François Groepe: Impact of the global financial crisis on South Africa

Keynote address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, at a luncheon hosted by the Western Cape region of the Institute of Internal Auditors, Cape Town, 6 June 2014.

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Members of the Institute of Internal Auditors and other guests,

Thank you for the invitation to join you at this lunch networking event, hosted by the Western Cape region of the Institute of Internal Auditors of South Africa, and for the opportunity to address you at this event.

Today, I wish to focus my remarks on the impact of the global financial crisis on South Africa, in particular with reference to the challenges it poses to financial regulation and the increased focus on macro-prudential financial regulation. In this regard, I will take you through the kinds of reforms the Bank is implementing, particularly in regard to its regulatory role and which forms part of the package of responses to the global financial crisis. Lastly, I would like to touch on the role that the auditing profession can play in support of achieving this objective.

The global financial crisis

There is no doubt that the global financial crisis has permanently changed the course of the global economy and has established a new normal. The severity of the 2008 financial crisis brought about significant damaging effects to both developed and developing countries.

Although the emerging market economies performed better than the advanced economies, and became the engines of global growth through the crisis, they were nonetheless affected through the trade and finance channels and as a consequence their growth rates, too had been negatively impacted.

In addition, the crises that started out as a banking crisis, then morphed into a sovereign debt crisis, and brought with it particular challenges for central banks and their previously well-defined mandates, for example:

- Many central banks now look much more closely at the build-up of imbalances in the financial system; and
- As part of its focus, regulatory reform is dealing with the central banks' role with regard to financial stability – or macro-prudential regulation (which concerns itself with more than just idiosyncratic risk and the soundness of individual institutions but is concerned with the soundness and stability of the entire financial system i.e. systemic soundness).

Rationale for a financial stability focus

The ultimate objective of economic policy is to create a sustainable level of economic growth through investment, employment and production. This is best achieved when contributions are made by all sectors in the economy, including the financial sector, which historically has made substantial contributions to the levels of economic growth achieved in many advanced and developing economies. This sector is therefore important and hence there rests a responsibility on policymakers to ensure its continued health.

In this regard, government has an important role to play in creating a stable environment underpinned by a legal framework that brings about certainty and supported by regulatory and supervisory arrangements that help to ensure constructive incentives for financial market participants. The central bank too has a role to play as it is tasked with the responsibility of contributing towards the achievement and maintenance of both price and financial stability. Instability in either of these carries significant costs, as we have witnessed. According to the International Monetary Fund (IMF), direct costs of banking crises in the past 15 years exceeded 10% of the GDP in more than a dozen cases.

The relationship between monetary policy and financial stability is important and central banks must ensure that monetary policy actions themselves do not contribute towards financial instability. Hence, central banks have an important role to ensure that the possible formation of asset price bubbles that may threaten financial stability are kept in check.

The increasing interdependence of economies and the interconnectedness of the global financial system have led to significant initiatives aimed at safeguarding financial stability, including the development of standards that are material in strengthening the global financial system. A concerted effort through various international bodies has seen agreement on common standards and principles for financial regulators and has, furthermore, resulted in central banks focusing more closely on financial stability and macro-prudential analysis.

What is financial stability?

Matters relating to monetary policy and monetary stability come naturally to central bankers. Monetary stability relates directly to the stability of the price level and the value of the currency and speaks directly to the mission of the South African Reserve Bank (SARB). Traditionally, the main objective of central banks – often enshrined in the constitutions of countries – has been to ensure price stability. For the Bank this responsibility is defined as "to protect the value of the currency in the interest of balanced and sustainable economic growth…". It was commonly believed that if central banks could achieve price stability (defined as a target rate or target range of inflation), financial stability would automatically follow. This assertion was found to be incorrect!

Therefore, the concept of financial stability is, in general, newer, more controversial, less quantifiable and more difficult to define. Several attempts have been made to come up with a generally acceptable definition. I will use the definition of the Bank of Canada, "…when households, businesses and financial-service firms can reliably hold and transfer financial assets, without a meaningful risk of disturbances that would undermine financial exchange fundamentally and lead to macroeconomic costs".

The SARB's mandate of price stability has been expanded with an explicit responsibility to oversee and maintain the stability of the South African financial system. While the price stability mandate of the Bank is narrowly defined and measureable, its mandate for financial stability is much broader and is a shared responsibility with other stakeholders in the financial and public sectors.

During the East Asian financial crisis in the late 1990s, however, countries with low inflation rates experienced severe instability in their financial systems as banks failed, exchange rates depreciated and financial markets experienced severe volatility. As a result many central banks focused increasingly on financial stability and it became an implicit secondary objective. In South Africa, this objective was mainly pursued through the regulation and supervision of banks, which has been the responsibility of the Bank Supervision Department within the Bank. It soon became clear, however, that sound and profitable individual banks did not guarantee a sound banking and financial system. Banks often have inter-linkages and might have significant common exposures to risks that will not be visible from the supervision of individual banks.

Hence the need for macro-prudential surveillance, or the monitoring of the "prudence" of the "broader" financial system was identified and which culminated in the SARB creating such capacity for this purpose as far back as 2001. The SARB further was given the objective of contributing to the stability of the financial system in South Africa, following the global financial crisis.

Following the publication of a policy document by National Treasury in February 2011 called "A safer financial sector to serve South Africa better" the SARB's responsibility for financial stability became more explicit. This policy document eventually culminated in the Financial Sector Regulation Bill, which states that "…the South African Reserve Bank has primary responsibility for promoting financial stability…". The Bill sets out further details to give effect to the Bank's financial stability mandate and is expected to be promulgated during 2014. It is important to note that financial stability is a shared responsibility with other stakeholders such as the prudential and market conduct regulators and the National Treasury.

Careful consideration needs to be given to co-ordinating monetary policy and financial stability objectives, which at times may result in diversion of policy choices. In South Africa, cross membership between the Bank's monetary policy and financial stability committee structures facilitates such coordination. The Bill also recommends a single committee structure for financial stability, namely the Financial Stability Oversight Committee (FSOC), chaired by the Governor of the Bank. The FSOC's mandate will be to continuously monitor the financial system for risks and initiate any action necessary to mitigate or remedy a risk. The FSOC thus will have a financial stability responsibility, in the same way as the Monetary Policy Committee (MPC) does for price stability, and will be able to hold to account various authorities or economic agents on actions to be taken to mitigate against/reduce systemic risk.

The Bank's expanded mandate for financial stability will not impact on its price stability mandate, which, eluded to above, is a narrowly defined, formal and explicit mandate. The Bank will therefore still be independent and free from influence in pursuing its primary objective of achieving and maintaining price stability.

Given this expanded role, it will require of central banks to evolve and to face up to the increased demands for greater accountability. Central banks will need to communicate on matters relating to financial stability, manage situations where conflicts arise in the goals of monetary policy and financial stability, and moderate unrealistic expectations of what can be achieved by financial stability policies.

South Africa, as a member of the Group of Twenty (G20), is committed to promoting financial stability and contributing towards strengthening the resilience of the global financial system.

The role of the auditing profession in supporting financial stability

There are a number of important and close linkages between the financial stability objective of the central bank and the auditing profession. As mentioned earlier, one of the four main aspects of the Bank's financial stability mandate is to promote the robustness of the financial system architecture. This is performed through a process of benchmarking the financial architecture of South Africa against the Financial Stability Board's twelve standards for sound financial systems. Amongst these standards are International Standards on Auditing (ISA) issued by the International Auditing and Assurance Standards Board (IAASB). As part of the Reports on the Observance of Standards and Codes (ROSC) initiative, the World Bank has established a programme to assist its member countries in implementing international accounting and auditing standards for strengthening the financial reporting regime. This enables authorities to analyse comparability of national accounting and auditing standards with international standards and to develop and implement a country action plan to strengthen the country's corporate financial reporting regime.

In addition to that, well-functioning financial markets require accurate information to ensure the efficient allocation of capital and other productive resources in the economy. Market participants need to have confidence that the system of financial exchange is transparent and fair. The market system depends on trust, and in this regard, good corporate governance is critical to ensure economic and financial stability as a breakdown in governance could significantly erode business efficiency.

In a testimony to the US Congress by the then Chairman of the Federal Reserve Board in 2002, Alan Greenspan stated that lawyers, internal and external auditors, corporate boards and rating agencies often fail to detect and blow the whistle on those who breach the level of trust essential to well-functioning financial markets. This could lead to widespread misinformation to shareholders and potential investors. The question is why corporate governance checks and balances that served the world well in the past broke down during recent years.

Both external and internal auditors have a key role to play in strengthening corporate governance as they are the third line of defence within the combined assurance frameworks. The Committee on Internal Audit Guidance for Financial Services in the United Kingdom has issued its recommendations for effective internal audit in the Financial Services Sector in July 2013. If implemented, these recommendations will improve the relevance of the internal audit function by repositioning the focus from testing and reporting on the internal control environment to supporting both executive and non-executive management in the effective management of key risks. The guidance for example suggests that the scope of internal audit include, *inter alia*:

(i) The risk and control culture of the organisation

This should include assessing whether the processes (e.g. appraisal and remuneration), actions (e.g. decision making) and "tone at the top" are in line with the values, ethics, risk appetite and policies of the organisation. Internal Audit should consider the attitude and assess the approach taken by all levels of management to risk management and internal control. This should include Management's actions in addressing known control deficiencies, as well as Management's regular assessment of controls.

(ii) Risk of poor customer treatment giving rise to conduct of reputation risk

Internal Audit should evaluate whether the organisation is acting with integrity in its dealings with customers and in its interaction with relevant markets. Internal Audit should evaluate whether Business and Risk Management are adequately designing and controlling products, services and supporting processes in line with customer interests and conduct regulation.

(iii) Capital and liquidity risk

Internal Audit should include within its scope the management of the organisation's capital and liquidity risks.

Conclusion

After much discussion and debate, we have to accept that, after nearly seven very challenging years, new challenges are being faced, which poses specific risks for emerging economies in particular. Some of these challenges include the unwinding of the extraordinary monetary policy actions in the US which is largely untested territory as there is no prior history to guide us. Nonetheless, I will not delve into this topic at present as we could spend many hours discussing the various issues surrounding it.

Let me stop here and thank you for the opportunity to talk to you today and to share a few ideas on the fascinating topics of financial stability and corporate governance. There is no question that good corporate governance and sound accounting and auditing standards and effective audit functions contribute significantly to sound, stable and well-functioning financial systems.

Thank you.