South African Reserve Bank

Opening address by Mr Daniel Mminele,
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at the G-30 Forum on Banking Conduct and Culture
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Governor Kganyago (SARB), Governor Sithole (Central Bank of Swaziland), Deputy Governor Mlambo (Reserve Bank of Zimbabwe), Deputy Governors, Groepe and Naidoo (SARB), Second Deputy Governor Sullivan (Central Bank of Seychelles), Sir David Walker (Vice Chair of the Group of Thirty Steering Committee), Dr Stuart Mackintosh (Executive Director of the G-30), Ms Maria Ramos (Chief Executive Officer of Barclays Africa), the leadership of banks and other financial institutions, panel members, and esteemed delegates.

It is a privilege and an honour for me to welcome you, on behalf of South African Reserve Bank (SARB), to this Forum on Banking Conduct and Culture, which we are co-hosting with the G-30 and Barclays Africa. The G-30 has, over the years, played a significant role in bringing together members of the banking, financial and regulatory community to discuss issues of common concern and examine the choices available to market practitioners and policymakers.

Given the enormous trust deficit that has built up since the global financial crisis, the topic of conduct and culture is of great importance and highly relevant to the global banking and financial sector.

Bankers have always had a delicate relationship with the societies they serve. It would appear that, at any point in time, it is almost a national sport across the globe to take a swipe at bankers. Mark Twain famously said: “A banker is a fellow who lends you his umbrella when the sun is shining and wants it back the minute it begins

to rain." And J M Keynes asked: "How long will it take to pay city men so entirely out of proportion to what other servants of society commonly received for performing social services not less useful or difficult?"

We would be terribly misguided to treat the current wave of discontent and deep mistrust as just another wave that will eventually subside.

The most recent global financial crisis, from which almost nine years later we are still struggling to recover, shook the very foundations of our financial system and almost caused its total meltdown. In a nutshell, the crisis was about failures in conduct, culture, and supervisory practices. The consequences are with us today in the form of multiple-agency and jurisdictional investigations, litigation, and massive penalties, the number and sizes of which are becoming difficult to keep pace with.

The task at hand, to which our deliberations here today are meant to contribute, is to see how we can restore confidence and trust in the leadership and staff of banks and other financial institutions, in the effective and efficient functioning of financial markets, and lastly but not least in the ability of regulators to give the right level of comfort around their supervisory practices. Trust is the most essential prerequisite for a healthy and useful banking and financial system.

Global regulatory standards for banking which were refined and adopted following bank failures and other financial stresses in the system, including rules such as Basel III, can help explain how financial disasters transpire and in their construct seek to address the risks, but of course only after the event. Yet these rules are not always effective in pinpointing institutional weaknesses, particularly those of a behavioural nature. The role of individuals, but also of groups or networks of staff both within and outside the employee boundaries of banks, has come to the fore as a determinant of corporate culture, which in turn has led to isolated action in some instances and institutional action in others that have eventually led to the compromise or even complete demise of banks. Inappropriate behaviour has increasingly set the tone for organisational interactions within markets, or regions, among both collaborating and competing banks. This phenomenon was especially

evident among banks in the United States that issued sub-prime mortgages; only one example of improper practices.

Banking regulation has historically been formulated by global agreement with the intent of setting minimum standards of risk mitigation for banks through the application of common measurement processes. To support these metrics, standard-setting bodies, in particular the Basel Committee on Banking Supervision, have introduced principles for risk management and governance which have focused more on the technical attributes of organisational risk-taking than on individual or collective behaviour. While the 'second pillar' of Basel III – with its enhanced coverage of all material risks and inclusion of corporate governance, culture, and values in the supervisory process – is encouraging, it appears that the rules repeatedly fail to address the organisational integrity of banks and bankers, and this has become the next frontier for ensuring the stability of domestic economies and the global financial system.

It is not an objective of regulatory oversight to stifle effort, reward, or innovative behaviour. However, in the interest of global financial stability and to ensure the longevity of the role of banking in financial systems, it has become critical that guidelines are developed to address integrity within banks as well as between banks and their clients, counterparts, and competitors – guidelines which are globally relevant, robust over time, and aspirational, and which influence behaviour across society.

The new frontier for standard-setting, however, comes with challenges. In the normal course of risk management, internal targets and banking rules take the form of a plethora of financial measures, numbers, statistics, and technical financial analysis, which form the primary toolset. The challenge is that these rules are a necessary precondition, but not a sufficient one. They help to guide compliance, which tends to speak to the letter of the rules, but seem insufficient in guiding culture, which goes further to also include the spirit of the rules.

The current charge requires the establishment of codes which are normative for individual and corporate behaviour. This is challenging from at least two

perspectives. The one is systemic: the legal paradigms of modern society protect individual rights, privacy, and autonomy. The other is practical: it is dramatically time-consuming to observe and analyse behaviour for non-compliance with codes. This also has the potential to create inordinate distrust, and this should not be overlooked by regulatory authorities.

Allow me to touch on the initiatives currently underway in South Africa, which will help in strengthening market conduct and culture.

Enhancing market conduct and culture in the banking and financial sectors: the Twin Peaks reforms

South Africa is in the throes of one of the most significant reforms to the financial regulatory landscape since the 1980s: the introduction of the Twin Peaks model of financial regulation, the heart of which includes a proposed new approach to market conduct regulation.

As most of you will know, the plan is to establish a Prudential Authority (PA) and a Financial Services Conduct Authority (FSCA). The reform process is an important opportunity to develop and enhance South Africa's market conduct regulatory framework. The soon-to-be-created FSCA, which will replace the current Financial Services Board (FSB), will be given the task of being an integrated market conduct regulator in the financial sector, with the following statutory objectives:

- Promote the fair treatment of financial customers.
- Enhance and support the integrity and efficiency of the financial system.
- Develop financial literacy and capability.
- Assist in maintaining financial stability.

For financial institutions, treating customers fairly means:

- Pay due regard to the interests and needs of customers.
- Do not engage in unfair business practices.

- Be transparent, and fully disclose all risks and rewards.
- Solve eventual problems in a timely and effective manner.

In the context of the Twin Peaks proposal, the expectation is that customers' interests should be at the heart of how firms in the banking and broader financial sector do business. Customers should expect to obtain financial products and services which meet their needs from firms that they can trust. Meeting their reasonable and fair expectations should be the responsibility of firms, not of the regulators, whose role should rather be to create a conducive regulatory environment and, through their supervisory activities, encourage good conduct.

It is important to emphasise that the proposed Twin Peaks reforms are not an adverse judgement on the country's current regulatory architecture. Rather, they are aimed at making continuous improvements to the regulatory framework which helped the domestic financial sector weather the storm of the global financial crisis better than many other countries. The Twin Peaks reforms answer the following question: "How can we do better in what we are already doing very well?"

The Financial Sector Regulation Bill provides for a broad mandate and scope for the FSCA to ensure improved market conduct outcomes in the South African financial sector. This mandate includes powers to issue conduct standards for product design, marketing, distribution, and disclosure. It also places an important onus on governance arrangements within financial institutions in order to ensure that such arrangements deliver on expected market conduct outcomes in support of the objectives of the FSCA.

Clearly, organisational culture is at the heart of improved market conduct outcomes for financial institutions, as it is 'the tone from the top', so to speak, that has the greatest impact on how a financial institution treats its customers, contributes to financial integrity, and ensures market efficiency.

Furthermore, the culture and approach to risk taking, particularly for material risk takers in regulated institutions, are a critical consideration from both a prudential and

a market conduct perspective. The Financial Stability Board has done much work in this area, specifically on the development of remuneration principles, *malus* and clawbacks for material risk takers. South Africa, as a member of the Financial Stability Board, subscribes fully to these principles. As such, both Twin Peaks authorities envisage having powers aimed at influencing the governance arrangements in regulated entities in order to ensure adequate risk outcomes from both a soundness and a consumer protection point of view, including through remuneration arrangements.

Failure to manage conduct risks can expose a financial institution to a variety of other risks which, if not managed properly, can threaten its solvency and sustainability. The regulatory regime for market conduct therefore provides a framework for the identification and management of conduct risk as a complementary framework to prudential regulation. This is part of the motivation for rigorous coordination and cooperation arrangements between the PA and the FSCA envisaged by the Financial Sector Regulation Bill aimed at ensuring that all risks are holistically managed within an overarching financial stability policy framework.

Strengthening conduct in wholesale OTC markets

Another initiative has been the development of a code of conduct for South African wholesale over-the-counter (OTC) financial markets in a collaborative effort between regulators and key market participants. I will return to this aspect later.

Against the background of various investigations undertaken in many foreign jurisdictions in relation to foreign exchange market manipulation, the SARB and the FSB launched a review of the foreign exchange trading operations of South African authorised dealers in October 2014. As the rand is a globally traded currency, the aim of the review was to establish whether there may have been any spillover into our markets in relation to any misconduct or malpractice.

It is important to note that, unlike in other jurisdictions, the South African review was not informed by whistle-blowing or any allegations – or indeed concrete evidence – of any misconduct. We had no evidence of widespread malpractice in the South

African foreign exchange market but felt that, given the broad-based nature of investigations in other jurisdictions (which also involved trading in emerging market currencies), it would be prudent to obtain comfort that our foreign exchange trading practices were in line with best practice. It was therefore a proactive step on the part of South African regulators.

The Foreign Exchange Review Committee established for this purpose – chaired by former Senior Deputy Governor James Cross, who is with us today – released its report in October 2015. The committee reported that it had found no evidence of manipulation or serious misconduct in the domestic foreign exchange market during the period covered by the review, but that there was scope for improvement in relation to governance and conduct. The committee also recommended that legislation be enhanced to give market conduct regulators wider powers to strengthen enforcement. South African regulators are in conversation with each other on how best to give effect to the implementation of the recommendations.

There was also the recommendation that a group of senior market professionals and compliance officers form a Financial Markets Standards Group, akin to the FICC Market Standards Board in the United Kingdom or the Treasury Markets Practice Group in the United States. In December 2015, the FSB began interacting with the Acting Chair of the FICC Market Standards Board, seeking opportunities to discuss possible future cooperative arrangements.

Early in the process of the review, it became apparent that South Africa would benefit from a unified code of conduct for wholesale OTC financial markets, and the decision was made to draft such a code in collaboration with market participants and other stakeholders, referencing a number of codes used in major international financial centres. The code is overarching and does not substitute market- or product-specific codes. Where applicable, the latter codes will be appended to the OTC code as subsidiary guidelines which contain detail relevant to each market and/or product.

Following the conclusion at the end of last year of the first round of public consultation, the SARB has reviewed the comments and has begun engaging with

fellow regulators and stakeholders on a revised code. It is envisaged that this process will be completed in the coming months.

The OTC code aims to ensure that the highest levels of professionalism and integrity are maintained in the South African financial markets. The code is also intended to serve as a template to assist authorities in supervising conduct in financial markets.

The code will be a living document which will continually benefit from evolving best practice, including international codes such as the upcoming Global Code of the Bank for International Settlements (BIS).

Conclusion

In conclusion, while much work remains to be done, it is nonetheless very encouraging to note that key steps have already been taken by regulators and financial institutions alike to strengthen behavioural standards in the industry. It is equally encouraging that South Africa, while largely sheltered from the global financial crisis, is embarking on measures to limit the risk of such crises occurring locally in the future, including strengthening market conduct regulations as part of the move towards a Twin Peaks system of regulation. Nonetheless, the evolution of the financial industry will bring new challenges for regulators and professional bodies alike.

In an industry where the conclusion and enforcement of contracts is based on trust – trust from the provider of capital that he/she will be fairly rewarded for the risk of potentially losing some of his/her assets; trust from the borrower that he/she will be charged a fair price for access to capital – any breakdown in that confidence can quickly lead to incorrect pricing and, in turn, improper allocation of resources. A lack of confidence in the financial system generally means rising counterparty risk, requirements for higher risk premiums, and raising the overall cost of capital in the economy.

Without sound values and proper conduct, we will not be able to restore trust, and this will affect confidence. And when there is little or no confidence, there are risks to stability, growth, jobs, and development.

Thank you.