANCIAL SECTOR REGULATION BILL**

BY

GODFRED DANQUAH

**Submitted in partial fulfilment of the requirements
for the degree of**

MASTER OF LAWS

at the

UNIVERSITY OF LAWS

SUPERVISOR: PROF CM VAN HEERDEN

NOVEMBER 2016

ACKNOWLEDGEMENTS

First and foremost, I would like to thank God for giving me the strength and determination to pursue this Master's degree.

I would also like to express my gratitude to my supervisor, Professor van Heerden, for her continuous guidance and patience throughout this process.

Last but not least, thank you to my family and good friends for their boundless support and encouragement.

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 Master of Laws in Mercantile Law. It has not been submitted by another student or any other person in any other institution.

Name: Godfred Danquah

12070077

Signature: _____

Date: 10 November 2016

SUMMARY

The 2008 Global Financial Crisis caused the collapse of a number of the so-called 'too-big-to-fail' financial institutions. The crisis highlighted the need to maintain and promote financial stability, by monitoring systemic risks in the financial system. One of the popular global trends in financial sector regulation in response to the crisis was a shift towards a Twin Peaks model. According to this model, the authority responsible for prudential regulation is given the power to designate certain institutions as systemically important financial institutions (SIFIs). Further, a number of international instruments have been published, setting out standards and guidelines for designation of SIFIs. South Africa is currently on the move towards the Twin Peaks model, which is facilitated by the Financial Sector Regulation Bill. This dissertation investigates the rationale behind SIFIs and the process of designating SIFIs in South Africa once the Bill is enacted as an Act. A comparative study of Australia and the U.S is undertaken and the conclusion is that South Africa should lean more towards the Australian approach of designating SIFIs.

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CHAPTER ONE

GENERAL INTRODUCTION

1.1. Background

The Global Financial Crisis of 2008 (GFC) saw the collapse of large financial institutions, which had to turn to their respective national governments for bailouts. A 'bailout' in this context refers to the act of rescuing a troubled financial institution in a crisis by providing financial aid to such institution.¹ While a bailout may ensure the protection of the investors of such institutions, who stand the risk of suffering major losses, it may also encourage moral hazard.² This means that large financial institutions, knowing that the government will bail them out of a crisis, are likely to take on more risk than is optimal. In the end, the consequences of the risky decisions and actions taken by these institutions are incurred by innocent taxpayers, who are obliged to pay taxes to the government.³

Among other reasons, a major cause of the GFC was securitisation and the subprime mortgage crisis in the United States (U.S). Securitisation involves the financial practise of pooling or bundling various loans into sellable assets. This way, financial institutions off-load risky loans (including but not limited to mortgages) onto others. On the one hand, for these institutions, securitisation did not only mean off-loading the risk, but it also meant earning higher credit ratings and lower borrowing costs. On the other hand, investors got the opportunity to invest in high quality assets and receive regular payments from all those mortgages. The early 2000s saw banks borrowing even more money, in order to create more securitisation.⁴

Some investment banks, notably Lehman Brothers in the U.S, got into the mortgage business. They would acquire mortgages in order to securitise them and trade them on. It got to the point where some banks would even lend out more to have an excuse to securitise those loans, resulting in banks resorting to granting mortgage

¹ The Australian Financial System Inquiry *Too-big-to-fail and moral hazard* available at <http://fsi.gov.au/publications/interim-report/05-stability/too-big-to-fail/> (accessed 15-08-2016).

² Moral hazard is defined as a situation in which one party gets involved in a risky event knowing that it is protected against the risk and the other party will incur the cost — The Economics Times, 'moral hazard' available at <http://economictimes.indiatimes.com/definition/moral-hazard>. (accessed 15-08-2016).

³ See fn 1.

⁴ Shah *Global Financial crisis* (2010) available at <http://www.globalissues.org/article/768/global-financial-crisis> (accessed 10-06-2016).

loans to subprime lenders (people who would not ordinarily qualify for credit due to poor credit history), which in turn created more risks for banks.⁵ With the rise of inflation, came default on payments. In addition, the property market at the time had become over-saturated to the extent that there were no buyers to sell the mortgaged properties to in order to realise cash on the default payment. The general public eventually caught on with these problems and lost confidence in financial institutions. Predictably, lending quickly slowed down and in some instances even ceased for a while. This gradually had a knock-on effect on the largest financial institutions, leading to the collapse of a number of so-called ‘too-large-to-fail’ financial institutions such as Bear Stearns, American International Group and Lehman Brothers.⁶ Since the GFC, the concept of “too-big-to-fail” financial institutions (or systemically important financial institutions) gained popularity as those institutions “whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity”.⁷ This concept includes banks, insurance companies and other financial companies whose failure might cause a widespread financial crisis.

In the bigger scheme of things, the decline in confidence in financial institutions and/or the collapse of these institutions affected not only the financial sector, but also other sectors because people had to make heavy cutbacks on consumption in order to weather the economic crisis. This consequently left businesses struggling to survive, resulting in further job losses outside the financial sector.⁸

The end of the 20th century saw the global financial system become highly interconnected. This high level of interconnectedness allowed for the rapid transfer of risk between non-bank financial companies (such as insurance companies and investment companies) and banks. Problems arising in any financial company could easily impact the others (the contagion–phenomenon), and if the risks involved were large enough, they could threaten the stability of the entire financial system. But even as the financial system grew more deeply interrelated, most financial regulatory

⁵ *Ibid.*

⁶ *Ibid.*

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

⁸ See fn 6.

systems continued to rely on regulations that often did not disclose information and failed to recognise critical emerging risks.⁹

After the 2008 GFC, it became apparent that financial stability¹⁰ was still not secured internationally and that to secure financial stability, the scope of regulation for financial institutions needed to shift from the conventional regulation of only banks to the regulation of all financial institutions that play a significant role in the financial system.¹¹ Consequently, as discussed in more detail below, South Africa following the trend in many jurisdictions, is on the move towards the so-called ‘twin peaks’ model of financial regulation.

The concept of ‘twin peaks’ was introduced by Michael W Taylor in response to the United Kingdom’s (U.K) multiple regulatory bodies in the 1990s.¹² Taylor found that the fact that financial companies (banking, security and insurance companies) continue to interlink with each other provided sufficient reasons for eliminating the then division of responsibility for ensuring their prudential soundness in the UK.¹³

In South Africa, owing to, *inter alia*, our sound framework for financial regulation and well-regulated institutions; limited exposure to foreign assets; a robust monetary policy framework; a proactive approach to dealing with bank credit risks; and a focus on reducing household vulnerability, the financial sector successfully weathered the financial crisis. Despite close to a million people becoming unemployed, the South African financial sector did not face the same financial turmoil experienced by advanced economies.¹⁴

⁹ Americans for Financial Reform *Background on the Financial Stability Oversight Council* (2014) 1.

¹⁰ See, in this regard, para 4.1 below.

¹¹ Liner *Understanding SIFIs: What Makes an Institution Systemically Important* (2015)

<http://www.thirdway.org/report/understanding-sifis-what-makes-an-institution-systemically-important> (accessed 10-10-2016)

¹² Taylor *“Twin Peaks”: A Regulatory Structure for the New Century* (1995) 2.

¹³ *Idem* 5. Taylor further finds that the then multiple regulatory system in the UK led to a number of problems, including the lack of clarity in the objectives of the existing regulatory bodies, which pursued both systemic and consumer protection objectives; and an excessive fragmentation of both the systemic protection objectives and the consumer protection objectives, but more particularly, the former.¹³ Hence, he proposed that the structure of regulation be reconfigured around the two main objectives, systemic protection and consumer protection 9-10.

¹⁴ The National Treasury *A Safer Financial Sector to Serve South Africa Better* (2011) 13 – 14.

The South African Reserve Bank (SARB) is the central bank of the Republic and is governed by the South African Reserve Bank Act (SARB Act).¹⁵ The primary object of the SARB is to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic.¹⁶ In pursuing this primary object, SARB is empowered by the Constitution of the Republic of South Africa¹⁷ to perform its functions independently and without fear, favour or prejudice,¹⁸ and is to act in terms of the powers and functions determined by the SARB Act.¹⁹ Although not expressly stated in the SARB Act or the Constitution, the SARB has had a broad financial stability mandate since February 2010, when the SARB's implicit responsibility to monitor macro-economic risks was explicitly confirmed in a letter²⁰ from the Minister of finance to the then Governor of the SARB, Gill Marcus.²¹

The move towards the twin peaks model of financial regulation in South Africa is facilitated by the Financial Sector Regulation Bill (FSR Bill), which is expected to be enacted in 2017.²² The twin peaks model will see the SARB as central bank being tasked with the promotion and maintenance of financial stability and the establishment of two new regulators for the financial services industry (including banks, as well as other financial institutions), namely: the Prudential Authority and the Financial Sector Conduct Authority. The supporting framework for the SARB in fulfilling its financial stability mandate will further be provided by the Financial Stability Oversight Committee (FSOC) and the Financial Sector Contingency Forum (FSCF). The Prudential Authority, established by clause 32 of the FSR Bill and operating within the administration of SARB, will be responsible for prudential regulation and supervision of regulated financial institutions (banks, insurance companies, market infrastructures).²³ Therefore, the prudential regulator will be

¹⁵ 90 of 1989. See also Section 223 of the Constitution of the Republic of South Africa.

¹⁶ The primary object of the SARB is spelt out in both the Constitution of the Republic of South Africa (Section 224(1)) and the SARB Act (Section 3).

¹⁷ 108 of 1996.

¹⁸ Section 223(2) of the Constitution of the Republic of South Africa.

¹⁹ Section 225 of the Constitution of the Republic of South Africa.

²⁰ Available at <http://www.moneyweb.co.za/archive/pravins-letter-to-gill-marcus/> (accessed on 30-10-2016).

²¹ De Jager *The South African Reserve Bank: Blowing Winds of Change (Part 2)* (2013) 499.

²² Financial Sector Regulation (FSR) Bill (July 2016) hereafter FSR Bill.

²³ Clause 161 of FSR Bill empowers the Prudential Authority to designate members of a group of companies as a financial conglomerate. A financial conglomerate designated in terms of this section must include both an eligible financial institution and a holding company of the eligible financial institution, but need not include all the members of the group of companies. The designation of a financial conglomerate is subject to a number of conditions specified in Clause 158(3) – (7) of the FSR Bill.

tasked with the oversight of the safety and soundness of the above-mentioned institutions.²⁴ The Financial Sector Conduct Authority (FSCA) as market conduct authority²⁵ will bear the responsibility of protecting customers of financial services and supervise the way financial institutions conduct their business, by ensuring that financial markets are efficient and exercise integrity, while promoting effective financial consumer protection and education.²⁶

The SARB's financial stability mandate entails the exercise of various functions, namely the obligation to monitor the financial system for risks, to take steps to mitigate risks that it has identified and regularly assessing the observance of principles in the Republic developed by international standard setting bodies.²⁷ It has to keep the level of financial stability in the country's financial system under review and must publish a Stability Review every six months.²⁸ The Governor of the SARB is given the power to determine that a specific event or circumstance constitutes a systemic event²⁹ and the SARB is obliged to take steps to prevent a systemic event from occurring or, where it has occurred or is imminent, to mitigate the adverse effects of the event on financial stability in the Republic and to manage the event and its effects. Throughout the course of the exercise of its financial stability mandate the financial sector regulators and other organs of state are obliged to co-operate with the SARB in the interest of financial stability. In the context of promoting and maintaining financial stability the SARB, through the Governor, also has the power to designate certain financial institutions as Systemically Important Financial Institutions (SIFI).

1.2. Nature and scope of dissertation

The 2008 GFC has highlighted the need for tightened prudential and market conduct regulation of all the players in the financial system and not merely that of banks. It

²⁴ See the National Treasury's media statement *Implementing the Twin Peaks Model of Financial Regulation - Invitation for public comments on the draft FSR Bill* (2013) 1.

²⁵ Clause 56 of the FSR Bill.

²⁶ Clause 57 of the FSR Bill.

²⁷ Clause 12(a)-(c) of the FSR Bill.

²⁸ Clause 13 of the FSR Bill.

²⁹ Clause 1 of the FSR Bill defines 'systemic event' as "an event or circumstance, including one that occurs or arises outside the Republic, that may reasonably be expected to have a substantial adverse effect on the financial system or on economic activity in the Republic, including an event or circumstance that leads to a loss of confidence that operators of, or participants in, payment systems, settlement systems or financial markets, or financial institutions, are able to continue to provide financial products or financial services".

has also emphasised the need to monitor risks in the financial system, especially systemic risk that can threaten financial stability and cause collapse of a financial system. Accordingly many countries have sought to regulate their financial systems with the focus of such regulation being on the maintenance and promotion of financial stability. One of the popular regulatory trends that emerged after the GFC was the move by many countries to move towards a Twin Peaks system of financial regulation as indicated above. A feature of many of these systems of regulation is the power that is given to the authority responsible for prudential regulation to designate certain institutions (banks and non-banks) as systemically important financial institutions (SIFI) which will enable it to regulate these institutions more strictly given their significance within the financial system.

The aim of this dissertation is to investigate the rationale behind designation of SIFI and to look at the criteria that are used as basis for such designation as well as the heightened regulatory compliance associated with being designated as a SIFI. This will be done by having regard to international instruments laying down guidelines for designation of SIFI as well as a broad overview of how SIFI-designation has been approached in jurisdictions such as Australia and the United States of America. Thereafter the approach that will be taken to designation of SIFI in the South African Financial Sector Regulation Bill (FSR Bill) will be analysed in order to benchmark it against international guidelines and the approaches in the two comparative jurisdictions. Finally certain conclusions will be drawn and suggestions will be made for South Africa regarding its approach to designation of SIFI.

1.3. Lay-out of Chapters

Chapter One: General Introduction: This Chapter sets the scene and provides a general introduction to the research topic.

Chapter Two: Rationale behind designation of SIFI and international instruments relevant to designation of SIFI. This chapter will discuss the reasons why SIFI-designation is pivotal in the context of financial regulation after the GFC. It will also set out the policy of international bodies regarding such designation.

Chapter Three: Designation of SIFI in comparative jurisdictions: In order to benchmark South Africa's approach to designation of SIFI it is important to look at

how SIFI-designation is approached in other jurisdictions that have made some headway with this important regulatory measure. In this context Australia, being the first country that implemented a twin peaks model of financial system regulation, and the US, being widely held responsible for triggering the GFC, will be looked at as comparative jurisdictions with regard to SIFI-designation.

Chapter four: SIFI-designation under the South African FSR Bill: This chapter will analyse the powers, process, designation criteria, regulatory implications and other implications of SIFI –designation in South Africa once the FSR Bill is enacted.

Chapter Five: This Chapter will contain conclusions and recommendations regarding the approach South Africa should follow as best practice in the context of SIFI-designation.

1.4. Methodology

The methodology to be employed is that of a literature review, which aim to extract information from international publications, legislations from different jurisdictions, articles and publications from other researchers in terms of what they have produced and concluded on the topic. The literature will be gathered through online resources.

1.5. Delimitation of study

This dissertation will focus mainly on the designation of domestic SIFIs, specifically Systemically Important Banks (D-SIBs) in South Africa, Australia and the U.S.

CHAPTER TWO

RATIONALE BEHIND DESIGNATION OF SIFI AND INTERNATIONAL INSTRUMENTS RELEVANT TO DESIGNATION OF SIFI

2.1. Rationale behind designation of SIFIs

The Financial stability board (FSB) defines SIFIs as those institutions whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.³⁰ SIFIs are colloquially referred to as ‘too-big-to-fail’.³¹

Kluza notes that over time large financial institutions changed their role from “market players” to “market makers”. The conclusion is that growing the size of a financial institution should ideally cause increased responsibility, which should be especially visible in the costs of activity.³² However the collapse of many financial giants during the 2008 GFC tells another story, namely that this increased growth and interconnectedness of very large financial institutions encouraged moral hazard through excessive risk-taking.

After the 2008 GFC, which caused the failure and public bail-outs of several large, global financial institutions, the G-20 Leaders called on the Financial Stability Board (FSB)³³ in 2009 at the Pittsburgh Summit to propose and develop a policy framework to address the systemic and moral hazard risks (negative externalities) associated with systematically important financial institutions (SIFIs).³⁴ The proposed framework was built on the broader policy actions to improve the resilience of the overall financial system, including the reforms to the Basel capital and liquidity framework.³⁵

³⁰The FSB *Progress and Next Steps Towards Ending “Too-Big-To-Fail” (TBTF) Report of the Financial Stability Board to the G-20* (2013) 2.

³¹ Kluza *Reflections on TOO BIG TO FAIL* (2012) 81 finds that although the concept of “Too Big To Fail” had originated from as early as 1914, he notes that the concept was popularised by American Congressman, Stewart McKinney, who referring to the issue of too big to fail and the government bailing out Continental Illinois Bank in 1984, raised the point that the U.S government had created a new class of banks, those too big to fail.

³² *Idem* 82.

³³ The Financial Stability Board (FSB) is an international body established in April 2009 as the successor to the Financial Stability Forum (FSF). With a board comprising of the G20 and other economies, The FSB monitors and makes recommendations about the global financial system — available at <http://www.fsb.org/about/>.

³⁴ FSB *Reducing the Moral Hazard Posed by Systemically Important Financial institutions* (2010) 1.

³⁵ The Basel Committee on Banking Supervision (BCBS) is the primary global standard-setter for the prudential regulation of banks. The Committee further provides a forum for cooperation on banking supervisory matters.

Further, the framework consisted of a set of additional policy approaches and tools to improve the capacity to resolve SIFIs without taxpayers bearing the costs; reduce the probability and impact of a SIFI failure; and strengthen the core financial market infrastructure to reduce contagion risks if failure occurs.

The FSB found that financial institutions should be subject to requirements proportionate to the risks they pose to the financial system. The Board advised that national authorities should have the capacity to impose more stringent requirements on financial institutions that due to their size, complexity or interconnectedness contribute to the build-up of systemic risk, give rise to greater negative externalities in case of resolution and remain more difficult to resolve.³⁶ By imposing measures equal to the level of systemic risk posed by financial institutions, national authorities tighten the regulation of SIFIs, with the aims of:

- (i) significantly reducing the probability of their failure by strengthening their resilience and loss absorbing capacity;
- (ii) reducing the negative externalities that could arise from their failure; and
- (iii) improving their resolvability and ensuring that essential functions for the financial system and broader economy can continue to be performed should the firm fail.³⁷

2.2. The Basel Committee on Banking Supervision

In response to the FSB's policy framework mentioned above,³⁸ the Bank for International Settlements (BIS) published a consultative document which sets out the proposal from the Basel Committee on the assessment methodology for global systemic importance in November 2011.³⁹ This document was updated and replaced

Since 1988 the BCBS, in exercising its supervisory authority, has been issuing a set of recommendations for the prudential regulation of banks. The recommendations are known as the Basel Accords (Basel I, Basel II and Basel III). As a response to the GFC, Basel III was developed by the BCBS to provide for a comprehensive set of reform measures aimed at improving the banking sector's ability to absorb shocks arising from financial and economic stress, improving risk management and governance, and strengthening the transparency and disclosures of banks. The publications of the BCBS are available online at <https://www.bis.org/bcbs/publications.htm?m=3%7C14%7C566>.

³⁶ *Idem* 4.

³⁷ *Ibid.*

³⁸ See, in this regard, para 2.1.

³⁹ Bank for International Settlements (hereafter BIS) "Global systemically important banks: assessment methodology and the additional loss absorbency requirement Rules text" 2011.

with the 2013 version, titled “Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement”.⁴⁰ The framework sets out higher loss absorbency (HLA) requirements that globally systemically important banks (G-SIBs) should have, and the arrangements by which they will be phased in. Accordingly, the framework subjects G-SIBs to more intensive co-ordinated supervision and resolution planning to reduce the probability and impact of their failure.

The ‘too-big-to-fail’ problem does however not only exist at global level but also at national level. As noted by the BIS, there are many instances where a bank may not be significant globally but could, in the event that it goes under stress, have a major impact on its domestic financial system and economy.⁴¹ In view of that, it was considered appropriate to review ways to address the externalities posed by D-SIBs.⁴² This led to the BIS publishing a framework for domestic systemically important banks (D-SIBs) in October 2012.⁴³ The D-SIB framework, like the G-SIB framework addressed the negative externalities posed by systemically important banks, but on a national or domestic level. The framework consisted of a set of 12 principles covering the assessment methodology for determining domestic systemic importance and the HLA requirement for D-SIBs. The 12 principles are broadly categorised into two groups: the first group (Principles 1-7) focuses mainly on the assessment methodology for D-SIBs while the second group (Principles 8-12) focuses on HLA for D-SIBs.⁴⁴ As already mentioned above,⁴⁵ this dissertation will focus mainly on D-SIBs.

2.2.1. Assessment methodology

National authorities are required to establish a methodology for assessing the degree to which banks are systemically important in a global and domestic context. The assessment methodology is based on a multiple indicator-based measurement approach. The selected indicators are chosen to reflect the different aspects of what

⁴⁰ BIS “Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement” (2013); hereafter the BIS (2013).

⁴¹ BIS “A framework for dealing with domestic systemically important banks” (2012) 1 — hereafter the BIS (2012)

⁴² *Ibid.*

⁴³ BIS(2012).

⁴⁴ BIS (2012) 2-3.

⁴⁵ See, in this regard, para 1.5.

generates negative externalities and makes a bank critical for the stability of the financial system. Other than its simplicity, what makes the multiple indicator-based measurement approach the most appropriate option is the manner in which it encompasses various dimensions of systemic importance and is more robust than any other approach.⁴⁶ The Basel Committee proposes that global systemic importance should be measured in terms of the impact that a failure of a bank can have on the global financial system and wider economy rather than the risk that a failure can occur.⁴⁷ Likewise, the Basel Committee is of the view that D-SIBs should also be assessed in terms of the potential impact of their failure on the relevant domestic reference system. This implies that, to the extent that D-SIB indicators are included in any methodology, they should primarily relate to “impact of failure” measures and not “risk of failure” measures.⁴⁸

The G-SIB methodology identifies five broad categories of factors that influence global systemic importance: size, cross-jurisdictional activity, interconnectedness, substitutability/financial institution infrastructure (including considerations related to the concentrated nature of the banking sector) and complexity.⁴⁹ Seeing as the G-SIB framework was aimed at ensuring a consistent international ranking of G-SIBs, the degree of detail is not necessary for D-SIBs, as the main focus is on the domestic impact of failure of a bank and each jurisdiction’s financial structure may differ greatly. Domestically, the cross-jurisdictional activity category does not find much relevance, since it measures the degree of global (cross-jurisdictional) activity of a bank, which is evidently not the focus of the D-SIB framework. Therefore, the impact of a D-SIB’s failure on the domestic economy should be assessed with regard to: size; Interconnectedness; substitutability/financial institution infrastructure (including considerations related to the concentrated nature of the banking sector); and complexity (including the additional complexities from cross-border activity).⁵⁰

⁴⁶ BIS (2013) 5.

⁴⁷ BIS (2013) 5.

⁴⁸ BIS (2012) 4.

⁴⁹ BIS (2012) 6.

⁵⁰ *Ibid.*

The principles laid down by the Basel Committee in the D-SIB framework is defined as a ‘principles-based’ approach⁵¹ as it allows for appropriate national discretion to accommodate structural characteristics of the particular domestic financial system. The framework thus recognises that local authorities are best placed to evaluate the impact of failure on their local financial system and the local economy. Thus, national authorities may identify additional measures applicable to D-SIBs, based on the specific features of the country and its domestic banking sector.⁵² A practical example noted by the Basel Committee is the size of a bank relative to the domestic gross domestic product (GDP): It seems practical to identify a bank as a D-SIB, if the size of that bank is relatively large compared to the domestic GDP, however, a same-sized bank in another country, which is relatively smaller to the country’s GDP, may not qualify as a D-SIB. Additionally, national authorities have discretion as to the appropriate relative weights they place on these factors depending on national circumstances.⁵³ This is in contrast with the G-SIB methodology, which places equal weight to each of the five categories of systemic importance (size, cross-jurisdictional activity, interconnectedness, and complexity).⁵⁴

2.2.2. Higher Loss Absorbency⁵⁵

The Basel Committee has fixed the magnitude of additional loss absorbency for the highest populated bucket at 2.5% of risk-weighted assets at all times, with an initially empty top bucket of 3.5% of risk-weighted assets.⁵⁶ The magnitude of additional loss absorbency for the lowest bucket should be 1.0% of risk-weighted assets. The magnitude of additional loss absorbency is to be met with Common Equity Tier 1 (CET1).⁵⁷

⁵¹ Mwenda *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* (2006) 12 finds that a principles-based system, which is common to most offshore financial centres, is one in which regulators simply issue a set of principles with which regulated businesses must comply. They are generally supplemented by broad codes.

⁵² See fn 49.

⁵³ *Ibid.*

⁵⁴ BIS (2013) 5.

⁵⁵ ‘Higher Loss Absorbency’ and ‘Additional Loss Absorbency’ may be used interchangeably.

⁵⁶ See Le Leslé and Amvramova (IMF) *Revisiting Risk-Weighted Assets “Why Do RWAs Differ Across Countries and What Can Be Done About It?”* (2012) — ‘Risk-weighted assets’ provides a common measure for a bank’s risk, to ensure that capital allocated to assets is commensurate with the risks and also potentially highlight where destabilising asset class bubbles are arising.

⁵⁷ BIS (2013) 12. Common Equity Tier 1 is the highest quality component of a bank’s capital as it is capable of fully absorbing losses whilst the bank remains a going concern. Although Common Equity Tier 1 is also the

The purpose of an HLA requirement for systemically important banks is to reduce the probability of failure of banks that are deemed to be systemically important, by increasing their ability to absorb losses on a going-concern basis. In other words, the HLA requirement is intended to reduce further the probability of failure of systemically important banks compared to non-systemic institutions, reflecting the greater impact that systemically important banks' failure is expected to have on the global and domestic financial system and economy.⁵⁸ The Basel Committee states that the level of HLA for D-SIBs should be subject to policy judgement by national authorities. Some form of analytical framework that would inform policy judgements is required. This was the case for the policy judgement made by the Basel Committee on the level of the additional loss absorbency requirement for G-SIBs.⁵⁹ However, for D-SIBs, the policy judgement on the level of HLA requirements should also be guided by country-specific factors which could include the degree of concentration in the banking sector or the size of the banking sector relative to GDP.⁶⁰

The HLA requirement imposed on a bank should be proportional to the degree of systemic importance, as identified by the impact of a D-SIB's failure on the domestic economy if assessed with regard to size; interconnectedness; substitutability/financial institution infrastructure (including considerations related to the concentrated nature of the banking sector); and complexity (including the additional complexities from cross-border activity).⁶¹ HLA requirements for D-SIBs should also be fully met with CET1 to ensure a maximum degree of consistency in terms of effective loss absorbing capacity. Additionally, national authorities are required to put in place any additional requirements and other policy measures they consider to be appropriate to address the risks posed by a D-SIB. Finally, national authorities are to implement the HLA requirement through an extension of the capital

most costly form of capital for banks to raise, this feature should itself help to level the playing field in the banking sector by reducing the funding advantages of G-SIBs that arise from expectations of public sector support. Therefore, the Basel Committee considers the use of Common Equity Tier 1 to be the simplest and most effective way for G-SIBs to meet their additional loss absorbency requirement.

⁵⁸ BIS (2012) 7.

⁵⁹ *Ibid.*

⁶⁰ *Idem* 8.

⁶¹ *Ibid.*

conservation buffer, maintaining the division of the buffer into four bands of equal size.⁶²

Since the D-SIB framework is complementary to the G-SIB framework, national authorities are required by the Basel Committee to identify and adopt appropriate D-SIB requirements, in line with the phase-in arrangements for the G-SIB framework from January 2016.⁶³

⁶² *Idem* 10.

⁶³ *Idem* 8.

CHAPTER THREE

DESIGNATION OF SIFI IN COMPARATIVE JURISDICTIONS

3.1. Australia

3.1.1. The Australian Financial System

Australia is the leader in the context of the Twin Peaks model of financial regulation, having adopted the model in 1997. In Australia, the Twin Peaks model is characterised by two main financial sector regulators, The Australian Prudential Authority (APRA) and The Australian Securities and Investments Commission (ASIC).⁶⁴

The Reserve Bank of Australia is the central bank of Australia and is responsible for the stability of the Australian currency, the maintenance of full employment in Australia and the economic prosperity and welfare of the people.⁶⁵

The APRA is a prudential regulator with the purpose of regulating financial sector bodies (such as banks, insurance companies and retirements) in order to ensure that these institutions compete in a safe and efficient manner and to ensure the promotion of financial stability in Australia. APRA fulfils its purposes by establishing prudential tools which include authorisation/licensing powers, continuous supervision powers and enforcement powers.⁶⁶

On the other hand, the ASIC⁶⁷ is a market-conduct regulator with the function of monitoring and promoting market integrity and consumer protection in relation to the Australian financial system and to the payments system by, *inter alia*, promoting the protection of consumer interests against misleading or deceptive and unconscionable conduct affecting all consumer products. ASIC regulates Australian companies, financial markets, financial services organisations and professionals who

⁶⁴ Australian Securities and Investments Commission (ASIC) *The integration of financial regulatory authorities – the Australian experience* (2006) 4.

⁶⁵ Section 10(2) of the (Australian) Reserve Bank Act, 4 of 1959.

⁶⁶ Section 8 of the Australian Prudential Regulation Act, 50 of 1998.

⁶⁷ ASIC is governed by the Australian Securities and Investments Commission Act, 51 of 2001.

deal and advise in investments, superannuation, insurance, deposit taking and credit.⁶⁸

3.1.2. Designation of SIFIs in Australia

Currently, the D-SIB framework in Australia focuses only on the larger banks. Other authorised deposit-taking institutions (ADIs), such as smaller banks, credit unions and building societies, though an important part of the competitive landscape, lack the scale and scope of banking activities to be considered within a D-SIB framework.⁶⁹

3.1.2.1. Designation of D-SIBs in Australia

The Australian Reserve Bank Act⁷⁰ and the APRA Act⁷¹ do not expressly lay out any provisions regarding the designation of SIFIs (be it globally or domestically), but as part of its prudential responsibilities, APRA has the mandate of designating SIFIs in Australia. In December 2013, APRA released a framework for D-SIBs in Australia.⁷² The D-SIB framework focused only on the larger banks as the other authorised deposit-taking institutions (ADIs), such as smaller banks, credit unions and building societies at the time lacked the scale and scope of banking activities to be considered within a D-SIB framework.⁷³

Since both the Reserve Bank of Australia and APRA are members of the Basel Committee, APRA's point of departure for designating D-SIBs is the Basel Committee's four objective key indicators of systemic importance: size, interconnectedness, suitability (including considerations related to the concentrated nature of the banking sector) and complexity.

3.1.2.1.1. Size

Size is a key measure of systemic importance as APRA notes that the larger the bank, the more challenging it will be for other banks to briskly replace its activities

⁶⁸ See ASIC's website: *Our Role* available at <http://asic.gov.au/about-asic/what-we-do/our-role/>. (accessed 09-08-2016).

⁶⁹ Australian Prudential Regulation Authority (APRA) *Domestic Systemically Important Banks in Australia* Information Paper (2013) 6.

⁷⁰ 4 of 1959.

⁷¹ 50 of 1998.

⁷² APRA *Domestic Systemically Important Banks in Australia* Information Paper (2013).

⁷³ *Ibid.*

and therefore, the more likely that its distress or failure would cause disruption to the financial markets in which it operates. The distress or failure of a large bank is also more likely to damage confidence in the domestic financial system and have an impact on the real economy.⁷⁴

Size can be measured in a number ways. In measuring the size of a financial institution, APRA follows the suggestions of the FSB and considers the balance sheet and off-balance sheet exposures of the institution, the volume of transactions it engages in and processes, and the volume of assets it warehouses or manages as these are all indicative of the extent to which its business with other institutions and customers will be disrupted and of the magnitude of losses its counterparties may face.⁷⁵

While the activities of a bank outside the home country can, in the event of the bank's failure or distress, have potential spill-overs to the local/domestic economy, the Basel Committee also accepts that cross-border activity may not be as directly relevant as a measure of size at the domestic level since it measures the degree of global activity of a bank, which is outside the scope of the D-SIB framework. In measuring the size of a bank for the purposes of the D-SIB framework, APRA considers total resident assets to be the best measure, because a bank's systemic importance for the domestic economy needs to be assessed on the basis of the bank's domestic impact.⁷⁶

3.1.2.1.2. Interconnectedness

Interconnectedness is the extent to which financial institutions have connections with each other and accordingly are exposed to each other's risk. Interconnectedness increases the risk that financial distress in one institution spills over to and generates financial distress in other institutions, whether they are clients and/or creditors. APRA finds that the more significant the number and size of connections, the higher the potential for spill-overs onto clients and/or creditors.⁷⁷

⁷⁴ APRA 8.

⁷⁵ *Ibid.*

⁷⁶ *Ibid.*

⁷⁷ *Ibid.*

The degree of interconnectedness can be measured by using the following indicators: intra-financial system assets and liabilities, and securities outstanding. Intra-financial assets, broadly defined, would include lending to financial institutions, holdings of securities issued by other financial institutions, net mark-to market reverse repurchase agreements (repos), and securities and over-the-counter (OTC) derivatives traded with other financial institutions. Intra-financial system liabilities would include deposits by financial institutions (including undrawn commitments), securities issued by the bank that are owned by other financial institutions, net mark-to-market repos, and securities and OTC derivatives traded with other financial institutions.⁷⁸

Securities outstanding may also be used to measure interconnectedness. Securities outstanding include debt securities, commercial paper, certificates of deposit (CDs) and equity market capitalisation. The securities outstanding indicator serves to assist to capture the vulnerability of a bank to funding shocks and the risk of spill-over to the broader financial system. In capturing the interconnectedness of banks in terms of intra-financial assets and liabilities, APRA considers loans and advances to financial corporations and deposits from financial corporations to be relevant measures. In capturing the amount of securities outstanding, APRA considers three measures to be relevant: short-term securities outstanding (such as repos, promissory notes/commercial paper, other short-term debt securities and short-term loans); long-term borrowings (such as loans and debt securities with a residual term to maturity of more than one year); and the volume of certificate of deposits issued.⁷⁹ APRA also reports that interconnectedness can also be assessed in terms of large exposures.⁸⁰

3.1.2.1.3. Substitutability

APRA recognises that some banks may lack immediate substitutes for the banking activities and services they provide. However, such banks may still be considered systemically important, because other financial market participants and customers,

⁷⁸ APRA 8-9.

⁷⁹ *Idem* 9.

⁸⁰ *Ibid.* See also APRA Reporting Standard ARS 221.0 Large Exposures (ARS 221.0).

especially borrowers, are reliant on them for the continuous provision of essential financial services and not because they are financially exposed to other institutions.⁸¹

As expected, the systemic importance of a particular bank increases in cases where it is difficult for other financial institutions to provide, in a timely manner, the same or similar services in the event of a failure or distress. The more significant a bank's role in a particular business line, the greater the disruption is expected to be following its failure. On the other hand, the costs borne by customers of the failed bank, in having to seek the same or similar service from another institution is likely to be higher for a bank with relatively higher market share in providing the service.⁸²

Globally, three measures of substitutability are used. They are: assets under custody, payments activity and underwritten transactions in debt and equity markets. The likelihood of a bank that acts as custodian for a large volume of assets on behalf of customers, or is involved in a large volume of payments activities, also acting on behalf of a large number of other institutions and customers (including retail customers) is great. If such bank were to fail, these other financial institutions and customers may be unable to process payments, which would directly affect their liquidity. Likewise, an obligation to purchase unsold securities indicates the reliance that financial market participants have on a bank for the continued provision of that service.⁸³

In this respect, APRA having regard to these three global substitutability measures in a domestic context, assesses substitutability by identifying those key services, disruptions to which would have potential to impact on the real economy because of the time and expense involved in finding replacement providers. The Australian financial system sees business models of banks predominantly centred on lending and deposit-taking, with loan portfolios concentrated mainly in lending to the Australian household sector. Consequently, APRA considers loans and advances to households and total domestic lending as indications of a bank's substitutability in the domestic market.⁸⁴

⁸¹ APRA 8.

⁸² *Ibid.*

⁸³ *Ibid.*

⁸⁴ *Ibid.*

3.1.2.1.4. Complexity

Complexity is a key measure of systemic importance because the larger and more interconnected a bank is, the more likely it is considered to be complex. The more complex the business and operations of the bank, the greater the costs and time needed to resolve the bank in the event of a failure, and the greater the uncertainty associated with the resolution.⁸⁵

On a global scale, three measures are used to assess complexity and they are: the notional amount of over-the-counter (OTC) derivatives,⁸⁶ the amount of trading and available-for-sale securities, and Level 3 assets⁸⁷ under fair value accounting. In principle, the greater the number and variety of non-centrally cleared OTC derivatives a bank enters into, the more complex its activities. Holdings of trading and available-for-sale securities could also generate spill-overs through mark-to-market losses and subsequent fire sale of these securities in the case an institution experiences severe stress. This can in turn result in a decrease in the prices of these securities and force other financial institutions to write-down their holdings of the same securities. In the same way, banks with a high proportion of Level 3 assets on their balance sheets could face severe problems in market valuation in the case of distress, thus impairing market confidence.⁸⁸

In order to measure a bank's level of complexity, APRA has had regard to the notional amount of OTC derivatives and holdings of trading and available-for-sale securities. The Australian OTC derivatives market is a relatively small share of the global market, with activity mostly focused on Australian dollar-denominated contracts. The majority of this activity is intermediated by a small group of domestic and offshore dealers. APRA also considers that the level of traded assets subject to a market risk capital charge can be indicative of the complexity of a bank's activities.

⁸⁵ *Ibid.*

⁸⁶ Over-the-Counter (OTC) derivatives are derivatives traded between two parties (bilateral negotiation) without going through an exchange or any other intermediaries — Edupristine *An insight into OTC Derivatives* (2015) available at <http://www.edupristine.com/blog/otc-derivatives> (accessed 09-09-2016).

⁸⁷ "Level 3 assets" are assets whose fair value cannot be determined by using observable measures, such as market prices or models — BIS: BSCS Consultative Document *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement* (2011) 9.

⁸⁸ APRA 10.

3.1.2.1.5. Higher loss absorbency capital requirement for D-SIBs

As mentioned above, the framework for D-SIBs is intended to reduce the probability of failure of banks considered to be systemically important by increasing their ability to absorb losses on a going-concern basis. The HLA capital requirement for D-SIBs is intended to reduce their probability of failure compared to non-systemic institutions, and also to avoid the possibility that any direct costs of support associated with moral hazard is borne by taxpayers.

The level of HLA for D-SIBs is intended to be subject to policy judgement by national authorities. This policy judgement should be informed and guided by both quantitative methodologies (where available) and country-specific factors, without prejudice to the use of supervisory judgement.⁸⁹

APRA considers a range of quantitative methodologies, which are generally informed by financial modelling ('model-based' options) and by reference to reasonable benchmarks ('reference based' options).⁹⁰ APRA in determining an appropriate HLA requirement for D-SIBS in Australia looked at the International Monetary Fund's (IMF) expected default frequency (EDF) based model. This model makes use of forward-looking market-based inputs to estimate HLA requirements, and its funding cost advantage method, where the estimate of additional capital is based on offsetting the funding advantage of systemic institutions. Furthermore, APRA also considered model-based methodologies applied by banks approved to use the Basel II 'advanced' methodologies for determining capital levels. These models are predicated on a 99.9 percent confidence level at which solvency is maintained. APRA assessed the implications of using higher confidence levels. The reasoning is that systemic institutions must have a higher probability of survival because the impact of failure of such institutions imposes a higher cost on the real economy.⁹¹

Additionally, APRA considers references to key benchmarks. These include:

⁸⁹ *Ibid.*

⁹⁰ *Idem* 19.

⁹¹ *Ibid.*

- historical losses (where estimations of an appropriate additional capital buffer could be based on the loss experience of large systemic banks in the past);
- APRA's stress-testing exercises (calibrating levels at which D-SIBs could be required to withstand a particular stress level of losses);
- the G-SIB framework (where the levels of the HLA required for G-SIBs range from 1.0 percent to 3.5 percent); and
- levels of HLA announced by peer jurisdictions.⁹²

The methodologies and benchmarks show that an appropriate range for the HLA requirement in Australia would be in the order of one to three (1-3) percent of risk-weighted assets.⁹³

APRA's conservative approach to the definition and measurement of capital has been widely acknowledged by the IMF, FSB and credit rating agencies. For example, APRA requires ADIs to maintain higher quality capital (in terms of regulatory adjustments allowed) and, for advanced banks, requires capital to be held against interest rate risk in the banking book and imposes a floor of 20 percent for downturn loss-given-default on residential mortgages. In APRA's view, the quality of capital and assets is as important as the 'headline' regulatory capital ratios reported by banks. Banks and other authorised deposit-taking institutions (ADIs) in Australia have traditionally held a higher quality capital base than many of their offshore peers, although reported headline ratios appear lower than those peers.⁹⁴

APRA finalised its framework for the supervision of Level 3 conglomerate groups in 2014. This framework ensures that Level 3 groups which contain a D-SIB will not be able to reduce their Level 3 Prudential Capital Requirement (PCR) through operational separation or separability of their non-APRA-regulated group members. According to APRA, investors and financial markets are expectant of banks that dominate their groups to cover losses sustained by group members, even if the affected members are operationally separated or separable from the ADI. APRA, therefore, prefers that D-SIBs should not be able to gain a capital benefit from

⁹² *Ibid.*

⁹³ *Ibid.*

⁹⁴ APRA 19-20.

diversification of their group activities, assumed the significant market concerns that would arise if a D-SIB was perceived as not standing behind any material group member.

In light of the above considerations, APRA believes that a HLA requirement at the lower end of the range used elsewhere is appropriate in Australia and has consequently led APRA to fix the HLA requirement for D-SIBs at one per cent (1%), which must be met in full by Common Equity Tier 1 capital.

In designating D-SIBs, APRA opts for a risk-based approach, which subjects institutions that pose greater systemic risks to more intensive supervision and other prudential requirements. This heightened supervisory attention on D-SIBs is considered to be a key aspect in supporting the one per cent (1%) HLA requirement. Currently, D-SIBs in Australia hold significant management capital buffers above the minimum requirements set by APRA and they, in addition, also have strong capital generation capacity through earnings retention.⁹⁵

3.1.2.1.6. Implementation of the D-SIB framework

The HLA requirement is to be implemented from 2016 in Australia through an extension of the capital conservation buffer, maintaining the division of the buffer into four bands of equal size. This is in full compliance with the Basel Committee's D-SIB framework. The capital conservation buffer is 2.5 per cent of an authorised deposit-taking institution's total risk-weighted assets, unless determined otherwise by APRA in writing. Accordingly, APRA will extend the capital conservation buffer for each D-SIB by the one per cent HLA requirement.⁹⁶

3.1.4. D-SIBs in Australia

In 2013, APRA's assessment methodology showed that the four major banks or D-SIBs in Australia were:

- Australia and New Zealand Banking Group Limited;
- Commonwealth Bank of Australia;

⁹⁵ APRA (2013) 20.

⁹⁶ *Ibid.*

- National Australia Bank Limited; and
- Westpac Banking Corporation.

3.2. The U.S

3.2.1. The U.S' Financial System

The U.S' financial sector is characterised by a multitude of regulatory agencies, at both the state and federal levels. Although these agencies are separate, they sometimes have duplicative regulatory authority over the financial services industry. This great level of duplication is caused by a combination of functional and institutional regulation.⁹⁷

In the U.S, there are eight (8) independent financial regulatory authorities, namely: the U.S. Securities and Exchange Commission (SEC); the Financial Industry Regulatory Authority (FINRA); the Commodity Futures Trading Commission (CFTC); the Federal Reserve System ("Fed"); the Federal Deposit Insurance Corporation (FDIC); the Office of the Comptroller of the Currency (OCC); the National Credit Union Administration (NCUA); and the Consumer Financial Protection Bureau (CFPB).⁹⁸

The Federal Reserve System (also known as the Federal Reserve or simply the Fed) is the central banking system of the United States. The Federal Reserve is governed by the Federal Reserve Act of 1913. The Federal Reserve's duties include supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of

⁹⁷ Mwenda *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator* 2006 9. Mwenda finds that "in a system that pursues functional regulation there is a general view that it is more important to regulate the functions performed by financial services businesses than the types of businesses that undertake them. 32 This approach requires rules pertaining to function to be applied consistently to any business that discharges them, irrespective of the type of business. In general, the idea of *institutional* regulation, unlike that of *functional* regulation, relates to the regulation of each single category of financial services business by a different authority, agency, or agency division.³⁶ This model is sometimes referred to as "regulation by silos" or "the by-markets regulatory model."

⁹⁸ Americans for Financial Reform *Background on the Financial Stability Oversight Council (2014)* 2.

consumers and maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.⁹⁹

In response to the 2008 GFC, the Dodd–Frank Wall Street Reform and Consumer Protection Act (commonly known as Dodd-Frank) was enacted into the federal law of the US on 21 July 2010.¹⁰⁰ The Act brought about major changes to the financial sector system and affected all federal financial regulatory agencies and the nation's financial services industry as a whole. The purpose of the Dodd-Frank Act as stated in its long title is ‘to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes’.¹⁰¹ Some of the key changes brought about by the Act are the creation of The Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR) and the supervision of certain non-bank financial institutions and their subsidiaries by the Federal Reserve System in the same manner and to the same extent as banking companies.

3.2.2. The Dodd–Frank Wall Street Reform and Consumer Protection Act (commonly known as Dodd-Frank)

Title I of the Act is dedicated to financial stability and is also referred to as the “Financial Stability Act of 2010”.¹⁰² This Title establishes the Financial Stability Oversight Council (FSOC).¹⁰³ The FSOC is responsible for identifying risks to the financial stability in the U.S that could arise from distress or failure,¹⁰⁴ promoting market discipline,¹⁰⁵ and responding to emerging threats to the stability of the United

⁹⁹ The Federal Reserve System <http://www.federalreserve.gov/aboutthefed/mission.htm> accessed 13 October 2016. The other duties of the Fed are conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates and providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system

¹⁰⁰ The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

¹⁰¹ Long title to the Frank-Dodd Act.

¹⁰² Section 101: short title.

¹⁰³ Section 111. There are ten (10) voting members of the FSOC, namely the Secretary of the Treasury, the heads of the eight independent financial regulatory agencies and an independent expert-member on the insurance industry appointed by the President

¹⁰⁴ Section 112(a)(1)(A). Distress or failure is not defined in the Act. However seeing as the rest of the section makes reference to the financial stability of U.S system, it is assumed that the distress or failure has to be systemic.

¹⁰⁵ Section 112(a)(1)(B).

States financial system.¹⁰⁶ In fulfilling its responsibilities, The FSOC is tasked to, *inter alia*:

- make recommendations to the Board of Governors of the Fed concerning the establishment of heightened prudential standards for risk-based capital, leverage, liquidity, contingent capital, resolution plans and credit exposure reports, concentration limits, enhanced public disclosures, and overall risk management for nonbank financial companies and large, interconnected bank holding companies supervised by the Board of Governors;¹⁰⁷
- identify systemically important financial market utilities and payment, clearing, and settlement activities;¹⁰⁸
- make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets.¹⁰⁹

Seeing as large non-bank financial companies¹¹⁰ such as American International Group (AIG) and Goldman Sachs played a key role in the 2008 GFC and continue to play a pivotal role in the modern financial system, it is important that the FSOC has the power to subject certain nonbank financial companies to prudential standards, if their distress could pose a threat to financial stability. This power is outlined in Section 113 of the Dodd-Frank Act, which provides that:

¹⁰⁶ Section 112(a)(1)(C). It is interesting to note that the Frank-Dodd Act does not define the concept of “financial stability” anywhere in the Act.

¹⁰⁷ Section 112(a)(2)(I).

¹⁰⁸ Section 112(a)(2)(J).

¹⁰⁹ Section 112(a)(2)(K).

¹¹⁰ Title I of the Dodd-Frank Act defines a “nonbank financial company” as a domestic or foreign company that is “predominantly engaged in financial activities,” other than bank holding companies and certain other types of firms. The Dodd-Frank Act further provides that a company is “predominantly engaged ” in financial activities if either (i) the annual gross revenues derived by the company and all of its subsidiaries from financial activities, as well as from the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated annual gross revenues of the company; or (ii) the consolidated assets of the company and all of its subsidiaries related to financial activities, as well as related to the ownership or control of insured depository institutions, represent 85 percent or more of the consolidated assets of the company.

“The Council, on a non-delegable [sic] basis and by a vote of not fewer than 2/3 of the voting members then serving, including an affirmative vote by the Chairperson, may determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards, in accordance with this title, if the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.”

In determining whether a non-bank financial company should be subjected to prudential standards, the Council is required to consider the following statutory considerations, *inter alia*, the extent of the leverage of the company; the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; and the amount and nature of the financial assets of the company. Furthermore, it is possible for the FSOC to subject foreign large non-bank financial institutions to US prudential standards, insofar as that institution has an effect on the U.S financial system.¹¹¹

The FSOC is to give a nonbank financial company written notice of a proposed determination, with an explanation of the basis of the proposed determination, that that nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards.¹¹² Within 30 days of receipt of any notice of a proposed determination, the nonbank may, in writing, request an opportunity to

¹¹¹ Section 113(b).

¹¹² Section 113(e)(1). With regard to the supervision by the Board of Governors, subject to prudential standards, Section 115 provides that “the Council may make recommendations to the Board of Governors concerning the establishment and refinement of prudential standards and reporting and disclosure requirements applicable to nonbank financial companies supervised by the Board of Governors and large, interconnected bank holding companies, that— are more stringent than those applicable to other nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States; and increase in stringency”. Further, the FSOC, in making recommendations for this enhanced supervision and prudential standards may differentiate among companies that are subject to heightened standards on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Council deems appropriate; or recommend an asset threshold that is higher than \$50,000,000,000 for the application of any standard in terms of the contingent capital, resolution plan and credit exposure credits; concentration limits; enhanced public disclosures; and short-term debt limits. In developing the prudential standards, the recommendations of the Council may include: risk-based capital requirements; leverage limits; liquidity requirements; resolution plan and credit exposure report requirements; concentration limits; a contingent capital requirement; enhanced public disclosures; short-term debt limits; and overall risk management requirements”.

contest the proposed determination. The FSOC is to give the nonbank company a further opportunity to submit written or oral materials to support their contest.¹¹³ Even after the FSOC has made a final determination to designate a nonbank financial company, that nonbank financial company may, within 30 days after receipt of the notice of final determination, appeal this decision in a U.S District Court. Upon review, the Court shall dismiss the appeal or direct the final determination to be rescinded if it is established that the FSOC acted arbitrarily and capriciously.¹¹⁴

On 18 December 2014, MetLife¹¹⁵ was notified by the Financial Stability Oversight Council (FSOC) that it had been designated a non-bank SIFI. MetLife challenged that decision in federal court and on 30 March 2016, the U.S. District Court ruled in favour of Metlife and found that FSOC's designation of MetLife as a SIFI failed to consider the impact that the designation would have on MetLife (whether the cost of compliance with this increased burden might actually weaken the very entity that it was intended to strengthen)¹¹⁶ and the U.S. financial system as a whole. Accordingly, the designation was ruled to be "arbitrary and capricious," and thus, unlawful.¹¹⁷ The court rescinded FSOC's designation of Metlife as a SIFI. The Department of Justice on behalf of FSOC has appealed the District Court's decision and the case is now under consideration with the U.S. Court of Appeals for the District of Colombia Circuit.

3.2.3. Designation of Systemically Important Banks

3.2.3.1. G-SIBs

The G-SIB identification process is made by national banking supervision authorities, primarily based on a scorecard of systemic importance indicators established by the Basel Committee. These systemic importance indicators, as already mentioned above are size, interconnectedness, substitutability, complexity and cross-

¹¹³ Section 113(e)(2).

¹¹⁴ Section 113(h).

¹¹⁵ MetLife, Inc. is the holding corporation for the Metropolitan Life Insurance Company (MLIC), better known as MetLife, and its affiliates. MetLife is in the financial services industry and provides a variety of products including insurance (home, car and life), variable life annuities and structured settlements and commercial mortgages.

¹¹⁶ Metlife Inc vs The Financial Stability Oversight Council, Case 1:15-cv-00045 par 131.

¹¹⁷ Idem par 70.

jurisdictional activity.¹¹⁸ The Board of Governors of the Federal Reserve System (FRB), as the central banking system, is responsible for identifying and regulating G-SIBs.¹¹⁹

The Basel Committee's scoring methodology is intended to measure the threat to global financial stability that a G-SIB would pose if it were to fail. Once adopted in a national jurisdiction, the result is a capital add-on intended to reflect these global threats. The FRB recently adopted this methodology to determine which U.S. banks are G-SIBs.¹²⁰

Section 165 of the Dodd-Frank Act is dedicated to enhanced supervision and prudential standards for nonbanks and banks. This section directs the FRB to establish prudential standards for nonbank financial companies that the FSOC has designated for supervision by the Federal Reserve and for bank holding companies with total consolidated assets equal to or greater to \$50 billion.¹²¹ In establishing these prudential standards, the Board of Governors must include:

(i) risk-based capital requirements and leverage limits, unless the Board of Governors, in consultation with the Council, determines that such requirements are not appropriate for a company subject to more stringent prudential standards because of the activities of such company (such as investment company activities or assets under management) or structure, in which case, the Board of Governors shall apply other standards that result in similarly stringent risk controls;¹²²

(ii) liquidity requirements;¹²³

(iii) overall risk management requirements;¹²⁴

(iv) resolution plan and credit exposure report requirements;¹²⁵ and

(v) concentration limits.¹²⁶

¹¹⁸ Glasserman and Loudis *A Comparison of U.S. and International Global Systemically Important Banks* (2015)

1.

¹¹⁹ BIS (2016) 8.

¹²⁰ Glasserman and Loudis 1-3.

¹²¹ Section 165(a)(1) of the Dodd-Frank Act.

¹²² Section 165(b)(1)(A)(i).

¹²³ Section 165(b)(1)(A)(ii).

¹²⁴ Section 165(b)(1)(A)(iii).

¹²⁵ Section 165(b)(1)(A)(iv).

It is required that these standards also increase in stringency based on several factors, including the size and risk characteristics of a company subject to the rule, and the Board must take into account the differences among banks.¹²⁷

Further, section 165(d) requires that bank holding companies with total consolidated assets of \$50 billion or more and nonbanks designated by the FSOC for supervision by the Federal Reserve periodically submit resolution plans to the Federal Reserve and the Federal Deposit Insurance Corporation. Each plan, commonly known as a “living will”, must describe the company’s strategy for rapid and orderly resolution in the event of material financial distress or failure of the company, and include both public and confidential sections.¹²⁸

3.2.3.1.1. Higher loss absorbency

In July 2015, the FRB approved the final rule on calibrating G-SIB surcharges, which requires the largest, most systemically important U.S. banks to further strengthen their capital positions.¹²⁹ The final rule requires G-SIBs to calculate their surcharges under two methods and use the higher of the two surcharges. The first method is based on the framework agreed to by the Basel Committee and considers the systemic importance indicators (size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity). Each indicator receives a 20 percent weighting in the calculation of a firm’s method 1 score. The second method uses similar inputs, but is calibrated to result in significantly higher surcharges and replaces substitutability with a measure of the firm’s reliance on short-term wholesale funding. As seen during the crisis, reliance on this type of funding left firms vulnerable to runs¹³⁰ and fire sales¹³¹, which may impose additional costs on the broader financial system and economy.¹³²

¹²⁶ Section 165(b)(1)(A)(v)

¹²⁷ Section 165(a)(2)(A).

¹²⁸ See the FRB “Resolution Plans” <https://www.federalreserve.gov/bankinfo/reg/resolution-plans.htm> (accessed 10-10-2016).

¹²⁹ See the FRB’s “Calibrating the GSIB Surcharge” (2015), a white paper which discusses how to calibrate a capital surcharge that tracks the systemic footprint of G-SIB.

¹³⁰ See Kaufman, *Bank Runs* available at <http://www.econlib.org/library/Enc/BankRuns.html> (accessed 3-11-2016): “A run on a bank occurs when a large number of depositors, fearing that their bank will be unable to repay their deposits in full and on time, simultaneously try to withdraw their funds immediately”.

¹³¹ “Fire sale” in this context refers to the instance where a bank sells its assets at extremely low prices, especially at a time where the bank faces bankruptcy.

¹³² The FRB “Calibrating the GSIB Surcharge” 2015 4.

An assessment by the BIS in 2016 found that the US implementation of the HLA requirements is judged to be compliant with the Basel framework. However, cases of non-material deviations in relation to the implementation of the HLA in the U.S were reported. The most important deviation for our purposes relates to the US capital planning framework.¹³³ In the event that a SIB breaches the HLA, the Basel G-SIB framework requires that bank to produce a capital remediation plan over a fixed timeframe of 12 months. Since the SIB HLA is implemented through an extension of the capital conservation buffer, this practically requires a capital remediation plan for a breach of the combined buffer.¹³⁴

In the US, SIB regulations do not explicitly contain a requirement for a capital remediation plan over a fixed time frame. However, the FRB ensures robust capital planning for all bank holding companies with total consolidated assets of equal or more than USD 50 billion under its Comprehensive Capital Analysis and Review (CCAR)¹³⁵ framework. Under the CCAR, the Federal Reserve may require a bank holding company to re-submit its capital plan within 30 days if the Federal Reserve or the bank holding company determines that there has been a material change in the firm's risk profile, financial condition or corporate structure. A material change in the instance would be a rapid decrease in the firm's capital levels.¹³⁶ Although U.S regulations do not explicitly link the submission of a capital plan to a breach of the combined buffer (like the Basel framework), the capital planning requirements in the CCAR framework are sufficiently comprehensive that this minor difference in approach is highly unlikely to have any significant impact.¹³⁷

3.2.3.2. Designation of D-SIBs

As noted in chapter 2, The Basel Committee issued the D-SIB framework in November 2012, as a 'complementary perspective to the G-SIB regime by focusing

¹³³ BIS (2016) 12.

¹³⁴ BIS (2011) 20-21.

¹³⁵ *Ibid.* The Comprehensive Capital Analysis and Review (CCAR) is an annual exercise by the Federal Reserve to assess whether the largest bank holding companies operating in the United States have sufficient capital to continue operations throughout times of economic and financial stress and that they have robust, forward-looking capital-planning processes that account for their unique risks.

¹³⁶ n 89.

¹³⁷ *Ibid.*

on the impact that the distress or failure of banks (including by international banks) will have on the domestic economy'.¹³⁸

As already mentioned under the US G-SIBs discussion, Section 165 provides that bank holding companies are to be assessed on the basis of total consolidated assets. The Federal Reserve has replicated this methodology for all bank holding companies with total consolidated assets of USD 50 billion or more, replacing aggregate US values for those used in the global denominators under the G-SIB framework. The BIS found that since there is a major difference between the systemic scores for G-SIBs and the scores for other banks, there is practically no difference in the institutions identified as G-SIBs and those that would be designated as US D-SIBs.¹³⁹

Furthermore, in 2010 the Federal Reserve established the Large Institution Supervision Coordinating Committee (LISCC). The LISCC currently conducts intensive supervision for financial institutions that may pose elevated risks to U.S. financial stability and are supervised by the Federal Reserve.¹⁴⁰ These institutions are selected based on their size, their interconnectedness, the lack of readily available substitutes for the services they provide, their complexity and their global activities.¹⁴¹ This is in line with the systemically important assessments conducted by the Basel Committee and the FSB.¹⁴²

3.2.3.2.1. Higher loss absorbency

The HLA surcharge applied in the U.S is effectively demonstrated through the published G-SIB rules (Basel Committee G-SIB framework and the Financial Stability Board's annual designation of G-SIBS). The overlap in the G-SIB and D-SIB framework assures that both the G-SIB and D-SIB framework are compatible with each other.¹⁴³

¹³⁸ BIS (2012) 1.

¹³⁹ BIS (2016) 17.

¹⁴⁰ The FRB *Large Institution Supervision Coordinating Committee* available at <https://www.federalreserve.gov/bankinfo/large-institution-supervision.htm>.

¹⁴¹ *Ibid.*

¹⁴² *Ibid.*

¹⁴³ BIS (2016) 18.

Given that the D-SIB framework replicates the global definition of the HLA requirement, the capital surcharge must be fully composed of Capital Equity Tier 1. All large US banking holding companies are subject to a set of enhanced prudential and supervisory requirements, including the CCAR, Dodd-Frank Act stress testing, liquidity standards, general risk governance standards and subsidiarisation for relevant FBOs. Furthermore, designated SIBs must also meet an enhanced supplementary leverage ratio.¹⁴⁴

3.2.4. Current U.S G-SIBs and D-SIBs

The U.S. considers the US G-SIBs to be those banks that would be designated as US D-SIBs. There are currently eight designated SIBs in the US, namely: Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street and Wells Fargo.¹⁴⁵

¹⁴⁴ *Ibid.*

¹⁴⁵ BIS (2016) 5.

CHAPTER FOUR

THE FINANCIAL SECTOR REGULATION BILL

4.1. Introduction

Following the government decision to shift towards the ‘twin peaks’ model of regulation in 2011 (as pronounced in the Policy Document, ‘A safer financial sector to serve South Africa better’),¹⁴⁶ the Financial Sector Regulation (FSR) Bill came to the public eye in the form of its first draft in December 2013, while its second draft was published in December 2014. The Bill was tabled in Parliament in October 2015. In July 2016, the National Treasury published an amended draft of the Bill, which reflects the proposed changes that have been made since the tabling of the Bill. The FSR Bill is expected to be enacted in 2017.¹⁴⁷

As the signature object of the FSR Bill,¹⁴⁸ “financial stability” is defined in Clause 4 of the Bill as the ability of financial institutions to generally provide financial products and services without interruption and to be able to continue providing these products services without interruption despite changes in economic circumstances. Financial stability also refers to a general confidence in the ability of financial institutions to continue to provide financial products and services without interruption despite changes in economic circumstances.¹⁴⁹

Once the FSR Bill is enacted, the Minister of Finance will be responsible for the administration of the Act.¹⁵⁰

As already mentioned in Chapter 1, the SARB will be responsible for protecting and enhancing financial stability, and in the event that a systemic event has occurred or

¹⁴⁶ See the National Treasury *A Safer Financial Sector to Serve South Africa Better* (2011) 15.

¹⁴⁷ Masthead *Financial Sector Regulation Bill revised by National Treasury: New documents and draft of Twin Peaks ...* <https://www.masthead.co.za/newsletter/financial-sector-regulation-bill-revised-by-national-treasury-new-documents-and-draft-of-twin-peaks-reform-programme-released/> (2016) (accessed 9-10-2016).

¹⁴⁸ Clause 7 spells out that the objects of the Act is “to achieve a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in the Republic, by establishing, in conjunction with the specific financial sector laws, a regulatory and supervisory framework that promotes — (a) financial stability; (b) the safety and soundness of financial institutions; (c) the fair treatment and protection of financial customers; (d) the efficiency and integrity of the financial system; (e) the prevention of financial crime; (f) financial inclusion; and (g) confidence in the financial system”.

¹⁴⁹ Clause 4(1)(c).

¹⁵⁰ Clause 8.

is imminent, for restoring or maintaining financial stability.¹⁵¹ The SARB must act in accordance with a policy framework agreed between the Minister and the Governor of SARB. It may utilise any power it has as central bank or conferred on it by law, while having regard to the powers exercised by other relevant state organs.¹⁵²

In fulfilling its responsibility for financial stability, the SARB is also responsible for monitoring the strengths and weaknesses of the financial system and any risks to financial stability, and the nature and extent of those risks.¹⁵³ The SARB, in response to any weakness or risk, must take steps to mitigate risks to financial stability and advise financial sector regulators, and any other organ of state, of the steps to take to mitigate those risks.¹⁵⁴ In addition, the SARB must make a review the stability of the financial system every six months.¹⁵⁵

4.2. The SARB's powers regarding systemic events

“Systemic Event” is defined in Clause 1 of the FSR Bill as:

“an event or circumstance, including one that occurs or arises outside the Republic, that may reasonably be expected to have a substantial adverse effect on the financial system or on economic activity in the Republic, including an event or circumstance that leads to a loss of confidence that operators of, or participants in, payment systems, settlement systems or financial markets, or financial institutions, are able to continue to provide financial products or financial services”.¹⁵⁶

The FSR Bill empowers the Governor of the SARB to determine that a specific event or circumstance or combination of events or circumstances, is a systemic event.¹⁵⁷ Before determining whether a specified event or circumstance or a combination of events or circumstances amount to a systemic event, the Governor has to consult

¹⁵¹ Clause 11(1).

¹⁵² Clause 11(2).

¹⁵³ Clause 12(a).

¹⁵⁴ Clause 12(b).

¹⁵⁵ Clause 13: Financial Stability Review.

¹⁵⁶ Clause 1: Definitions. For a recent example of a systemic event see Stewart & Eavis (NYC Times) *Revisiting the Lehman Brothers Bailout That Never Was* (2014) available at http://www.nytimes.com/2014/09/30/business/revisiting-the-lehman-brothers-bailout-that-never-was.html?_r=0 (accessed 09-10-2016) — The 2008 GFC, which started in the U.S with the collapse of large financial companies such as Lehman Brothers and the AIG), whose respective sizes and interconnectedness with other financial institutions made them significant sources of systemic risk. The collapse of these firms caused massive problems in the financial system and the economy.

¹⁵⁷ Clause 14(1).

with the Minister of Finance and may consult with the Financial Stability Oversight Committee (FSOC).¹⁵⁸ In the event that a systemic event is determined, the SARB must notify the financial sector regulators of such determination and of any amendment or revocation thereof.¹⁵⁹ Such determination, revocation or amendment must be published by the SARB.¹⁶⁰

In relation to systemic events, the SARB is tasked with taking reasonable steps to prevent systemic events from occurring,¹⁶¹ and if a systemic event has occurred or is imminent, to mitigate as soon as possible the adverse effects of the event on financial stability and to manage the systemic event and its effects.¹⁶²

Financial sector regulators play an important role in managing systemic events and the effects thereof, thus it is of great importance that once the Governor has determined that a systemic event has occurred or is imminent, the financial sector regulators must provide the SARB with any information in their possession.¹⁶³ In addition, each financial sector regulator must consult the SARB before exercising any of its powers aimed at managing the systemic event or any effect thereof.¹⁶⁴

In the context of the SARB's financial stability mandate collaboration with and co-operation among organs of state is also envisaged as no other organ of state may, without the approval of the Minister, exercise its powers in a way that is inconsistent with a decision or steps taken by the Governor or SARB in order to manage a systemic event or the effect thereof.¹⁶⁵

4.3. Regulating co-operation

Clause 20 of the FSR Bill provides for the establishment of the Financial Stability Oversight Committee (FSOC),¹⁶⁶ with the primary objectives of supporting SARB with SARB's functions in relation to financial stability,¹⁶⁷ and facilitating co-operation and collaboration, and co-ordination of action among the financial sector regulators

¹⁵⁸ Clause 14(2).

¹⁵⁹ Clause 14(6).

¹⁶⁰ Clause 14(7).

¹⁶¹ Clause 15(1)(a)

¹⁶² Clause 15(1)(b).

¹⁶³ Clause 17(a).

¹⁶⁴ Clause 17(b).

¹⁶⁵ Clause 19(1).

¹⁶⁶ Clause 20(1).

¹⁶⁷ Clause 20(2)(a).

and SARB in respect matters relating to financial stability.¹⁶⁸ The functions of the FSOC include, *inter alia*, to make recommendations to the Governor on the designation of Systemically Important Financial Institutions (SIFIs),¹⁶⁹ and to serve as a forum for representatives of SARB and of each financial sector regulators to be informed, and to exercise views, about the activities of SARB and the financial sector regulators regarding financial stability.¹⁷⁰ The Governor must also, in terms of clause 25 of the FSR Bill, establish a Financial Sector Contingency Forum,¹⁷¹ to assist the FSOC with the identification of potential risk that systemic events will occur, and with the co-ordination of appropriate plans, mechanisms and structures to mitigate those risks.¹⁷² Other organs of states tasked with functions relating to financial stability must upon request by the SARB and/or FSOC must provide assistance and information to the Bank and the FSOC in order to maintain and restore financial stability.¹⁷³

4.4. Systemically important Institutions (SIFIs)

4.4.1. Designation of SIFIs

Part 6 of the FSR Bill is dedicated to the designation of SIFIs. This is a novel intervention in the South African regulating arena and a very important power that is assigned to the SARB in fulfilling its financial stability mandate. Clause 29 provides that the Governor may designate a financial institution as a SIFI by sending a written notice to that institution.¹⁷⁴ It is important that the Governor, before the designation, gives the FSOC notice of the proposed designation, with reasons as to why the designation is proposed.¹⁷⁵ After considering the FSOC's advice, if the Governor still proposes to designate the financial institution in terms of this clause, he/she must invite the financial institution to make submissions on the matter, and afford it a reasonable time to do so.¹⁷⁶

¹⁶⁸ Clause 20(2)(b).

¹⁶⁹ Clause 21(b).

¹⁷⁰ Clause 21(a).

¹⁷¹ Clause 25(1).

¹⁷² Clause 25(2)(b).

¹⁷³ Clause 28.

¹⁷⁴ Clause 29(1).

¹⁷⁵ Clause 29(2)(a).

¹⁷⁶ Clause 29(2)(b).

The Governor must take into account the following factors in the designation of a financial institution as a SIFI:

- 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;
- d) whether there are readily available substitutes for the financial products and financial services that the financial institution provides;
- e) recommendations of the FSOC;
- f) submissions made by or for the institution; and
- g) any other matters that may be prescribed by Regulation.¹⁷⁷

If the Governor determines that a systemic event has occurred or is imminent, he/she may, without complying, or complying fully, with the above conditions, designate a financial institution as a SIFI.¹⁷⁸ However in this case, the financial institution may make submissions on the designation to the Governor within 30 days after being notified of the designation.¹⁷⁹ Any submissions by the financial institution must be considered by the Governor and he/she must consequently confirm or revoke the designation.¹⁸⁰

It is specifically and significantly provided that a financial institution being designated as a SIFI does not imply/entitle that institution to a guarantee or any form of credit or other support from any organ of state.¹⁸¹ This provision highlighted in Clause 29(5) of the FSR Bill provides a huge warning for financial institutions that may be designated as SIFIs, as their designation will not imply or entitle them a government bail-out, in the event that they collapse.

¹⁷⁷ Clause 29(3).

¹⁷⁸ Clause 29(4)(a).

¹⁷⁹ Clause 29(4)(b).

¹⁸⁰ Clause 29(4)(c).

¹⁸¹ Clause 29(5).

A designation may be revoked by the Governor in writing and subject to due process. A designation and the revocation thereof must be published.¹⁸²

4.4.2 Supervisory Implication of designation as SIFI

In order to mitigate the risks that systemic events may occur, Clause 30(1) of the FSR Bill empowers the SARB may, after consulting the Prudential Authority, direct the Prudential Authority to impose, either through directives or prudential standards, requirements applicable to one or more SIFIs or to such institutions generally in relation to any of the following matters:¹⁸³

- a) Solvency measures and capital requirements, which may include requirements in relation to counter-cyclical capital buffers;¹⁸⁴
- b) leverage ratios;¹⁸⁵
- c) liquidity;¹⁸⁶
- d) organisational structures;¹⁸⁷
- e) risk management arrangements, including guarantee arrangements;¹⁸⁸

¹⁸² Clause 29(6).

¹⁸³ Clause 30(1).

¹⁸⁴ The Oxford Dictionary defines solvency as “the possession of assets in excess of liabilities; ability to pay one’s debts”. In the banking context, requirements relating to “solvency measures and capital requirements” measure the ability of a financial institution to pay its debts – available at <https://en.oxforddictionaries.com/definition/solvency>. See also the BIS: BCBS’s consultative document on *Countercyclical capital buffer proposal* (2010) 2, which provides that the aim of using a countercyclical buffer is 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”.

¹⁸⁵ The assets to capital on a bank’s balance sheet, which also includes off-balance-sheet exposures — Carney *Everything you ever wanted to know about bank leverage rules* (2013) available at <http://www.cnbc.com/id/100880857>. See also BIS *Basel III Leverage ratio framework and disclosure requirements* (2014) 1 — which provides that the Basel III leverage ratio is defined as the capital measure (the numerator) divided by the exposure measure (the denominator).

¹⁸⁶ “Liquidity is a measure of the ability and ease with which assets can be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations; examples of liquid assets generally include cash, central bank reserves, and government debt. To remain viable, a financial institution must have enough liquid assets to meet its near-term obligations, such as withdrawals by depositors” — The FRB *What is the difference between a bank’s liquidity and its capital?* available at https://www.federalreserve.gov/faqs/cat_21427.html#Liquidity (accessed 10-10-2016).

¹⁸⁷ Elsaid et al *Defining and Solving the Organizational Structure Problems to Improve the Performance of Ministry of State for Environmental Affairs – Egypt* (2013) — ‘organisational structures’ is the way that an organisation arranges people and jobs so that its work can be performed and its goals can be met.

- f) sectoral and geographical exposures;¹⁸⁹
- g) required statistical returns;¹⁹⁰
- h) recovery and resolution planning;¹⁹¹ and
- i) any other matter in respect of which a prudential standard may be made that is prescribed by Regulations made on the recommendation of the Governor.

The Prudential Authority may issue directives¹⁹² or make prudential standards¹⁹³ as provided above.¹⁹⁴ The Prudential Authority further has to notify SARB and the FSOC of any steps taken to enforce a directive issued or prudential standard made in terms of and the effect of those steps.¹⁹⁵

¹⁸⁸ The Oxford Dictionary defines ‘risk management’ in business as the forecasting and evaluation of financial risks together with the identification of procedures to avoid or minimize their impact — available at https://en.oxforddictionaries.com/definition/risk_management. (accessed 10-10-2016)

¹⁸⁹ See the BIS: *BCBS Countercyclical capital buffer proposal* (2012) 3 – 4, which provides that financial institutions must identify the sector and geographic location of their exposures because the countercyclical capital buffer is activated on a jurisdictional basis and the buffer add-on that will apply to each bank will reflect the geographic composition of its portfolio of private-sector credit exposures.

¹⁹⁰ According to the SARB, statistical returns consist of regular and timeous information on a number of data categories that must be prepared by the financial institution and be released to the public — available at <https://www.resbank.co.za/Publications/Guides/Pages/Guide-for-the-completion-of-statistical-returns-by-public-sector-institutions.aspx> (accessed 10-10-2016).

¹⁹¹ See the FRB *Resolution Plans* available at <https://www.federalreserve.gov/bankinfo/resolution-plans.htm> (accessed 10-10-2016) — “resolution plans” require “a financial institution to issue a plan that best describes the company’s strategy for rapid and orderly resolution in the event of material financial distress or failure of the institution. This is also known as the so-called ‘living will’”.

¹⁹² Clause 143 provides that the Prudential Authority may issue a written directive to either a financial institution that provides a financial product or securities services, or that is a market infrastructure or a key person of financial institution or a holding company of a financial conglomerate requiring the person or the holding company to take action specified in the directive if the financial institution is conducting its business in an improper or financially unsound way and there is risk that the financial institution may not be able to comply with its obligations or the person/holding company or another company in the financial conglomerate concerned is conducting its business in an improper or financially unsound way and, as a result, there is a risk that an eligible financial institution in the conglomerate will not be able to comply with its obligations under a financial sector law or in relation to a financial product or financial service that it provides or offers to provide; has contravened or is likely to contravene a financial sector law; is involved or is likely to be involved in financial crime; or is causing or contributing to instability in the financial system, or is likely to do so.

¹⁹³ Clause 105. This is dedicated to prudential standards and provides that the Prudential Authority may make prudential standards for, or in respect of financial institutions that provide financial products or securities services; financial institutions that are market infrastructures; and key persons of such financial institutions. A prudential standard must be aimed at ensuring the safety and soundness of those financial institutions; reducing the risk that those financial institutions, significant owners and key persons engage in conduct that amounts to, or contributes to, financial crime; and assisting in maintaining financial stability.

¹⁹⁴ Clause 30(2).

¹⁹⁵ Clause 30(3).

CHAPTER FIVE

CONCLUSION AND RECOMMENDATIONS

Michael Taylor finds that with relatively small countries, the financial system is distributed by a small number of financial conglomerate groups and as such, combining all regulatory functions within a single agency seems to offer some advantages, as it expensive to establish different regulating agencies with their associated support services and infrastructure. Furthermore, it is common for relatively small countries, where the economies of scale gains are significant, to adopt a single regulatory authority.¹⁹⁶ However, in bigger countries with more complex financial systems, the ineffectiveness of combining a number of regulatory functions in a single agency outweighs by far the potential efficiency gains.¹⁹⁷ Although South Africa is not relatively as big as other countries, the highly interconnectedness of the South African financial sector and the fact that the financial sector is dominated by large financial groups propels it to go with the current or more “fashionable” approach to financial sector regulation, the twin peaks model.

In comparison with other jurisdictions such as Australia and the U.S, South Africa’s FSR Bill provides a descriptive and reader-friendly Bill governing the designation of SIFIs. Although the U.S Dodd-Frank Act also provides a very descriptive process of the designation of SIFIs, the Act which is “[to] promote the financial stability of the United States” does not define the concept of financial stability and other important terms including ‘systemic event’. South Africa’s FSR Bill defines all these terms in its definition clause.¹⁹⁸

With regard to the Australian process of designation of SIFIs, both the Australian Reserve Bank Act¹⁹⁹ and the Australian Prudential Regulation Authority (APRA) Act²⁰⁰ make no mention of the process of designation of SIFIs in Australia. This might be attributed to the fact that the designation of SIFIs became a big deal after the 2008 GFC, while Australia adopted the twin peaks model and consequently the

¹⁹⁶ Taylor “The Road from Twin Peaks and the Way Back” 2009 89.

¹⁹⁷ *Ibid.*

¹⁹⁸ See section 1 of the FSR Bill.

¹⁹⁹ 4 of 1959.

²⁰⁰ 50 of 1998.

APRA Act 50 of 1998 a decade before. However, APRA in December 2013, released an information paper on domestic systemically important banks in Australia, setting out the approach that the APRA intends on taking in implementing the D-SIB framework in Australia. It is interesting to note that while the APRA Act has been amended a number of times, with the latest amendment being as recent as March 2016,²⁰¹ the Act has never been amended to include provisions dedicated to the designation of SIFIs. While the 2013 Information Paper provides binding information and guidance as to APRA's methodology for assessing which banks are designated as D-SIBs, it is submitted that the Australian legislative authorities amend the Act to reflect how SIFIs will be designated and the implications thereof.

While the supervisory implications of designating a SIFI in both the U.S and South Africa are similar,²⁰² one notable difference found in the designation process is the authority responsible for designating SIFIs in these two jurisdictions. Although the differences between banks and non-bank financial companies for the purposes of regulation have become less relevant, the Dodd-Frank Act places the tasks of designating banks and non-banks on different authorities. The Act mandates the FRB to designate systemically important banks and the FSOC to designate non-bank SIFIs. It appears that once a bank holding company has consolidated assets of \$ 50 Billion, it becomes subject to stringent prudential standards but only once it has passed the Basel Committee's Banking Supervision requirements and the U.S risk-based capital surcharge (G-SIB surcharge) will it be considered a systemically important bank. The Dodd-Frank Act makes no mention of the possibility of a U.S systemically important bank opposing a proposed designation. However, in the case of systemically important institutions that are non-banks, the Act provides for an opportunity to oppose the FSOC's designation.²⁰³ The U.S position differs from the South African position which will see that the Governor of the SARB (within which

²⁰¹ The Australian Federal Register of Legislation *Australian Prudential Regulation Authority Act 1999* available at <https://www.legislation.gov.au/Series/C2004A00310> (accessed 18-06-2016).

²⁰² See section 165(b)(1)(A) of the Dodd-Frank Act and clause 30(1) of the FSR Bill. Both these provisions make reference to *inter alia* the leverage ratios/limits; liquidity requirements; resolution plans and risk of a financial institution once its systemic importance is established.

²⁰³ See section 113(e) of the Dodd-Frank Act. See also *MetLife Inc v FSOC* Case 1:15-cv-00045, which saw MetLife successfully oppose FSOC's designation of MetLife as a SIFI because the FSOC failed to consider the impact that the designation would have on MetLife (whether the cost of compliance with this increased burden might actually weaken the very entity that it was intended to strengthen)²⁰³ and the U.S. financial system as a whole. The Department of Justice on behalf of FSOC has appealed the District Court's decision and the case is now under consideration with the U.S. Court of Appeals for the District of Columbia Circuit.

the Prudential Authority operates) designating SIFIs (no reference to banks or non-banks). Further, any South African financial institution that the Governor proposes to designate will have an opportunity to oppose the designation.

The U.S, coming from being widely responsible for triggering the 2008 GFC and having to bailout some of its major financial institutions, is very vocal about “protecting the American taxpayer by ending bailouts”.²⁰⁴ The Dodd-Frank Act further provides for Title II, Orderly Liquidation Authority, which is dedicated to providing a process to quickly and efficiently liquidate SIFI that is on verge of failing.²⁰⁵ This approach is in line with the FSB’s 2010 policy framework on reducing the moral hazard posed by SIFIs.²⁰⁶ One of the recommendations that were set out by the framework was aimed at “actions that seek to ensure that firms can be resolved safely, quickly and without destabilising the financial system and exposing the taxpayer to the risk of loss”.²⁰⁷ The South African FSR Bill makes it clear that SIFIs who will be designated in terms of this Bill will not receive a bailout out from the government.²⁰⁸ South Africa is following the global trend of providing bail-in provisions for financial institutions.²⁰⁹ ‘Bail-in’ refers to any process outside of liquidation that has the effect of allocating losses to liability holders or shareholders, for the purpose of increasing the capital ratio of the institution.²¹⁰ Bail-in, as an alternative to bail-out, decreases the level of moral hazard by reducing the status of

²⁰⁴ See the Long title to the Dodd-Frank Act, provides that the Act is enacted “[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect the consumers from abusive financial practices, and for other purposes”.

²⁰⁵ Cornell University Law School *Dodd-Frank: Title II - Orderly Liquidation Authority* available at https://www.law.cornell.edu/wex/dodd-frank_title_ii (accessed 02-11-2016) — Title II is aimed at protecting the financial stability of the U.S economy, forcing shareholders and creditors to bear the losses of the failed financial company, removing management that was responsible for the financial condition of the company, and ensuring that payout to claimants is at least as much as the claimants would have received under a bankruptcy liquidation.

²⁰⁶ The FSB *Reducing the moral hazard posed by systemically important financial institutions* (2010).

²⁰⁷ *Idem* 3.

²⁰⁸ See clause 29(6) of the FSR Bill. See also 2.4.1.

²⁰⁹ The National Treasury’s *Strengthening South Africa’s Resolution Framework for Financial Institutions* (2015). See also Section 69(3)(j) of the Banks Act, 94 of 1990, which provides that the Minister of Finance may empower the curator to raise funding from the Reserve Bank, or any entity controlled by the Reserve Bank, on behalf of the bank and, notwithstanding any contractual obligations of the bank, but without prejudice to real security rights, to provide security over the assets of the bank in respect of such funding: provided that any claim for damages in respect of any loss sustained by, or damage caused to any person as a result of such security, may be instituted against the bank after the expiration of a period of one year as from the date of such provision of security.

²¹⁰ The National Treasury *Strengthening South Africa’s Resolution Framework for Financial Institutions* (2015) 43.

a financial institution, which in turn helps to reduce risk taking and to ensure non-subsidised pricing for risk by shareholders and creditors.²¹¹

In conclusion, it is clear that the designation of SIFIs is important in order to prevent another global financial crisis from happening. Judging by the developments made by South Africa to shift towards the twin peaks model in terms of the FSR Bill, which among other things will facilitate the designation of SIFIs, the process of designating SIFIs as intended by the Bill is consistent with the relevant international standards proposed by the Basel Committee on Banking Supervision. Seeing as there are very high standards that must be met by a financial institution for it to be designated as a SIFI, a designated SIFI is less likely to fail.²¹² Even in the unfortunate event that one SIFI fails, the prudential standards to which SIFIs are subject to are meant to ensure that such failure does not spread onto other financial.

As evidenced in the U.S case between Metlife and the Financial Stability Oversight Council,²¹³ firms are reluctant to be designated as SIFIs as it increases the regulations and standards which that institution is subject to. However, it is submitted that the designation of SIFIs is a necessary action which needs to take place in South Africa, not only because South Africa is a member of the G-20, but also because it recently regained its position as Africa's largest economy. Accordingly, any failure of one its major financial institutions will not only have an adverse effect on the local economy, but may also have an adverse effect on the African economy. Seeing as South Africa is following the twin peaks model, which proved highly successful for the Australian financial sector during the GFC, it is submitted that South Africa follows the approach taken in Australia to designate D-SIBs, while bearing in mind the South African situation.

²¹¹ *Idem* 44.

²¹² See 2.4.2.

²¹³ *Metlife Inc v Financial Stability Oversight Council*, Case 1:15-cv-00045.

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