Regulatory responses to the global financial market turmoil

The global financial market turmoil that emerged during 2007 and deepened to unprecedented levels during 2008 was the culmination of a period of exceptional credit growth and leverage in the international financial system. The background to the turmoil was discussed in the 2007 *Annual Report* (see pages 3–5 of the 2007 *Annual Report*). The disruptive effects of the turmoil, which included increased risk aversion, reduced liquidity, market uncertainty and tightened credit intermediation, prompted supervisory, regulatory and central bank bodies across the globe to reassess and enhance market and institutional resilience through appropriate policy responses to the turmoil.

The following summary of responses by certain of these standard-setting bodies is deemed appropriate to provide some insight into the key areas that regulators, supervisors and central banks across the globe will be focusing on in the future.

Financial Stability Forum (FSF)[1,2]

The Financial Stability Forum (FSF) was established to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. It comprises senior representatives of national financial authorities (central banks, regulatory and supervisory authorities and ministries of finance), international financial institutions, standard-setting bodies, and committees of central bank experts.

During the first quarter of 2008 the FSF completed an analysis of the causes and weaknesses that produced the turmoil. The FSF's final report, issued in April 2008, identified five key focus areas for regulators/supervisors to increase the resilience of financial markets and institutions in the future:

1. Strengthen prudential oversight of capital, liquidity and risk management
   - Raise capital requirements for certain complex structured credit products, introduce additional capital charges for default and event risk in trading books and strengthen the capital treatment of liquidity facilities to off-balance-sheet conduits.
   - Provide additional supervisory guidance regarding the supervision and management of liquidity risk.
   - Enhance oversight of banks' identification and management of group-wide risks, and banks' stress-testing practices, and ensuring the sound management and reporting of off-balance-sheet exposures.
   - Encourage market participants to ensure the soundness of the settlement, legal and operational infrastructure of over-the-counter derivatives.

2. Enhance transparency and valuation
   - Encourage financial institutions to make robust risk disclosures.
   - Issue further guidance under Pillar 3 of the *International Convergence of Capital Measurement and Capital Standards* to strengthen disclosure requirements.
   - Standard setters to improve and converge financial reporting standards for off-balance-sheet vehicles.
   - Expand the information provided about securitised products and their underlying assets.

3. Changes in the role and uses of credit ratings
   - Differentiate ratings on structured products from those on bonds and expand on the information provided.

- Regulators to review the roles given to ratings in regulatory and prudential frameworks.

4. Strengthen the authorities' responsiveness to risks
   - Translate risk analysis into actions to mitigate risks.
   - Improve information exchange and co-operation between authorities.
   - Enhance the speed, prioritisation and co-ordination of policy development work by international bodies.

5. Robust arrangements for dealing with stress in the financial system
   - Central banks to enhance their operational frameworks and authorities to strengthen their co-operation for dealing with stress in the financial system.

Group of 20 Finance Ministers and Central Bank Governors[3]

The Group of 20 (G-20), a forum that brings together systemically important industrialised and developing economies to discuss key issues in the global economy, noted at a meeting held in November 2008 that the financial crisis was largely the result of the following:

- Excessive risk-taking in financial markets
- Faulty risk management practices in financial markets
- Inconsistent macroeconomic policies
- Deficiencies in financial regulation and supervision.

The G-20 committed itself to implementing policies consistent with the following principles:

- Strengthen transparency and accountability in financial markets through enhanced disclosure requirements
- Enhance sound regulation of financial markets, products and participants (including rating agencies)
- Promote integrity in financial markets
- Reinforce co-operation between regulators, on a regional, national and international level
- Reform international financial institutions, *inter alia*, by means of the expansion of the membership of major standard-setting bodies such as the FSF.

The G-20 also requested the finance ministers of member countries to focus on the following key aspects:

- Mitigate against pro-cyclicality in regulatory policy
- Review and align global accounting standards, specifically with regard to complex securities in times of stress
- Strengthen the resilience and transparency of credit derivatives markets, including improvement of the infrastructure of over-the-counter markets
- Review compensation practices as they relate to incentives for risk taking and innovation
- Review the mandates, governance and resource requirements of international financial institutions
- Define the scope of systemically important institutions and determine their appropriate regulation or oversight.

Basel Committee on Banking Supervision[4]

The Basel Committee on Banking Supervision (Basel Committee) provides a forum for regular co-operation on banking supervisory matters. It seeks to promote and strengthen supervisory and risk management practices globally. As at 31 December 2008, the Basel Committee's members were from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States of America (USA).

On 20 November 2008 the Basel Committee announced its strategy to address the fundamental weaknesses revealed by the financial market turmoil related to the regulation, supervision and risk management of internationally active banks. The focus of the strategy was on strengthening capital buffers to contain leverage in the banking system, and stronger risk management and governance practices to limit risk concentrations in the banking sector. The strategy took account of the April 2008 recommendations of the FSF and its key building blocks included the following:

- Revising the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II), with particular focus on risk capturing in respect of the trading book and off-balance-sheet exposures
- Enhancing the quality of Tier 1 capital
- Enhancing the capital framework to build in a capital cushion to be drawn upon during periods of market stress and also to dampen procyclicality
- Assessing the need to supplement risk-based measures with simple gross measures of exposure in both prudential and risk management frameworks to help contain leverage in the banking system
- Strengthening supervisory frameworks to assess funding liquidity at cross-border banks
- Strengthening counterparty credit risk capital, risk management and disclosure at banks
- Promoting globally co-ordinated supervisory follow-up exercises to ensure implementation of supervisory- and industry-sound principles.

The existing South African legal and regulatory framework already incorporates and/or makes provision for many of the items that have been highlighted above. However, the Bank Supervision Department of the South African Reserve Bank (the Department) continues to provide input to, and take cognisance of, comments and guidance papers issued by the relevant standard-setting bodies, and it continuously monitors developments within the domestic banking industry and international markets that could have an impact on South African banks and the domestic banking legislative and regulatory framework. Where necessary, adjustments will be made to ensure that the legal framework pertaining to domestic banking legislation reflects local and international market developments, and complies with the applicable international regulatory standards and best practice.

Notes

1 At the beginning of April 2009 the Financial Stability Forum was reconstituted as the Financial Stability Board.
2 http://www.financialstabilityboard.org.
3 http://www.g20.org.
4 http://www.bis.org.