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The Banking Association's 2011 Banking Summit

Keynote address by Minister of Finance Pravin Gordhan

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Good morning to the Chairman of the Banking Association, Mr Stephen Koseff; Gauteng Finance MEC Mandla Nkomfe; Bank CEO's; and ladies and gentlemen. I thank you for the opportunity to address you at this year's Banking Summit.

Financial crises, bailouts, bubbles, stress tests, real economy impacts, job losses, firm closures, prudential regulation and bankers' remuneration – these have all been key features of the global economy in the past three years.

The financial crisis has brought to the fore incisive reflections on the role of the financial sector, the scope of its operations, the excesses in pursuit of profit, the balance between regulation and freedom, the moral hazard dilemma and the devastating effects of systematic failure in the financial sector.

South Africa is certainly allowed some self-congratulation. The financial sector and the regulators must be congratulated on their respective contributions to ensuring the resilience of the sector during the 2008 crisis. This was mainly due to a sound and robust regulatory framework, with our banks remaining well-capitalised, with limited exposure to high risk and foreign assets.

The domestic banking sector has also grown to the rest of the African continent and continues to be active and competitive in financial markets elsewhere around the globe.

To date, the domestic banking sector remains resilient in the face of volatility and turbulence in global markets, with well-capitalised and relatively profitable institutions.

However, due to the interconnectedness in the global financial system, South Africa remains vigilant in order to mitigate any financial stability risks. The uncertainty of the stability of the European banking system, the European sovereign debt crisis and the recent US downgrade constitute serious downside risks.

The role of the banking sector in the SA economy

The banking sector certainly plays a critical role in the realisation of the developmental aspirations of any country, including South Africa. The sector acts as a catalyst for economic growth and employment creation, and ensures sustainable economic development for the country and its people. It provides a platform for ordinary citizens to transact and exchange payments for goods and services. Through its important intermediary role, the financial services sector touches the lives of ordinary people around the globe.

In South Africa, the financial services sector contributes about 10.5 per cent of the annual gross domestic product (GDP). Moreover, the sector also employs above a quarter of a million people, translating to about 4 per cent of total formal employment in this country.

As Government's New Growth Path is implemented and our efforts to rebalance and restructure the South African economy proceed, the role of the financial sector generally and the banking sector in particular will come more sharply into focus. The question that will arise is: how does a sustainable and competitive financial sector contribute to inclusive economic growth and greater labour absorbing industries, and promote more energetically enterprise development and the creation of 5 million jobs by 2020?

The financial services sector has an important role to play in the attainment of these goals. Being such a significant player in the economy and an important anchor for the growth of the real economy, it is important that the sector remains competitive, well regulated and stable. But equally, the current times, both globally and in South Africa, require that there be better alignment with our national imperatives and a clearer commitment to playing its rightful role in our country's development.

Lessons of the global financial crisis

There are many lessons arising from the global financial crisis. First, the lesson from history is that recovery from a financial crisis takes longer than from other recessions. In a study done by Reinhart and Rogoff (*"This time is different: Eight centuries of financial folly"*) they note three distinct phases: first, a prolonged fall in asset prices; second, a fall in output and employment, and finally an explosion in government debt, all of which we have seen. Internationally, we are seeing the third phase in full swing.

The next lesson is that there is a need to take a holistic view of the financial sector – hence the call for a shift towards a macro-prudential perspective in regulation, as a complement to the micro-prudential regulation, i.e. the focus should be on the system, in addition to the soundness of individual institutions.

Third, we need to deal with the challenge of moral hazard. Explicit or implicit taxpayer guarantees for losses result in excessive risk-taking behaviour.

Fourth, the challenge of privatising gains and socialising costs impacts on the livelihoods of millions of families and imposes on sovereign debt.

Lastly, through the interconnectedness of the global channels of funding, we have learned that risks emanating from one part of the global financial system can be rapidly transmitted across borders at the speed of light, with disastrous consequences for the global economy.

For example, the developments we have witnessed in Europe and the USA over the past few weeks have had the impact of dampening the nascent growth we have witnessed in the global economy, and created greater uncertainty on the overall picture of economic recovery.

We might want to heed the excruciation of Samuel Brittan when he reflected in an article in the Financial Times recently on the financial markets in the developed world:

> "It goes without saying that we need mechanisms for channelling surplus savings into physical investment, for a second-hand market in titles to ownership, for shifting personal spending over time, for saving for old age, and much else. But when these markets become overextended to the point of determining the fate of governments it is time to call a halt. This is especially the case when the funds in question arise from artificially created money rushing across frontiers. To change the metaphor, it is the tail wagging the dog."

As an example, Northern Rock began as a simple building society in Newcastle, taking deposits in order to finance homes. Over time, it morphed into a complex bank, with domestic and international capital markets as its primary source of funding. To support this funding, it securitised its mortgages. We all know how the rest developed. John Plender, also writing in the Financial Times, makes the important point "…..as banks moved from conventional deposit taking and lending to trading in all manner of paper instruments in the 1980s and 1990s, ancient wisdom about appropriate bank assets was junked…".

As banks increased in complexity, scope and offerings, they took on more risk. While in the short term, this increased risk appetite boosted their returns, in the long term this was devastating.

From these experiences rises the dynamics we have seen in reforms in the global financial system.

Global financial regulatory reforms

At the international level, South Africa remains an active participant at G-20 forums, including the Financial Stability Board. The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF). The FSF was founded in 1999 by the G7 Finance Ministers and Central Bank Governors.

In November 2008, just after the Lehman phenomenon, the Leaders of the G20 called for a larger membership of the FSF. The FSB was then established. This board is to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. Central to its work is the realisation emerging from the 2008 global financial crisis, that public policy has a critical role in the regulation of markets in order to prevent the build-up of excesses and put in place mechanisms to protect the poor and vulnerable from the effects of boom – bust cycles.

As such, globally, we have committed to:

- Implementing the Basel III bank regulations
- Developing a framework to supervise Systemically Important Financial Institutions (SIFIs).
- Implementing the internationally agreed principles for the compensation of financial sector employees
- Improving critical market infrastructure such as securities exchanges, OTC derivatives markets and credit rating agencies. As Government, we have already initiated legislation in this regard.
- Exploring the regulation of the shadow banking system.

We will continue to build on this financial sector regulatory reform agenda to plug any gaps and overlaps that may exist in the current framework. However, we are cognisant of the need to adapt international standards to local conditions where appropriate. In applying international standards, due consideration will be taken to ensure that international standards are implemented in a robust framework but with appropriate flexibility so as not to unfairly prejudice South Africa's economic growth and development.

Proposed reforms to the South African financial services sector

Let me now turn to the South African reforms, which will be discussed more extensively here later today.

As you know Treasury has released a policy document entitled "A Safer Financial Sector to Serve South Africa Better". Implicit in this title is the connection between the stability and wellbeing of the financial system and the wellbeing and development of society more generally – a connection we need to explore a lot more in the South African case.

In order to further strengthen the regulatory architecture and to mitigate the cost of financial crises in the future, we have decided that South Africa should move towards a "twin-peaks" model of financial regulation.

This approach envisages the separation of prudential regulation of financial institutions and locates it within the SARB while locating the responsibility for market conduct regulation and consumer protection within the Financial Services Board (the local FSB). It is hoped that this change will help to address the challenges faced by consumers with regard to high and at times opaque fees and unfair treatment. In addition, it will also coordinate the implementation of the comprehensive Treating Customers Fairly (TCF) initiative.

The twin peaks model recognises the different skill sets required for prudential and market conduct supervision and further emphasises that, in order to protect the consumer, it is necessary to prioritise the regulation of the market conduct of financial sector participants. The creation of an independent market conduct regulator within the Financial Services Board will strengthen consumer protection, particularly in the area of retail banking. The challenge therefore will be to strike a balance between improvements in financial sector market conduct regulation on the one hand, while continuing to focus on the soundness and prudential regulation of the sector on the other hand. This is the dual task that we hope the leadership of the banking sector will embrace and work with us on.

The implementation of the proposals contained in the policy document will be championed by a task team that was formed comprising of the South African Reserve Bank, the Financial Services Board and the National Treasury.

In the months ahead, the task steam will focus on engagements with various stakeholders and developing a roadmap for the implementation of the proposed reforms.

Market conduct regulation: the banking enquiry panel

In the Treasury's policy document, we outlined a number of changes in the area of market conduct, consumer protection and financial inclusion, including a new approach to dealing with high and opaque bank charges, as well as insurance and savings charges. We are clear that although financial stability is an important policy objective, it is certainly not the only priority – market access and consumer protection will remain a key focus area for policy and regulatory reform in South Africa.

Access to banking

While there has been an improvement in the number of adult South Africans who are banked - from 51% in 2006 to 63% in 2010 – more can certainly be done. I am aware that institutions have recently undertaken innovative developments in this area. I certainly think that those can be reinforced and speeded up. Technological advances have made mobile banking solutions a reality and made it possible to have viable points of banking presence in even deep rural areas. These innovations must surely make it possible to bank more than 70% of adult South Africans by 2013.

The future architecture of the banking sector in South Africa

We mentioned earlier that the South African banking sector did not experience the financial upheaval seen in advanced economies during the 2008 financial crisis. However despite the strengths mentioned, the domestic banking sector is still faced with significant challenges.

Financial inclusion

Financial inclusion in banking is one of these. The pace and scale of the sector's financial inclusion efforts is something I hope you will reflect upon a lot more.

In its diagnostic over-view, the National Planning Commission states that "*for those South Africans who are excluded from the formal economy, live in informal settlements, depend on social services which are either absent or of very poor quality; the political transition is yet to translate into a better life.*"

We therefore need to speed up the collective efforts of the financial sector, organised labour, community constituencies and Government in our contribution to improve and to ensure financial inclusion for all those South Africans who are currently excluded.

For the financial sector in general, the launch of the financial sector charter in 2004 was a good start in setting concrete targets for transformation for the sector as whole, and for the banks in particular. Under the financial sector charter, significant strides have been made with respect to lending to black SMEs, black farmers, low-cost housing, transformation infrastructure and BEE finance as well as improvements in the employment profiles in all tiers of management and governance.

I have been advised that the Financial Sector Charter Council is very close to finalising its proposals for the Financial Sector Code. The Minister of Trade and Industry and I keenly await the update from the Charter Council on the revised draft agreement for our consideration.

Cooperative banks and community-based co-operative financial services

As we all know, there are high levels of concentration in our banking sector. According to the Bank Supervision Department, the four largest banks in South Africa accounted for 84.6 per cent of the balance-sheet size of the total banking sector as at the end of 2010, a level similar to that recorded in 2009.

It is therefore crucial that we create diversity in banking in order to achieve healthy levels of competition.

In this regard, we promulgated the Cooperative Banks Act in 2007, in terms of which the Cooperative Banks Development Agency was established in 2009.

Since 2009, two co-operative banks have been registered and 19 applications are being considered. There are currently over 121 co-operative financial institutions with about fifty nine thousand members and over R175 million in savings.

Many of these cooperative financial institutions are community-based and are small in scale. There is a need for the scaling up of cooperative financial institutions in order to absorb the high and growing demand for financial services in many of our communities. I have requested the CBDA to convene a meeting between the Banking Association and the associations of cooperative financial institutions to work out some collaborative efforts to promote the growth and sustainability of cooperative financial institutions.

Lending to SMEs

This is also a challenge in South Africa. One of the critical areas where banks can make a significant contribution to support the robustness and vibrancy of the real sector of our economy is the area of lending to small and medium sized businesses. These businesses are the largest employment creators in any economy. Our view is that the domestic banking sector can do more to support these businesses.

For example, SME lending as a share of gross credit exposure has been deteriorating in the recent past from an average peak of 16 per cent in 2009 to 10.4% in June 2011. Cognisant of the important role that the SMEs play in the development of the economy and the creation of jobs, these figures are an indication that more can be done to service such an important sector of the South African economy.

More resources should be directed to this sector in order to promote entrepreneurship and ensure that SMEs continue to make a meaningful and more substantial contribution to the economy.

Remuneration

Following from global discussions, excessive remuneration in a context of increasing inequality and the exacerbation of the ‘insider/outsider’ phenomenon is still an unresolved issue amongst us. The pursuit of certain objectives with increasing rewards as the sole tool is a race, I suggest, to the bottom. More will have to be done by this industry to establish different benchmarks based on a different value system. We might also ask, where are the Warren Buffets of South Africa – those who will say voluntarily ‘I have enough, I need to share for the benefit of all’? Bold moral and business leadership is needed and needed urgently to take South Africa in a different direction of hope and progress for all.

Recommendations of the banking enquiry panel

Let me briefly make reference to these recommendations. Over the past year, I know there has been some progress in areas such as:

- Lowering of penalty fees on dishonoured debit orders;
- Improving the management of current debit order systems, and greater transparency of ATM fees and charges;
- The implementation of a standardised switching code to promote ease of switching bank accounts between banks; and
- Improving consumer education.

However it is clear that while we have left it to the banks to take undertake unilateral action with regard to appropriate pricing strategies and levels, we would like to see a reduction in the overall levels of the fees. We plan to have further engagements with the industry in this regard.

Conclusion

I hope your deliberations during this summit will be robust, interesting and fruitful. We look forward to engaging with each one of you on the issues we have raised and those you will raise during this summit, and together building a safer financial sector to serve South Africa better.

To quote an article by Sim Tshabalala (CEO of Standard Bank South Africa), which appeared in the Business Day in July 2011, *"Given the scale and depth of South Africa's problems, banks can and should do more to contribute to transformation, growth and development. It is arguable that they (banks) need to look hardest in these areas: investment in job-intensive sectors, SME financing, co-operative financing, infrastructure and agriculture financing".* I cannot agree more with this statement from one of your own and look forward to working with you to achieve these objectives.

Thank you.