Daniel Mminele: Flourishing in financial markets post crisis – how do we achieve this?

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Gordon Institute of Business Science Conference on "Flourishing in Financial Markets Post Crisis – How do we achieve this?", Johannesburg, 2 October 2012.

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1. Introduction

Good morning ladies and gentlemen and thank you to the Gordon Institute of Business Science (GIBS), Payments Association South Africa (PASA) and Strate, for the invitation to provide the opening remarks this morning. Let me at the outset congratulate the organisers for putting together a programme that is quite wide-ranging in terms of content, and brings together a broad spectrum of speakers to provide different perspectives from their respective vantage points in the financial markets and financial market infrastructure space. Unfortunately, I will not be able to stay for the rest of the day.

The theme of the conference: "Flourishing in Financial Markets Post Crisis – How do we achieve this?" is encouragingly forward-looking and results- oriented – how do we get there, how do we achieve this? Allow me, however, to sound a word of caution when it comes to *post crisis,* because such a characterisation would be pre-mature at this stage. The crisis is not over yet, and in fact may be deepening.

Global economic prospects and financial market conditions have been deteriorating in recent months, growth projections for 2012 and 2013 are being adjusted lower, and indications are that the balance of risks is firmly on the downside. The three main risks to a sustained recovery of the global economy on our way to a *post crisis* environment are: (i) the on-going sovereign debt crisis in the euro area (with feedback loops into the banking system), (ii) the fiscal situation in the United States with regard to the so-called "fiscal cliff", and (iii) resurgent oil prices and rapidly rising global food prices. All three factors represent external shocks that weigh on household disposable income and economic growth, with a disproportionate impact on emerging markets and lower income households (where food is a larger share of the consumption basket).

While the authorities in the euro area have recently made significant efforts to help address weaknesses in their economies, such as through the recent announcement of the European Central Bank's Outright Monetary Transactions programme and the ratification of the European Stability Mechanism by the German Federal Constitutional Court, the success and credibility of these efforts, which have resulted in near-term risks to global financial markets at least subsiding somewhat, is critically dependent on timeous activation and effective implementation.

But, let me not divert too much and turn to the topic I have been asked to speak on, namely, the importance of inter-regulatory harmonisation in the Financial Markets including cooperation at the industry level.

2. The importance of cooperation and collaboration

The global financial crisis has brought to the fore and encouraged an environment of increased cooperation and coordination among regulatory authorities, with the view of preventing or at least minimising the impact of possible market disruptions arising out of financial crises. In the wake of the global financial crisis, the international community embarked on various initiatives aimed at improving the regulation of the financial sector, and by so doing, creating an environment that fosters financial stability, in support of growth and development. In addition, a number of changes are also envisaged in the areas of market conduct, consumer protection and financial inclusion. South Africa participates in various international fora (such as the G20, the Basel Committee for Banking Supervision, the Financial Stability Board) and standard setting bodies where these initiatives are being undertaken, and thereby contributes towards building a safer and more efficient global financial system.

The G20 in particular has been at forefront of international efforts to harmonise regulation. G20 Leaders have endorsed the broadening of the regulatory net to all markets, institutions, and infrastructures that are systemic (like hedge funds, credit rating agencies, OTC derivatives, and the catch-all phrase of "shadow banking"), thereby encouraging agreed international standards in this regard to be translated into domestic environments.

While South Africa's financial sector may have come through the crisis relatively unscathed, we are part of the global community and are also undertaking various regulatory reforms to ensure that our financial sector is further strengthened. To this end, in early 2011, the National Treasury published a document entitled "A safer financial sector to serve South Africa better", which is the guiding document in migrating South Africa towards a twin-peak approach to financial regulation, addressing both prudential regulation and market conduct. Collaborative engagements are underway among various South African regulators and stakeholders to ensure the successful implementation of these regulatory reforms in the near future.

A safe and effective financial system supports the regulators' objective of ensuring financial stability. Systemic and prominent market participants and infrastructures (such as the National Payments System, which my colleague Dave Mitchell will provide more detail on later) require appropriate regulation, supervision and oversight. It is thus imperative that relevant regulatory authorities have the oversight powers and resources to carry out this task. In exercising these powers, authorities should be transparent, adopt relevant standards and principles and apply them consistently. It is also crucial for central banks, market regulators and other authorities to cooperate in undertaking these tasks. The need for increased cooperation also stems from the fact that the crisis has made us appreciate more the interconnectedness (domestically and internationally) of the various parts of the financial system we operate in, and how, in the absence of cooperation and coordination, regulatory arbitrage (on the back of financial innovation) can lead to a rapid build-up of systemic risks.

Market regulators should always strive to implement interventions that are in the interest of the system as whole and do not serve the interest of individual participants only, or certain sections of the market. Although it is recognised that a disorderly failure in the financial market infrastructure or problems with systemic market participants can interrupt or impede the effective operation of markets, and cause severe systemic disruptions and financial instability, it is imperative that all regulatory actions or interventions should still maintain the correct balance. This is of course easier said than done! In most instances the impact of any crisis would differ across jurisdictions, depending on the stance of the relevant authorities on regulation and oversight, that is, whether regulators adopt more of an intrusive approach or take an arms length approach. Depending on the approach taken, the market participant's risk management practices will be different and therefore the impact will differ accordingly. A coordinated approach by regulators is thus imperative to ensure that the swing does not move to over-regulation, based on the experience of only one, thereby having detrimental effects or even introducing systemic risk in other jurisdictions. It is therefore imperative to ensure that any changes in the regulatory environment in different parts of the financial sector, whether within one country or across countries, are not in conflict with each other.

The potential for spill overs has increased substantially over recent years, as global financial market systems have become highly interlinked, creating significant dependencies. Under these circumstances, it thus becomes crucial that regulators have formalised arrangements to harmonise their regulatory practices and align these to appropriate best practice. Appropriate international standard setting bodies thus become key in driving the agenda to achieve these practices. These platforms should have appropriate structures that will foster effective consultation, so as to ensure the appropriateness of the desired harmonised standards or regulatory frameworks and avoid unintended consequences. That is where the role of the G20, the Basel Committee, the Financial Stability Board and IOSCO becomes very important.

Once appropriately harmonised standards or regulatory frameworks have been adopted and implemented, a consistent assessment of implementation should be undertaken. These assessments could take three forms:

- Systemic participants and financial market infrastructure operators should conduct periodic formal full or partial self assessments of their observance of the set standards and principles. The outcome of these assessments would lead to continuous improvement or enhancement of risk management practices, which should also meet organisational objectives rather than being just relevant for regulatory compliance purposes.
- Regulatory and oversight authorities, as part of discharging their mandates, should regularly assess adherence to standards and observance of relevant principles by entities that they regulate or oversee
- Independent assessments could be undertaken by international financial institutions (IFI) such as the IMF and World Bank, or take the form of country peer reviews, also in order to ensure that there is a standardisation of assessments to determine best practice.

Current requirements that have been set for banking institutions are being interrogated by various jurisdictions to see how best they could be adopted and to ensure implementation. As many of you will be aware, a second draft of revised regulations to give effect to the Basel III Accord in South Africa was released in September 2012. The revised regulations will come into effect on 1 January 2013, and steps had been taken to ensure that South African banks will be in a position to comply with the Liquidity Coverage Ratio by 2013.

Some jurisdictions and entities viewed international standards as only the minimum benchmark and rather strive to achieve higher goals, an approach that South Africa has tended to follow when it comes to capital adequacy. It is also important to always reiterate that in the implementation of standards and principles, as much as there is an important role for regulators, similarly, there is also an important role for market participants. It is in the interest of market participants to cooperate with regulators to ensure a safer financial system in which they operate.

3. Areas of cooperation and collaboration by regulatory authorities

Cooperation among regulatory authorities should be fostered both domestically and internationally. This should happen in normal times where ideas and experiences are shared with a view to strengthening the overall financial system. This also allows for building and strengthening of relationships that would be useful in more stressful situations.

Due to the interlinkages of the various markets and their financial systems as well as global financial institutions that operate in multiple jurisdictions, the need for cooperation will also be crucial in crisis situations. It is specifically in such times that it is in the interest of all the regulatory authorities to coordinate their actions in the interest of achieving a smooth recovery or resolution that could have affected entities or infrastructures in which they have some form of regulatory authority. In the implementation of standards and principles, various authorities with common interests will have to cooperate and collaborate in various areas such as oversight, supervision and recovery and resolution.

4. Regulation of financial market infrastructures

As mentioned earlier, 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 and securities 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.

South Africa is expected to adopt these principles and ensure that systemic and prominent financial market infrastructures in its jurisdiction do observe them. These principles will apply to payment systems, securities settlement systems, central security depositories, central counter parties as well as trade repositories. The principles will in most probability be adopted in either of the following ways:

- through policy positions that are outlined by regulatory authorities in a transparent manner;
- incorporated in relevant regulation applied by the relevant regulatory authorities; or
- incorporated in law or legal provisions administered by the relevant authority.

This will happen in parallel with the regulatory reforms that South Africa has chosen to undertake in the effort to drive towards "A safer financial sector to serve South Africa better" as stated earlier, and it is envisaged that the two objectives will be complementary and aligned. South Africa also sees itself as part of the broader region as well as the international community and thus also strives to drive its financial sector development initiatives with this goal in mind.

5. Concluding remarks

There can be no doubt that going forward we need better and appropriately regulated financial markets, institutions and infrastructures, such that strong, sustainable and balanced growth can be achieved in order to support our national objectives. Luckily when it comes to regulatory reform in South Africa it is the case of making good even better, or great, rather than having to fix what is broken. South Africa's financial system is rated among the best in the world. In the recent World Economic Forum's (WEF) Competitiveness Survey, South Africa ranked third on overall financial market development, first in the regulation of securities exchanges and first in the strength of auditing and reporting standards. But there is no room for complacency, and the need for various regulators to work together more closely is crucial. We also have our work cut out in the area of financial inclusion, to address the challenge of a large proportion of the population not having access to formal banking, insurance and investment products.

Financial Market Infrastructures are a source of strength for the financial system, but could also bring risk that could be catastrophic. It is heartening to say that the South African regulatory environment is well developed and should foster confidence in our financial institutions as well as our financial market infrastructures. These institutions strive to meet international standards and best practice in order to be open for integration with other markets to ensure that we take advantage of opportunities that present themselves and manage risks appropriately. It is also encouraging to note that some of our domestic Financial Market Infrastructure operators are already conducting self assessments based on the recently released international principles in the positive spirit of accepting the standards as being good for their risk management rather than viewing them as something that is being imposed on them by regulatory authorities.

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 and shape them.

I thank you for the opportunity to share these thoughts and trust that you will have a good conference.

References:

Principles for Financial Market Infrastructures, BIS CPSS & IOSCO, April 2012

A safer financial sector to serve South Africa better, National Treasury Policy Document, Republic of South Africa, February 2011