Daniel Mminele: The importance and development of sound financial market infrastructures to position South Africa in SADC, BRICS and worldwide

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the SWIFT Business Forum, Johannesburg, 6 September 2012.

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1. Introduction

Good afternoon ladies and gentlemen.

It is a privilege to be here today and to participate in this SWIFT Business Forum. It is taking place at a special time, coinciding with the celebration of South Africa's three decade long association with the SWIFT community. It is quite fitting then that today is also the first forum that focusses specifically on the South African financial community. I should also at the outset acknowledge SWIFT as a worldwide Financial Market Infrastructure which is extensively used in South Africa and also indicate that South Africa has recently joined the SWIFT Oversight arrangement headed by the National Bank of Belgium.

The program looks to be one that should provoke a lot of discussion, particularly around South Africa's role in international fora such as BRICS, and how we can best contribute towards and leverage off these relationships.

2. Why is BRICS important?

In December 2010, it was announced that South Africa had been invited to become a full member of the BRIC group. In April 2011, South Africa joined the BRICS group at the third Summit in China. South Africa's inclusion into BRICS was met with surprise by many, for a number of reasons, not least of which relates to the economics. It is true that South Africa's economy is dwarfed by the other BRIC countries when measured in GDP purchasing power parity terms. South Africa's unemployment rate is also much higher, while in terms of population, we are similarly much smaller. Had it been on the basis of economics alone, South Africa probably would not be part of BRICS today. Why then? South Africa is strategically important, boasts a relatively developed economy, deep and liquid financial markets, a well-regulated banking sector, strong institutions, democratic governing standards, and has the ability to influence the global agenda as a result of its participation in fora such as the G20 and the Basel Committee on Banking Supervision.

South Africa is also systemically important in the African context. To quote from the 2012 New Delhi BRICS report, "With the most developed industrial and financial capabilities on the African continent, South Africa's role in the integration of policies, markets, finance, and infrastructure is vital to Africa's economic development and realization of the continent's potential as a growth pole in the global economy. Outwardly oriented South African companies are among the largest sources of FDI in Africa and the country's development financing institutions are playing an increasing role in the funding of regional infrastructure investment." Therefore, our inclusion in BRICS has implications not just for South Africa but for the continent as a whole and adds a continent-wide dimension to BRICS, which lends it greater credibility and significance. Rather than being a mere "gate-crasher" at somebody's party, South Africa has an important role to play and can add significant value to BRICS.

Why is BRICS important? Globally, BRICS accounts for over 40 per cent of the world population, over a quarter of world GDP and 16 per cent of world export volumes. In the medium to long-term, the significance of BRICS countries on the global arena is expected to grow, and this presents immense opportunities for cooperation in a number of areas, including trade, infrastructure development and finance.

The BRICS have identified a number of areas for cooperation. Among these is the proposed new BRICS Development Bank. A feasibility study is being conducted currently, and it is hoped that the creation of such a bank will help mobilise resources for infrastructure and sustainable development projects in BRICS and other emerging economies and developing countries. These efforts are to supplement the existing efforts of multilateral and regional financial institutions for global growth and development. A report back is expected by the fifth Summit to be held in South Africa in 2013. There are also ongoing discussions about the possibility of local currency swap agreements. We look forward to further developments with respect to BRICS, and the hosting of the fifth BRICS Summit in March next year provides South Africa with an opportunity to give strategic and directional input into various BRICS initiatives.

3. The importance of financial market infrastructure

I will now turn to the topic of this forum, being the importance of financial market infrastructures. All of us sitting here today understand and appreciate the importance of sound financial market infrastructures. They play a critical role in the global financial system, often likened to the "plumbing of a building", largely going unnoticed, until such time that there is a leak or a pipe bursts. A problem with the plumbing of the financial system can have severe repercussions for financial markets and the real economy. A disorderly failure in the financial market infrastructure can interrupt or impede the effective operation of markets, causing severe systemic disruptions and financial instability. Financial market infrastructures went largely unnoticed until the global financial crisis broke, and although they performed well through the crisis, it was only then that an appreciation was found for the true importance of such infrastructures, reflecting the fundamental role they play in ensuring financial stability.

With this in mind, in April 2012, the Committee on Payment and Settlement Systems at the Bank for International Settlements (CPSS) and the International Organization of Securities Commissions (IOSCO) published new international standards for payment, clearing and settlement systems, including central counterparties. The main objectives of the new principles are to ensure a robust global financial market infrastructure, which if faced with the financial shocks of the magnitude experienced in 2007/2008, will continue to operate effectively.

These new standards are tougher and are due to be adopted by CPSS and IOSCO members by the end of 2012. However, I note that the next session will be dealing specifically with this issue, insofar as it pertains to South Africa and our state of readiness, and so I will refrain from going into any further detail.

4. Financial market infrastructure developments in South Africa

It is important to indicate at the outset that financial market infrastructures in both the payment and securities markets require a collaborative approach from all the stakeholders. Clearing and settlement processes in both these areas involve the interaction of various parties, including participants, infrastructure providers and regulatory authorities, who all have an important role to play.

As early as 1993, discussions were initiated between the South African Reserve Bank (the Bank) and the banking industry to modernise and develop the domestic payment system. In this process, a strategic approach for the development of the payment system was adopted and meetings were held at different levels with various stakeholders, which culminated in the publication of the Framework and Strategy document for the National Payment System (commonly known as the "Blue Book"), in 1995. The Blue Book outlined various strategies envisioned for the payment system over the next ten years, leading up to 2005. The strategies addressed various aspects of payment system reform that had been identified, as well as the establishment of key pillars of the desired financial market infrastructures and appropriate supporting arrangements. One of the strategies, for example, relates to the establishment of a sound legal framework which culminated in the promulgation of the National Payment System (NPS) Act in October 1998. A review completed in 2003, revealed that all major payment system strategies that had been identified in the Blue Book had been achieved.

The South African payment industry has matured immensely since the launch of the Blue Book and subsequently two additional vision documents with a shorter time horizon of five years, namely, Vision 2010 and Vision 2015, were established to guide the development of the payment system into the future.

I would like to briefly sketch a broad outline of the payments industry in South Africa, before delving into the achievements made in the payment space since the introduction of the Blue Book.

At the end of August 2012, there were 24 active settlement participants in the South African Multiple Options Settlement system (SAMOS). The bulk of settlement happens in the real time stream, which captures over 90 per cent of settlements, the remainder accounted for by the retail stream. The latter has experienced a significant increase in electronic funds transfer (EFT) credits over the years, increasing from 58 per cent of the retail stream in 2005 to 74 per cent in 2011. There has also been a substantial decline in cheque usage, given that this is a relatively expensive payment instrument and much more vulnerable to fraud. In volume terms, the bulk of purchases at retailers are in cash (5.3 billion), as compared to credit (360 million) and debit cards (460 million). In value terms, however, the difference is less stark, as cash accounts for R332 billion worth of purchases at retailers, and credit and debit cards accounting for R134 billion and R120 billion respectively. As at December 2011, there were a total of 24 063 automatic teller machines and 277 478 point of sale devices. If one looks at the number of cards in issue, debit cards are by far the most widely used, amounting to 42 million out of a total number of cards in issuance of 62 million. Credit cards in issue are just under 8 million and gifts or pre-paid cards being the next highest at 5.8 million. The growth in the credit card industry has been hit by the global financial crisis, largely owing to more stringent borrowing terms and shrinking credit limits. The use of mobile devices by banks' clients, to access their accounts and to initiate/facilitate transactions, has also grown significantly over the past few years. These mobile devices include mobile phones and the various tablets available in the market today. There has also been a steady increase in the use of mobile phones to facilitate person to person payments/transfers.

Since the launch of the Blue Book, numerous achievements have been made. On 9 March 1998, the South African Multiple Options Settlement (SAMOS) system was implemented. Since then various upgrades have taken place to ensure that the settlement system is well-functioning, safe and efficient. Thus far during 2012, the average value settled through SAMOS on a monthly basis equates to approximately R7.3 trillion. In October 2008, at the height of the global financial crisis following the collapse of Lehman Brothers, a record settlement of R8.5 trillion took place.

The upgrades to the SAMOS system were undertaken in the interest of the financial system as a whole and in order to ensure South Africa's continued participation in the global financial arena. Some of these include facilities that enabled the integration of the payment system and securities clearing and settlement system. This enabled the South African financial markets to conform to international best practice with the introduction of the delivery versus payment (DVP) principle, as well as various other liquidity saving mechanisms to make settlement more efficient.

The low value Rand payment clearing systems have also evolved to current best practice and interfaces for these systems to the core SAMOS system have been established to ensure that settlement of all transactions is undertaken in central bank money and, as far as possible, the principle of same day settlement is achieved.

As was mentioned earlier, the NPS Act was promulgated in October 1998. The Act provided the SARB with the mandate to oversee the payment system and several amendments have been effected over time where necessary. Clearing and settlement agreements and rules have also been implemented as part of the objective of creating a sound legal and regulatory framework.

One of the most important achievements in the NPS was the inclusion of the South African rand in the Continuous Linked Settlement (CLS) system in 2004. CLS is a worldwide industry initiative implemented to reduce the risks associated with cross-currency transactions by settling the two legs of a foreign exchange (FX) transaction simultaneously in order to eliminate FX settlement risk.[1]

Leading up to the Rand joining the CLS settlement system, the SARB issued a position paper late in 2002 supporting the inclusion of the rand as a settlement currency in the CLS system and encouraged South African registered banks to support this initiative in areas where their actions were required to enable this initiative.

On 6 December 2004, CLS Bank International (CLS Bank) announced that four new currencies went live in the CLS system, one of them being the South African rand. At the time, this brought the number of currencies being settled through the CLS system at the end of 2004, to fifteen. This achievement ensured the integration of the domestic financial market infrastructure to the international system that enables our local participants to benefit from the risk reduction opportunities offered by the CLS system.

We are aware that while none of the other BRICS countries have joined the CLS, they are currently in the process of joining the CLS system, although they are at different stages in the process. Such initiatives, when implemented, will provide a platform for transactions among the BRICS countries to be undertaken in a safe and efficient manner and will help facilitate the many initiatives underway in the BRICS and the achievement of our objectives.

Another major project which is currently underway is the integration of the payment systems in the Southern African Development Community (SADC), so as to create a regional financial market infrastructure. The approach adopted in this process is to implement the desired infrastructure on a small scale, initially linking a few countries and thereafter rolling it out to more countries in a controlled manner. This will go a long way in facilitating trade within the region. International standards are adopted in this process to ensure that where appropriate in the future, the regional financial market infrastructure is enabled to integrate with other market infrastructures in other regions as well as internationally. It is envisaged that this infrastructure could be launched for testing as early as 2013.

It is imperative that domestic financial market infrastructures are developed with due consideration of international standards and best practice. This will enable integration with those operated by other countries and/or regions and thus facilitate cross border trade. Financial market infrastructures should endeavour to meet the highest standards of security, availability and operational effectiveness in order to retain the confidence of its users. In this regard, reputational risk is key in maintaining a high level of confidence and trust in the system.

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[1] FX settlement risk is the risk that originates once a currency has been irrevocably paid by one party, and thereafter the counterparty fails to meet its obligation in the trade.

There are, however, challenges that need to be managed in the development of a financial market infrastructure. Some of these relate to striking a balance between interoperability and innovation. It is an accepted fact that interoperable systems are effective and convenient for their users. On the other hand, during the early stages of innovation, it is difficult to also meet the interoperability objective. A managed process is thus necessary to move new innovations to interoperable standards. Another important factor relates to regulation vs. innovation. While regulators should avoid stifling innovation in terms of how they introduce their regulation, there is sometimes a thin line in balancing this act. In the South African context, we have chosen an approach where regulation follows innovation. In this regard, we closely watch innovative developments and develop appropriate regulation to manage any possible risk as the system develops.

Another aspect of focus in the development of financial market infrastructures relates to considerations for public policy objectives such as financial inclusion. We recognise the importance of understanding the needs and requirements of the market so as to avoid putting effort into initiatives that would not address the core needs of the targeted users. Examples of such initiatives such as the Mzanzi account that have been undertaken in the quest to address our financial inclusion objective exist and some lessons have been drawn from these initiatives.

Financial inclusion has been placed on the Mexico G20 agenda in 2012, focussed on improving access to finance and improving the confidence and integrity of the financial sector. The work is divided into three subgroups, being data measurement, standard setting bodies and principles, and SME financing. South Africa co-chairs the first sub-group and will be hosting a Global Partnership for Financial Inclusion (GPFI) forum and the first plenary meeting in Cape Town at the end of this month. The second subgroup has commissioned a study into the relationship between financial inclusion, financial stability, financial integrity and financial consumer protection with South Africa as the first country to be studied in this regard.

5. Concluding remarks

Overall, the South African financial market infrastructures are well developed and always strive to meet international standards and best practice in order to be open for integration with other markets. Our participation in regional formations, international standard setting bodies and oversight arrangements also offers a platform for us to gain insight and learn from developments elsewhere. This also offers us an opportunity to make a contribution to these regional and international developments.

I thank you for the opportunity to share our experiences and look forward to hearing your views.