Tenth BCBS-FSI High-level Meeting for Africa on "Strengthening Financial Sector Supervision and Current Regulatory Priorities"

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Keynote address – recent developments in the African region

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Introduction

Good morning ladies and gentlemen.

Thank you for inviting me to the Tenth BCBS-FSI High-level Meeting for Africa and to share my views on the recent developments in the African region.

I will provide you with a brief overview of possible risks for the African region that are associated with a new round of quantitative easing in developed economies. I will also discuss the impact of low oil prices on sovereign and corporate debt issuance, and global growth and the implications of these developments for the region. I shall conclude by giving an update on regulatory developments.

Despite a strong performance by the US and UK economies, the global economic growth outlook remains mixed, with the growth prospects having deteriorated in a number of the other advanced economies, with Japan in a technical recession and the Eurozone remaining weak amid the possibility of deflation.

The lower oil and other commodity prices have had a significant and divergent impact on recent macroeconomic developments, with deteriorating prospects in some emerging markets contributing to the lowering of the IMF's 2015 global growth forecast by 0,3 percentage points to 3,5 per cent with notable downward revisions made to Brazil, China, Nigeria, and Russia. Growth in China is expected to moderate to 6,8 per cent in 2015 and although Africa remains one of the high-growth regions, weaker commodity prices pose downside risk to the outlook.

Currency devaluations and the potential impact on the African region

The global increase in liquidity, resulting predominantly from capital injections by the Bank of Japan and the European Central Bank (ECB), could have negative spill over effects to sub-Saharan Africa and emerging market economies (EMEs) in general.

Concerns over losses in the export market as a result of a strengthening of domestic currencies could give rise to attempts at currency devaluations in some developed economies and encourage monetary policy easing in the context of a subdued inflation outlook environment, specifically in industrialised nations. The announcement of further large-scale asset purchases by the ECB and the Bank of Japan precipitated the weakening of the euro and the yen, respectively, amidst expectations of monetary policy normalisation in the US.

Already, Denmark and Canada have cut interest rates, while the proponents of interest rate increases in the UK are retreating. Subsequent to the ECB's announcement to fend off deflation threats through an asset-purchase programme, the Swiss Franc appreciated strongly, increasing the risk of falling exports and a possible contraction.

In Asia, the advent of Abenomics raised concerns that China could respond in an effort to protect its exports market share and with its growth easing to 7,4 per cent for the fourth quarter in 2014, the lowest in 24 years, devaluation of the Chinese yuan may be considered a possible policy option.

In summary, the further quantitative easing may in the short term increase global liquidity and lead to capital inflows to emerging market economies, but this may be accompanied by increased currency volatility on the back of dollar strength and in some countries weaker growth. Currency devaluations flowing from quantitative easing in external markets may also have a negative impact on countries that export to those countries.

Currency risk, sovereign and corporate downgrades

For the sub-Saharan African region, the past five years of highly accommodative monetary policies in the US, Europe and Japan have stoked the currency risk

associated with the increase in sovereign debt issuance. The persistent search for high-yielding securities presents an additional dimension of risk for African countries.

Backed in recent years by comparatively stronger regional growth, African nations are now able to issue billions of dollars in sovereign bonds, prompting the IMF to issue a warning that too much debt in the region could derail the best economic period observed in this generation.

The uptick in borrowing in the region lifted public debt to a ten-year high of 35 per cent of GDP in 2014. Although such debt levels are much lower than in Europe and some Asian countries, the associated currency risk is significant. The cost of servicing a US dollar-denominated Eurobond, issued by an African state may look cheaper than that of a debt issue in local markets, but if the relevant country's currency declines, the cost of foreign borrowing could increase, thereby exerting unwelcome pressure on national budgets. This risk is more pronounced in oil-exporting countries that draw a significant portion of government revenue from their energy sectors.

As an illustration, Russia's credit rating has been downgraded to below investment rate for the first time in a decade. A number of oil producing countries on the African continent, too will need to adjust to the falling oil prices and declining fiscal revenue by cutting fiscal expenditure and possibly raising taxes.

The risk of sovereign downgrades, on the back of deteriorating fiscal and external balances could also extend to the corporate sector and may spill over to vulnerable non-oil producing countries. Yields on corporate bonds, issued by the energy sector, have risen sharply since June 2014. The prospect of defaults due to over-lending to the energy sector is a possibility that cannot be ignored.

Unless oil prices rebound significantly to enable borrowers to refinance their debt on more favourable terms, the cross-sectional risks of multiple exposures of different industries to the energy sector would be propagated through the financial system. Consequently, share prices of oil-listed companies, along with those that provide services to the energy sector, could be negatively impacted.

The impact of low oil prices on the interconnectedness of financial institutions - a risk for global growth

The obvious similarities between the transmission mechanism of the 2006 fall in US house prices and the fall in the price of oil since June 2014 have prompted some analyst to predict that the correction in the oil price could lead to a plunge in stock markets, with subsequent negative spill over effects to the global economy.

The global financial crisis had its roots strongly embedded in the procyclical risks that were amplified and propagated over time by the highly leveraged US housing market. Accordingly, a sharp fall in US house prices led to bankruptcies of major financial institutions that had significant exposures to the real-estate market. As companies filed for bankruptcies and the risk of default increased in the financial markets, refinancing of existing debt became increasingly difficult. The shutdown of the US commercial paper market made it difficult for corporates to borrow money over the short-end of the yield curve, resulting in an unprecedented financial meltdown and significant job losses as economic activity came to a halt.

Through different financial institutions' interconnectedness, a well-contained and relatively limited exposure to the US real-estate market soon spilled over to the global financial system, with negative consequences for regional growth in Africa. While the origins of the crisis might have been procyclical, it is essentially the distribution of risks during the 2007-08 crisis that amplified the losses incurred.

In less than a decade, since the crisis, we now have another highly leveraged sector - the US shale oil industry – that capitalised on the rise in the price of oil that started almost ten years ago. Banks' lending to the energy sector of billions of dollars could pose a systemic risk to the global financial system as the exposure was seen as low-risk and the pricing of risk by lenders might have been less robust during the upward swing in oil prices.

Resultantly, the plunge in oil prices has stoked concerns over growth of particularly oil producing countries, fuelling fears about deflation and intensifying scrutiny of capital spending across the energy sector, with companies set to slash their exploration and development budgets. Some estimates put the figure of possible losses related to halting exploration projects at US$1 trillion.

Moreover, low oil prices are a major threat to high cost oil producers. For as long as prices remain below US$50 per barrel, a number of those oil producers will struggle to break even. This could trigger a new wave of bankruptcies and defaults with concomitant negative spill over effects to the financial sector.

It is evident that although low oil prices could boost consumption its impact on growth could be mixed, with oil exporting countries particularly negatively impacted by these developments in the form of deteriorating fiscal and external balances. This will furthermore result in a sharp decline in the flows into sovereign wealth funds and given the fiscal deficits could result in significant sell off by these funds.

The lower oil prices may also accelerate the build-up of deflationary pressures and possibly result in stagflation becoming more entrenched in certain economies.

The impact of low oil prices on revenue projection in the African region

Some sub-Saharan African countries are particularly at risk from the fall in oil prices, with oil exports accounting for 40-50 per cent of GDP for Gabon, Angola and the Republic of the Congo and 80 per cent for Equatorial Guinea. In Angola, the Republic of Congo and Equatorial Guinea, the oil industry accounts for 75 per cent of government revenue, while in Nigeria oil still accounts for more than 70 per cent of the national budget, leaving public institutions exposed to the ebb and flow of global energy prices.

Cheaper oil is complicating Ghana's efforts to reduce its significant trade and budget deficits. In August 2014, it requested a US$500 million bailout from the IMF. In order to meet bailout terms, Ghana is taxing oil at the pump; however, the fall in oil prices may exacerbate its difficulties in meeting its debt obligations.

Most oil exporters need oil prices to be considerably above US$57, the projected price for 2015, to cover government spending, which has increased in recent years in response to rising social pressures and infrastructure development goals. Furthermore, vulnerability to currency risk increases if the borrower is dependent on the exports of one or two commodities for revenue.

East Africa is set to emerge as a global supplier of oil and gas within the next decade due to the recent major oil and gas discoveries in Mozambique, Tanzania, Kenya

and Uganda. Kenya and Uganda alone are estimated to hold 4 billion barrels of crude oil, while Tanzania and Mozambique claim reserves of 200 trillion cubic feet of natural gas. With the promise of unprecedented petro-revenues possible, host governments are working on bold, detailed and comprehensive local content policies as they eye the next phase. All these plans could be jeopardised if oil prices do not rebound in the medium term.

Lastly, the fall in oil prices has negatively affected revenue projections of oil-exporting countries and their currencies' exchange rates. While emerging market currencies generally track inflation differentials over the long run, large moves in the crude oil price have directly affected exporters' currencies in the short-term, because of a perceived diminished value in export flow revenue.

Regulatory, supervisory and financial stability matters

Turning to regulatory and financial stability matters, the global financial crisis has necessitated, among other things, a serious regulatory reform agenda in order to address the excesses of the period leading up to it; anchor future economic growth and ensure a sound regulatory and financial stability framework.

The current overhaul of the global regulatory system is broad and covers a range of relevant financial issues. Some of the key themes thereof include addressing the too-big-to-fail (TBTF) problem of systemically important financial institutions (SIFIs), building resilient financial institutions, reducing the opacity of the over-the-counter (OTC) derivatives markets, mitigating the impact of shadow banking on financial stability, enhancing financial benchmark transparency and promoting the convergence of accounting standards.

Within each of these themes there are a number of regulatory initiatives, such as the regulation and resolution of SIFIs under the TBTF problem and Basel III and proposals for a basic capital requirement for insurers to strengthen the theme of building resilient financial institutions. This list, although not exhaustive, suggests the significant scope and amount of the work still ahead. Compounding the problem further are the implementation and monitoring processes, such as FSAPs and related peer reviews to assess progress made with the implementation of internationally agreed regulatory standards by member jurisdictions.

Given the extensive range of regulatory reforms currently under way, South Africa has since last year been calling for a consolidation phase where emphasis should be placed on the adoption and implementation of agreed international regulatory standards and greater understanding of the impact of new regulatory reforms on emerging market and developing economies (EMDEs). This call was firstly made to avoid unacceptable, uneven, and differing implementation of these new standards, thereby creating regulatory arbitrage opportunities globally, and secondly out of concern for the impact of the cost of new regulatory developments on EMDEs. Also, given the nature of "Tenth BCBS-FSI High-level Meeting for Africa" meeting, we need to alert global regulatory authorities and standard setters that there is a possibility of a widening gap between regulatory standards in advanced economies and those in sub-Sahara Africa, where a number of countries are only now implementing Basel II. South Africa, as a member of the G-20 and the FSB, is able to participate and, hopefully, influence formulation of policy, but unfortunately a number of our peers on the continent are not as fortunate as us and hence are denied this opportunity. South Africa, therefore, welcomes the recent decision by the FSB to allow opportunities for non-FSB members to contribute to this process and it supports the monitoring processes that have been put in place. We furthermore welcome the decision not only for the reasons highlighted above, but also so that we can obtain an independent assessment of the progress that South Africa has made in this regard.

Recent domestic developments

On 1 January 2013 South Africa implemented the Basel III framework. The implementation period for several of the Basel III requirements that were incorporated into the domestic banking regulations commenced on 1 January 2013 and includes transitional arrangements, which will be phased in until 1 January 2019. The purpose of the transitional arrangements is to afford banks sufficient time to meet the higher standards while still supporting lending to the real economy.

South Africa underwent an FSB peer and thematic review in 2013 and recently participated in an IMF/World Bank Financial Sector Assessment Program (FSAP), which was finalised towards the end of 2014. The purpose of FSAPs is to assess the stability of member jurisdictions' financial systems as a whole, and not that of

individual institutions. FSAPs are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Overall, the assessment of South Africa's financial sector and the supervision and regulation thereof was positive, with the report noting a high level of compliance and strong supervision, but found that the financial sector operated in a challenging economic environment and some gaps were identified.

Regarding the implementation of a twin peaks model of financial regulation, South Africa decided in 2011 to change its regulatory architecture into a twin peaks regulatory system. The original 2011 policy document on the twin peaks model set-out key proposals aimed at enhancing financial stability, consumer protection, and financial inclusion.[1] In terms of the twin peaks model, the approach will change from regulation by institution to regulation by objective. In this new approach, the South African Reserve Bank (SARB) will be responsible for the prudential oversight of banks, insurers, financial conglomerates, and financial market infrastructures and it will also become the Resolution Authority. The current Financial Services Board will be re-named the Financial Sector Conduct Authority (FSCA) and will be responsible for the market conduct of all financial services institutions, including banks.

Under the planned twin peaks approach, there will be opportunity to streamline the supervision of the financial system between the SARB and the yet-to-be-formed FSCA. There will be a phased approach to the implementation of a twin peaks model, starting with the enactment of relevant legislation to establish the relevant regulators. In December 2014, the National Treasury (NT) released, for public comment, the cabinet-approved second draft of the Financial Sector Regulation Bill to give effect to the establishment of the necessary regulators, their powers and responsibilities. It is noteworthy that chapter 6 of this proposed Bill deals with coordination, cooperation, collaboration, consultation and consistency between regulations, a matter raised in the 2014 FSAP report. South Africa, as it seeks to strengthen its financial system and regulatory framework, is willing to learn from all relevant stakeholders, whether here or abroad, and adopt these lessons to domestic circumstances.

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[1] See the policy document titled, *A Safer Financial Sector to Serve South Africa Better* (commonly referred to as the Red Book), released by National Treasury in February 2011.

Conclusion

It is clear that the slump in oil prices poses risks to financial system through its possible impact on stock market developments. The highly indebted US shale oil producers are possible trigger points and should be monitored. There is a risk that losses may intensify in the derivatives market.

These negative developments can affect global growth, which could remain weak in a deflationary environment, forcing central banks to inject more liquidity into their respective economies in an attempt to revive economic activity. Finally, while low oil prices are generally positive for consumers and business confidence, an extended period of low oil prices could pose a number of risks for global financial stability.

I have also highlighted the scale of the global regulatory reform process under way and some of the challenges in this regard. Given the growing complexity and interconnectedness of the global financial system, it is imperative for regulators in individual jurisdictions to cooperate and coordinate their efforts in the interest of a more robust global financial system. It is in this spirit that I wish you well as you share your experiences, ideas and insights at this meeting.