Mr. Stals discusses financial sector reforms and their implications for the banking industry in South Africa Address by the Governor of the South African Reserve Bank, Dr. C. Stals, at the official opening of the new Head Office Building for Mercantile Bank in Sandton on 9/4/97.

1. The need for financial sector reforms

In many countries in the world there is at this stage a need for major reforms of the financial sector, which invariably holds important changes for the banking industry. Looking around the world, at least three reasons can be found for financial restructuring.

Firstly, there are the countries of Central and Eastern Europe where major transitions are taking place in the economies of the former centrally-planned countries of the now defunct Communist world. The transition from socialist to market-oriented economies requires in most of these countries a major reform of the functions and of the role of the central bank, the introduction of private sector banking institutions driven by the profit motive, the development of financial markets, and the acceptance of macroeconomic monetary policies that played no role in the previously centrally-planned systems.

In these countries, it was necessary to introduce certain basic minimum requirements first, such as a recognised system of business laws including corporate, bankruptcy, contract, consumer protection and private property laws that can be consistently enforced and will provide a mechanism for fair resolution of disputes. In most of these countries until a few years ago there did not exist well-defined accounting principles and rules, and independent auditors were not available to certify financial statements and accounts of banking institutions.

In summary, the public infrastructure for the management and running of modern banking activity did not exist and had to be established before modern financial market systems could be developed.

Secondly, a number of developing countries, particularly from the African continent, have recently embarked on major macroeconomic restructuring programmes, in many cases in collaboration with the International Monetary Fund and the World Bank.

In a recent publication of the United Nations Economic Commission for Africa the need for the reform of the financial sectors of African economies was described as follows:

"Financial systems in Africa are characterized by the low level of financial intermediation which takes place in the formal sector, the distressed nature of financial institutions, the high risk profile of financial asset portfolios due to the concentration of numerous countries' economies in only a few commodities and industrial sectors and the vulnerability of financial asset portfolios to price and supply shocks. In addition, very few formal financial institutions have shown the capacity or willingness to provide financial services to the small-scale entrepreneur and the rural operators.

"Furthermore, the range of financial institutions and instruments is narrow. Public ownership of financial institutions is pervasive. Institutions are plagued by a large proportion of non-performing loans in their portfolios. Management lacks the relevant management skills. Financial market depth and breadth is still very limited."

Reforms in these developing countries have focused on improving the legal, regulatory, supervisory and judiciary environment, reducing financial repression, restoring bank soundness, rehabilitating financial infrastructure, and have included programmes designed to downsize publicly-owned banks, privatising them where possible and encouraging new entrants.

Thirdly, reference can be made to financial sector reforms in the emerging economies of the world. In these countries some stage of advancement has already been reached in the development of financial systems. However, new demands are now being made in light of a new global financial environment, characterised by a liberalisation of financial markets, an integration of major global markets and an exposure of individual countries to relatively large international capital movements.

In these countries, exchange controls have been or are being removed, multinational financial institutions, including banks, are granted unrestricted entry, and international rules for financial regulation and supervision are being introduced that must be complied with to the satisfaction of international investors. Domestic monetary policy objectives must be brought to terms with the requirements of international market operators, and governments must accept some eroding of their sovereign autonomy for the management of the national economy.

2. Financial sector reforms in South Africa

South Africa is part of the latter group of countries. Together with the major social and political reforms of the past few years, we also had to contend with some important restructuring of the financial system.

Firstly, the South African financial sector, not unlike other countries on the African continent, had to adapt to the changes in the socio-political environment. Provision was made in the banking legislation for the existence and continuation of numerous informal savings clubs (“stokvels”) operating outside the normal constraints of bank regulation and supervision, but also then, of course, without access to central bank accommodation at the discount window. New legislation to provide for communal ownership of a banking institution was introduced in the form of the Mutual Banks Act. South African banking institutions also adopted their own internal policies to provide for greater participation in the social upliftment programmes of the country.

Secondly, bank regulation and supervision underwent major changes over the past ten years to apply the world-wide supported directives of the Basle Committee. At this stage, bank regulation and supervision is based primarily on risk identification and management, with clearly defined roles for shareholders, boards of directors, senior management and internal and external auditors.

Thirdly the South African banking scene was opened up for foreign banks. South African banks, in turn, were allowed to establish branch offices, subsidiaries and representative offices in many countries around the world.

Fourthly, major changes were introduced in the operations of the financial markets. The Johannesburg Stock Exchange led the way with a major restructuring last year to provide for electronic screen trading, corporate and non-resident participation, and provision for negotiated commissions and principal versus broking trade by members of the Exchange.

Fifthly, with the gradual removal of exchange controls, the South African market in foreign exchange became more competitive and volumes increased to an average of more than $6 billion per day.

Sixthly, with South Africa's active participation in the Southern African Development Community (SADC), the way has been opened up for South African banks to play an enhanced role in the Southern African region.

The process of financial sector reform in South Africa is continuing. Exchange controls have only been removed partly, and South African banks are only gradually adapting themselves to the environment of greater freedom in their international financial operations. Further important changes will be introduced in the structure of the domestic capital market, particularly in so far as the primary issues of government bonds are concerned, and also in the secondary market-making activities of the Reserve Bank. A major revision of the national payment, clearing and settlement system is now under way to provide for real-time on-line settlement on a gross basis of large transactions, and a daily netting and settlement of small transactions in the money market.

3. Implications for the banking sector

These financial reforms have important implications for the South African banking sector. Not only did the liberalisation of the markets bring greater competition for the traditional domestic South African banks, but they were also more exposed to the vicissitudes of volatile international capital movements. Our banks were forced to adopt a more open and global attitude in the daily management of their activities. Not only the policies of the South African monetary authorities, but also developments in, for example, the United States of America, the European Union, the Far East, and in other emerging economies of the world, now have a profound effect on the South African money, capital and foreign exchange markets.

There are now more than ten foreign banks with formally established branches or subsidiaries in South Africa, and more than 60 international banks with representative offices in the country. These foreign banks provide enhanced competition for the South African banks, particularly in the field of wholesale banking, international trade financing, and in the market for foreign exchange.

The liberalisation of the financial market also opened up opportunities for unscrupulous financial operators that are making use of the opportunity to exploit ignorant South Africans with offers of unrealistic yields on deposits, and promises of instant miraculous profits on financial investments. It is amazing that so many South Africans still fall for deceptions such as the ill-fated pyramid schemes that has just recently pushed Albania over the edge of complete social and political collapse. It is even more amazing that the efforts of the Registrar of Banks to protect the South African public against inevitable losses through these exploitations must be defended in courts and in time-consuming litigations. In his efforts to avoid an Albanian situation from developing here, the Registrar is even accused of acting against the Constitution.

The changing financial environment also holds important implications for monetary policy in South Africa. The explosion in the volumes of transactions in all the financial markets, the greater participation of all South African residents in financial market operations, the reintegration of South Africa in the world financial system and the liberalisation of financial operations such as foreign exchange transactions, have had an important effect on the amount of bank credit extension and the money supply. These conventional anchors of monetary policy also increased at unacceptably high rates over the past two years, partly because of structural changes, and partly because of normal pressures of demand increasing at a rate in excess of real income increases.

For both the Reserve Bank and the individual banking institution the changing environment brings many challenges. Banks operating in the new environment must be aware of the increased risk exposures that are inevitably associated with an extended process of change. Conventional bank prudency becomes even more important in this situation than under more stable conditions. In many other countries a period of major financial sector reforms ended in major restructuring and rationalisation of the banking sector, often because of unsustainable over-expansion in individual institutions. The Reserve Bank's concerns about the excessive increases in bank credit extension are not only for the effect it has on the total money supply, but also because of the inherent dangers of a concerted future major default in the servicing of the debt under less favourable macroeconomic conditions. The capacity of borrowers to meet future commitments of interest and debt repayment must not be over-stretched during this period of structural change and rapid expansion in the financial markets.

4. Mercantile Bank and financial sector reforms in South Africa

The Mercantile Lisbon Bank Holdings Group has been and continues to be part of the financial sector adjustment process in South Africa. With a substantial shareholding by the Banco National Ultramarino of Portugal, Mercantile is firmly linked to the expanding international participation in South Africa. Furthermore, this association brings to Mercantile Bank the experience of Portugal's largest commercial bank in its participation in the structural financial adjustment of a country that is preparing itself for the major reforms demanded of prospective participants in the European Union's integrated financial system and common Euro currency.

South Africa obviously has a great interest in these developments now taking place in Europe. Our recent successful negotiations for qualified access to the Lomé Convention provide proof of the importance attached to our future relations with the European Union. The supportive role of Portugal in these negotiations was appreciated. We believe that Portugal will be able to comply with the Maastricht requirements for full participation in the first round of Economic and Monetary Union scheduled for 1 January 1999, and will therefore also continue to carry South Africa's interests into the European Union.

Mercantile Bank has also been part of the domestic South African financial sector reforms in recent years. Since the acquisition in 1994 of Central Registrars, the operations of the two companies were gradually integrated. The changes in the operations of the Johannesburg Stock Exchange last year had a significant impact on Mercantile Registrars, and its contribution to the non-interest income of the Group had increased considerably with the larger volumes traded on the JSE.

Finally, Mercantile Bank is also expanding its interests to other African countries, for example Mozambique, and is therefore taking up the challenge of greater financial co-operation in the SADC region.

I can only wish you well in your future operations, and may this new building contribute to your future successes, in the interest of the development of a sound and well-managed banking sector in South Africa.