South African Reserve Bank

Keynote address by
Lesetja Kganyago, Governor of the South African Reserve Bank,
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Good morning, ladies and gentlemen.

Let me begin by thanking the organisers for inviting me to address you today.

Today, I would like to talk about the evolving banking landscape, specifically the regulatory and governance challenges that face banks in emerging markets. I would also like to discuss the challenges relating to correspondent banking as well as the opportunities and risks that come with fintech and digitisation developments. Last but not least, I will touch on the concept of 'financial inclusion' and the framework for the resolution of troubled financial institutions.

The increased volume, complexity and impact of regulatory reforms on the financial sector in recent years are a challenge for both supervisors and banks. The concern for supervisors is that the volume and complexity of new international standards are placing increased demands on limited supervisory resources (particularly in emerging markets). This may affect supervisory effectiveness.

Supervisors and the supervised institutions alike demonstrate a high demand for staff most suitable for ensuring regulatory compliance. It remains a challenge for the regulator, similarly to the rest of the financial sector, to attract and retain adequately skilled human resources in the current environment of increased regulatory and compliance scrutiny, as the South African Reserve Bank – or SARB – competes with commercial banks for the same set of skills and experience to address the regulatory requirements imposed on banks.

The combination of the new credit, market and interest rate risk in the banking book and liquidity standards, the changes to provisioning, capital buffers as well as the implementation of the total loss-absorbing capital (or TLAC) and resolution frameworks are specific challenges. Banks are also facing growing compliance challenges from the increase in new requirements, which further affect their resources in order to keep up with regulatory developments.

A concern we hear frequently relates to the potential risks and impact on banks of the interaction of the various new regulatory and supervisory standards. The understanding of these risks and their likely impact is necessary to avoid the unintended consequences of the cumulative modification of regulatory standards.

As a member of the Basel Committee on Bank Supervision, South Africa continuously strives to strengthen its regulatory and supervisory framework as well as to promote and enhance the stability of its financial system.

The G-20[1], the Financial Stability Board and the Basel Committee on Banking Supervision have made significant strides in future-proofing the resilience of the global financial system and finalising the core elements of the regulatory reforms. The first phase of this new global regulatory initiative focused on ending the ‘too big to fail’ problem in order to reduce the risk to the fiscus and taxpayers. In particular, this has meant increasing the resilience of individual institutions.

The G-20 has tasked the Financial Stability Board with developing a framework and ensuring that the relevant international standard-setting bodies prepare new standards for large and important financial institutions, particularly the systemically

[1] Founded in 1999, the Group of Twenty (G-20) is an international forum for the governments and central bank governors from 20 major economies.

important financial institutions (SIFIs). Regulatory bodies have since developed common standards, monitored by mutual peer reviews, to ensure that economies can still enjoy the benefits of global trade while reducing the risks caused by a financial crisis.

South Africa is also imposing new regulatory requirements, especially on banking groups, which are material subsidiaries of global systemically important banks (or G-SIBs). The requirements being imposed on these G-SIBs and their material subsidiaries in the emerging markets have the potential to create an uneven playing field with other locally incorporated banking groups and carry the consequence of bringing unwanted risk into the South African financial system.

The second phase of the global reforms involves authorities reducing the costs from the failure of a financial institution. In a document titled *Key attributes of effective resolution regimes for financial institutions*, the Financial Stability Board has set out key principles to ensure that the consequences of the failure of individual financial firms are minimised.

South Africa has implemented Basel III through the 2013 Bank Regulations and the Banks Amendment Act 22 of 2013. A new prudential framework for insurers will be introduced through the Insurance Bill now being considered by Parliament. This prudential framework may be expanded to other financial sectors in the near future to ensure a consistent regulatory approach. These reforms will support the shift towards the coming Twin Peaks approach to regulating the financial sector in South Africa. Making financial institutions safer is important, but the possibility of failure remains.

Considering the fact that South Africa is an emerging market and that South African banking groups operate mainly in other emerging markets, some of the regulatory requirements developed or being developed could have a negative impact on the South African banking system and/or financial market, such as the Net Stable Funding Ratio or the proposals being developed around TLAC. Some of these requirements may in fact be more suitable for, or may have been calibrated to be more applicable in, developed markets; they may not always be fit-for-purpose in emerging markets such as South Africa.

The large banking groups regulated by the SARB mainly have operations on the African continent and/or in other emerging markets. Some supervisors on the continent and in other emerging markets where South African banks have operations have yet to implement the regulatory reforms. This imposes an obligation on the SARB, which is the only African member of the Basel Committee on Banking Supervision, to effectively supervise the subsidiaries of South African banks in the rest of the African continent and other emerging markets.

Failure to do this creates inconsistencies in how regulatory capital and other risks are measured, and in how supervisory standards are applied. Another example of an inconsistent application of international standards is different supervisory expectations in Africa of the same international standards relating to the use of risk models under the advanced measurement approaches.

Although there is a need for more standardisation and comparability of risk-weighted assets across banks and jurisdictions, the SARB believes that there remains a need for banks to be able to apply quantitative risk models to adequately measure risk across portfolios and/or risk types. If the expectation is to reduce the use of risk models in measuring regulatory capital, then banks will become less inclined to invest in the use of test requirements imposed under Basel II.

The SARB believes that the use of test requirements has made a significant positive contribution to the way in which banks measure and manage risk, and that this has led to improved risk management and pricing of risk across the regulated entities. The SARB supports the risk models under the advanced measurement approaches to be used.

The regulatory framework is beginning to succeed in meeting its objective of addressing the ‘too big to fail’ problem as G-SIBs are in general adjusting their balance sheets and evaluating their complex business models to meet strengthened regulatory demands in many areas, especially in respect of higher-quality capital ratios and the difficult economic environment we are currently facing.

As you know, these developments have spilled over into South Africa when a G-SIB headquartered in the UK[2] announced its partial withdrawal from a domestic systemically important bank, or D-SIB, mainly due to global regulatory pressures. As a result, we might face various policy considerations going forward as we need to carefully assess the effect and potential impact of home regulatory requirements on local markets and if we are not perhaps importing structural instability (uncertainty) into our markets.

An unintended consequence of the reforms to end ‘too big to fail’ is deglobalisation, resulting in G-SIBs reducing their activity in some emerging market economies, which in turn has a potential impact on the stability of those financial systems and policy implications.

Another consequence of the regulatory reforms is that the regulated banking system is being scrutinised and regulated more strictly but no similar requirements or oversight are currently imposed on the shadow-banking environment. This is being discussed in the international meetings we attend.

Let me turn to digital innovations. Innovative technologies are emerging as a potentially transformative force in financial markets. ‘Fintech’ is used as a broad term for technically enabled financial innovation that results in new business models, applications and/or products with an associated material effect on financial markets, institutions and the provision of financial services.

Coping with opportunities and threats from innovation and technology remains a key area for banks and continues to pose challenges for supervisors. New technologies may be outpacing the ability of banks to put in place adequate controls and information technology (IT) systems. Furthermore, supervisors do not necessarily have sufficient expertise to assess a bank’s capability in this area. Building capacity

[2] United Kingdom

to address IT needs and cyber-risks is therefore becoming more urgent in the context of the growth of fintech.

With greater reliance on technology comes a greater risk of cyberattacks. The risk of cyberattacks on the financial sector has dramatically increased in recent years. The financial sector stands out as a particularly attractive target for cyberattackers. Cyberattackers' ambition and capacity to manipulate and gain direct access to financial data and services may lead not only to severe losses of trust in the global financial sector but also to high costs for market participants and customers.

With today's financial systems being globally interconnected and dependent on technical core infrastructures and services, cybersecurity incidents compromising such a core function could, by contagion across sectors and jurisdictions, even develop a capacity to undermine global financial stability.

The SARB joined the Alliance for Financial Inclusion (AFI) during 2016. Representatives from the SARB have attended AFI Global Policy Forums in the past two years. We are also a member of the AFI African Mobile Phone Initiative (AMPI). By participating in international forums, it is clear that the solutions are probably in fintech, specifically mobile phones and regulatory sandboxes.

Financial inclusion covers aspects of affordability and the ability to use financial services, which involves a certain level of financial literacy. The SARB has not been actively driving financial inclusion, but it has done some work on financial literacy. Going forward, financial inclusion will be an ancillary objective for the Prudential Authority in terms of the Financial Sector Regulation Bill.

Derisking and deglobalisation contribute to global financial market fragmentation and could end the open and integrated structure we are all striving for. Derisking can create financial exclusion.

Digital innovation can also be used to enhance global financial inclusion. A peer exchange between countries and regions on emerging policy practices for achieving digital financial inclusion could help those who lack access to financial services to better steer their implementation efforts.

We believe that the global phenomenon of derisking through a decline in correspondent banking services requires priority and expedited action. This is one area where proportionality in the implementation of regulatory reforms is very appropriate. Evidence reveals that the picture is especially bleak in the sub-Sahara Africa region where some countries are constrained since they are potentially unable to process payments across international borders.

To date, a limited number of correspondent banking relationships with South African banks have been terminated but derisking has not had a significant impact on cross-border flows from a South African point of view. However, South African banks are being subjected to heightened scrutiny by foreign counterparts. Markets in all jurisdictions must have access to a well-functioning global financial system in order to develop and prosper. This development goes straight against our goal of financial inclusion, which is a critical element for long-term global economic growth and for the elimination of poverty.

In conclusion, the fact that the South African banking sector remains profitable and adequately capitalised is not a cause for complacency. The future performance of the domestic banking sector could be adversely affected by a number of factors, including constrained household-sector balance sheets, a weak domestic economic growth outlook, the subdued global growth outlook, the effects of the threat of a sovereign downgrade, and increasing regulatory compliance pressures. As a regulator, the SARB will remain vigilant in monitoring and, where possible and appropriate, mitigating the impact of the challenging environment in which domestic banks are operating.

Thank you.