SOUTH AFRICAN RESERVE BANK

Keynote address by Lesetja Kganyago,
Governor of the South African Reserve Bank,
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Market conduct and financial stability

Good morning

Thank you for inviting me to speak at this inaugural industry-wide Financial Sector Conduct Authority (FSCA) Conference.

My topic today is the relationship between market conduct and financial stability.

As you know, these are the Twin Peaks of our new model for financial regulation, which came into force in 2017. This was the same landmark reform that birthed the FSCA as well as the Prudential Authority (PA).

The South African Reserve Bank (SARB), which incorporates the PA, has ultimate responsibility for financial stability. At the same time, the FSCA is the apex authority for market conduct. There is a clear separation.

Our Twin Peaks model has yet to fully mature. For instance, pension funds and collective investment schemes are expected to move to the PA only in April 2026. It is nonetheless a comparatively robust model, especially for a highly concentrated financial sector with a small number of large players, as well as for the continuous development of financial technology.

Still, even with a clear division of labour, the details of how we pursue financial stability and good conduct are more complex, and sometimes confusing. For instance, if you go to the FSCA website, you will find a list of five strategic objectives, and number one is 'ensure the stability of financial markets'.[1]

You might have thought that was the SARB's responsibility, not the FSCA's.

[1] Note that on the FSCA's website, there are five strategic objectives, of which the first is, 'ensure the stability of financial markets'. https://www.fsca.co.za/Pages/Vision-and-Mission.aspx

But of course, to protect financial stability and to restore it when a crisis breaks out, the SARB does not operate in isolation. We rely on other authorities such as the National Treasury (NT), the Financial Intelligence Centre (FIC), the National Credit Regulator (NCR) and, of course, the FSCA. Cooperation between these institutions is also institutionalised through the Financial Sector Oversight Committee (FSOC) and the Financial Sector Contingency Forum (FSCF).

Similarly, Twin Peaks clearly assigns market conduct issues to the FSCA, but that hardly means we at the SARB can ignore conduct issues. Indeed, as I shall argue in this speech, financial stability and conduct issues are ultimately connected. A system rife with misconduct will also become unstable.

Before I turn to our South African context and challenges, let me start by delving into global regulatory and conduct issues.

The global narrative on financial regulation changed completely with the global financial crisis (GFC). Before 2008, finance was widely considered an industry where light touch regulation would free smart people to generate astonishing wealth. This narrative had the most traction in the advanced economies. Indeed, financial crises were often portrayed as things that happened in emerging markets, which could usually be blamed on governments. But, of course, the GFC was triggered by events on Wall Street, the very centre of advanced economy finance. And the private sector was plainly guilty of excessive risk-taking and bad judgement.

The lessons of that crisis ushered in totally new narratives on financial sector regulation. I say narratives because there were two – a technocratic version and what we can call a popular or even populist version.

The technocratic part was about re-engineering finance to make another GFC impossible, through changes such as raising bank capital levels and intensifying supervision. Many people here are experts in this complex, jargon-heavy field.

The popular story was quite different. People saw highly paid bankers bring the economy to its knees, causing extensive job losses, and walking away with no jail time and no claw-back of past bonuses. This made a lot of people angry, manifesting in protests like the Occupy Wall Street movement.

The technocratic mindset and the populist mindset are very different, and the two are usually uncomfortable in each other's company.

Populists are often bored and uncomprehending in technocratic conversations, while technocrats usually flounder when they try and do politics.

But the lesson we must take from this is that financial stability is not just an engineering problem.

I do not think it is possible, at least in a democracy, to have a good policy regime for protecting financial stability, if you do not also have an effective regime for regulating conduct. If people feel abused, tricked or betrayed by the financial sector, they are not going to be interested in thoughtful technocratic proposals for obscure variables such as liquidity coverage ratios. Their elected representatives will not be interested either. The political discussion will centre on moral outrage and that will drain the oxygen out of technocratic debates.

You can try and push along with the technocratic work, following global best practice and debating ratios, but sooner or later the political and the technocratic worlds will need each other. You will get crises, and in crises you really need people to work together, across government, the private sector, and also civil society. If you get to that point and trust has been burnt up by misconduct, good luck getting policy right.

We live in difficult times, so the margin for error is small.

There is a very clear upshift in geopolitical tensions in the world. Our headlines are full of war horrors. This is going to be a record year for elections – and some of these election results could be highly disruptive.

We have also experienced the worst global inflation surge in a generation. Just a few years ago the monetary policy debate in the advanced economies was about inflation that was too low, about deflation risk, about tools for providing stimulus when interest rates are as low as they can go. Now we have significantly higher inflation, and although headline numbers are coming down, underlying inflation is still quite sticky.[2] Interest rates are staying higher for longer.

These higher rates are necessary to stabilise inflation. But elevated interest rates also create stress. We have seen some poorer countries, especially in Africa, lose access to global bond markets.[3] And we have seen bank failures. This month marks the one-year anniversaries of the Silicon Valley Bank (SVB) failure in the United States, and the collapse of Credit Suisse – a global systemically important bank – in Switzerland. The example of SVB is especially interesting. It was basically undone by losses on government bond holdings; not exactly risky assets, but assets which necessarily lose value as long-term interest rates rise. There are some rich ironies here. One of the lessons of the 2008 crisis was meant to be that complex derivatives and risky assets were the cause of bank failures. But here we have a failed bank that got in trouble

[2] https://www.bis.org/publ/qtrpdf/r_qt2403d.pdf
[3] https://www.imf.org/en/Publications/REO/SSA/Issues/2023/04/14/regional-economic-outlook-for-sub-saharan-africa-april-2023

because of its holdings of the world's classic safe asset, and which failed to hedge the risk[4] – in other words, that did not use derivatives. This is a valuable reminder that risk takes many forms, and the conventional wisdom of the last crisis may be misleading for the next one.

Overall, it is fair to say that we live in challenging circumstances.

Here in South Africa, our region is largely peaceful and likely to remain so. But we are not completely insulated from geopolitical confrontations, irrespective of how far they might be from where we are.

Our economy is also not growing, and there are many signs that our living standards are falling. Growth last year was just 0.6%. Since 1994, there have been only four years with worse growth, of which one was the 1998 emerging market crisis, one was the 2009 crisis, and one was the 2020 COVID-19 crisis. The gap between South African growth and world growth is now double its longer-term average.[5] We are falling behind. A big reason for this is that other places have functioning rail networks, ports and electricity.

At the same time, government debt has risen too fast and is now too high. Accordingly, we have lost our sovereign investment-grade credit rating. This is costing us dearly, through higher borrowing costs and lost investment funds.

Furthermore, we are on the Financial Action Task Force (FATF) greylist, and have been there for just over a year – since February 2023. We got this 'high risk' designation partly because of poor conduct by institutions and because of the exploitation of vulnerabilities in the existing financial frameworks relating to anti-money laundering regulations. We feel confident that South Africa will be removed from the greylist by the next review date, in 2025, given the fixes we are implementing. But this has been a costly episode for us. The lesson is that joint efforts are required to look after the integrity of South Africa's financial system. We all suffer when this is compromised.

At the same time – despite all this bad news – we must appreciate that our financial system is resilient. The test of a system is how well it handles stress. You never want to see stress. But we have had a lot of it in recent years, and the good news is that the system has largely coped well. Capital buffers have held up. We have not seen a rise in defaults that would indicate irresponsible risky lending, or large-scale ever-greening of loans designed to conceal losses – both problems experienced in various other jurisdictions, where financial systems are a source of vulnerability rather than

[4] https://www.ft.com/content/f9a3adce-1559-4f66-b172-cd45a9fa09d6

[5] Data for these comparisons are drawn from the IMF *World Economic Outlook* database and Statistics South Africa. For 1994-2022, the gap between SA and world growth averaged 1.14%; in 2023 it was 2.36%

strength. The ability of the market to get through catastrophic events like COVID-19 has been clearly demonstrated.

Of course, there are also problem cases, such as certain institutions which we put into curatorship recently. But I think those actions should be interpreted as vigilance, mitigating problems before they grow too large. In a well-regulated financial system, you are more likely to see banks being closed from time to time, rather than dysfunction being tolerated indefinitely.

Unfortunately, we cannot say the public image of the financial sector is everything it should be. It was remarkable, with the allegations last year about banks manipulating the exchange rate of the rand, how ready people were to believe that there was in fact a giant conspiracy to rig the rand, and that this had seriously weakened the exchange rate, pushed up inflation and raised interest rates.

Economists and market specialists understood that even if there had been market manipulation by some traders, the macro effects of the exchange rate being a few cents weaker or stronger for an hour or so would have been trivial. The impact on inflation and rates would have been zero. We also saw the Competition Appeal Court rule in January that there was no evidence of a general conspiracy.[6] But this was not the conversation taking place in the public domain. Most people could tell that traders were behaving unethically, plotting in chat rooms, and this misconduct was so obviously wrong, it eclipsed further analysis.

What I learnt from this is that public trust in the financial system is not as deep as it needs to be. I worry about our ability to have well-informed policy conversations, in potentially more stressful circumstances, if bad analysis can get this kind of public reaction.

Effort to bolster consumer education on the intricacies of financial regulation or financial economics are ongoing. But many people have strong opinions on the ethical questions, and especially the ethical failures. This is the stuff that can catch fire with the public. If one of these fires start, it is going to be a very difficult conversation to control, and a very difficult environment for making policy.

The solution here is the solution with all fire risk: you need to reduce the supply of flammable material, you need early detection systems, and you need firefighting equipment. For our purposes, this means you need to have a financial system which treats people fairly, where misdeeds are detected, and are then dealt with promptly and effectively. If you do not have this, the system will be fundamentally unsafe.

[6] https://www.businesslive.co.za/bd/opinion/columnists/2023-11-17-hilary-joffe-overarching-goals-make-competition-watchdog-prone-to-overreach/

Ultimately, your moral capital is like your financial capital. You need it most in a crisis, and if you do not have it, that is when you fail.

You, the FSCA, are the guardians of the financial sector's moral capital. I do not know how you devise a capital adequacy ratio to measure whether we have enough – but let us have no doubt, even if we cannot measure it, this trust is every bit as valuable as financial capital. So even though we are at the top of two different peaks, you lead on market conduct and we lead on financial stability, and we need each other to succeed.

Thank you.