T T Mboweni: International regulatory developments and the South African banking sector

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, to trainee chartered accountants in the Western Cape, at the South African Institute of Chartered Accountants, Cape Town, 2 October 2006.

* * *

Honoured guests
Ladies and gentlemen

1. Introduction

Thank you for the invitation to address you today. Financial markets have become increasingly globalised and our markets are no exception. Within this context, regulation according to international best practice, has a big part to play in ensuring the stability of the financial sector. You may be aware the international community has adopted some measures to harmonise the regulation of banks. Today I will provide a brief overview of two of these initiatives namely, the new Capital Accord and the Basel Core Principles, which have been adopted under the auspices of the Bank for International Settlements (BIS). I will pay particular attention to how these initiatives impact on the regulation of banks in South Africa. As future chartered accountants, these developments will have an important impact on your working lives. I will conclude by making some observations on the performance of the South African banking sector.

2. The Bank for International Settlements

Many industries and businesses have established associations, whose aims are to conduct research, review important issues and promote the development of these industries or businesses. The BIS, established in 1930, could be described as a club or association for central bankers. The BIS was established in the context of the Young Plan, which dealt with the issue of the reparation payments imposed on Germany by the Treaty of Versailles following the First World War. The name of the BIS is derived from this original role, and was also created to promote central bank cooperation in general.

The reparations issue quickly faded, focusing the activities of the BIS entirely on world-wide cooperation among central banks and, increasingly, other multi-lateral agencies in pursuit of monetary and financial stability. Today, central banks from 55 countries are members of the BIS.

The BIS fulfils its mandate by acting as a forum to promote discussion and policy analysis among central banks and within the international financial community. It is also a centre for economic and monetary research; a prime counterparty for central banks in their financial transactions; and acts as an agent or trustee in connection with international financial operations.

The most important meetings held at the BIS are the regular meetings of Governors and senior officials of member central banks. I regularly attend these meetings which are held every two months in Basel. These gatherings provide an opportunity for participants to discuss the world economy and financial markets, and to exchange views on topical issues of central bank interest or concern. Other meetings of senior central bank officials focus on the conduct of monetary policy, the surveillance of international financial markets and central bank governance issues.

The growth of international financial markets and cross-border money flows in the 1970s highlighted the lack of efficient banking supervision at an international level. National banking supervisory authorities basically regulated domestic banks and the domestic activities of international banks, while the international activities of these banks were not always closely supervised. The collapse in 1974 of Bankhaus Herstatt in Germany and of the Franklin National Bank in the United States prompted the G10 central bank Governors to set up the Basel Committee on Banking Supervision. This Committee, known as the Basel Committee, concerns itself with guidelines for international co-operation in bank supervision. The Committee, which includes representatives from the major supervisory agencies as well as from central banks, provides a forum for regular cooperation on banking supervisory matters.

Over the years, the Committee has developed increasingly into a standard-setting body on all aspects of banking supervision.

3. The Basel Capital Accord

No bank can maintain the public's trust for long if it lacks sufficient capital, so supervisors impose capital requirements to safeguard the banking system. Since capital is the last line of defense against bank insolvency, regulatory capital requirements are one of the fundamental elements of banking supervision.

In 1988 the Basel Committee issued the Basel Capital Accord. This introduced a credit risk measurement framework for banks which became a globally accepted standard. South Africa complies with the Basel Capital Accord. A revision of this Capital Accord, known as Basel II, is due to be implemented worldwide from the end of 2006. Such standards aim to achieve a better and more transparent measurement of the various risks incurred by internationally active banks, limiting the possibility of contagion in cases of a crisis and strengthening the global financial infrastructure overall.

The new Capital Accord is based on three pillars, namely, minimum capital requirements, a supervisory review process, and effective use of market discipline, through minimum disclosure standards. With regard to the first pillar, a material development was the internal rating-based approach to credit risk. Since the board of directors and management of a bank have, or ought to have, the most complete understanding of the risks that their bank faces, the board and management have primary responsibility for the management of these risks. Internal ratings are intended to become an integral part of a bank's risk-management process and its own assessment of capital adequacy before such ratings may be applied in the determination of the bank's statutory capital requirement.

Supervisory review of capital, the second pillar of the new Accord, will be a critical complement to minimum capital requirements. Supervisors will have to evaluate how well banks are assessing their capital needs relative to their risks, including whether banks are appropriately addressing the relationship between different types of risk.

Market discipline, the third pillar, performs an essential role in ensuring that the capital of banking institutions is maintained at adequate levels. Since effective public disclosure enhances market discipline and allows market participants to assess a bank's capital adequacy, disclosure can be a strong incentive for banks to conduct their business in a safe, sound and efficient manner.

South Africa has made good progress with preparations for the implementation of Basel II on 1 January 2008. The South African Reserve Bank remains committed to providing a regulatory environment that will allow South African banks to adopt international best practice. South Africa's financial sector is held in high regard, and the introduction of Basel II will enable South African banks to maintain, if not strengthen, their international standing, to the benefit of the economy.

4. The Basel Core Principles

Countries use the Basel Core Principles as a benchmark for assessing the quality of their supervisory systems and for identifying future work needed to ensure sound supervisory practices. The Core Principles have also been used by the International Monetary Fund and the World Bank in the context of the Financial Sector Assessment Program. Changes have occurred in banking regulation over the years, however, and much experience has been gained with implementing the Core Principles in individual countries. Subsequently, the Basel Committee established the Core Principles Liaison Group to update the Core Principles to reflect these changes. This is to ensure their continued validity, usefulness and relevance as a flexible, globally applicable standard.

The updated Principles remain focused on banking supervision. Issues related to the necessary infrastructure for effective banking supervision are discussed as preconditions and provide background for the assessment. The review also stresses the importance of the independence, accountability and transparency of bank supervisory authorities.

Recently, an exercise benchmarking the bank supervisory framework of South Africa against the revised Core Principles was conducted and areas of non-compliance identified. An action plan has been initiated to implement the changes, thereby ensuring that the South African bank supervisory framework meets international standards.

5. The global financial sector

According to the 76th Annual Report of the BIS, the main risks confronting the global financial sector are of a macroeconomic nature. These relate to the potential effects of higher interest rates, a turn in the credit cycle and, possibly, associated declines in real estate prices and aggregate expenditure. The current global environment places a premium on system-wide risk management. The report highlights the importance of making available information about risk as well as the interplay, and need for consistency, between financial reporting standards, risk management practices and the overall prudential framework.

The South African financial sector is also exposed to these risks and the planned implementation of Basel II by South African banks will strengthen reporting standards and market discipline.

6. The South African banking industry

The South African banking system is sound and stable. Banks are well capitalised, and the average risk-weighted capital-adequacy ratio for the banking system as a whole was 12,3 per cent at the end of July 2006.

Growth in the total balance sheet of banks remained strong during the past year and by the end of July 2006, the total assets of banks – comprising, amongst other things, money, loans and advances, investment and trading position and non-financial assets – had increased by 20 per cent year-on-year, to a level of R1 939,5 billion.

By the end of July 2006, the South African banking sector had recorded year-on-year mortgage-lending growth of 30,8 per cent to a level of R608,9 billion. This growth was due to a number of factors including lower mortgage-interest rates, a lower level of inflation, lower income-tax rates and an increase in the real disposable income of households. There was also an increase in speculative buying, known as the 'buy-to-let' boom. Real estate prices are currently experiencing a slow-down in growth, which suggests some strong resistance from consumers.

Consumer spending through credit card lending has recorded year-on-year growth of 38,6 per cent to a level of R36,9 billion at the end of July 2006, while the growth in installment-sales debtors has also continued unabated, growing by 18,8 per cent, to a level of R201,6 billion over the same period. As the regulator of banks, the Bank Supervision Department of the South African Reserve Bank will continue to ensure that banks' risk-management processes are appropriate for monitoring these activities in the light of increasing household sector indebtedness and the increasing cost of credit.

This high rate of credit extension has become a major cause for concern for the Bank. The high levels of credit extension have resulted in record levels of household debt, which have reached levels of almost 70 per cent of household disposable income. The high levels of consumer expenditure have also contributed to the expanding deficit on the current account of the balance of payments. These developments pose a threat to the inflation outlook, and have prompted the Monetary Policy Committee to raise the repo rate by 50 basis points at each of the past two MPC meetings.

7. Conclusion

In conclusion, there are three points which I would like to emphasise. Firstly, the implementation of the new Capital Accord by our banks will result in the adoption of a globally accepted standard, which will lead to a more transparent risk measurement and better corporate governance practices.

Secondly, complying with the Basel Core Principles, will ensure that banks are regulated according to international standards. Finally, it will be in consumers' own interests to take note of local economic trends, such as the recent increases in the repo rate of the Bank, prior to incurring new debt.

I thank you.