

Daniel Mminele: South Africa in the global regulatory context – progress, challenges and opportunities

Keynote address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the 8th Risk and Return Conference, Cape Town, 13 March 2014.

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1. Introduction

Good morning ladies and gentlemen. Thank you to Incisive Media for the kind invitation and the privilege for me to deliver the opening keynote address for this 8th Risk and Return South Africa conference. This conference provides a good opportunity for dialogue and sharing of experiences as it brings together a wide spectrum of financial market participants, especially risk and investment management professionals, at a time when there are critical, wide-ranging and historic changes to the financial markets landscape.

While there does not seem to be any major disagreement around the weaknesses and vulnerabilities that were exposed by the global financial crisis, there have been intense debates around how best to go about strengthening regulatory frameworks to restore confidence in financial systems. These range from appropriateness of certain regulatory standards based on country-specific circumstances (danger of “one-size-fits-all” approach), the speed and sequencing of implementation, to possible unintended consequences that could stifle innovation and development, reduce liquidity in certain markets, or affect the flow and cost of credit.

I have been asked to speak on the progress, challenges and opportunities of global regulatory developments, and in particular, South Africa’s experience.

The global financial regulatory reform agenda is a daunting and gigantic project for all involved, and in the limited time available this morning one is unlikely to do justice to the task. Following some remarks to set the context, I will talk about the regulatory alignment and supervisory change in South Africa, make brief comments about our regulatory architecture reform, then touch on the 2014 G20 priorities for financial regulatory reform and look at where South Africa is in relation to that.

2. From crisis to Basel III

The costs of the global financial crisis were significant and included substantial job losses and depressed economic activity. The severity of it was compounded by a number of factors, including a pro-cyclical deleveraging process and weaknesses in the banking sector, such as inadequate and low-quality capital, and insufficient liquidity buffers. The interconnectedness of systemically important financial institutions (SIFIs) meant that these weaknesses and consequences thereof, quickly spread to other countries and regions. On the regulatory side, inadequate mandates, autonomy, resources and instances of regulatory capture also contributed. Shortcomings were highlighted in evaluations such as the Financial Sector Assessment Programmes (FSAP). It is not surprising then, that regulators and standard-setting bodies decided on the need for a major overhaul of the global banking regulatory framework, hence Basel III.

Prior to the events of 2008, regulators were already faced with evidence highlighting the shortcomings of Basel II, including over-reliance on financial risk models to determine capital levels and the role of credit rating agencies (I see the conference programme includes the important topic of model risk). In early 2008, Basel II had only recently been adopted in some of the world’s dominant economies, with preparations underway for a comparable capital regime in the insurance industry in the form of Solvency II. Basel II.5, which focused on tougher controls on trade credit and securitisation derivatives, was introduced too late to

have any mitigating effect on banking capital. Therefore, some argue that its publication essentially became a matter of course that had to be dispensed with before the framework in its entirety received renewed scrutiny. Basel III, the Basel Committee on Banking Supervision's (BCBS)¹ response to the global financial crisis, sought to improve the banking sector's shock absorbing ability, thus reducing the risk of spill over from the financial sector to the real economy.

As time passed, the complexity of the financial reform agenda increased, particularly in terms of institutions covered, instruments subject to regulation, and cross-border implications. As I indicated earlier, now that we have reached the point of implementation and monitoring, concerns are being raised around issues such as inconsistency in the domestic implementation of the new regulatory standards and their applicability to all countries, and possible "unintended consequences", which include the economic impact of the reforms which need to be balanced against the need for financial stability. The G20, which put financial regulation high on its agenda since the first Leaders' summit in 2008, has recognised the importance of "finishing the job", and the focus for 2014 is to deliver on a range of outstanding reform issues, which I will elaborate on later.

3. Regulatory alignment and supervisory change in South Africa

South Africa, as a member of the G20, seeks to adhere to international standards of financial supervision and regulation as far as possible, taking into account domestic circumstances. Basel II compliance by South African registered banks commenced in January 2008. As alluded to earlier, not all G20 member jurisdictions managed to meet the deadlines, leading to uneven playing fields. Alignment with Basel II played a role in sensitising South African banks and the regulator to risk and capital, complementing a pre-existing culture of responsibility and relative conservatism, and led to the practice where banks were required to hold more capital than the internationally prescribed 8 per cent. It can be argued that to some extent this stricter and more conservative approach to bank regulation in South Africa served to cushion the domestic industry from the practices that led to problems elsewhere.

Basel III primarily addresses the problem of counter-cyclicality, quality and quantity of capital held at banks to absorb losses, and will introduce new standards for leverage and liquidity. Some elements of these new standards (such as the Liquidity Coverage Ratio) have already been agreed upon whilst others (such as the Net Stable Funding Ratio) are still being finalised in accordance with the agreed gradual phasing-in up to 2019. As many of you are aware, their impact is substantial and not limited to the banking industry as it flows over into the over-the-counter (OTC) derivatives market and so-called shadow banking activities. Simultaneously the role of (SIFIs) took centre-stage, with tightened capital requirements and other regulatory requirements such as resolution plans. The concept of increased capital charges for global systemically-important banks has been carried over to domestically-important banks and a similar process began for the insurance industry as well as the non-bank, non-insurance financial industry.

This was followed by the standard-setting bodies agreeing that SIFIs should have recovery plans and that resolution authorities should be established to implement resolution frameworks. Whilst these undertakings are easily defined in principle, the cross-border implications of resolution are proving to be very challenging. Resolution frameworks are fraught with implementation complexity and global comparability is further complicated by the significant differences between national legal systems and the intricate interaction between

¹ The Basel Committee is the primary global standard-setter for the prudential regulation of banks and provides a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. The Committee reports to and seeks endorsement for its major decisions and work programme from the Group of Governors and Heads of Supervision (GHOS).

proposed resolution- and other contingent laws. Clearly, achieving some sense of appropriate or best practice will take time and the G20 has therefore set a target that by the November 2014 Brisbane Summit, a framework for recognition of cross-border actions will be in place.

South African banks are in general well-positioned to meet the Basel III requirements for higher and better quality capital as they are phased-in. There are other areas, however, which have proven to be more difficult. Compliance with the liquidity coverage ratio (LCR) presents a challenge for countries like South Africa with less liquid corporate debt capital markets and limited availability of government debt securities. The Bank has therefore provided a collateralised Committed Liquidity Facility (CLF) to assist banks where necessary in meeting up to 40 per cent of these new liquidity requirements. This facility came into effect in January 2013, two years before the Basel III compliance date. . A bigger challenge for South Africa is the Net Stable Funding Ratio (NSFR), which comes into effect in 2018, and which favours retail funding with maturity in excess of one year. Such a requirement disadvantages a banking system like that of South Africa, which while relying more on wholesale funding has nevertheless been part of a sound financial system. The Liquidity working group of the BCBS, which the Bank is represented on, is in the process of considering various options, including rule changes. However, for South Africa the availability of high quality liquid assets will continue to be an issue for a while because of structural constraints.

The revised leverage ratio² framework was published on 12 January 2014 and disclosure requirements come into effect from 1 January 2015. The Basel standard was set at 3 per cent, but subsequently jurisdictions have debated imposing the leverage ratio at far higher levels nationally, suggesting a global revision to a far more conservative level.

Derivative markets, often the source of misunderstanding and occasional fear amongst regulators, were destined to bear some responsibility for the crisis. In order to tighten controls on this market, reforms are focused on the totality of the derivative system, both within and beyond the normal reach of financial regulation. The Financial Stability Board (FSB) and standard setting bodies are working to enhance the transparency of OTC transactions through requirements to trade on organised platforms, to report transactions to trade repositories, by placing central counterparties (CCPs) between the two parties to a transaction, and by setting minimum capital and margining requirements. Jurisdictions that already had these CCP and trade repository infrastructures had an immediate advantage in the timetable to compliance. Other countries, which do not have these structures in place, like South Africa, still have to establish requisite structures and appropriate rules. In this regard, as a country with a small, but stable and growing OTC market, it is important for us to ensure that differing enforcement dates and approaches, especially in larger jurisdictions, combined with cross-border application of domestic regulations, do not unduly stifle development in our financial markets. Some jurisdictions are offering their banks economically-favourable compromises to the Basel OTC derivatives capital charges, which is to the detriment of our own banks and corporate customers. Operational and legal complexities arising from jurisdictional differences, exacerbated by the cross-border nature of OTC derivatives, have not yet been resolved. In South Africa regulations for OTC derivative infrastructures are prescribed in regulations under the recently-implemented Financial Markets Act which is a critical element in our national OTC financial reform programme.

As for regulatory alignment overall, I would say that South Africa has made good progress in adopting and implementing the new international standards and has been an active participant in the relevant fora in which regulatory reform efforts are being addressed. Where

² Measures the degree to which an institution's capital is converted to both on- and off-balance sheet exposures.

appropriate we have indicated our concerns around the uneven implementation of Basel III across different jurisdictions.

4. Regulatory architecture reform

Even though South Africa's financial system weathered the storm of the financial crisis relatively well and is generally commented upon favourably, and has received positive ratings in various surveys, South African authorities felt that there should be no room for complacency, and embarked on a wide-ranging set of reforms to make the financial sector better and safer.

Our national regulatory architecture is thus undergoing significant transformation. Late last year, Cabinet approved and released for public comment the Financial Sector Regulation Bill. Once passed by Parliament, the legislation will establish two new regulatory agencies: a Prudential Authority, in the SARB; and a Market Conduct Authority that will replace the Financial Services Board.

The principles behind the revised structure include integration of the banking and insurance supervisory functions, increased focus on financial stability responsibilities, expansion of supervision to financial markets infrastructures, focused conglomerate supervision, reduced potential for regulatory arbitrage and increased organisational effectiveness. These structures are widely regarded as essential to ensure the fluent supervision of a vastly changing financial landscape. Good things it is said, like Rome, are seldom designed, built and functioning in a day. The SARB, National Treasury and the Financial Services Board are engaged in thorough preparation and look forward to robust implementation of the new regulatory architecture. We trust that you, the practitioners and other stakeholders involved in our markets, will also be reaping the benefits in the not-too distant future.

5. The G20 agenda for financial regulatory reform in 2014

At the time of the Brisbane G20 Summit in November 2014, four core financial reform deliverables will be assessed which ties in with the FSB focus for the upcoming year on "completing the job". The policy priorities needed to "complete the job" are: building the resilience of financial institutions; ending too-big-to-fail; transforming shadow banking; and making derivatives markets safer. The FSB will also undertake a review of its governance structures and submit a final report to the G-20 Leaders Summit. I will address each of these policy priorities separately, without going into too much detail, in particular in those areas I have already touched on such as the OTC derivatives market.

Building the resilience of financial institutions: The outstanding reform issues revolve around the Basle III capital framework and include the finalisation of the LCR, the NSFR, capital requirements for the trading book and addressing the various methodologies followed to determine risk weighted assets. South Africa fully implemented the risk-based capital component of the Basel III framework on 1 January 2013, with the exception that the capital charge for credit valuation adjustment (CVA) risk on banks' exposures to ZAR-denominated OTC derivatives and non-ZAR OTC derivatives transacted purely between domestic entities, was zero-rated for 2013, which exemption has been extended to 2014. The CVA exemptions have been a necessity because of the lack of a domestic CCP and a similar carve out in larger jurisdictions like Europe.

Another focus area is to improve the comparability across banks of the risk weights that they use in their internal risk models. A high degree of convergence and harmonisation should be reached so as to level the playing fields.

Ending too-big-to-fail (TBTF): Only a few jurisdictions (most notably the US and the EU) have made the necessary legislative reforms to implement the Key Attributes of Effective Resolution Regimes, which all G20 jurisdictions are expected to fully implement in substance and scope by the end of 2015.

The earlier mentioned Financial Sector Regulation Bill establishes the Bank as the Resolution Authority for domestic SIFIs and market infrastructures, and affords certain resolution powers to the Bank. During 2012/13 the Bank focused on the development of recovery and resolution plans (RRPs, also called “living wills”) by all banks registered in South Africa. A Resolution Policy Working Group (RPWG) was established, consisting of representatives from National Treasury, the Financial Services Board and the Bank, which is to draft the Resolution Bill taking cognisance of the requirements of the Key Attributes. We hope to have this Bill finalised by the end of 2014.

Strengthening oversight and regulation of shadow banking entities: The shadow banking industry has grown tremendously in recent years. The FSB’s 2013 report indicated that non-bank financial intermediation grew by US\$5 trillion in 2012 to reach US\$71 trillion. The assets in the shadow banking system expanded in most jurisdictions in 2012, helped by a general increase in valuation of global financial markets, while bank assets stagnated. Globally the assets of Other Financial Intermediaries (OFIs) represents on average about 24 per cent of total financial assets, about half of banking system assets and 117 per cent of GDP.

A broad regulatory policy framework for strengthening oversight and regulation of shadow banking entities was endorsed by all G20 members. The framework addresses five policy areas: mitigation of risks in banks’ interactions with shadow banking entities; reducing the susceptibility of money market funds (MMFs) to runs; improving transparency and aligning incentives in securitization; dampening pro-cyclicality and other financial stability risks in securities financing transactions such as repos and securities lending; and, assessing and mitigating financial stability risks posed by other shadow banking entities and activities. Peer reviews by IOSCO of implementation on the regulation of money market funds will start in 2014.

A particular issue for South Africa is that the definition of shadow banking namely, “*credit intermediation involving entities and activities outside the regular banking system*” – has different implications in different countries. In the case of advanced economies, it is primarily applicable to such entities as money market funds, hedge funds and private equity funds which play a large role in the financial systems of these countries. In the case of EMDEs like South Africa, these entities are less prominent and although we agree with the intent to bring unregulated or under-regulated activities into mainstream regulation, there could again be unintended consequences that require careful consideration during implementation. In South Africa the definition of shadow banking as currently stated would cover credit-extending institutions that address the financial needs of individuals and SMEs who are not adequately integrated into the traditional banking sector. Some of these institutions play an important role in deepening our financial system and advancing financial inclusion. A careful balance therefore needs to be struck between creating an enabling environment on the one hand, and ensuring appropriate market conduct provisions, protection of consumers and guarding against irresponsible and exploitative lending practices on the other.

FSB Governance Review: As part of the process to enhance trust and confidence in the financial system, the FSB has proposed a review of its governance structure to ensure a comprehensive approach to representation in the FSB across all levels. South Africa recognises the value of having the widest possible participation when developing global solutions to regulation in a highly globalised financial system and supports the principle of equal and balanced representation. The development of global financial standards, principles and processes require coordination between central banks, prudential and market conduct regulators, as well as policy making institutions such as the Ministries of Finance. A representative member body, in which each participant is able to contribute effectively, will improve the FSB’s ability to develop standards and rules that are responsive to the needs of key stakeholders in the global regulatory community, and will lead to greater compliance with global financial standards.

Before I conclude, let me say that completing the four remaining core reforms is quite an ambitious agenda which if rushed through could result in compromises being made and create its own challenges in the future. The fact that the leading global regulators have not reached sufficient agreement to issue joint regulations is causing divergences and market fragmentation between them. It is also having a big impact on efficiency and financial stability and is increasing the business costs for both the providers and the users of financial services. South Africa is suffering direct and indirect consequences from this situation. More impetus and direction to address the current situation of fragmentation and arbitrage and push for a higher level of coordination is required. In the past, we have stressed the importance of national discretion and flexibility and we should continue in this vein. However, the scope, substance and spirit of the global regulatory objective should still be met and demonstrated at all times.

6. Conclusion

In conclusion, the task of global regulatory reform is complicated by the fact of blurring lines between banking, insurance and capital markets. Interconnectedness of markets within and across countries requires an element of harmonisation without neglecting country-specific circumstances. The other challenge is that “we are making our way as we go”, because the crisis is not over yet, and we are working on the basis of preliminary lessons without being able to fully assess the likely consequences.

This calls for a collaborative effort between regulators to minimise uncertainty for financial institutions and markets, so as to allow them to structure their risk management processes, price products and embark on long-term planning. Similarly, financial market participants and institutions need to take responsibility for being responsive to, accepting and communicating to their other stakeholders the need for and benefits of regulatory reform. Standards such as Basel III will not address good day-to-day risk management within banks, or the lack thereof, including strategic risks that banks undertake in pursuit of return on equity demands from shareholders who often have a short term view of the world. And of course Basel III only covers banks and therefore the financial system as a whole will remain vulnerable until we have regulations in place for the system as a whole.

I wish you a successful conference and hope that you will be able to take away useful insights to help you navigate the challenging environment.

Thank you.