The Central Bank's Financial Stability Mandate: Sizing up Twin Peaks in South Africa

By:

Gerda Van Niekerk

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Introduction

The basic roles that central banks have traditionally had were those of maintaining price stability and financial stability, and acting as lender of last resort. The financial stability role of central banks globally was not one of its initial core roles and developed only at a later stage, notably around 1914. Bordo indicates that, after World War I, central banks began to be concerned about employment, real economic activity and the price level; and they began to attach a greater weight to maintaining the stability of the domestic economy.

Milton Friedman, arguably the foremost neoliberal economist, in 1967 submitted that "the monetary authority could make a major contribution to promoting economic stability". He opined that the state should not have a heavy hand in the economy, but he allowed that the Federal Reserve may try to curb inflation by manipulating the money supply. But nothing more than that.

In the new global economy, the financial stability mandate of central banks has become a key instrument of financial regulation. In this contribution the move in South Africa to the Twin Peaks financial regulation landscape will be analysed against the background of the changed financial stability mandate of the South African Reserve Bank. Debate continues whether the neoclassical economics behind the price stability mandate of the central bank, should be replaced or amended by alternatives. This contribution seeks to examine the question whether the change that Twin Peaks has brought to the financial stability mandate of the central bank, changes the way neoliberalism believes that monetarism will promote economic stability. This contribution will endeavour to show that the new explicit financial stability mandate of the central bank, could be a progression of the SARB to becoming a semblance of a developmental bank.

Financial stability, as a function of central banks

The central bank's financial stability mandate cannot be exercised in a vacuum. The mandate should be implemented within the parameters of an enabling legislative framework for financial regulation. Such regulation should focus on providing an optimal institutional architecture to facilitate the execution of this crucially important mandate.

Before the 2008 global financial crisis (GFC), central banks generally did not have explicit financial stability mandates to be carried out within a designated regulatory framework that focused on the content and extent of such mandate and the manner by which and measures through which it should be sought to be achieved. They also did not have an explicit legislatively entrenched obligation to conduct macroprudential or system-wide surveillance, within a dedicated framework, of all the financial institutions (and not only banks) that were active in a given financial market.

The 2008 GFC revealed the crucial importance of financial stability; and it emerged as defining regulatory pursuit post-GFC with emphasis being placed on the role of the central bank as "keeper or guardian of financial stability". In their Framework for Financial Stability, the Group of Thirty recommended that, where not already the case, central banks should accept a role in promoting and maintaining financial stability. They further recommended that, in countries where the central bank is not the prudential regulator, it should have a strong role in the governing body of the prudential regulator – thus acknowledging the essential link between prudential regulation and financial stability.

Rationale behind the move to a Twin Peaks system of financial regulation in South Africa

Although the financial sector in South Africa had withstood the 2008 GFC relatively successfully, it was clear that some important changes were necessary. The South African financial services industry functions in an international environment where there is significant interconnectedness between financial institutions and a crisis in one economy can spread to another. This position increased the risk of financial instability and heightened the need for appropriate supervision of the financial sector. Accordingly Treasury indicated that the 2008 GFC, being a watershed event in the context of financial regulation, emphasized the need for better coordination of monetary and fiscal policies in financial regulation as well as the need to focus on prevention and management of systemic risks .

The South African government, at the 2010 Seoul Summit of the G-20, undertook to rethink the fragmented domestic system of financial regulation and committed itself to the global financial reform agenda in order to strengthen financial stability in South Africa.

The South African National Treasury subsequently gave momentum to the reform of financial sector regulation in South Africa by issuing a policy paper entitled “A Safer Financial Sector to Serve South Africa Better” in February 2011. This document, commonly known as “the Red Book”, considered the lessons learnt from the GFC and assessed the structure and characteristics of South Africa's financial sector for gaps and weaknesses. After considering other approaches to financial regulation, National Treasury identified the Twin Peaks model of financial regulation as the appropriate regulatory approach that South Africa should embrace in the future to provide the legal and institutional framework and broader context for implementing the various regulatory changes that had to be made.

The first stage of South Africa's move towards a Twin Peaks system of financial regulation is encapsulated in the Financial Sector Regulation Act, 9 of 2017 (FSR Act), designed to put the Twin Peaks architecture in place. On 21 August 2017, more than six years after the publication of the Red Book, the President signed the FSR Act into law. The commencement date of the Act was 1 April 2018.

The gist of the South African model is that the financial sector would be made safer (and thus more stable) through a comprehensive financial stability framework, backed by a stronger prudential and market conduct framework, each located in a separate regulator. The Prudential Authority (PA) is the entity responsible for prudential supervision of the wider spectrum of regulated financial institutions. The Financial Sector Conduct Authority (FSCA), as market conduct authority, is responsible for protecting consumers of financial services and promoting confidence in the South African financial system by regulating and supervising the market conduct of financial services providers.

The SARB's financial stability mandate in terms of the FSR Act

The Twin Peaks model revolves around three main themes, namely financial stability, prudential regulation and market conduct regulation. It accords financial stability a prominent position and clearly envisages that both prudential and market conduct regulation will serve the greater objective of systemic stability.

The main focus of the FSR Act is financial stability. In the Act the concept of financial stability is described as the status quo that originates when financial institutions generally provide financial products and services and market infrastructures generally perform their functions and duties in terms of financial sector laws. Both these efforts are attained without interruption, and are capable of continuing to be attained despite changes in economic circumstances. Moreover there is general confidence in the ability of financial institutions to continue to provide financial products and services and market infrastructures to perform their functions without interruption despite changes in economic circumstances (section 4).

The role of the SARB as central bank in relation to financial stability was thus changed significantly by the FSR Act. The mandate of the SARB is expanded to include promoting, maintaining and restoring financial stability (section 11). And the SARB's oversight of systemic macroprudential aspects of the financial system is expanded by establishing a comprehensive legal framework for macroprudential supervision. This amplified and express mandate includes the obligation to identify systemic risks in the financial system (section 14(1)), taking all reasonable steps to prevent systemic events from occurring (section 15(1)(a) and, if it has occurred, to mitigate the adverse effect thereof on financial stability (section 15 (1)(b)). The FSR Act provides that the Governor may by written notice designate a financial institution as a "systemically important financial institution" (SIFI) (section 29(1)(a)) inter alia subjecting it to heightened prudential regulation (section 30(1)) and increasing its loss absorbency capacity and requiring the SARB's concurrence in its rescue or resolution should it fall into distress (section 31). This power to designate and regulate SIFIs is a significant new power afforded to the SARB in the context of financial stability.

The SARB does not however have a carte blanche as to how it will exercise its financial stability mandate but must exercise this mandate within a policy framework agreed with the Minister of Finance (section 11(2)(a)). The SARB may utilise any power vested in it as central bank (section 11(2)(b)) and must have regard to the roles and functions of other organs of state exercising powers that affect aspects of the economy (section 11(2)(c)).

Considering the current ongoing COVID-19 pandemic, the question comes to mind whether that constitute a systemic risk. It is my submission that it does not seem to be the case on the surface. Although the economy was slowed and growth is currently almost zero, there was no financial instability as such. It appears as if the Twin Peaks model has enabled the SARB to weather the pandemic admirably, considering that the Rand has kept its value. On 28 February 2020, before the first lockdown, the exchange rate for 1 USD was R15.6645. On 1 March 2021 the exchange rate for 1 USD was R15.047

This expanded financial stability mandate has to be exercised by the SARB in the broader context of the Twin Peaks model. The FSR Act creates a legislative and institutional framework dedicated specifically to facilitate the effective execution of such mandate. It also provides a broader framework enabling the effective implementation of the complete Twin Peaks model of financial regulation. Herein the SARB plays a pivotal stabilizing role.

Objective of the SARB and neoliberalism

In terms of section 3 of the 1989 South African Reserve Bank Act (SARB Act) , the primary objective of the SARB was stated to be the protection of the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic. The SARB thus had the responsibility for implementing monetary policy aimed at price stability. This was also confirmed in section 224(1) of the Constitution in 1996. This mandate has been expanded by the FSR Act to also include that the Bank is now also responsible for protecting and maintaining financial stability as envisaged in the FSR Act of 2017 (section 3(2) SARB Act).

It is widely accepted that neoliberal (or neoclassical) economics informs the law behind the SARB's mandate of price stability. Previous studies have reported that neoliberalism could be oversold, since neoliberal polices can increase inequality because they sometimes undercut growth, which is the exact thing they mean to boost . The question that now comes to mind is whether this new financial stability mandate of the SARB is also informed by neoliberal (or neo-classical) economics? According to Zongwe, neoliberal theorists believe that "the route to greater economic growth and higher levels of welfare for all goes through reducing interventions by the state in the economy….". Since the SARB is empowered to actively promote, maintain and restore financial stability, it is submitted that this mandate deviates from neoliberal economics. Although a principle of neoliberalism is "stabilization", in pure neoliberal economics, the central bank will not interfere in the economy by heightening the prudential regulation of SIFIs. Pure capitalism would expect the market to correct this, and that it should not be corrected by regulation, thus from outside the economy. It is the author's submission that the explicit financial stability mandate of the SARB is a deviation of neoliberalism.

The central bank as developmental central bank

Neoliberalism is often criticized that it increases inequality and undercuts growth. Taking into account the history in South Africa and inequalities that stem from colonialism and apartheid, one has to consider whether neoliberalism should be embraced by the SARB. The question that has to be answered is whether another option, namely that of the central bank becoming more of a developmental bank, should not be considered.

Zongwe maintains that, in a developmental state, the central bank could behave as an agent of development, although he does not regard South Africa as an example of developmental statism. He points out that a developmental state exhibits amongst others the characteristics of a robust bureaucracy, respecting the market but intervening in it, and the promotion of domestic industry. He refers to Sibiya that maintains that South Africa does not have a professional and highly skilled bureaucracy to be a successful developmental state. The problem, as Gumede argues, is that South Africa is still very far from becoming a fully-fledged developmental state. The author attributes this to the weak policies and policy confusions in South Africa, even 25 years after democratization. He suggests that a clear development agenda should be put forward by the ANC Government for the implementation of the National Development Plan - Vision 2030. Some critics claim that the Twin Peaks model is only a neoliberal tool, but writer hereof affirms that South Africa should retain the Twin Peaks model because the SARB's financial stability mandate as written into the FSR Act, combines ideas from both neoliberal and developmental-state theorists. This combination of theories can also be seen in the mandate that the FSR Act assigns to the FSCA in the Twin Peaks model, namely to protect consumers.

In view of all that has been mentioned so far, it is proposed that South Africa as a developing country needs to have a central bank that has the semblance of a developmental central bank, and that takes care of consumers, different than the orthodox, neoliberal central bank that focuses on price stability and lowering of inflation and expect market forces to protect consumers. The Twin Peaks model of financial regulation where the central bank is explicitly appointed as the guardian of financial stability, could be a small step on the way of the SARB becoming such semblance of a developmental central bank.

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