Lesetja Kganyago: South Africa's September 2014 Financial Stability Review

Introductory remarks by Mr Lesetja Kganyago, Deputy Governor of the South African Reserve Bank, at the launch of the September 2014 *Financial Stability Review,* Johannesburg branch of the South African Reserve Bank, Johannesburg, 29 October 2014.

* * *

Members of the press, guests and colleagues, welcome to the release of the September 2014 edition of the *Financial Stability Review*.

The *Financial Stability Review* has been published semi-annually since 2004 which makes this year its tenth anniversary. In addition to its primary objective of price stability, the Bank also oversees and maintains financial stability. In pursuit of this mandate and to contain systemic risk, the Bank continually assesses the stability and efficiency of the key components of the financial system and formulates and reviews policies for intervention and crisis resolution. Through the publication of its *Financial Stability Review* the Bank endeavours to communicate its assessment of potential risks to financial system stability. The Bank also strives to enhance the understanding of, and encourage informed debate on these complex and challenging matters related to financial stability.

South Africa is in the process of reforming its financial-sector regulatory architecture by implementing a twin peaks model of financial regulation. Under this approach, supervisory roles will be streamlined between the Bank and the Financial Services Board. The Financial Sector Regulation Bill, 2013, gives primary responsibility to the Bank for promoting financial stability. In terms of this Bill, a newly created Prudential Authority within the Bank will be responsible for the prudential supervision of banks, insurers, financial conglomerates and financial market infrastructures. The Financial Services Board, in future to be known as the Financial Conduct Authority, will be responsible for consumer protection through its market-conduct regulation and supervision.

The Bank transformed its Financial Stability Unit into a fully-fledged Financial Stability Department with effect from 1 April 2014, and elevated the status of the Financial Stability Committee which has been in existence since 2000 to include deployment of macro prudential tools. The Financial Stability Review is currently being revamped in line with the explicit financial stability mandate of the Bank and global best practice. The revamped publication will report in more detail on financial stability policy decisions once the new architecture is in place. The Financial Stability Department is in the process of developing a toolkit of macro-prudential policy instruments in addition to further refining its monitoring framework for financial stability, developing a top-down stress testing model and preparing policy proposals for the development of a resolution framework for the systemically important financial institutions and markets in South Africa. The definition of financial stability has also been refined to the following statement:

"Financial stability refers to a financial system that is resilient to systemic shocks, facilitates efficient financial intermediation and minimises the macroeconomic costs of disruptions in such a way that confidence in the system is maintained."

This edition of the *Financial Stability Review* covers the six-month period ending June 2014, but also takes into account some events up to the point of publication. It consists of three main sections. The first section provides a reassessment of financial stability risks that were identified as potential risks in the March 2014 edition of the Financial Stability Review. In the second section the main financial stability developments and trends over the period under review are analysed from a global and domestic perspective. The final section provides a review of the developments in the domestic and international financial and regulatory environment. This edition also includes three boxes on the following topics:

- The curatorship and resolution of African Bank;
- Shadow banking in South Africa; and
- Debt ratings

The South African banking sector remained sound with adequate levels of capital, increased levels of high-quality liquid assets, good asset quality and profitability that compares favorably with other jurisdictions. The sector's total capital adequacy ratio of 14,6 per cent remained well above the regulatory requirement of 10 per cent. The soundness of the banking sector was achieved despite a deteriorating domestic economic growth outlook and the first significant bank resolution in almost a decade when African Bank Limited was placed under curatorship in August 2014. The SARB managed the resolution of African Bank Limited in a speedily and decisive manner, limiting the potential risk of contagion to the rest of the banking sector. As part of this process the Bank put in place a package of measures which are in line with the *Key Attributes of Effective Resolution Regimes* of the Financial Stability Board (FSB), enabling the institution to continue operating. Although the intervention of the Bank managed to avoid systemic risk materialising and there were no significant adverse effects on the rest of the banking sector, the broader financial markets and or the economy, some limited spillovers did occur. The limited contagion to other parts of the financial system occurred mainly as a result of the wholesale nature of African Bank Limited's funding model. Coordinated interventions by the authorities, regulators and the private sector contained these spillovers and ensured the continued stability of the financial system and the banking sector in particular.

Although household debt, as a percentage of disposable income, has been improving consistently since reaching a peak in the first quarter of 2009 and the ability of households to service their debt has remained strong given an extended period of low interest rates, the household sector is now faced by a rising interest rate cycle and higher cost of living. Household wealth has increased strongly, however this was mainly as a result of a significant increase in the valuations of financial assets, possibly leaving consumers in a financially vulnerable position.

House prices in South Africa are fairly valued at present and do not present any risks to financial stability. Equity market valuations, on the other hand, are currently at fairly elevated levels and a sudden and sharp correction in equity markets could reveal vulnerabilities that could have certain indirect negative effects on the financial system.

South Africa has been participating in the FSB's monitoring exercise of non-bank financial intermediation activities, or shadow banking as it is commonly known, since 2012. Although their share of total financial assets increased to about 18 per cent in the fourth quarter of 2013, non-bank financial intermediaries currently provide only about 11 per cent of total credit extension in the South African financial system.

The optimistic outlook for some advanced economies continues to diverge from the more subdued growth outlook for EMEs amid persistent concerns over country-specific weaknesses. While leading indicators are pointing to the global recovery gaining strength in the second half of 2014, some constraints from both the fiscal and the monetary sides, as well as slow progress with structural reforms in some instances, remain a risk to a sustainable global recovery. A prominent exogenous risk to domestic financial stability is the effect that monetary policy normalisation in advanced economies and the US in particular could have on EMEs, including South Africa. Although normalisation has been discounted to an extent and forward guidance allows markets to anticipate policy moves better, the timing and magnitude of interest rate increases and their effects on capital flows and financial markets remain uncertain.

Another important global development, not reported on in the FSR, is the results of the European Central Bank's comprehensive assessment of bank balance sheets and stress testing announced recently. Twenty five banks failed the assessment and need to raise

€25 billion of new capital. Twelve banks have already covered their shortfalls in the year to September. The ECB expects the in-depth review of the largest banks to boost public confidence in the banking sector.

Apart from implementing a twin peaks financial regulation framework in South Africa, several other initiatives are reported on in this publication, aimed at improving the robustness of the domestic financial infrastructure. On 4 July 2014, the National Treasury published for public comment a policy document and proposed regulations on OTC derivatives. These regulations form part of a broader package of global regulatory reforms aimed at making derivatives markets safer and strengthening the resilience of the financial system. Other initiatives include the introduction of a Global Legal Entity Identifier system and the adoption of the Committee on Payment and Market Infrastructures (formerly CPSS) and International Organization of Securities Commissions (IOSCO) Principles for Financial Market Infrastructure.

The South African financial system continues to be resilient in the wake of a volatile and uncertain global environment and a degree of domestic economic concerns. Although the current conjuncture is uncertain and several challenges remain, the financial system remains sound.

I have briefly highlighted the key issues raised in the *Financial Stability Review*. More detailed analyses are available in the publication itself, and some will be covered in the presentation by my colleague, Dr Hendrik Nel, highlighting some of the analyses that were conducted by the Financial Stability Department. I trust that you will find these stimulating and relevant to the current environment and invite you to provide comment as part of the process of on-going debate on financial stability.

Thank you.