South African Reserve Bank

Address by Lesetja Kganyago, Governor of the South African Reserve Bank, at the 14th BCBS-FSI high-level meeting for Africa on 'strengthening financial sector supervision and current regulatory priorities'

Cape Town, South Africa, 31 January – 1 February 2019

Introduction

Good morning, ladies and gentlemen.

I am pleased to once again welcome you to South Africa, Cape Town for the 14th Basel Committee on Banking Supervision (BCBS) – Financial Stability Institute (FSI) high-level meeting for Africa on 'Strengthening financial sector supervision and current regulatory priorities'.

Allow me to first thank you all for attending this meeting, which has become an important annual event for the South African Reserve Bank, BCBS, FSI as well as representatives from other various sub-Saharan African central banks and supervisory authorities. I hope that this meeting will be as successful as the past meetings we have had over the years.

Importance of financial sector regulation

Before we get bogged down in very technical discussions around financial sector regulation and our regulatory priorities, it is important that we first remind ourselves of the policy imperatives behind the need to continuously strengthen the regulation and improve the resilience of our financial systems.

The financial sector plays an important intermediation role in the economy – by allocating capital from savers to borrowers, managing financial risks, facilitating trade, as well as offering access to the payment system. Financial intermediaries and financial markets play this role by moving funds throughout the economy that in turn affect businesses and the production of goods and services[1]. A financial system is therefore the lifeblood of a modern economy. Inclusive growth and sustainable development objectives would not be achieved without a stable and well-functioning financial system.

The 2008 global financial crisis highlighted the strong connection between the financial sector and the real economy and the extent to which challenges in the financial sector can have negative effects on the real economy. While the financial crisis originated in developed countries, it negatively impacted on most of the emerging market and developing economies, in very significant ways. On our continent, the effects were

[1] "Reforming the Financial System in Sub-Saharan Africa: the (long) Way Ahead", Peter Gakunu, 2007

particularly felt through reduced foreign investment, trade and remittances. The crisis exhibited itself in growing budget and trade deficits, currency impacts, higher rates of inflation, increasing public debt and dwindling currency reserves[2].

So to reiterate, a stable and well-regulated financial sector is vital for the achievement of our long-term sustainable economic growth and developmental objectives.

Given the growing interconnectedness of financial markets, international financial stability has become a global public good. Despite governments, central bankers and regulatory bodies mainly operating in their respective jurisdictions, we need to recognise that some of the decisions we make in our own jurisdictions can have global reach. In order to achieve a stable global financial system, coordination and cooperation becomes important. Our gathering here is one such form of coordination and cooperation towards the strengthening of our financial sector supervision and contributing towards a more resilient and safer global financial system. The interactions here, the sharing of ideas and experiences as well as the fostering of professional relationships will make the regulation of our financial sector better.

Financial sector development in Africa

The financial system in Sub-Saharan Africa is generally bank based and somewhat less sophisticated than our developed country counterparts, with countries on different levels of development. However, there has been remarkable progress over the past two decades. While the emergence of non-bank financial institutions and other alternative sources of capital, such as stock markets has been noticeable, with the exception of a few, financial systems are still dominated by informal finance and traditional banks, most of which are state or foreign-owned.

The banking sector in Africa is undergoing reforms focused on privatisation and other forms of restructuring with respect to state-owned banks, with a view of improving the quality of the banks[3]. A review of the Sub-Saharan Africa banking system published[4] by the IMF in 2013 makes the following observations:

- banking systems account for the preponderance of financial sector assets and activities;
- the depth and coverage of financial systems – as measured by the ratios of broad money (M2) and private sector credit to GDP – have been gradually increasing over the past decade, albeit from a low base;
- the scale of financial intermediation in the region remains significantly lower than in other developing regions of the world;
- access to financial services is also relatively low, reflecting a combination of low income levels, small absolute size, and infrastructure weaknesses;

[2] The Economics Student Society of Australia, Julia Pham, 2017
[3] "Review African financial systems: A review", Franklin Allen etal, Finance Department, The Wharton School, University of Pennsylvania, 2011
[4] Banking in Sub-Saharan Africa: The Macroeconomic Context, Montfort Mlachila, Seok Gil Park, and Masafumi Yabara, Washington DC, IMF, 2013

- most banking systems are small in absolute and relative size, characterised by low loan-to-deposit ratios;
- large shares of assets are held in the form of government securities and liquid assets;
- lending is mainly short-term in nature, with about 60 percent of loans having a maturity of less than one year; and
- market structures are typically oligopolistic, as indicated by the high share of total assets accounted for by the three largest banks, which tends to constrain the intensity of competition.

I am highlighting these key elements of our financial system in Sub-Saharan Africa, to ensure that we have context. The structure of our regional financial system and development should also play a role in informing and shaping our regulatory priorities. This context matters, particularly in light of the discussions we are going to have around proportionality of regulation and institutional reforms.

Furthermore, according to the report published by the IMF I have just alluded to, the Sub-Saharan Africa banking systems were well positioned to handle the 2008 financial turmoil given:

- low leverage;
- generally healthy capitalisation levels;
- ample liquidity;
- little reliance on external funding; and
- limited or no exposure to either foreign and/or toxic financial assets.

Ladies and gentlemen, while the Sub-Saharan Africa region was broadly able to weather the shock from the 2008 global financial crisis, without suffering severe banking failures as was experienced in other parts of the world, this is not a reason to be complacent. In the main, the banking systems in Sub-Saharan Africa came under pressure indirectly via international trade linkages, as the global economic turmoil fed into reduced exports; slower domestic economic growth and rising unemployment. This in turn adversely affected borrowers and contributed to increased default risk as well as higher levels of nonperforming loans.

No one can claim to know the exact nature, origin and timing of the next financial crisis. We then need to ensure that we continuously strengthen and enhance our regulatory and supervisory frameworks to ensure that they are current and sufficiently robust. This is not necessarily aimed at reducing the probability of failure by individual institutions, the reform agenda is targeted at allowing orderly resolution of failing institutions in order to safeguard stability and depositor interests.

Financial sector regulation post the global financial crisis

Let me now say a few words about the overarching regulatory priority reforms that the G20 put in place in the aftermath of the global financial crisis. I will be quick to say that most of the policies are largely in place and – even more relevant to our gathering today– I will also touch on the specific Basel Committee reforms.

The comprehensive financial sector reform programme was put in place in order to build a safer and more resilient global financial system. The G20 reform package included, among other key reforms; ending too-big-to-fail, building resilient financial institutions, making derivative markets safer and enhancing resilience of non-bank financial intermediation. The Financial Stability Board was tasked with coordinating the implementation of these reforms.

As a member of the G20, South Africa has made significant progress in implementing these reforms and we continue to make progress. Some of the major highlights are as follows:

- we implemented the Twin Peaks regulatory approach to strengthen our regulatory framework – my colleague, Unathi Kamlana will touch on that in greater detail during the session on 'institutional arrangements for financial institutions';
- we have developed and implemented our macro-prudential toolkit to strengthen and embed our financial stability mandate;
- the process of adopting a resolution framework for dealing with banks and non-bank SIFIs is at an advanced stage – the reform package includes the establishment of a Deposit Insurance Scheme as well as seeing the South African Reserve Bank becoming the Resolution Authority;
- work for the implementation of margin requirements for non-centrally cleared over-the-counter (OTC) derivative transactions, is at an advanced stage; and
- development of a regulatory framework for financial conglomerates is ongoing – my colleague, Denzel Bostander will also touch on this in one of the next sessions.

Colleagues, we are committed to implementing all the G20 financial reforms that are applicable to our financial system. We are duty-bound to improve the resilience of our financial sector to make sure that it is safe and prudentially sound.

Turning to specific reforms in the banking sector, the Basel III framework, announced in 2010 is a fundamental response by the Basel Committee to the global financial crisis. As you are aware, the framework was put in place in order to address a number of weaknesses that were identified during the financial crisis and provides a basis for a more resilient banking system. This first phase of the reforms focused at achieving the following:

- improving the quality of regulatory capital;
- increasing the level of capital requirements;
- enhancing risk capture by revising areas of the risk-weighted capital framework;
- adding macroprudential elements to the regulatory framework;
- specifying a minimum leverage ratio requirement to constrain excess leverage; and
- mitigating excessive liquidity risk and maturity transformation.

Implementation of these reforms is progressing well, driven by a broad-based consensus to reduce the negative spillovers emanating from deep financial crises like the one we saw ten years ago.

The finalisation of the remaining elements of Basel III in 2019 also marked the completion of the post-crisis reforms. The amendments were put in place to restore credibility in the risk based capital framework as well as address weaknesses identified with the use of internal models for the calculation of regulatory capital. The 2017 improvements seek to improve the comparability of banks' capital ratios by:

- enhancing the robustness and risk sensitivity of the standardised approaches for credit risk, credit valuation adjustment risk and operational risk;
- constraining the use of the internal model approaches – by placing limits on certain inputs used to calculate capital requirements under the internal model approach and removing the use of internal models in some cases;
- introducing a leverage ratio buffer – to further limit the leverage of global systemically important banks; and
- replacing the existing Basel II output floor with a more robust risk-sensitive floor based on the revised Basel III standardised approaches.

Emphasis is now being placed on complete and timely implementation of the reforms in a consistent manner in order to secure the benefits of a more resilient financial system. In the case of South Africa, the implementation of Basel III is largely in place and we are currently busy with implementing the remaining elements of the Basel III reform package as articulated above.

I am sure there is going to be interesting discussions around these matters over the next day and a half.

Addressing the unintended consequences of the reforms

Let me turn to another matter which is of great importance especially to emerging markets and developing economies.

Given the progress made with the implementation of the G20 reforms, an analysis of the unintended consequences of these reforms is becoming possible. To this end, the FSB has already developed a *Framework for Post-Implementation Evaluation of the Effects of G20 Financial Regulatory Reforms* to guide analyses of whether the reforms are achieving their intended outcomes, and to help identify material unintended consequences that might need to be addressed, without compromising the objectives of the reforms.

The evaluation is motivated by the need to better understand the effects of the reforms on the financing of real economic activities. Unintended consequences of the reforms on specific areas such as trade finance, infrastructure finance, SME finance and market liquidity may lead to sub-optimal social outcomes.

The reforms aimed at ensuring that the global financial system is safe and stable should be balanced with the need to ensure that the financial sector continues to play its important role in the economy. A very stable financial sector that plays no meaningful role in economic development is not beneficial – as such, there is a pressing need to consider and understand the costs versus benefits of regulatory reform. This should be done fully appreciative of the fact that an unstable financial system poses a significant risk of reversing the short terms gains emanating from unsustainable growth in the economy. These are trade-offs that require a careful balancing act.

Banks can only effectively and efficiently serve the public interest when they are safe and sound. A collapse of the financial system has dire consequences on the economy with negative effects on the general welfare of households.

In the letter to the G20 leaders in November 2018, the former Chair of the FSB, Mark Carney, pointed out that "*In assessing what is working as intended and addressing any inefficiencies or unintended consequences, the FSB is tailoring not tapering. It is critical that this process of evaluation and adjustment does not compromise overall system resilience. Safeguarding progress does not mean defending all aspects of reform at all costs"*. This is a very key message to keep at the back of our minds as we have robust discussions around this matter.

Evaluation of the effects of regulatory reforms is an important aspect of any regulatory reform process. As you might be aware, there are some jurisdictions that have already signalled to alter post-crisis reforms should they find that they have unintended consequences to their financial systems. It is an issue that we cannot ignore. However, we have agreed at the FSB level that any assessments and possible adjustments thereof need to be 'evidence-led' and implemented in a coordinated manner across all relevant jurisdictions.

The local adjustments are often as a result of "one size fits all" approach that requires small players to comply with rules that are designed for larger institutions like Global Systemically Important Financial Institutions. With increased financial sector regulation, shadow banking has also been on the rise. The regulatory gap in respect of shadow banking was also particularly felt during the global financial crisis. We subscribe to the notion that the regulation of shadow banking should be a priority in order to reduce regulatory arbitrage and prevent the shifting of risks from the regulated financial institutions to unregulated parts of the financial system, compromising financial stability.

The issue of proportionality when looking at regulatory reforms also becomes an important consideration to ensure that different financial institutions are regulated proportionately according to the size, scope and complexity of regulated financial institutions and/or activities.

The evolution of the financial sector and emergence of new risks

I would also like to turn to a very topical issue these days on the increasing use of technology in the financial sector.

The financial sector has evolved over time and continues to evolve. The adoption and use of technology in the provision of financial services has been at the centre of innovation in the financial sector and is changing the way financial service providers operate and deliver products and services to their consumers. The accelerating pace of technological change has real implications not only for the regulated sector but also for policy makers and regulators. The evolution of the financial sector requires that our regulatory and supervisory frameworks also evolve to ensure adequate and effective regulation of the sector.

I am aware of the work that has been conducted by the Basel Committee to provide insight into the fast-growing adoption of financial technology (FinTech) specifically by banks. We appreciate the contributions made by the Basel Committee and others in the official sector to get a better handle of developments in this area.

FinTech has helped to reduce costs, manage risks better, create new business opportunities, improve people's lives and has even assisted authorities to achieve public policy objectives such as financial inclusion and competition in the financial services sector. Like all positive developments, FinTech has also brought with it new risks and new challenges for supervisors and regulators.

While financial innovation fosters competition in the provision of financial services, regulations must apply equally to all types of market players, banks, non-banks and electronic platforms offering services similar to those offered by financial institutions. This will ensure that we avoid pushing the market towards a particular structure (regulatory arbitrage).

The same innovative technologies that are driving FinTech are now also being used by financial institutions to ensure that they implement the latest regulatory changes, monitor compliance and report correctly to the various supervisory bodies, through Regulatory Technology (RegTech). RegTech has been necessitated by increasing levels of regulation and a greater focus on data and reporting. Adoption of RegTech means improved data quality that can be shared quickly and securely with various entities as well as improved compliance, both of which are positive for the stability of the financial system.

Financial innovation is changing traditional banking business models, structures and operations as well as the nature and scope of banking risks. Key risks associated with the emergence of fintech include strategic risk, operational risk, cybersecurity risk and compliance risk. It has also become important for supervisors to assess their current staffing and training programmes to ensure that the knowledge, skills and tools of their staff remain relevant and effective in supervising the risks of new technologies and innovative business models.

There has been increased use of technology by supervisors and regulators to support the supervision of financial institutions through Supervision Technology (SupTech). SupTech is currently found primarily in two areas: data collection and data analytics and helps supervisory authorities to digitise reporting and regulatory processes, resulting in more efficient and proactive monitoring of risk and compliance at financial institutions. FinTech, RegTech and SupTech are all new innovations that we need to embrace.

While we harness the benefits of new financial technologies we need to ensure that the risks posed by such innovations, particularly to financial stability are adequately managed and mitigated.

The rise in cybersecurity-risk

Financial innovation has also led to an increase in cybersecurity risk, which is slowly becoming a major concern than before. The remote access of financial services by customers through electronic gadgets has presented an opportunity for hackers and other cyber-criminals. Financial institutions need to ensure that they have effective IT and other risk management processes and control environments that effectively address cybersecurity risk. This is one of the issues that are very close to my colleague Deputy Governor Francois Groepe and I am sure he will discuss this matter with you in greater detail during the relevant session on this topic.

Conclusion

As we enter the second decade following the global financial crisis, the strides we have made in developing the financial sector regulatory reforms geared towards addressing the identified weaknesses are under constant scrutiny. With the finalisation of the Basel III reform package in 2017, which marked the completion of the post-crisis reforms, emphasis has now shifted to implementation and evaluation of the effectiveness of reforms and to address any unintended consequences. This is a critical step in the process if we are to ensure that we build a safe and resilient global financial system. As we engage with each other today and tomorrow, let us learn from each other’s experiences and strive to make our financial system better to serve our citizens and deliver our developmental aspirations.

Please engage robustly and enjoy the meeting.

Thank you