South African Reserve Bank

Introductory remarks by Francois Groepe,
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at the Financial Stability Forum and release of the first edition
of the *Financial Stability Review* for 2018

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Members of the press, guests and colleagues, ladies and gentlemen.

Welcome to the release of the first edition of the *Financial Stability Review (FSR)* for 2018. The *FSR* has been published twice a year since 2004. Through this publication, the South African Reserve Bank (SARB) communicates its assessment of systemic risk in the domestic financial system.

Your presence at this Financial Stability Forum is appreciated, as the forum intends to encourage informed debate on, and therefore to enhance the understanding of, the complex and challenging matters related to financial stability.

Consensus is growing globally that regulatory frameworks should focus more on mitigating the risks to the financial system as a whole, as significant risks can build up and threaten the stability of the financial system while individual financial institutions seem stable and sound. In pursuing this goal, the Financial Sector Regulation Act 9 of 2017 (FSR Act) confers on the SARB an explicit statutory mandate to protect and enhance financial stability. The SARB and National Treasury have consequently developed new legislation that will facilitate the orderly resolution of systemically important financial institutions that are failing, which is an important pillar of the SARB's expanded mandate. This legislation will be effected through amendments to the FSR Act. A key component of the resolution framework is the establishment of an explicit deposit insurance scheme for banks in order to protect depositors from losses in the event of a bank failure.

Overall, the message of this *FSR* is that the stability of the financial system in South Africa has improved notably since the previous FSR. This is based on a more synchonised and more sustained economic recovery in the advanced economies, a more positive (albeit still a challenging) domestic economic growth outlook, as well as improved levels of confidence domestically following positive political developments and ratings outcomes. Against this background, the SARB has assessed the risks to financial stability with a view to identifying and mitigating any vulnerabilities in the domestic financial system; it has also analysed the probabilities and potential impacts of these risks in the *FSR*. In the presentation to follow, Dr Greg Farrell will share a more detailed assessment of these risks.

During the reporting period, a number of event risks occurred that proved not to be systemic in nature but which had potential financial stability implications. These risks included the announcement of an investigation into accounting irregularities at Steinhoff International Holdings in December 2017, followed by the resignation of their Chief Executive Officer and Chairman. The Group's share price subsequently declined by more than 80%, which resulted in a short-term liquidity crisis within the Group. To date, the Group has taken various actions in an effort to stabilise its finances and operations in the medium term. Any potential financial implications arising from this event would most likely be the result of some form of default risk in respect to the Group and related parties' debt obligations that the financial sector may be exposed to. While such a default could cause losses for banks, lenders and investors, it is unlikely to result in financial instability as most of the exposure to the Group and related parties' lies with foreign banks. Developments relating to this situation are, nevertheless, closely monitored.

Furthermore, since December 2017 we have observed an increase in the volatility of selected equities listed on the JSE Limited. The sharp, though brief, decline in the share price of Capitec Bank (Capitec) was likely been triggered by a 'short-selling' strategy applied by certain investors. The common traits of such a 'short-selling' strategy include influencing market participants' perceptions by means of extensive use of social media platforms and potentially, running an ongoing campaign against the targeted entity.

This type of ‘short-selling’ strategy has the potential to create financial instability, especially if the targeted company is a deposit-taking institution. Although a decline in a bank’s share price does not necessarily create systemic risk, there may be a risk to financial stability. This could transpire if the information being spread by the ‘short-selling’ campaign, whether it be true or not, results in a negative feedback loop between lower investor confidence, as reflected in a decline in the equity price of the targeted institution and a loss of depositors’ and lenders’ confidence in the targeted deposit-taking institution. This may ultimately result in a decline in deposits or a ‘run’ on the bank. The negative feedback loop can exacerbate the circumstances even if the trigger event was based on inaccurate information. In the Capitec case, statements by the SARB and appropriate responses by Capitec calmed fears and led to a recovery in Capitec’s share price.

VBS Mutual Bank (VBS) was placed under curatorship on 11 March 2018 in order to maintain the functioning of the bank and to promote the safety of depositors’ funds. This intervention was deemed necessary to, among other objectives, preserve depositors’ confidence and trust in the South African banking system. After a thorough assessment of VBS, the curator recommended that an independent review of VBS’s business conduct be undertaken, after which the SARB commissioned a forensic investigation into the affairs of the bank.

Other potentially systemic events that occurred during the reporting period included two settlement failures at domestic financial market infrastructures causing certain trades to either fail or remain in an unsettled state in the securities market. These events were reported via the Financial Sector Contingency Forum and then managed by the SARB through its interaction with market participants. A review of these settlement disruptions has been commissioned, and they will be addressed and monitored in future.

Globally, economic conditions continued to improve during the second half of 2017, and it appears that a broad-based cyclical recovery is underway. In January 2018, the International Monetary Fund (IMF) revised upwards most countries’ economic growth outlooks for 2018 and 2019, but also warned against possible risks to economic growth recovery, including subdued productivity, increased protectionism, higher geopolitical pressures, and the possibility of sharp financial market corrections in cases where asset valuations were overextended.

Institutional soundness remains a feature of the financial system in South Africa. The analysis presented in this *FSR* confirms that banks are well-capitalised and profitable, and that they hold sufficient levels of liquidity. Although impaired advances and credit impairments increased in January 2018, this was largely a result of the implementation of International Financial Reporting Standard 9 (IFRS 9). It inter alia specifies how an entity should classify and measure financial assets and liabilities and one of the fundamental changes that IFRS 9 introduces is the concept of Expected Credit Loss (ECL) provisioning. This new principle replaces the current incurred losses model and has materially changed the way in which companies, and in particular banks, are required to account for impairments for credit losses.

Similarly, the insurance sector seems to be sound. A selection of indicators commonly used to identify macroprudential risks in the industry did not reveal any significant concerns from a systemic risk perspective despite the subdued level of economic growth and which impacts negatively on the insurance industry's premium income, lapses and surrenders. Pension funds are subject to risks stemming from a sovereign credit rating downgrade because of the size of their bond holdings. Their large exposure to this asset class does not, however, present a financial stability risk as pension funds normally hold these bonds to maturity.

A healthy, well-functioning financial system is integral to an environment in which structural, fiscal and monetary policies can be most effective. Recent assessments of the South African financial system by the IMF claim that regulatory reform has made the system relatively safer. Designated procedures for systemically important financial institutions have been put in place; stress testing has become a regular part of the supervisory toolkit; capital buffers have been increased; new rules to address liquidity vulnerabilities have been introduced; resolution frameworks have been strengthened; and over-the-counter derivative regulation has been enhanced.

There are important areas where more progress is still required, including the full implementation of strengthened resolution frameworks, measures to increase the resilience of central counterparties, and measures to address the systemic risk emanating from asset management activities. New challenges are emerging from technological changes and innovation, such as the digitisation of finance. Ongoing financial innovation, changes in business models, and strengthened bank regulation have all supported an increasing shift from bank lending to market-based finance, and the importance of non-banks has continued to grow.

In conclusion, it is clear that the global and domestic financial systems' have become more resilience since the publication of the previous *FSR* in November 2017. Some global uncertainties caused by a number of economic and financial developments remain, including faster-than-expected monetary policy normalisation in the advanced economies, as well as protectionist measures and possible retaliatory actions by others.

Despite these challenges, the South African financial system continues to efficiently facilitate financial intermediation and mitigate negative spillovers and disruptions.

Overall, despite some headwinds from a moderate economic growth scenario and some remaining fiscal challenges, the South African financial sector is assessed as strong and stable. The sector is characterised by well-regulated, highly capitalised, liquid and profitable financial institutions, supported by a robust regulatory and financial infrastructure.

I have briefly highlighted the key issues raised in this *FSR.* More detailed analyses are available in the publication itself, and some of these will be highlighted in the presentation by my colleague, Dr Farrell. I trust that you will find these interesting, stimulating, and relevant to the current environment, and I invite you to share your views as part of the all-important process of ongoing debate on financial stability.

Thank you.