Global Financial Reform: What Effect on Financial Services Trade in Southern Africa

by

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for the

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Agenda

1. Setting the Context - the G20 Reform Agenda

- From G7 to G20; Origins of the Crisis; & the Protagonists
- Basel 3 Proposals: Capital & Liquidity; Securitization; & Conglomerates
- Impacts on Trade, Corporate & Project Finance

2. Global Reform & SADC Trade in Financial Services

- Overview of Trade in Services Negotiations
- The Great Trade Collapse & the Financial Crisis
- A Tale of Two Countries
- Financial Services in Southern Africa
- Impact of the Crisis on the Financial Sector
- Ex-post Regulatory Reform
- What Effect on Trade in Financial Services?
- Concluding Remarks

Paper 1: G20 & its Reform Agenda

- **G7- G20**
  - Recognition of role of emerging markets
  - G20 has replaced G7 on finance issues

- **Origins of Crisis**
  - Macroeconomic imbalances
    - Current Account Surpluses vs. Current Account Deficits
    (Asian & Oil Exporting) (US, UK, Eurozone)
  - Loose monetary policy } Mispriced risk & credit ⟹ Asset price bubbles
  - Excessive leveraging (pro-cyclical regulation & regulatory arbitrage)
  - Complex, non-transparent derivatives market

Paper 1: G20 & its Reform Agenda

- **Protagonists**
  - Financial Institutions: the crisis was in the main caused by and impacted on Investment Banks
  - Policymakers: – are not in total agreement on the way forward and on the instruments for reform
    - ❑ Capital requirements: UK, USA, Canada vs. Germany, France & Japan;
    - ❑ Taxation: France & Germany vs. Australia, South Africa, USA
  - Regulators & Supervisors: FSB; Basel Committee; IOSCO; IAIS; Joint Forum
  - Research, Advisory & Surveillance: IMF & World Bank
  - Advocacy on Trade: WTO

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Paper 1: G20 & its Reform Agenda

- **Capital Requirements:** 4 key elements
  1. Raising quality, consistency & transparency of the capital base
  2. Strengthening risk coverage of capital framework
  3. Introduces a leverage ratio requirement as an international standard – as a measure of the quality of the balance sheet
  4. Measures to promote the build-up of capital buffers in good times that can be drawn upon during times of stress (i.e. a counter-cyclical component to address concerns that existing requirements are pro-cyclical – in that they encourage reducing capital in good times when capital is more easily raised and increasing capital in bad times, when access to capital is limited)

- **Liquidity:** 3 key elements
  1. "Liquidity Coverage Ratio" – to ensure bank maintains adequate level of unencumbered high-quality assets that can be converted into cash to meet liquidity needs for a 30-day time horizon
  2. "Net Stable Funding Ratio" – to promote more medium and long-term funding of the assets and activities of banks over a 1 year time horizon; &
  3. Monitoring Tools – setting out minimum information banks should report on to supervisors & which supervisors should use to monitor liquidity risk profiles of banks.

Paper 1: G20 & its Reform Agenda

- **Securitization**
  - Subprime "toxic" assets
  - Turner: off-balance sheet products, used for "rent extraction" not credit intermediation
  - OECD Governments' failure to regulate and supervise OTC derivatives market
  - Regulators: not seeking to ban – but to design safer framework:
    - ❑ transparency;
    - ❑ less complexity; packaging; trading through multiple Balance Sheets;
    - ❑ more distribution to end investors
    - ❑ Retention of some risk (5-10%) by Originators.
    - ❑ Some risk by Credit Rating Agencies?

Paper 1: G20 & its Reform Agenda

- Conglomerates
  - Offer services across banking, securities & insurance sectors
  - Viewed as capable of threatening financial stability at local & global levels
  - Mix of services blurs traditional supervisory & regulatory boundaries among sub-sectors of the Financial Services Sector
  - Regulatory arbitrage?

- Joint Forum: an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency
  - January 2010 Report focuses on:
    - unregulated entities when calculating capital adequacy;
    - intra-group transactions and exposures including those involving unregulated entities; &
    - unregulated entities, particularly parent companies of regulated entities.

- All financial groups, especially those active across borders, to be subject to supervision & regulation capturing full range of activities & risks
  - Supervisory Colleges (Old Mutual PLC – FTSE & JSE: FSA in UK)

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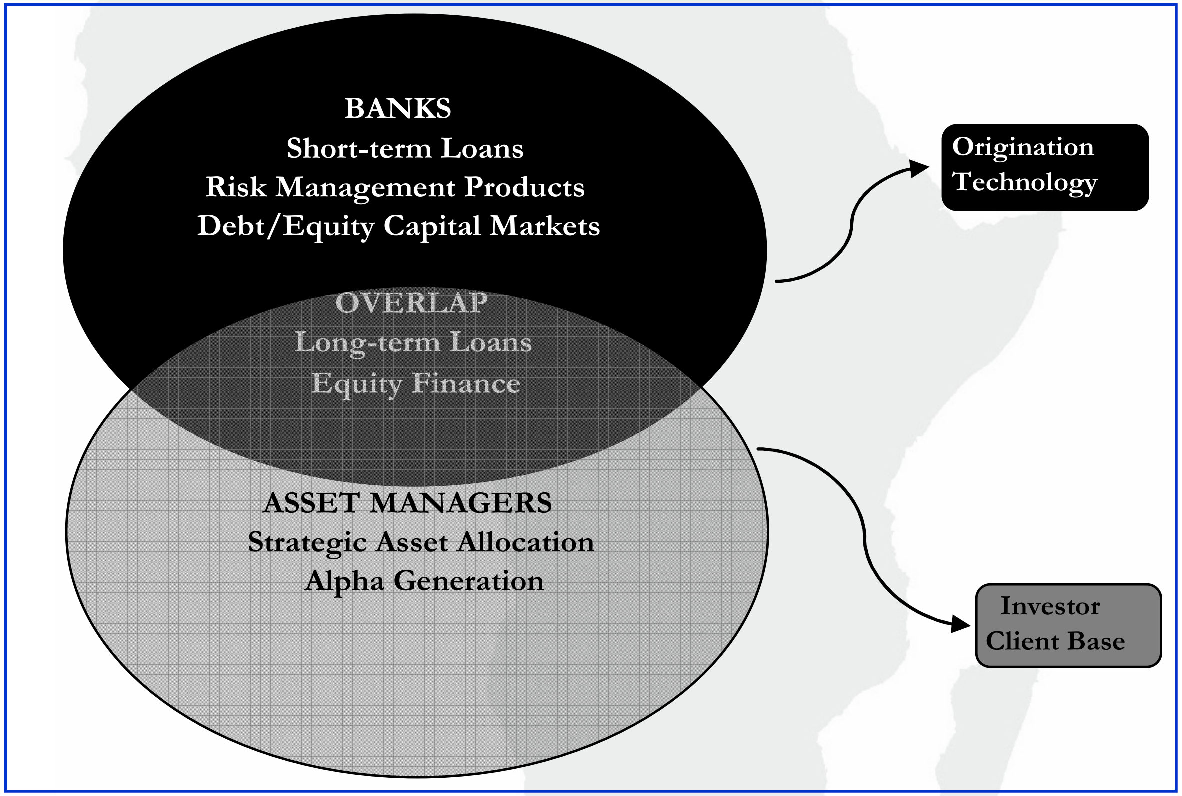
Paper 1: G20 & its Reform Agenda

- Impact on Trade Finance
  - Basel II: negative impact on ability to provide Trade Finance
    - ❑ IMF/BAFT (WTO Sept 09 meeting);
    - ❑ ICC (161 banks in 75 countries)
  - London Summit – USD250bn (Apr 2009)
  - Leverage Ratio
  - One year maturity floor applied under Basel II considered excessive for TF which is short-term in nature (180 days)
  - Basel II allows for national dispensations for TF

- Corporate & Project Finance
  - Basel III: 2 types of assets will become more expensive for banks on B/S (Van der Merwe, 2010):
    - ❑ Long-term loans (infrastructure & mortgage finance)
    - ❑ Equity related exposures

Paper 1: G20 & its Reform Agenda

The Banking Asset Management Model



Source: P Van der Merwe, ABSA, July 2010

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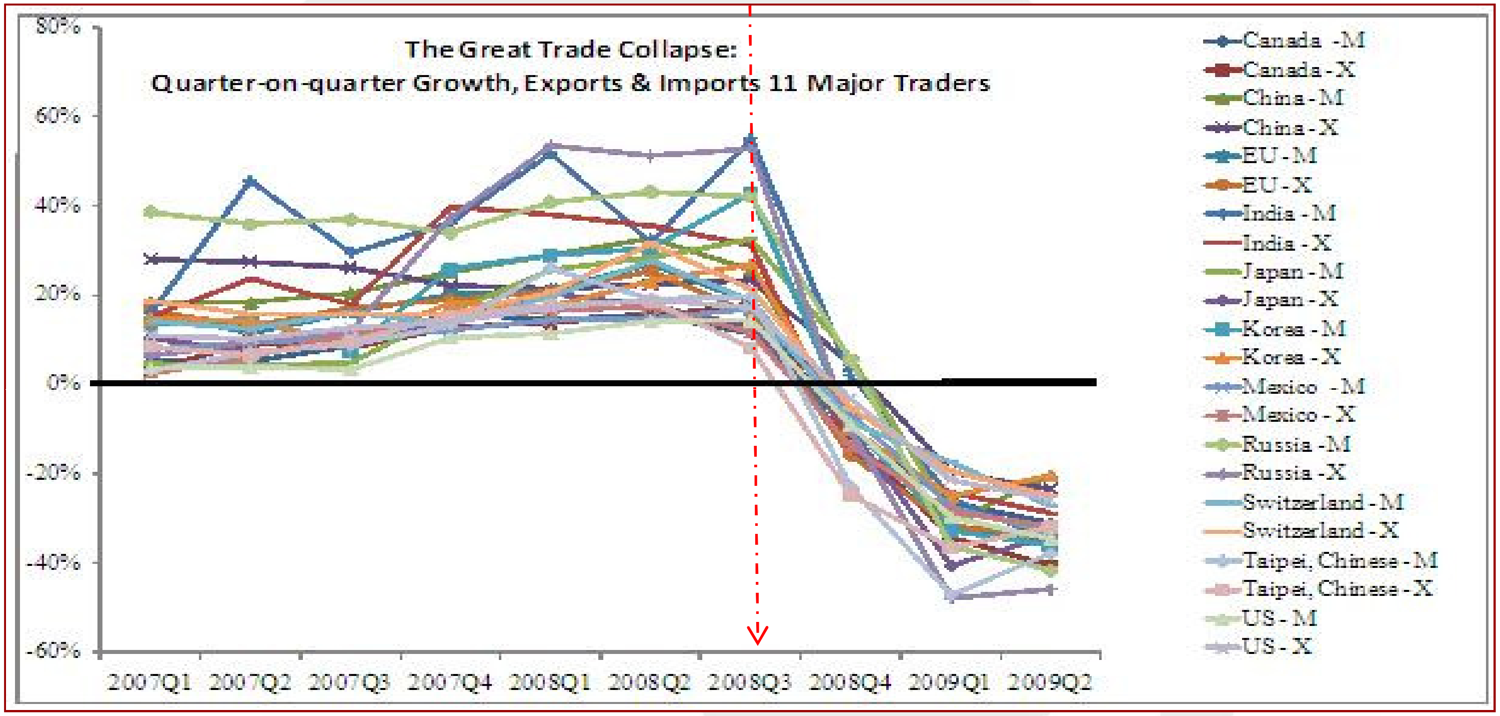
Paper 2: SADC Trade in Financial Services

- **Overview of SADC Trade in Services Negotiations**
  - 14th TNF-Services: 11 Nov 2009 – adopted Negotiating Guidelines
  - Approach: initiated on basis of measured liberalization
    - ❑ To achieve harmonious, balanced & equitable development
    - ❑ To achieve progressively higher levels of liberalization
    - ❑ Promote interests of all participants on mutually advantageous basis
  - First round to be concluded 3 years after adoption of Protocol
  - Starting point – Member States' existing GATS schedules on request-offer basis
  - Protocol adopted by SADC Ministers of Trade on 3 July 2009 – but has yet to be submitted to Summit for signature
- **Liberalization of Trade in Services** (define)
  - Requires reduction of regulatory barriers to market access & discriminatory national treatment across all modes of supply
- **Complicating Factor for Negotiations?**
  - Unprecedented international regulatory reform agenda driven by G20
  - South Africa as member – macro-prudential & micro-prudential regulations substantially strengthened
  - Negotiations need therefore to be viewed within this context
  - Foresee difficulties given Basel III changes

Paper 2: SADC Trade in Financial Services

The Great Trade Collapse & the Financial Crisis



- Collapse of Lehman Bros. (Sept 2008) ushered in worst phase of crisis & paralysis in markets -
  - (Paper 1) Collapse in International Supply Chains
  - Simultaneous drying up of short-term Credit

Paper 2: SADC Trade in Financial Services

- **A Tale of 2 Economies:**
  - **South Africa**: Economy ran out of steam in 2008; Recession in 2009
    - Drop in export volumes end of 2008 – exacerbated situation – first real contraction Q1 of 2009;
    - GDP output shrank 3% in Q3 & Q4 2009
    - On positive side – consumption expenditure by Govt – infrastructure spend = 25% of GDP (highest in 25 years)
    - Mining sector shrank by 22%; factory productive capacity – 21% idle; 47% rise in company failures
    - Household debt – rose to 80% of disposable income
    - Exports fell 24% Q1 of 2009
    - SARB – trimmed rates (Dec 08 – Aug 2010) by 550 bp down to 6.5% - lowest in 10 years.
    - Stimulus package – 3 year program of R787 bn (US$ 98 bn)
  - **Botswana**: 1960-2008 GDP aver. growth = 10%; 2008 Q4 - declined to 2.9%
    - Mining sector contributes 40% of GDP – ground to halt; mining suspended from December 2008 – Apr 2009; (5 months to re-commission = 9 month stoppage)
    - Q1-Q3 2009: Contracted by 38.4% & accounted for only 24% of GDP
    - Diamond exports fell from P20.8 billion in 2008 to P15.2 billion: Trade receipts for 2009 declined 26.5% .
    - Govt expenditure on infrastructure, etc., kept imports high
    - From December 2008, Bank of Botswana reduced rates by 400bp

Paper 2: SADC Trade in Financial Services

Percentage share of Services Sector of GDP

	2002	2003	2004	2005	2006	2007	2008
South Africa	62.2	63.1	63.5	63.8	64.5	65.0	65.6

Financial Services in Southern Africa

- **South Africa**: *Full range of banking & non-banking financial services*
- FSAP – commercial banks = largest segment with assets representing 120% of GDP
- ABSA (Barclays '05), FirstRand, Nedbank (HSBC 2010?) & Standard Bank (ICBC '07) – fully compliant on Basel II since Jan.2006.
- Insurance companies assets = 80% of GDP ('07); penetration = highest globally @ 16% of GDP
- JSE = largest in EMs by Mkt Cap; 16th largest worldwide; liquidity limited because of buy-to-hold strategies of Institutional Investors;
- BESA – a leader among EMs; 2008 =R19.2 Trillion; annual liquidity 38xmkt cap = one of most liquid EM bond mkts in world.
- **Dominance makes SA net exporter of financial services in SADC**

Paper 2: SADC Trade in Financial Services

Percentage share of services sector of GDP

	2002	2003	2004	2005	2006	2007	2008
Botswana	47.7	46.5	46.6	47.5	47.0	48.6	51.4

- **Financial Services in Southern Africa**
  - **Botswana**: diversified & grown rapidly over past 10 years – with range of institutions
  - BOB on Basel I still – will move to Basel II only by 2011/2012
  - Banks 11 (commercial (6/1); DFIs (3); merchant (1)) – foreign big banks (3) on Basel II; rest Basel I.
  - Institutional Investors 129 (Insurance (14); Pension funds (115); NBFI (39))
  - BSE (stock mkt (19); bond mkt (23))
  - **FSAP** – pension funds & banks make up most important by size
  - Substantial accumulation of national financial resources & high degree of liquidity
  - Sizable cross-border investments of pension funds & establishment of new regulator (NBFIRA - 2008)
  - Need for better coordination & partnership between MOF & Central Bank (re: BOBC); & for national strategic framework to guide reform process.
  - Capacity constraints in F/sector of skilled & trained Accountants, Actuaries & others

Paper 2: SADC Trade in Financial Services

- **Impact of the Crisis on the Financial Sector**
  - First round effects – missed SA banking sector; impact of crisis globally on real economy (trade) – affected SA (& the 3 banks interviewed);
  - Interbank lending mkt; risk premium = 500bp; risky to hold funds – short-term only = funding mismatch (assets/liabilities) (Std Bank-Asian financiers;

    ABSA: saw European aversion for African business; too slow to respond because of for-ex controls!
  - Increase in claims against short-term credit insurance (trade) (CGIC) by 165% & medium-term guarantees (projects) (ECIC)
  - Corporate: risk premium on corporate bonds increased by 600bp; knock-on effects on companies (Q2-Q3 2009) losses to business (industry right-sizing); Q3-Q4 2008, JSE declined by 31%; BSE – 17%. Bots: bank credit froze in 2009 – lasted longer in corporate finance; (Basel III = marginal effect on C/F!)
  - Project Finance: African Govts cancelled or delayed infrastructure projects; deals not reaching financial closure; (SA & Bots – stimulus programs); “club” rather than syndication; PPPs dropped sharply in 2008/09. More Brazilian & Chinese financing - Morupule B.
  - Generally, though – banking sectors in both countries pretty healthy. Basel II requirements (9.5% for SA; 15% for Bots)

Paper 2: SADC Trade in Financial Services

- **Ex-post Regulatory Reform**
  - Long list of regulatory reforms on reform agenda – focus on only 3:
    - ❑ Capital & Liquidity
    - ❑ Transparency of Complex Derivatives
    - ❑ Systemically important Institutions
  - Capital & Liquidity: Basel III – Dec 09: Strengthening resilience of banking sector –
    - ❑ Tier 1 & 2 Capital simplified – re-emphasis of "common equity" as predominant - that banks required to hold as a % of their loans & other RWA – to protect bank against unanticipated loss
    - ❑ <u>Rationale</u>: shareholder equity in banks is on average comparatively small when compared to their borrowings and deposits which can exceed 10 X equity.
  - Banks: pushing back against this requirement – supported by work coming out of BAFT and IIF.

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- **Ex-post Regulatory Reform**
  - Derivatives: designed to transfer credit risk – contributed to crisis.
    - ❑ Collapse of Lehman Brothers, Merrill Lynch; *Landsbanki*
    - ❑ Joint Forum Report findings?
    - ❑ Recommendations: greater transparency; closer collaboration of regulators; continuous review of prudential requirements for CDS/FGs; strengthen market infrastructure & standardisation; better dialogue among supervisors
    - ❑ IOSCO & Basel Committee to play active role in managing systemic risk
    - ❑ FSB in SA – regulatory oversight through Financial Advisory & Intermediary Services Act 2002
    - ❑ JSE – Single Stock Futures Market (experience of Absa & RMB as clearing agents) - strengthened trading rules

Paper 2: SADC Trade in Financial Services

Ex-post Regulatory Reform

- Systemically Important FIs
  - Services offered across banking, securities, insurance sectors
  - Capable of threatening financial stability
  - 3 banks interviewed are part of such Groups
  - Joint Forum:
    - Calculation of Group Capital Adequacy?
    - Contagion & difficulty of assessing risks to sustainability of Group & separate entities
    - Separate Jurisdictions with no oversight authority (Landsbanki)
  - Expressed view: all Groups – especially if active across borders – subject to supervision & regulation capturing full range of their activities & risks
  - Diversity of regulatory frameworks – meant did not fully capture potential costs of risks they face
  - Common cross-sectoral standards called for
  - All regulators to work together in <u>Supervisory Colleges</u> across sectors – to enhance consistency
    - South Africa: Old Mutual PLC – FTSE/JSE listings; FSA leads supervisory college.
  - SADC: now “moral suasion”; legislation in 2012; CISNA cooperation via MMOU under FIP

Paper 2: SADC Trade in Financial Services

- **What Effect on Trade in Financial Services?**
  - Opening statement: Complicating factor for Trade Services Negotiations?
  - Unprecedented international regulatory reform agenda driven by G20; negotiations to be viewed within this context!
  - Given Basel III changes: difficulties on horizon:
    - Apart for Botswana and Mauritius, reforms under discussion have little relevance for most countries in region
    - Most trade is unidirectional from SA to rest of region
    - SA likely to dominate discussions on trade in FS (if NT engaged; DTI? difficulties with mandate issues?)
    - SA as G20 member will follow global approach, except where national dispensations permit or rules not relevant
    - Botswana already embracing much of regulatory reform influenced by global developments; foreign banks will embrace rules of home state (SA banks in Botswana)
    - Impact mainly on Investment Banks –on structured (including trade), corporate & project financing;

Paper 2: SADC Trade in Financial Services

- **Concluding Remarks**
  - Reforms will impact on the provision of finance in both South Africa and the region, and create new “barriers” to trade:
    - By reducing leverage in banking system, & pushing for Tier 1 (common equity) – viewed as a negative bias of Basel III - will lead to reduced funding in Africa as riskier prospects attract higher capital requirements
    - Less appetite for Infrastructure financing
    - Bias in favour of better rated countries
    - Likely to become a impediment to financial services trade
- **Discussion?**

Thank You!

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