An address by Francois Groepe,

Deputy Governor of the South African Reserve Bank,

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'Strengthening financial sector supervision and current regulatory priorities'

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Introduction

Good morning, distinguished guests, ladies and gentlemen.

It gives me great pleasure to warmly welcome you to Cape Town, South Africa, for the 13th BCBS-FSI[1] high-level meeting for Africa on 'Strengthening financial sector supervision and current regulatory priorities'.

I would like to thank you for your attendance and wish to emphasise that the South African Reserve Bank (SARB) truly values such interactions which, among other things, facilitate the sharing of each of our views and experiences as well as the establishment and fostering of professional relationships. This can only contribute towards the strengthening of cross-border regulation and supervision through enhanced relationships with our peers and thus contribute towards a safer and more sound global financial system.

Regulatory blind-spot quotes about the 2008 global financial crisis

The lessons learned from and the stories told about the global financial crisis of 2008 can never be referred to as a platitude. The crisis continues to be a constant reminder of our ostensible blind spots as well as the incessant need for us, as regulators and supervisors, to be ever aware of avoiding regulatory and supervisory complacency – notwithstanding the charges of over-regulation and the more recent attempts to roll back some of the reforms.

It is important to acknowledge that the financial sector and the risks associated with it are constantly evolving. It therefore follows that regulatory frameworks need to evolve with the sector. Increased regulation should not be construed as a burden of over-regulation, but should rather be viewed as evidence of the evolution of the financial sector as well as the associated risks and the regulatory response to them.

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[1] Basel Committee on Banking Supervision – Financial Stability Institute

I would like to share a quote with you, which relates to the global financial crisis of 2008. Barack Obama, the former US[2] President, once said:

> The question we ask today is not whether our government is too big or too small, but whether it works … Nor is the question before us whether the market is a force for good or ill. Its power to generate wealth and expand freedom is unmatched, but this crisis has reminded us that without a watchful eye, the market can spin out of control.

This quote gives impetus to the need for avoiding regulatory complacency. Efforts to constantly strengthen and enhance our regulatory platforms should therefore be viewed in a positive light.

Before the global financial crisis of 2008, while the banking world focused on the implementation of Basel 2, the extent of regulatory deficiencies was not fully known and, in hindsight, regulatory and oversight weaknesses were clearly more than significant.

The crisis of 2008 has highlighted the extent to which financial groups are embedded within economic and financial systems as well as the high degree of interconnectedness and which significantly increase spill over risks. Governments and central banks in a number of jurisdictions had to implement crisis resolution measures to stabilise and mitigate the potentially damaging effects of the failure of large financial groups on their respective economies.

The way for Basel 3 had thus been paved. These were, in essence, reactive regulatory reforms in response to the lessons learned from the global financial crisis.

Failures in supervision have highlighted the shortcomings in traditional supervisory frameworks, where oversight was restricted. This is particularly important for financial groups that operate in multiple jurisdictions and conduct cross-sector activities.

[2] United States

South Africa has recognised the integral importance of Financial Conglomerate Supervision, and significant regulatory reforms have been introduced in favour of this supervisory model. The intended outcome of these regulatory reforms is to strengthen domestic financial sector regulation, which in turn should play a part in strengthening financial sector regulation on the continent.

Evidence of regulatory complacency and the existence of regulatory blind spots may reveal itself in the form of inertia with regard to the introduction of new and enhanced regulations. I am pleased to note, however, that since the global financial crisis that inertia has lifted, as is evident in the tightening of regulation and supervision of banks on a global scale. It is further chronicled by the regular publications of the BCBS.

Proportionality and bank regulation

The Basel Standards, as developed by the BCBS, are designed to apply to internationally active banks.

In South Africa, proportionality is limited to the regulatory options embedded in the Basel framework for each of the Pillar 1 risk categories. For example, for credit risk purposes, banks may choose between the standardised approach, the simplified standardised approach, the foundation internal-ratings-based approach, and the advanced internal-ratings-based approach.

In 2012, the South African Minister of Finance approved the amended Banks Regulations that incorporated the applicable requirements set out in the Basel 3 framework.

The amended Regulations, including specific reporting requirements, took effect on 1 January 2013. These Regulations continue to apply to all banks, with the exception of mutual banks and cooperative banks. Additional capital requirements have been imposed on domestic systemically important banks.

The Regulations continue to make provision for separate and additional capital requirements to be imposed on banks based on idiosyncratic risk factors in the form of Pillar 2b capital add-ons.

The SARB prefers a risk-based approach to supervision and applies the principle of proportionality as an integral part of its regulatory and supervisory frameworks. Additional reporting requirements are imposed on banks as and when necessary.

The requirements specified in the Basel Standards remain the minimum regulatory requirements for all South African banks, with the exceptions previously mentioned.

Expected loss provisioning

International Financial Reporting Standard (IFRS) 9, 'Financial instruments', became effective for the financial periods beginning on or after 1 January 2018. This international accounting standard will significantly change the manner in which banks determine impairments for non-performing loans – and will therefore affect banks' profits and capital levels. While the aim of IFRS 9 is to ensure that impairments recognised earlier than under International Accounting Standard 39, i.e. as soon as a significant increase in credit risk has been identified and after considering forward-looking macroeconomic information, the changes required to data, processes, and systems are onerous and will require a much greater coordination of efforts between the various functions in banks, e.g. between the risk and finance functions.

Over the past three years, the SARB has engaged through various means with banks and the auditing profession to monitor the IFRS 9 implementation process by the banking industry. A significant amount of time was spent on debating technical accounting, financial modelling, and disclosure issues. There were and there remain, to some extent, some challenges to overcome.

For example, an industry-wide shortage of the necessary skills and resources, particularly suitable quantitative modelling resources, resulted in some banks finding it difficult to meet internal project milestones and targets. Consequently, some banks

had to reduce the duration of their planned parallel runs prior to the implementation date. Banks with operations across the African continent were also experiencing challenges with regard to data availability and quality suitability for impairment modelling purposes. Furthermore, IFRS 9 does not define what a 'significant increase in credit risk' is, and it was left to each bank to develop an appropriate methodology that would meet the objective of the standard. The industry, not just locally but internationally, grappled with this and other interpretative issues. The various methodologies adopted will have to pass the rigorous analysis and scrutiny that are expected from the auditing profession when they audit these accounting entries.

It should come as no surprise that IFRS 9 will also impact on bank regulators. For this reason, the BCBS issued a guidance document titled 'Credit risk and accounting for expected losses' in December 2015. This document contains, among other things, the principles that regulators will expect banks to follow with regard to expected credit loss provisioning. In March 2016, the SARB issued Guidance Note 3 of 2016, requesting banks to assess their current policies, processes, and practices against the principles contained in the BCBS document, taking into account the nature, size, complexity, and risk profile of their activities. Compliance with the BCBS requirements will be a focus area for the SARB going forward.

Another important area relating to IFRS 9 that has received particular attention is the issue of disclosure and communication with stakeholders such as market analysts. The SARB has engaged with the Johannesburg Stock Exchange on what its expectations are in terms of reporting to the market.

Given the substantial effort and dedication that has been and is still being directed at this change in the accounting framework, I am confident that we can expect a smooth transition to IFRS 9 which will serve the overall banking sector well into the future.

Declining correspondent banking relationships

Over the past few years, it has been reported that a number of the large international financial institutions have reduced their foreign correspondent banking relationships. This is a process commonly referred to as 'de-risking'.

Notwithstanding the underlying reasons for de-risking, its culmination may be that financial transactions are forced into less-regulated or even non-regulated channels, thereby reducing the transparency of financial flows and countering efforts aimed at reducing financial exclusion. This will inevitably result in increased risks of money-laundering and terrorism financing. Furthermore, the decline in correspondent banking relationships renders it difficult to effect cross-border payments and may potentially threaten the stability of financial systems in the adversely affected countries.

The World Bank and the International Monetary Fund conducted studies in 2015 and 2016 which found that one of the common key drivers responsible for the decline in correspondent banking relationships was the fact that correspondent banks did not find some of their correspondent banking relationships to be cost-effective and also perceived the money-laundering and terrorism financing risks as unmanageable. A further contributing factor was the fear of administrative sanctions and enforcement by regulators in the event of the correspondent bank being found to have inadequate systems and/or controls in place to curb money-laundering and the financing of terrorism.

The Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) conducted a survey on de-risking for its 2016-2018 work programme. A fair number of respondent banks in the ESAAMLG region indicated that correspondent banking relationships had been terminated or restricted between 2011 and 2016. The reasons cited for the terminations and restrictions varied and included, but were not limited to, concerns over money-laundering and the financing of terrorism. Countries that were particularly affected countries included Angola, Tanzania, and Zimbabwe.

The ESAAMLG survey also indicated that not all respondent banks reported having found replacement correspondent banking relationships or having made alternative arrangements. Once individuals and entities become unbankable as a result of de-risking, the risk increases that underground financial systems may develop.

The magnitude of illicit capital flows in Africa

Illicit capital flows continue to present a serious problem to authorities, particularly on the African continent. In order to resolve the problem of illicit capital flows, there is a need for coordinated efforts in sourcing data from all countries in order to understand the magnitude of the problem. One of the reasons is that the availability of data in respect of illicit capital flows is inadequate. Organisations such as Global Financial Integrity and the Organisation for Economic Co-operation and Development play an important role in attempting to estimate of the magnitude of global illicit financial flows. There are however significant challenges when it comes to conducting research in this regard.

African governments have a strong interest in stemming illicit financial flows, including through obtaining the cooperation, compliance, and commitment of other actors. In the context of absent political will in some jurisdictions, there is a need to take urgent steps towards international coordination with the intention of collecting reliable data and addressing the problem of illicit capital flow.

The need for effective crisis resolution regimes

The most recent global financial crisis has demonstrated unequivocally that there is a strong case to be made for robust resolution regimes being established for financial institutions given their vital role in any country's economy.

The global financial crisis severely compromised the stability of the financial sectors of many countries. Even in countries where the direct impact was limited, significant indirect consequences were experienced due to the subsequent global economic downturn.

This proved that more stringent supervision is not necessarily sufficient to appropriately safeguard the resilience of the global financial system and that inadequate powers to deal with financial failures pose a financial stability and a fiscal risk.

The failure or distress of financial institutions as well as the possible spillover effect that these failures can have on the wider economy is something that all countries are exposed to. History has also shown that disorderly bankruptcies lead to uncertainty, which in turn leads to a disruption in financial markets and a sharp fall in bank equity prices. To best deal with the risk that failed or distressed financial institutions might pose, regulators have to ensure that they have appropriate powers and arrangements in place to effectively contain or mitigate the risk(s) that the failed or distressed institution poses to the wider economy.

The Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes) set out the powers and tools that national resolution authorities should have at their disposal for firms in all financial sectors that could have a systemic impact if they failed. The Key Attributes also set out recovery and resolution planning requirements for such firms, and require that crisis management groups of home and key host authorities are set up to coordinate group-wide resolution strategies and plans for global systemically important banks.

The overarching objective of the Key Attributes is to assist in an orderly resolution without making use of taxpayer funds as it has been proven that the injection of capital from national authorities into a stressed institution might lead to recurring calls for further capital injections. The Key Attributes therefore aim to provide resolution authorities with the necessary powers, allowing them to recapitalise the stressed financial institution and to avoid making use of public funds as far as practically possible.

It is important for resolution authorities to have these powers to assist with orderly resolutions, but it is just as vital to put these powers to the test in a simulated

scenario. To this end, simulation exercises are powerful tools to diagnose what is not working in existing crisis management regimes and to provide training in the form of ‘learning by doing’. Simulation exercises are therefore useful in refining conceptually adequate crisis management arrangements.

Simulations, especially regional crises resolution simulations, are important for a number of reasons. The resolution of a distressed financial institution in one jurisdiction can have an economic impact on other jurisdictions, especially the neighbouring countries. Quick and adequate information sharing between home and host regulators is therefore critical considering that a chosen resolution option might be highly beneficial for the financial institution in distress but that it can also have a negative impact in the host jurisdiction if there is a lack of coordination between the home and host regulators.

As an example: a banking group in the home country might find it beneficial to sell off one of its banking subsidiaries in a host country as it will relieve the liquidity stress of the banking group within the home country, but the banking subsidiary might be significant in the host country’s financial sector and can therefore have far-reaching effects on the host country’s financial stability.

Even though cross-jurisdictional information-sharing arrangements are in place, in times of crises it is likely that jurisdictions will first act in their own best interest before considering wider regional repercussions.

A regional crisis resolution simulation would therefore assist in testing the available resolution tools, the communication plans in place, and the possible knock-on cross-border effects, thus allowing regulators to be better prepared in a real-life situation by ensuring that the most appropriate solution with the most desirable intended consequences is exercised.

FinTech

Given the rapid developments in financial technology (FinTech), it is evident that we are potentially facing one of the most severe innovation- and technology-driven disruptions to products and services, particularly in the financial sector space.

Regulators across the globe are grappling with understanding these technological developments and assessing the regulatory implications. We as the SARB favour a 'back to basics' approach. Regulators should focus on regulatory principles that are risk-based rather than creating excessive rules-based regulations aimed at these technologies or products. For example, financial regulators do not regulate the Internet, biometric technology, or mobile devices. Regulatory intervention should be appropriate and should be applied to the underlying economic function. In the case of most central banks, the regulated activities should fall within the ambit of their regulatory mandate and would typically include deposit taking, payments, lending, insurance, and investments.

The SARB has recently decided to establish a FinTech Unit, with three dedicated full-time staff members that report directly to me. This unit is required to strategically review the emergence of FinTech and assess the related user cases. Its primary responsibilities are expected to include the facilitation of the development of appropriate policy frameworks for the SARB across the FinTech domain. This will be done by robustly analysing both the pros and the cons of emerging FinTech innovations as well as the appropriate regulatory responses to these developments.

Besides collaborating locally, the SARB actively participates in international regulatory and standard-setting bodies. Work undertaken by the various working groups at the Financial Stability Board and the Bank for International Settlements has been proactive in trying to understand FinTech developments and robustly exploring its benefits, risks, and appropriate regulatory frameworks.

The SARB is committed to staying abreast of and contributing to global thought leadership on FinTech.

Cyber-risk

In addition to these FinTech innovations, we are witnessing a rise in cybersecurity risk, which could undermine financial stability. The rapid adoption of new and emerging technologies increases the possibility of technology and systems failure. Customers are demanding real-time and remote access to financial services while institutions are sharing data more freely and more frequently; this consequently creates additional opportunities for cybercriminals. Increased access along with the rise in blockchain technologies increases the number of entry points for cyber attackers. As interconnectivity increases the attack surface for cyber-hackers into financial systems, institutions need to develop a more detailed understanding of mobile, cloud, Big Data, and security technologies. Authorities should persist in increasing collaboration with industry players to ensure that integrity, security, and privacy are all part of the design, operation, and development process of innovations.

Conclusion

As has been said on numerous occasions: in these times that we live and operate, change is the only constant we are guaranteed. When presented with opportunities to learn from each other and to lean on the areas of expertise of our counterparts – global, regional, and local – none of us should offer any resistance, whatever the reasons may be. Engaging and interacting with each other is a powerful tool that we should never take for granted.

As the 19th-century French author Alexandre Dumas wrote in his famous book, *The Three Musketeers*: “One for all and all for one.” This is very relevant to us as regulators and supervisors who each play a part in maintaining global financial stability in our respective jurisdiction and in the process are contributing towards a more stable global financial system.

Please do enjoy the rest of this meeting day.

Thank you.