

Chapter 7

ASSESSMENT OF THE FINANCIAL REGULATORY REGIME IN SOUTH AFRICA

1. Introduction

The boom in the global financial industry over the past few decades has been fuelled by an explosive combination of economic growth, demographic changes, technology and financial innovation. In this rapidly changing world¹ the optimal alignment of regulatory instruments has become a complex and highly dynamic process. Not surprisingly, even tested approaches to standard regulatory challenges now require some serious reconsideration. Indeed, “change is the only constant”.

Not only South Africa, but also the industrialised countries are faced with fundamental changes in their socio-economic environment. For example, the following structural changes are evident: the decreasing powers of the national state in a world consisting of offshore financial centres² and “e-citizens”; the attainment of the upper limits of the social welfare state; pressures for lower (global) taxes and thus a smaller state; the massive migration of refugees from one nation to another; and the ageing of the population in the West. In the South African context the socio-economic challenges may even be greater than those faced in the industrialised countries, because of the country’s underlying dualistic nature³ and the problems caused by nearly half the population being undereducated, and as such unemployable, in what are today known as the “knowledge economies”.

Section 2 emphasises the evolutionary trends in

South African financial regulation. In this section the following basic questions are posed: “What is so different today on the regulatory front compared with, say, a decade or two ago? And what is to be expected in regulation during the next decade?” To address such issues an effort is made to identify the engines of socio-political change and to evaluate, against this background, whether the use of the regulatory instruments was appropriate. The projection of the South African economy during the next decade is based on a supply-driven econometric model that ultimately is driven by available production factors such as fixed capital stock, skilled labour and multi-factor productivity. Thereafter, a rough guess is made to see whether the financial system is able to confront these economic challenges with a degree of confidence.

Against the socio-economic background of Section 2, Section 3 attempts to identify existing regulatory gaps, and thus set the regulatory targets,⁴ in the current financial system. The emphasis is on three issues, namely institutions, markets and infrastructure. The last section sets out a few possible guidelines for the South African regulatory regime in the years ahead.

2. The evolutionary trends in South African financial regulation

Regulation takes place in a specific socio-economic environment. Although it is not the aim of this section to sketch in any detail the socio-political developments of the past, nonetheless note has to be taken of this environment in the overall assessment process.

Accordingly, a short summary is first given of the socio-economic background, and then the regulatory issues are addressed in greater detail.

¹ The shape of financial markets is set by factors such as financial engineering, computer technology, e-commerce, volatile international capital flows and powerful global financial conglomerates.

² “By some estimates more than half of the world’s stock of money passes through offshore centres, about 20% of total private wealth is invested in those centres and about 22% of banks’ external assets are invested offshore.” See Francis, J. “The Bahamas perspective”, in *The Financial Regulator*, Vol. 4, No. 4, London: Central Bank Publications, 2000, p. 27.

³ As reflected, for instance, in a highly sophisticated financial sector in what is basically a lower-income developing country.

⁴ Regulatory targets are usually aimed at improving the regulatory instruments – irrespective of whether the authorities or the markets use these instruments.

2.1 The socio-economic environment during the past few decades and prospects for the next decade

Table 7.1 summarises some of the key variables and characteristics of the South African economy and the role that the financial sector plays in it. The aim of the table is not to present yet another economic projection. The aim is rather to present a *conservative scenario*, which highlights possible future trends and emphasises some of the major constraints placed on the economy. Obviously, the scenario presented may prove unrealistic, but from a planning point of view “stress testing” of the regulatory environment has to be done. The scenario assumes world economic growth of some two per cent per annum and stable terms of trade for South Africa. The following remarks can be made:

- *Demographic developments:* After the population had grown at an average rate of 2,3% p.a. during the past two decades, it is expected to flatten out from 2007 onwards. The population may even fall from 2010 onwards, mainly owing to the impact of diseases (e.g. Aids, TB and malaria), as well as better birth-control measures. In fact, during the next 15 years some 12 million people may die from Aids and the population is likely to peak at some 50 million at the end of this decade. The average life expectancy of South Africans may even drop to a mere 40 years by 2015. The financial sector will be affected in a number of ways as a result. For instance, retail banks may experience no real growth in credit extension, bad debts on mortgage finance may rise sharply (another consequence of Aids), and there may also be major claims on medical aid schemes and insurance in general. The term structure of the banks’ loan books is likely to become shorter, which may have an adverse effect on long-term fixed investments.
- *Households:* Without any material increase in real savings, households will struggle to reduce their debt to more acceptable levels. The impact of Aids will make this reduction even more difficult. People will spend less on normal consumption items, but significantly more on health care. Being

already heavily taxed, households are expected to make no material contribution to the national savings and thus fixed investments in the foreseeable future. At best they will remain neutral, even though this sector accounts for as much as 63 per cent of GDP. In this environment it will be very difficult for the government to encourage microlending to disadvantaged communities.

- *Corporate sector:* This sector is likely to be the sole engine of economic growth in the immediate future. To support long-term economic growth of say some 1,5 per cent per annum, the nation’s gross capital formation has to be some 18 percent of GDP (it is currently around 16 per cent). Net foreign capital inflows have financed about 15 per cent of South Africa’s gross capital formation since the end of 1994 and, on the basis of *net* capital formation⁵, they amounted to over 70 per cent. This dependence on foreign savings to finance local investments will remain the Achilles heel of the South African economy until the government and private households start saving seriously again. For a relatively open economy⁶ such as South Africa, import protection has progressively fallen away in recent years. Moreover, in the years ahead, as Aids takes its toll, the corporate sector may have to rely increasingly on highly skilled, imported labour (particularly in the securities markets). Although profit margins in corporate banking are already thin, competition in this sector is likely to remain stiff as foreign banks may start to operate more aggressively in this market segment. A shakeout of cost-inefficient banks is to be expected in future, which in turn may require the involvement of the central bank in a number of ways.
- *Government sector:* The finances of the state are overstretched on nearly all fronts, as reflected in the general government’s dissaving since the early 1980s. From the government’s point of view, its

⁵ Net capital formation is equal to gross capital formation minus the depreciation of existing capital stock.

⁶ Total imports and exports account for around half of the nation’s output.

Table 7.1: Socio-economic indicators of the South African economy						
Demographics						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Birth rate	%change pa	3,0%	2,9%	2,7%	2,4%	2,1%
Death rate	% change pa	0,9%	0,8%	1,0%	1,6%	2,4%
Aids deaths	number pa	-	10 231	105 650	426 846	828 488
Normal death	number pa	284 926	305 600	323 571	337 440	344 096
Total population	millions	32,4	35,8	39,9	45,4	50,5
Total population growth	% change pa	2,5	2,3	2,2	1,8	0,9
Labour market						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Highly skilled labour/total employment ratio	%	10,2	12,7	14,3	16,0	17,5
Highly skilled labour/total employment ratio	% change pa	3,2	2,1	3,0	1,6	1,0
Real output per worker	% change pa	0,7	1,5	3,7	1,5	1,5
Real wages	% change pa	1,0	0,8	3,8	1,5	1,5
Capital/labour ratio	% change pa	1,9	2,1	3,4	2,0	2,4
Total labour force growth	% change pa	2,6	2,6	2,7	2,5	2,3
Unemployment rate	%	24,1	33,3	39,6	42,8	41,6
Saving						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Net household saving/disposable income	%	5,9	3,1	1,2	0,7	1,3
Net corporate saving/corporate profits	%	23,3	24,0	19,8	16,9	15,8
Net government saving/government revenue	%	-8,5	-21,0	-14,8	-9,8	-9,4
Total gross domestic saving/GDP	%	23,5	17,3	15,1	15,2	16,4
Fixed investment						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Gross fixed capital formation	% change pa	-3,6	-1,7	3,0	3,7	1,9
Gross fixed capital formation/GDP	%	21,8	16,1	15,9	16,1	17,9
Net capital formation/GDP	%	6,0	1,7	3,5	3,6	4,5
Real capital stock	% change pa	2,5	0,6	1,6	1,9	2,0
Gross foreign direct investment/GFCF	%	-	0,8	6,9	7,0	5,5
Net foreign direct investment/GFCF	%	0,0	-3,1	-0,7	-0,5	-1,0
Net capital inflow/net capital formation	%	-21,5	-48,5	70,7	31,3	15,9
Net capital inflow/gross capital formation	%	-5,8	-5,2	15,0	7,0	4,0
Debt exposures						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Household debt/disposable income	%	47,4	52,5	59,7	58,3	57,8
Government debt/GDP	%	33,0	42,0	49,2	52,9	60,9
Foreign debt (non-monetary private sector)/GDP	%	6,2 (85-89)	3,8	5,0	6,0	7,5
Foreign debt/export earnings	%	100 (85-89)	91,0	102,7	105	108
Output						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Actual GDP growth	% change pa	1,4	0,2	2,0	1,3	1,1
Potential GDP growth	% change pa	1,5	1,5	2,0	2,0	1,5
Government sector						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Total government consumption expenditure/current income	%	73,7	79,0	73,4	72,5	73,8
Total government fixed investment/GFCF	%	6,9	13,9	11,9	12,2	12,0
Total taxes/GDP	%	22,2	24,1	25,2	25,9	25,7
Total tax on imported goods and services total/imports	%	7,8	8,7	4,8	4,2	4,5
Monetary sector						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Real prime rate	%	1,6	5,8	11,3	8,6	7,9
Real effective exchange rate	% change pa	-0,7	2,1	-4,2	-1,9	-1,0
Real domestic credit extension	% change pa	2,0	0,4	7,8	1,0	1,0
Headline inflation rate	% change pa	14,7	11,9	7,2	5,2	5,5
Financial sector						
		1980-1989	1990-1994	1995-1999	2000-2004	2005-2015
Real financial sector output/GDP	%	14,8	16,1	17,2	17,5	17,0
Real financial sector capital formation/GFCF	%	21,6	22,9	23,1	23,5	23,0
Financial sector imports/total imports	%	6,0	3,7	3,0	3,2	3,0

Note: GFCF = Gross fixed capital formation

major concern remains the possibility of a fiscal debt trap. Although the structure of government finances has improved materially since the mid-1990s, the impact on government debt of a structurally lower inflation rate and a more competitive open economy has not yet fully worked through the public accounts. Because government has committed itself to a high level of consumption expenditure for socio-political reasons, virtually no funds remain for public fixed investments. Privatisation is one possible solution in this context. Although the level of government debt is currently not too far out of line with international standards, the interest costs of servicing this debt are nonetheless placing a severe burden on the state's finances. The management of government debt will be a major challenge in the years ahead.

- *Total economic output*: The sustainable growth rate of real output of the South African economy is likely to be some 1,5 per cent per annum for the medium term. This relatively low growth rate is due to the impact of Aids, a low level of fixed investments, the scarcity of highly skilled labour and relatively low productivity. In this depressed macroeconomic environment, the financial sector may try to support its historical growth performance by progressively investing abroad. This scenario implies that local financial institutions would aim to become global conglomerates, which in turn would have some major consequences for local regulators.

2.2 The regulatory regime in the 1980s

The 1980s were a period when the first hesitant steps were taken by the authorities to free the economy from over-regulation. A generation ago the regulatory world was quite different from what it is today. For instance, during that period: regulators hardly looked beyond the national frontiers (despite rapid growth in cross-border business); capital requirements were based on simple gearing ratios of capital to total assets; off-balance-sheet items were virtually disregarded

(derivatives were unheard of); consolidated supervision was an unknown concept; country risk was little heeded (because "countries don't go bust"); the financial sector components – banks, insurance and the capital markets – were regarded as separate species nationally; regulators seldom spoke to one another; international contacts were just beginning; and supervisory co-operation at an international level (not to mention co-ordination or standardisation) was still only a pipe dream⁷.

Owing to its politically isolated position, South Africa followed these international trends rather sluggishly in the 1980s. In fact, co-operation with foreign regulators was nearly non-existent, and as a result the regulatory structure became progressively out of line with international best standards. In South Africa, the process of deregulation only started to gain momentum in the 1990s. These local developments will be analysed now by looking at the three pillars of the financial system in somewhat greater detail, namely financial institutions, markets and infrastructure.

2.2.1 Financial institutions

The true forces of competition arrived only recently in the South African financial sector. For instance, banks have started to compete on price (i.e. interest rates) only since early 1983 (i.e. with the abolishment of the Register of Co-operation). Building societies had favourable funding benefits from the government that effectively resulted in controlled lending and deposit rates until the mid-1980s. Price competition between banks and building societies started in earnest on the asset side on their balance sheets in 1984 (when Standard Bank came into the bond market) and on the liability side in 1998 when the phasing-out of the tax privileges on building societies "shares" began⁸. A level playing field between banks and building

⁷ Cooke, P., "The future of financial regulation", *The Financial Regulator*, Vol. 4, No.1, London: Central Banking Publications, 1999, p. 23.

⁸ Building societies were immediately forced to start competing on a level playing field for deposit funding, even though they continued to benefit from the endowment factor of the tax-privileged share funding for another 5 years.

societies materialised only with the Deposit-taking Institutions Act of 1990 (renamed the Banks Act in 1996). Money-market funds were not yet available as an alternative to bank deposits.

Owing to South Africa's politically isolated position until 1994, competition from foreign banks was very limited in the 1980s. Foreign banks were exclusively active in the corporate market, often concentrating solely on their home clients' businesses in Africa. In fact, some of the major overseas shareholders (e.g. Standard Chartered, Barclays and ABN AMRO) disinvested their South African bank holdings for political reasons in the mid-1980s. Local financial companies picked up these shares cheaply, which resulted in even higher levels of financial power in the local market. By 1994 the four largest banks granted more than 80 per cent of all local credit.

Competition among the long-term insurance companies was (and still is) limited due to "industry agreements". The fiscal aspects of life assurance contracts were co-ordinated effectively by the Life Offices Association (LOA). Most insurance companies and associated bodies toed the line of the LOA in respect of illustrative values, replacement of life assurance contracts and disclosure policies. Likewise, competition between assurance intermediaries (agents and brokers) was based mainly on the "quality of services" rendered and only to a limited extent on price. Insurance commissions paid to intermediaries are still statutorily capped and not disclosed to the paying consumer, implying that usually the maximum commissions are charged.

As the 1970s and 1980s were characterised by low, and often negative, real interest rates and high inflation, the insurance industry was in a preferential competitive position *vis-à-vis* the banking sector. Another major factor that benefited insurers was the preferential tax treatment of income (on the basis that the insurer was treated and taxed as the "trustee" for the policyholders). This resulted in an uneven playing field, and the Sixth Schedule of the Income Tax Act was subsequently amended in the early 1990s in an attempt to restore this imbalance (it was eventually

replaced by measures in the Insurance Act⁹). Moreover, the fiscal regime was particularly attractive to insurers as the government turned a blind eye to the long-term contractual impact of inflation. This favourable competitive position of the insurance industry was reflected in the rapid growth of its market share during the 1980s.

2.2.2 Securities markets

Seen from an international perspective, the development of the South African securities and investment institutions and business was seriously delayed, mainly because of uneven playing fields for the various financial institutions. For instance, banks were in an unfavourable competitive position *vis-à-vis* the insurance industry, and the development of the securities market was effectively constrained by the lack of competition on the Johannesburg Stock Exchange (JSE). Price competition on the stock market only arrived after the Big Bang on the Johannesburg Stock Exchange in 1995. Prior to this date, stockbrokers competed solely on their "quality of service". They could not trade as principals with their clients (but could with other brokers) and had to rely on their limited personal resources for capital purposes. As a result, stockbroker investment in the exchange's trading, clearing and settlement systems was neglected (which only became particularly evident towards the end of the 1990s).

Considering all the trading restrictions imposed by the JSE on its members¹⁰ prior to the Big Bang, the opening of the futures market (SAFEX) in 1989 was a welcome sign of somewhat greater price competition in the securities markets. Initially this competition was limited to futures on equity indexes. Futures on individual shares had not yet been developed or approved.

In South Africa the bond market started very

⁹ Insurance companies (long- and short-term) were regulated by means of a single Act, namely the Insurance Act 27 of 1943. This act was separated only in 1998 into Long- and Short-term Insurance Acts.

¹⁰ For instance, single-capacity trading, fixed commissions, no corporate membership, floor trading and unlimited liability structures.

informally and rigidly in the late 1960s when institutions began purchasing bonds directly from the, then, Department of Finance (now the National Treasury). Eskom (the electricity parastatal) started to make markets in its own stock as well as government bonds in the late 1980s. Statutorily the JSE was the only formal bond market until 1996, because bonds were a form of security as defined in terms of the Stock Exchanges Control Act, 1985. However, an active informal bond market existed outside the JSE, particularly among well-capitalised merchant banks. It was only in the early 1990s that bond brokers became proper financial intermediaries between institutions and the government (and other issuers) in both the primary and secondary markets. In 1989 the informal and formal bond markets were combined into the Bond Market Association (BMA), which in turn was transformed into a formal exchange, the Bond Exchange of South Africa (BESA) in 1996.

2.2.3 Financial infrastructure

The financial sector's infrastructure was rather rudimentary in the 1980s. Incentive structures between the regulator and the regulated were unknown at that time, and transparency and accountability were generally poorly developed. Industry codes of business conduct and ombudsmen procedures to address consumer complaints were established under the auspices of voluntary industry arrangements in 1985 for life assurance and in 1989 for short-term insurance respectively, but not for banks and financial advisers.

The disclosure regime in the 1980s clearly left room for improvement. Banks at that time were not subjected to certain provisions of the Companies Act, which implied, for instance, that their (secret) reserves were not disclosed. With some of the key data missing from the banks' balance sheets, the creditworthiness of banks was difficult for investors to judge. In fact, creative accounting and the non-reporting of major off-balance-sheet positions were standard practices in banking at the time. The disclosure requirements for insurers were even less demanding. In essence, the chief actuary, in line with the stipulations of the

Insurance Act and LOA policies, took responsibility for disclosure, and the policy always seemed "the least said the better". Last but not least, various corporate structures – e.g. nominee companies, non-voting shares and pyramid company structures – obscured ownership and effective control in South Africa in the 1980s.

At this time, companies were not required to comply with formal corporate governance rules.

2.3 The regulatory regime in the 1990s

To face the challenges of financial innovation, capital mobility and global financial conglomerates, the ethos of regulation changed rapidly after the late 1980s. The structure of regulation moved strongly in the direction of deregulation, with significantly more reliance on market forces. More important was that the consumer moved more to centre stage and that for the first time the authorities took consumer protection issues more seriously. As a result, corporate governance rules, disclosure, transparency and accountability became key concepts in regulation.

During this period, international experience was broadly along the following lines:

- Financial regulators and supervisors started to meet regularly in national and international groupings;
- national financial regulatory regimes were edging closer together, producing much greater international cohesion;
- core principles of supervision for banks were developed and widely adopted, if not yet effectively implemented universally, and similar efforts were made for the capital markets;
- basic concepts for capital-adequacy measures were agreed upon;
- fundamental concepts of the management of risk and associated emphasis on effective management control systems were becoming increasingly accepted as the cornerstones of supervisory practice; and
- in a world increasingly dominated by complex international financial groups, supervisors were striving to devise effective global arrangements.¹¹

¹¹ Cooke, *op. cit.*, p.23.

Until the early 1990s South Africa somewhat lacked these international developments, but after its political isolation came to an end in the mid-1990s, the country quickly adjusted to international standards.

2.3.1 Financial institutions

Today banking in South Africa is a highly competitive industry. In the span of a decade, with the exception of the few constraints on foreign banks,¹² competitive constraints on banks have been removed. However, competition between banks and the securities market is not yet on a level playing field, owing to a range of restrictions on the issue of commercial paper and corporate bonds.¹³ Despite initial opposition from the banking industry, money-market funds¹⁴ as a competitive alternative to bank deposits, appeared on the financial scene in 1997.

During the 1990s not much happened on the securitisation front in South Africa, but considering international parallels, the next decade could see some massive changes. In fact, to encourage the financing of *inter alia* housing or small business through the securities markets, securitisation may be a key concept in future. Initially the banks resisted securitisation as their attention was focused on growing their interest income and holding the assets on their balance sheets.

¹² For example, foreign banks may currently not accept deposits of less than R1 million from the general public.

¹³ For instance, commercial paper to obtain operating capital may only be issued by a listed company with net assets exceeding R100 million. In addition, commercial paper has to be issued in denominations of R1 million or more, unless –

- the paper is listed on a recognised financial exchange.
- the paper is endorsed by a bank.
- the paper is issued for a period longer than five years.
- the paper is issued or backed by the government.

Moreover, only the following persons may be ultimate borrowers of the money obtained from the general public against the issue of commercial paper:

- The issuer.
- Subsidiaries and holding companies of the issuer.

These restrictions make it utterly impossible at present to use the securities markets as a competitive alternative force for small business finance.

¹⁴ These funds are managed as a subdivision of the unit trust industry and are today an important section of the market.

However, during the second half of the 1990s, banks started to reassess their policies of holding all assets on the balance sheet, because of higher capital requirements (particularly for developing countries), increased compliance costs in banking, the entry of new niche and foreign banks, and the need to eliminate cross-subsidisation to ensure long-term profitability.

The favourable competitive position of the insurance industry established in the 1980s continued into the 1990s. In 1980 the insurance industry output was 27 per cent of the value added in the financial sector, and its contribution in 1995 had grown to 42 per cent.

2.3.2 Securities markets

The Big Bang on the Johannesburg Stock Exchange took place in 1995, heralding price competition, corporate membership and dual-capacity trading. The previous lack of stockbroker investment in the exchange's trading, clearing and settlement systems was now evident and even massive investment since Big Bang has not succeeded in resolving all the outstanding issues. Even today, settlement on the JSE is an activity that requires a degree of patience, as it is carried out on a fixed basis only once a week¹⁵.

Compared to the levels of competition faced by exchanges in the industrialised countries today, South African securities markets are still sheltered¹⁶ against the competitive gales blowing abroad. Nonetheless, South African's exchanges are not immune to foreign competition. For instance, international participation is about half of the turnover on SAFEX, and a third on both the BESA and the JSE. Because the JSE adjusted so late to international competitive forces, it now trails behind these international developments, with shortcomings in its organisational structure (perceived to be expensive), clearing and settlement systems (unacceptably out of date) and listing requirements (not yet fully comparable to international requirements).

¹⁵ Settlement is non-contractual and for no fixed date, it takes place from every Tuesday, but can be extended at times for weeks if there is any problem with the scrip delivery.

¹⁶ Mainly by the protection offered by existing exchange-control regulations.

The situation is exacerbated by a perception of high transactions costs. Of course, there are reasons for this state of affairs. For example, the JSE is involved in expenses that are not faced *to the same extent* by SAFEX and the BESA, such as the supervision of securities firms' capital-risk adequacy¹⁷, an education programme for the general public¹⁸, control systems to police insider trading (a requirement of the Insider Trading Act) and the costs of assisting the Securities Regulation Panel (SRP). Despite its high operating costs, the JSE will be protected from serious competition from abroad (or locally) as long as the securities traded are not fully dematerialised and foreign-exchange controls remain in place.

During this period, despite strong opposition from the JSE, the activities of SAFEX were extended to futures on individual shares in 1997 (although they only became accepted a few years later). The JSE successfully countered this shortly afterwards by introducing warrant instruments on individual shares. Meanwhile the Bond Market Association established itself. OTC trading in bonds was phased out slowly from 1989 and totally eliminated with the formal implementation of the Bond Exchange of SA (BESA) in 1996. Prior to licensing, the BESA implemented an electronic trade matching, clearing and settlement system (delivery versus payment).

The commercial paper and corporate bond markets are poorly developed in South Africa, because of the constraints imposed by the Banks Act (see Section 2.3.1 above). These restrictions could be lifted, in principle, when Parliament has approved the proposed Collective Investment Schemes Control Bill, the Investment Services Bill and the amendments to the Companies Act. However, in the absence of this legislation, the Registrar of Banks is hesitant to deregulate this market, as small investors need protection against the abuses still possible under

current legislation (as was evidenced in the Masterbond and Supreme Bond debacles during the early 1990s).

2.3.3 Financial infrastructure

The first corporate governance rules were published by the King Commission in 1994; risk-based capital requirements, in line with the EU directives, were introduced for banks in 1991 and for securities firms in 1995; banks (not other financial institutions!) were required to report in terms of the generally accepted accounting rules in 1996; and consolidated accounting rules for financial conglomerates (and therefore the avoidance of double counting of regulatory capital) were made mandatory for banking groups in 2000.

In rapid succession, minimum international standards were introduced, for example in respect of capital adequacy, accounting and audit, and disclosure. Of the 25 Core Principles set by the Basel Committee¹⁹, South Africa has implemented today 80 per cent fully and 12 per cent partially, though 8 per cent are not addressed at all. The outstanding areas are mainly related to items such as loan classification, concentration within portfolios, intra-group exposures, country risk management, money laundering, consolidated supervision and timely corrective action against banks which fail to meet prudential requirements (e.g. the revocation of their banking licences). After the implementation of the new Regulations under the Banks Act (probably later in 2000), South Africa will fulfil some 95 per cent of these Core Principles and partially fulfil the remaining 5 per cent.

Statutory formalised adjudicator offices were established during the late 1990s for banks and pension funds, and draft legislation on the recognition of voluntary schemes in the insurance industry²⁰ is currently being prepared.

Despite the initial opposition of the industry, the

¹⁷ For banks the Bank Supervision Department of the SA Reserve Bank carries this expense. Most securities firms are *de facto* supervised in terms of their capital adequacy by the JSE and not by the BESA or SAFEX or even the FSB.

¹⁸ Strictly speaking, public education is not an exchange task – not even the education of the investing public.

¹⁹ For details of the principles see the Bank for International Settlements' Website at: <http://www.bis.org/publ/bcbs30a.htm>

²⁰ During the 1990s Short- and Long-term Insurance Ombudsmen were appointed voluntarily by the respective South African insurance associations, which pay their remuneration and the administrative expenses.

authorities started to improve the infrastructure of the insurance industry during the mid-1990s.

Early in 2000, significant progress had already been made, as reflected *inter alia* in a detailed disclosure regime for consumers (i.e. the Policyholder Protection Rules in accordance with the Long- and Short-term Insurance Acts). Financial advice and the intermediary services will be subjected to regulatory requirements soon (with the promulgation of the Financial Advisory and Intermediary Services Act expected later in 2001). Moreover, the development of the different codes of business conduct and ombudsmen procedures will become more and more important and could even become a statutory requirement.²¹ In fact, South African insurers today fulfil substantially 13 of the 17 core principles set by the International Association of Insurance Supervisors (IAIS)²², and partially fulfil the remaining four core principles. Most of the shortcomings are in the area of corporate governance, internal controls, transparency of reinsurance and conduct of business (i.e. investor protection).

Likewise, major strides were made in the securities markets by 2000 to improve the financial infrastructure of markets. All exchanges are moving towards fully automated trading, clearing and settlement systems – ideally all seamlessly interconnected.²³ The JSE is undergoing a major restructuring process, mainly aimed at improving listings requirements to ensure greater competitiveness with overseas bourses and better investor protection. This entails *inter alia* that listed companies should comply with generally accepted accounting practices, more disclosure and transparency, suitability standards for directors, a rise in the minimum public float, and a higher and longer profit history before listing will even

be considered. It is expected that the majority of these changes will be implemented on the JSE in October 2000. Of the 30 Core Principles of securities regulation set by IOSCO²⁴, South Africa complied fully with 24 and partially with 6. Shortcomings were mainly in the area of investor protection, too much informal oversight, not enough enforcement powers, inadequate clearing and settlement systems, and issues related to financial fraud and money laundering. With the proclamation of the Financial Advisory and Intermediary Services Act, South Africa will fulfil all IOSCO's Core Principles except for some specific measures against financial fraud, money laundering and clearing and settlement standards.

2.4 The expected regulatory regime in the 2000s

Obviously the future is and will always remain unknown. Nonetheless an indication of possible future developments has to be given for regulatory planning purposes. Based on the projections given in Section 2.1 above, the socio-economic scenario a decade from today may be rather depressing. Of course, better socio-economic conditions may materialise in reality, but regulators are by nature more interested in the downside potential. The power of “negative” thinking cannot be ignored in this context²⁵. Accordingly, consideration must be given to an economic environment dominated by the impact of Aids, a lack of domestic savings, a high dependence on foreign capital flows, increased globalisation of local companies and even greater poverty among the uneducated part of the population. The optimal regulatory regime has to be designed against this background.

Based on current trends in net capital formation, the supply of highly skilled labour and multi-factor productivity, the South African economy has an output growth potential of some 3 per cent per annum at best. This optimistic scenario assumes no impact

²¹ With the exception of the Pension Funds Adjudicator, none of the ombudsmen are “statutory”. They are all voluntary and at best there is a contractual obligation on the institution. In time to come it is likely that the various industry codes and adjudicators will run in tandem with the statutory codes of conduct and adjudicators.

²² For detail of the principles see the IAIS's Website at: <http://www.iaisweb.org/framesets/pas.html>

²³ Floor trading on the JSE was abolished in 1996 and eventually on the BESA in 1998.

²⁴ For details of the principles see IOSCO's Website at: <http://www.iosco.org/download/pdf/1998-objectives-eng.pdf>

²⁵ Indeed, even luxury ocean-going sailing yachts, exclusively used for recreation, should be able to withstand gales.

from Aids. However, if no affordable defence against, or cure for, Aids is found, sustainable GDP growth may be reduced to some 1,5% p.a. by 2005, implying that actual GDP could be some 10% lower in 2010 than it would have been without Aids. So, within a decade, the country may be faced not only with a marginal decline in its population, but also with stagnant economic output. Moreover, Aids will be expensive in terms of its opportunity costs. Medical expenses, lower productivity, sick leave, early retirement (but with insufficient retirement funds), and the expensive retraining of new staff (for relatively short periods) may result in a massive increase in bankruptcies among small companies that are by nature highly dependent on a few key persons. Moreover the social problem of a potential 2 million orphans will place a heavy burden on the government's social expenditure budget. With more than a quarter of the South African workforce potentially affected by Aids by 2005, large companies are likely to soften the blow by greater automation. As domestic savings are already low, larger companies will have to rely increasingly on retained earnings to finance these investments.

As the monetary authorities are *inter alia* responsible for systemic stability, the capital-adequacy rules for financial institutions and other infrastructural requirements will have to be reconsidered in the light of all this. To secure the foreign financing of domestic fixed investments, the authorities have to ensure that foreign creditors deal with local financial institutions that are sound and safe, despite all the potential macroeconomic setbacks. No doubt these prudential requirements will be harsh for South African financial institutions, but as the county is so dependent on foreign finance, the attitude overseas may be more or less along the lines of "beggars can't be choosers".

2.4.1 Financial institutions

In a stagnant economic environment, the existing socio-economic dichotomy of South African society may increase even further in the years ahead. In fact, local financial institutions may follow a similar trend

by falling into two broad categories – global financial conglomerates and specialised local financial institutions. In future the large South African banks are bound to become truly complex financial groups with a sharp international focus to their business. In South Africa, their main focus is the corporate and government sectors as well as relatively wealthy households, but the delivery of financial services to the poor and small business sectors may become an "unprofitable sideline" activity (i.e. mainly for socio-political reasons). With their corporate clients borrowing and investing around the globe, banking has become a 24 hour-a-day business with major trading operations in the different time zones. Ultimately, these global banks will cluster in only a few financial centres like London and New York where they can source the important parts of their business – particularly their most skilled and highly priced employees. Business in Johannesburg may become no more than an important branch for such South African-owned global banks. For these institutions, national boundaries become increasingly unimportant, *inter alia* because it is becoming difficult to define a domestic market (as reflected in for instance remote trading²⁶). Global banks will be under severe competitive pressures to reduce costs and thus try to eliminate cross-subsidisation wherever possible.

By contrast, financial services to the poor in South Africa are likely to be supplied by more specialised financial institutions, such as core banks (see Section 3.13 below), mutual banks which specifically foster community banking and various types of savings co-operatives²⁷. These institutions are very small compared to the few large global banks in South Africa, but have the advantage that they are in much

²⁶ Commercially the distinction between "international" and "domestic" has disappeared. Only the regulators and the tax authorities still have to hold on to these concepts, as the state, in contrast to companies, is dependent upon the taxes it levies.

²⁷ These various legal entities, e.g. village financial services co-operatives, credit unions, microlenders, start-up venture capital providers and *stokvels* all operate on an effective exemption basis under the Banks Act, 1990 (rather than being legitimised by it).

closer contact with their supporting communities²⁸. Considering the type of lending they are involved in, their dependence on skilled personnel is far less critical than for complex financial groups.

The challenges facing the banking industry in the years ahead seem twofold. Firstly, how to ensure that the financial sector remains systemically stable in an environment of rapid technological change and sharply increased competitive conditions. And secondly, how to ensure that banking services are delivered to the broad community which includes the poor. These challenges entail, in essence, two conflicting regulatory goals and accordingly different instruments would have to be used to address them simultaneously. In Section 3 below, three specific regulatory targets and regulatory instruments are proposed in this context: increasing global competition in the local financial markets (Section 3.1); the development of the commercial paper and corporate bond markets in South Africa (Section 3.5); and the establishment of core banks (Section 3.13).

2.4.2 Securities markets

Since the securities markets are almost totally dominated by wholesale transactions, they are exposed even more than the banks and insurers to the influences of technology and globalisation. As technology improves, the competitive position of the securities markets becomes enhanced virtually automatically *vis-à-vis* the traditional financial intermediaries. And, as exchanges become more global in nature (typically starting with remote trading), the competition displays an increasingly international character. Already South African securities are traded simultaneously in Johannesburg, London, New York, Frankfurt and Zurich. The local bond market is a very liquid market with major

foreign participation. There is a potential, over the next few years, for new large markets to develop quickly in South Africa. These new markets in commercial paper, corporate bonds and securitised assets are bound to have a major impact on the financial system in general and the banking industry in particular (see Section 3.5 below). In future the government bond market may shrink somewhat owing to the proceeds from privatisation and greater fiscal discipline, but private enterprises (including banks) are expected to make increasing use of the securities markets. The end result of this type of enhanced competition from the securities markets will be lower interest margins and reduced loan business for banks. In fact, some of the undercapitalised banks in South Africa may be forced to look for assistance in the securitised asset markets, *inter alia* as a means to fulfil their capital adequacy requirements²⁹.

The South African securities markets will probably face a period of increased consolidation in the years ahead. This consolidation process is an international phenomenon and it is unlikely that South Africa can distance itself from it. Consolidation in the securities markets is driven by factors such as the following:

- Consolidation processes in the United States and particularly in the European Union (with the euro creating new financial markets) are bound to have major side-effects in South Africa.
- Deregulation and freer trade are helping to consolidate international firms into a handful of international financial centres.
- Technology, particularly in clearing and settlement systems, will support economies of scale and thus the consolidation of various exchange activities.
- The tendency of capital to look for low costs, high-quality skills and lenient regulation, results in the

²⁸ A close tie with the local community is extremely important in the South African context because the government cannot always ensure law and order in the townships and rural areas. As a result, the large banks have hesitated to lend in these areas as the operational risks were considered simply too great.

²⁹ If a bank is undercapitalised and its shareholders are unwilling to support it in a rights issue, one alternative for the bank would be to securitise part of its assets (usually mortgage loans and instalment credits) and so reduce the size of its asset book in line with its available capital.

consolidation of finance into a few financial centres with international efficiency³⁰.

- The international wave of mergers in finance is shaking up entrenched businesses. These mergers are, as a rule, across borders, as securities firms, banks and fund managers build their global businesses.
- To improve their risk-management systems, particularly operational risks and thus human resource management³¹, there is a strong pull towards centralisation in a firm.
- The financial industry likes to cluster because clusters create innovative – and therefore competitive – businesses³².

There is little doubt that the securities markets in South Africa will become even more international in the years ahead. Similar to the banks that have already established major treasury operations in their overseas branches, the securities markets (exchanges) may start to reallocate part (or even all) of their operations abroad. Such a development would imply that all securities traders in the local market could become remote traders. An international trading platform for the South African securities markets would have a number of powerful advantages. These are for example: the full integration of local operations with the international capital markets; strongly capitalised institutional traders; access to a large pool of highly skilled labour and expertise; and a level playing field between local and overseas brokers.

Liquidity, the Achilles heel of the securities markets, will be further enhanced if the traditional exchanges

could be broken down into three separate (but seamlessly connected) operations: (i) execution; (ii) clearing and risk management; and (iii) settlement and delivery systems. In essence, an exchange proper only trades in information. Accordingly the execution of trades could be conducted in future on many different platforms simultaneously. Execution specialists could be the traditional exchanges (or various competing exchanges), Internet exchanges, or any other form of electronic community network (ECNs). The clearing and risk-management operations of a market could well, in future, be taken over by the large primary dealers, such as J.P. Morgan, Merrill Lynch, Morgan Stanley and ABN AMRO. These firms have first-class trading names internationally, extensive capital resources and expertise. The clearing-house for South African securities could, in such a scenario, become part of an international clearing system such as Euroclear (which is operated by J.P. Morgan). In future the execution of securities trades could well be performed on various platforms, predominantly from abroad. Clearing could be carried out domestically by a large international specialist in this field. Traders would have a choice of more than one of these clearing systems³³ as they would be compatible.

Because separately operating clearing and risk-management systems can simultaneously deal effectively with many different execution channels, competition in trade as well as cross-market risk management will improve. Such systems also allow for better netting of trading positions, both in the spot and derivative markets. Finally, the settlement and delivery system (including a central depository) could be operated as a separate local activity, although it could be provided by the same institutions running the clearing systems (as already happens with Euroclear).

If South African securities markets develop roughly along the abovementioned lines, the local market could well split into two tiers. The first tier would consist of blue-chip multinationals that are likely to have their

³⁰ Around the world no self-respecting politician lacks plans to turn his/her city into a capital of finance. For most cities this is simply a pipe dream. Drawbacks in South Africa are, for instance, that the country is not a net exporter of capital and is a long distance from industrialised countries. Anyhow, the promotion of a financial centre is not a regulatory task, but primarily a responsibility of the central bank.

³¹ Major losses have occurred in the past because human management was too dispersed (e.g. Barings, UBS, NatWest and Daiwa).

³² Of course, a “rough neighbourhood” will chase the muses away. And without the arts (particularly artful business lunches), the skilled staff of the banking industry cannot be truly happy. A financial centre simply cannot blossom on a “sports” culture.

³³ In the international securities markets there is, for example, the choice between Euroclear, Clearstream and Clearnet.

primary listings on the London Stock Exchange and their secondary listings on the JSE. Their internal governance and prudential standards would be world class and accordingly have immediate access to the international capital markets and no exchange controls. The foreign home regulators would do the regulation of these companies, while South Africa would become in essence a host regulator. The South African National Treasury could also be part of this first-tier market. It is in the government's interest to have a notable slice of its bonds listed abroad (i.e. either as eurorand bonds or international bonds). The reasons for an overseas presence by the Treasury are the familiar ones, such as enhancing liquidity standby facilities, securing capital inflows or simply raising the government's profile abroad. Already commodities and currencies are trading around the globe, so it is probably only a matter of time before bonds and equities will do likewise. The basic problem seems to be that global capitalism is not matched by a "global society".

The second tier in the securities market would consist mainly of local companies, with local clients and local personnel. The local authorities would be the home regulator for this market segment. The standards for this second-tier market may be close to but not necessarily the same as those of the first tier, because of some country specifics. As the top 25 companies on the main board of the JSE account for some 80 per cent of market turnover, the second-tier market will be relatively small in turnover and therefore less profitable for broking firms.

Today, the exchanges in the major financial centres cross borders with ease. This in turn results in sharply increased competition and remote trading. The exchanges are under huge pressure to reduce costs and to consolidate in strategic critical areas so that they stay competitive. To facilitate this transformation, exchanges are changing their ownership structures from mutual to shareholder-owned organisations. An exchange owned by shareholders, rather than its trading members, has the advantage that it avoids conflicts of interest, which in turn enhances quicker and cleaner decision making. Once this change in

ownership structure is complete, the exchanges look critically at their execution, clearing and settlement structures. These fundamental functions in turn can be consolidated or split off. For instance, clearing and risk management can be consolidated with other exchanges (e.g. embracing both spot and derivative exchanges) or cross-border (e.g. consolidating local and foreign clearing systems), and execution functions can be placed on a highly competitive basis (e.g. traditional broking *vis-à-vis* electronic broking channels). To date, international experience indicates that alliances between exchanges are more popular than full-scale mergers. Although the ultimate aim of the exchanges may be to create a "virtually integrated market", a "network of networks" seems, for the time being, to be more probable than such a single integrated network. In short, the immediate aim is a large expansion of remote trading.

No doubt, from a regulatory perspective, the securities markets will become a major focus point in future, not only because of the expected dynamic growth in this market segment, but primarily because the new and changing aspects require the regulatory framework to keep pace. In summary, some of the issues that the regulators have to address are the following:

- *Commercial paper and corporate bond markets:* The development of these markets seems only a matter of time, and South Africa clearly lags behind international trends here. How are the regulators to support these developments without compromising consumer protection goals?
- *Securitised asset markets:* Seen from an international perspective, like the commercial paper market, this market is grossly underdeveloped in South Africa. One of the reasons might be that the underlying regulation is still dominated too much by banking legislation.
- *Clearing and settlement systems:* Particularly worrying here are the outdated settlement systems of the JSE. Globalisation of the execution activities in the equity market (either the JSE or a new competitive exchange) are a possibility.

- *Remote trading and foreign competition:* Electronic trading is bound to change the structure of the local securities markets fundamentally. The key issue for the regulators is the impact of remote trading on systemic risk management. The regulatory example for the authorities could be the foreign-exchange markets, where the market itself is free of regulation, but not its participants³⁴.
- *Competition from e-exchanges:* Although it is still early days, the regulators have to now consider carefully the possible consequences of the execution of trades through *inter alia* the Internet.
- *Liquidity management and systemic support:* As the securities markets grow in size, their importance in systemic risk management grows proportionally. The authorities face here the fundamental question of under what conditions they are willing to support these markets during a liquidity crunch.³⁵
- *Circuit breakers and super-regulation:* The super-regulation of markets becomes of crucial importance if one market stops trading³⁶ and other markets continue trading in similar instruments or their derivatives. Should the authorities impose circuit breakers on exchanges? And, if so, should these circuit breakers be applied automatically to other exchanges as well (local and abroad) in times of a liquidity crisis? The current trend is for exchanges to move away from the use of circuit breakers.
- *Cross-market risk management and netting:* Typically, the questions faced here by the regulators are whether effective cross-market risk can be managed properly if every exchange manages in isolation only the risk exposures of its own members, or whether trading positions in different exchanges may be netted for prudential requirements.
- *Supervisory structures:* Currently the capital adequacy of banks is supervised by the SA Reserve Bank, whereas that of brokers by the exchanges (predominately the JSE) themselves. The regulators have to consider whether it is better, from both a competitive and prudential viewpoint, to supervise the prudential requirements of all securities firms (i.e. exchange members as well as OTC firms) centrally using systems similar to Euroclear.
How the authorities decide to deal with each of the above issues will have a major impact on the competitive position of the South African securities markets during the next decade. Clearly, the securities regulators face “interesting times”.

2.4.3 Financial infrastructure

In recent years, major progress has been made with improving the infrastructure of the South African financial system. However, it is unlikely that the speed of change will slacken in the years to come. In order to support the three pillars of the financial system (i.e. institutions, markets and infrastructure), three sets of incentive systems (i.e. internal governance, supervision and market discipline) have to be developed rapidly. These incentive systems have both a private and a public-sector dimension.

Private-sector incentive arrangements

- *Corporate governance rules:* As a matter of urgency South Africa’s corporate governance rules have to be adjusted to best international standards.
- *Accounting and audit rules:* Generally accepted accounting rules have to be made compulsory for the financial reporting of any company in order to enhance transparency. The Companies Act requires an urgent amendment in this respect. Likewise, audit rules have to be improved to international best standards, particularly for global financial conglomerates.
- *Disclosure and transparency:* Many adjustments have been made in this area since the mid-1990s, but there is still plenty of scope for providing better information to the financial press. An example would be far more useful

³⁴ In the foreign-exchange markets, brokers use one another’s systems (e.g. Reuters), trade at the same price and exchange the same legal contracts.

³⁵ In fact, during crisis management, the authorities are always confronted with the trade-off between the provision of liquidity and the implied moral hazard.

³⁶ For whatever reason: e.g. computer failure or a liquidity crisis.

information on competitive structures and investors' support profiles.

- *Market monitoring and discipline:* As the securities markets become increasingly placed in a competitive position, it becomes easier for the market to monitor and discipline traders and financial intermediaries. The authorities have to support this market process wherever possible and generally give the markets greater responsibilities.
- *Private-sector ratings:* The authorities, for prudential requirements, have to recognise more explicitly the ratings of private-sector agencies, particularly their ratings of financial institutions and securities market instruments.
- *Capital-adequacy rules and value-at-risk systems:* Although the authorities stipulate an absolute minimum capital standard based on risk-weighted assets, they should encourage the use of in-house value-at-risk systems in financial institutions, as such systems explicitly take the inter-relationships of portfolio compositions into consideration.

Public-sector incentive arrangements

- *Supervision of complex groups:* A draft Financial Conglomerates Review Bill has been drawn up by the FSB, but much work has still to be done on this topic. This situation exists despite the fact that the nation's largest insurer (the Old Mutual Group) already operates as a large global financial conglomerate from the UK.
- *Competitive neutrality vis-à-vis global financial conglomerates:* From an internationally competitive perspective it is crucial that the authorities ensure a level playing field by reconsidering, for instance, their transaction taxes on securities trade.
- *Home and host regulatory arrangements:* The regulation of complex groups implies a far greater degree of co-operation between home and host regulators than is currently the case.
- *Super-regulatory agency:* Ideally the supervisory structure follows the structure of the supervised institution. Accordingly, complex groups have to be supervised by a multidisciplinary agency or

arrangement (i.e. embracing both banking and insurance specialists). Moreover, such a supervisory team may consist of home and host regulators. Research on this issue has only just commenced in South Africa.

- *Safety net arrangements:* Deposit insurance, and its link with the lender-of-last-resort facilities of the central bank, is currently under investigation in South Africa, and the implementation of new policies may have a major impact in years to come.
- *Financial stability policy:* In 2000 a Financial Stability Unit was established at the SA Reserve Bank to address all questions of a systemic nature. Much work has still to be done in this area.
- *Co-operation between non-bank supervisors and the central bank:* As the public sector lacks the discipline of the profit motive, it is far more difficult to ensure co-operation than in the private sector. A Memorandum of Understanding has been drafted between the FSB and the Registrar of Banks to ensure effectiveness and efficiency, but more detailed work still needs to be done.
- *Financial fraud and money-laundering control systems:* The government has still to decide whether the SA Reserve Bank or the National Treasury is going to undertake this regulatory responsibility.
- *Exchange controls:* Considering that there are an estimated R20 billion in blocked rands still outstanding and a mismatched forward currency book of some US\$10 billion, exchange controls cannot be lifted immediately in a Big Bang fashion. Nonetheless, internationally competitive forces make it essential to remove this constraint as soon as possible.
- *Regulatory accountability:* In the end any sensible accountability of the authorities can only be ensured if a regulatory audit agency is established by Parliament. Nothing has yet been done in this respect in South Africa.

From the issues stated above it is clear that the South African regulatory agencies confront a challenging agenda for the next decade. Time is clearly not on their

side. In fact there is a distinct danger that a regulatory failure may badly affect South Africa's competitive position in years to come.

3. Regulatory targets and gaps

The essence of regulatory targets is that they can be quantified, i.e. targets can either be hit or missed. The authorities should be able to state – i.e. after a specified time period – whether they were successful in the stipulation or establishment of, say, minimum standards, or whether their support of or encouragement for specific private-sector initiatives did bear fruit. A regulatory gap³⁷ is likewise quantifiable, but of course avoided wherever possible.

This section summarises the various regulatory targets that support the regulatory intermediate goals as identified in Chapter 2. Most of these targets are refinements of existing regulatory instruments, i.e. by improving their regulatory instruments the authorities hope to better target their intermediate goals (see Chapter 4). The various intermediate goals are addressed in the same order as they appear in Table 4.1 (see Chapter 4). Accordingly, Sections 3.1 to 3.6 below aim at supporting the objective of systemic stability; Sections 3.7 to 3.9 focus on institutional safety and soundness objective, while Sections 3.10 to 3.15 support the objective of fairness and consumer protection. The approach in this section is along the following lines: to begin with, a short overview is given of the issues at stake for each intermediate goal, and thereafter the specific regulatory targets are identified³⁸.

3.1 Competitive market infrastructure

The South African financial sector has a great concentration of economic power. In terms of value

added, the four largest banks represent some 75 per cent of all the industry's business, while the four largest assurers have a 65 per cent market share. Likewise, securities trading on the financial exchanges is dominated by about five large (mainly foreign) companies. Limited competition is one of the reasons for this state of affairs. For instance, the existing statutory limitation that foreign banks may not accept from the general public deposits of less than R1 million rand excludes them effectively from the retail market, while the stipulation that foreign insurers have to establish a local subsidiary (rather than a branch) to write insurance has severely limited foreign competition. Likewise, the dominant position of foreign primary dealers in local securities trading is primarily a direct result of South Africa's dependence on foreign capital inflows as well as too protective a regulatory policy on undercapitalised stockbrokers for too long³⁹. In-house rules may also limit competition. The members of the JSE for example cannot easily start a competing local exchange as they are only allowed to hold membership of BESA and SAFEX within South Africa.

To ensure that the South African financial industry can perform satisfactorily in the long term – i.e. under the pressures of globalisation, liberalisation, financial innovation and deregulation – the authorities have to create a competitively neutral environment between local and foreign financial services providers. The authorities themselves cannot actively guide the financial industry in the new world of, for instance, e-money, e-commerce and electronic broking (whose services are directly available through any computer linked to the Internet). Technology continuously lowers the barriers of entry and distance. Internationally networked computers distribute information with great speed that undermines traditional local operations. These technological developments are bound to change the competitive conditions fundamentally in South Africa, and at best the authorities can assure that the

³⁷ Often these gaps result from regulatory failure – either in regulatory structure or plain mismanagement.

³⁸ Once the major targets are identified, they could be grouped in a number of similar classes and be handed over to specific task groups for investigation and execution. The successful attainment of targets could imply that these targets would be dropped from the list of future targets. However, this is unlikely in practice, as targets are hardly ever completely finished (e.g. fulfilling minimum accounting standards is a moving target as these standards themselves change over time).

³⁹ Clearly, the Big Bang on the JSE should have occurred far earlier than 1995.

most efficient players in the local market win in this game. As a “referee” the authorities should be concerned with the “rules of the game”, rather than whether a local or foreign player wins in this game. The regulator should be concerned primarily with the risk exposures of firms (e.g. sufficient capital and management skills), irrespective of whether these resources are financed by local or foreign investors. In short, in an increasingly globalised industry, it is neither effective nor cost-efficient to behave in a protective nationalistic manner.

In order to increase competition in the local banking industry, the South African authorities could conduct an investigation similar to that of the Cruickshank Commission in the UK, whose final report became available in March 2000. This Commission found that British banks: (i) were making monopolistic (cartel) profits from the payments system; (ii) were too often allowed to write their own rules in the name of systemic soundness; (iii) were granting too few loans to small businesses (because of local monopolistic powers, but also because the entrepreneur lacked the necessary risk capital to support the bank loan and the government failed in its “loan guarantee” programme); and (iv) were not supplying sufficient useful information to consumers. Moreover, the Commission recommended that a core banking account should be made available to the public by the government, which should call for tenders from the banks to provide that service on behalf of the government. Considering that the South African banking industry is more concentrated than the British industry and less subject to international competition, it would be beneficial if these same issues were scrutinised in the local market.

To promote a competitive market infrastructure in future, the South African authorities could focus on the following regulatory targets:

- *Establish a payments system open to all financial institutions:* The authorities should license access to the payments system and remove unnecessary entry barriers and any uncompetitive practices between banks⁴⁰. Obviously opening the payments system should not result in more settlement risk,

and competition has to take place on a level playing field (i.e. in terms of capital requirements, settlement accounts with the central bank and cash reserves). In addition, new entrants should share, on a fair basis, the costs of the infrastructure that supports the existing payments system.

- *Promote competitive trading, clearing and settlement systems:* Without effective and efficient operational systems, systemic risk management is seriously impaired.
- *Promote competitive listing requirements:* Unless local listing requirements meet minimum international standards, local companies may find it difficult to obtain international finance.
- *Stipulate minimum infrastructural standards:* Corporate governance, accounting, audit, transparency and disclosure rules are of particular importance in addressing major operational risks.
- *Establish interrelated and competitive markets:* Financial engineering enforces a close interrelationship between new and different markets, which in turn improves efficient pricing and thus competitive market conditions.
- *Establish regulatory neutrality towards foreign participants:* Only through foreign competition can the authorities combat possible local cartel structures in finance and ensure that the industry remains globally efficient. Foreign competition encourages domestic banking practices to approach international best standards.

3.2 Acceptable maturity and currency mismatches

Systemic risk management emphasises that the maturity mismatches of loans and currencies should be “acceptable” for both companies and the nation at large. In financial firms their in-house value-at-risk models ultimately check these maturity mismatches. The greater the risk taken, the higher the resulting

⁴⁰ This step is not simplistic and may have consequences for the availability and distribution of money, the accommodation policy, the lender-of-last-resort function and the SA Reserve Bank’s regulatory responsibilities for the payment system.

capital adequacy requirements. However, the government does not subject itself to such prudential requirements, which creates serious problems at times (e.g. Russia, 1998).

Once currency and maturity mismatches have built up, particularly relative to long-term debt, they become very difficult to resolve. The Asian crises in the late 1990s emphasised this point. Asian banks were financing their lending with short-term (often call) deposits, and preferred rolling over their short-term loans (permitting market liquidity and corporate creditworthiness). As Asian corporates had no access to long-term financing in the domestic markets, they turned to the international markets with the resulting currency-risk exposures. As this borrowing was done on an uncovered basis, major currency risks soon built up. A hardening in macroeconomic policy brought this house of cards down eventually. The solution to this type of dilemma lies in the development of a long-term debt market in the local currency. By its nature this is a time-consuming exercise.

South Africa withstood the Asian crisis relatively well, mainly owing to the quality of its financial regulation and supervision. Nonetheless, inherent problems are easy to spot in the South African currency book. To obtain long-term foreign capital during the lengthy episode of political and financial isolation, the South African government aggressively supported any foreign borrowings of local companies by granting forward cover at subsidised costs until the late 1980s⁴¹. Owing to this long historical legacy of massive cross-subsidisation, South Africa is today saddled with a poorly structured currency book. Repositioning this book will take many years, as the government will have to buy foreign currency during periods of rand strength and then use these proceeds to reduce the forward oversold position of some US\$10 billion. Accordingly, the rand will remain an inherently weak

⁴¹ In the past, foreign borrowing has tended to be sporadic and ad hoc, with confused roles between the private and public sectors. Government should consider a regular programme of foreign borrowing and the establishment of a reliable market for South African paper in the international markets.

currency at least until the forward book is more balanced, and ideally handed over to the private sector.

To promote a better-structured loan and currency book in the years to come, the South African authorities could focus on the following regulatory targets:

- *Promote accurate value-at-risk systems*: Without VaR modelling techniques it is impossible for the authorities to define “acceptable” mismatches.
- *Promote the management of the forward currency book by the private sector*: On the basis of principle, the government (i.e. in practice the central bank) should not be responsible for the day-to-day running of this exposure and it should be handed over to the private sector as soon as possible.
- *Promote prudent debt-management systems in the public sector*: In order to promote an active bond market and to avoid the build-up of systemic pressures, the government should ensure that its public debt is managed professionally⁴².

3.3 Acceptable cross-market exposures

Cross-market exposures are still poorly regulated in South Africa. If trade on one exchange halts for whatever reason, it is still unclear how other exchanges would react to this. Co-operation among the exchanges is difficult to enforce in view of their underlying competitive nature. South Africa does not apply circuit breakers on exchanges⁴³ and accordingly these mechanisms are not integrated into the overall risk-management systems of markets. A fundamental problem may be the existing structure of local exchanges which do execution, clearing and settlement on an integrated basis per exchange, rather than breaking these functions up and integrating the clearing and settlement functions across exchanges.

Today the spot and derivative markets have become

⁴² For example, one of the EU fiscal yardsticks is that the government debt/GDP ratio should not exceed 60 per cent.

⁴³ Whether such circuit breakers are desirable in the South African context is a different question. Preliminary investigations, carried out by Quant Financial Research, seem to indicate that such structures are undesirable.

so intertwined, that the risk management thereof is probably best performed by one entity rather than having this function split among different exchanges. To enhance competition between exchanges and to face the expected competition from e-exchanges (which are likely to be outside South Africa's jurisdiction), it is probably better that the local exchanges should start concentrating solely on their execution functions. Such a structure implies that the risk management, clearing and settlement systems would be left to more specialised and better capitalised institutions.

To support the intermediate goal of better cross-market risk management, the following regulatory targets can be identified:

- *Establish cross-market risk management, clearing and settlement facilities:* Without such facilities major risk exposures can fall into the cracks between the various markets.
- *Establish legally binding netting agreements between markets:* Risk management requires offsetting positions in different markets to be fully taken into consideration in the overall risk assessment. Ideally all markets could use the same legal contracts for netting purposes.

3.4 Sufficient market liquidity

Liquidity in the securities markets usually ebbs and flows with the movements of the business cycle. Liquidity-enhancing instruments are fundamental to securities markets. For instance, one of the reasons that futures contracts were developed alongside forward contracts was their liquidity-enhancing qualities. Likewise, dual-capacity trading is encouraged on exchanges to support the liquidity-enhancing qualities of well-capitalised market makers. The large international investment banks usually perform the function of market makers and they prefer to operate on the large exchanges in the international centres. In any case, large exchanges attract more liquidity than small exchanges. The more liquid the market, the less the "impact" cost of conducting large trades. Investors avoid small exchanges as they have small trading volumes and therefore prices may move against them

when they make big trades. This is the fundamental reason for the monopolistic nature of exchanges: trading always gravitates to whichever market has the biggest share of liquidity in a specific security. And it is *inter alia* for this fundamental reason that competition among exchanges has to be promoted wherever possible by the authorities, as only competition can ensure the lowest costs to the consumer.

South African markets are competing with foreign exchanges for liquidity. For locally traded securities this competition can be faced without any great difficulties, but for South Africa's large multinational companies this competition is fierce. As noted earlier, fund managers (and particularly foreign fund managers) go to the market with the least impact cost, and if that market is found on the London Stock Exchange, the JSE will fight a losing battle to compete, at least for its most liquid internationally quoted shares.

Beside impact cost arguments, a financial centre's attractiveness depends crucially on the tax regime. Withholding taxes or transaction taxes imposed unilaterally by the government can result in a massive shift in funds, and can even cause the demise of a financial centre.

The conditions under which the authorities are expected to assist the securities markets during a liquidity crunch have become, recently, a hot topic among the monetary authorities. The tendency seems to be towards less support by the authorities and more reliance on the market mechanism to detect in good time any drainage of market liquidity.⁴⁴

To promote liquid markets as an intermediate goal, the South African authorities could focus on the following regulatory targets:

- *Establish a financial stability unit at the central bank:*⁴⁵ Such a unit should monitor liquidity conditions particularly in the securities markets as

⁴⁴ For instance during the crisis around Long Term Capital Management in 1998, the US Federal Reserve arranged a private-sector rescue package rather than easing its monetary policy stance.

⁴⁵ At this time (August 2000) this unit is in the process of being implemented.

any crunch here quickly flows over to the banking sector and the foreign-exchange markets.

- *Formalise the standby facilities of the central bank:* The financial markets need, at times, assistance from the monetary authorities, and the basis of such assistance has to be published *ex ante* in great detail⁴⁶.
- *Remove (tax) constraints on market turnover:* To maintain a level playing field internationally and improve the attractiveness of local markets, the tax authorities should think twice before imposing transaction taxes and stamp duties on the securities trade. Currently the JSE is subjected to a 0,25 per cent transaction tax (i.e. the Marketable Securities Tax), which, for instance, does not apply in the UK. To avoid paying this indirect tax, foreign investors would obviously prefer the London market. Moreover, bankers' acceptances, fixed-rate deposits and promissory notes attract stamp duty of 0,05 per cent and listed instruments a duty of 0,25 per cent. These tax differentials between nations and local markets create price distortions between closely integrated markets and drain liquidity from the local markets.
- *Promote foreign participation in local markets:* Only the large foreign investment banks and fund managers have the capital resources and the expertise to support liquidity in the local markets on a daily basis. With the increased globalisation of finance, it is probably a better regulatory strategy to take foreign competition kindly by the arm, than to challenge it permanently on all fronts.

3.5 Securities markets as an alternative to financial intermediation⁴⁷

Securitisation – i.e. the process that turns loans into tradable securities – has the major advantage that it removes the need for borrowers to stay close to

lenders. In contrast to banks, bond lenders rely on credit-rating agencies to rate the securities in terms of the borrowers' creditworthiness. Usually the lenders' exposure to one specific private borrower in the securities markets is small, as their assets are spread much wider than bank loans. Moreover, lenders in the securitised asset markets have tradable paper that makes their ability to adjust their risks easier, which in turn lowers the cost of borrowing. Current legislation in South Africa in respect of securitisation is still influenced by banking legislation, but over time these constraints are likely to be lifted. Once this occurs the securities markets will rapidly grow and become a major competitor to the banking industry.

Although access to credit can always be improved, generally banks have advanced extensive credit to small, medium and micro-enterprises (SMMEs), provided these enterprises were adequately capitalised and had the necessary managerial skills. The basic problems in South Africa's microlending industry are the inadequate capitalisation of these businesses and the high risks attached to the granting of this type of venture capital. The demand for credit is aggravated by the fact that unemployment is running at excessively high levels and that the credit institutions were unable to provide risk capital at the bottom end of this market on a sustainable basis. In essence, these loans cannot be made part of the normal commercial and prudential activities of the banks.

Perhaps in the years ahead, more venture capital, even for small and micro-enterprises, could be funded – at least partially – through the securities markets. When it comes to the granting of credit the securities markets can compete effectively with banks, and they may be even more cost-efficient in this higher risk area. Anyway, the supply of credit is not exclusive to banking. Many institutions (both financial and non-financial) grant credit. The needed investment funds for SMMEs (or housing finance for that matter) can in principle be generated through the securities markets on a competitive basis *vis-à-vis* the banks. The advantages of this type of funding are the following:

⁴⁶ See for instance: Bank Supervision Department, *Annual Report*, Pretoria: The South African Reserve Bank, 1999, pp. 4–19.

⁴⁷ Currently the external funds provided to non-financial businesses in South Africa are comprised roughly as follows: 46% bank loans, 32% equity, 18% bonds and 4% other sources.

- In contrast to banks, securities markets cannot become insolvent but only illiquid. As a result they are able to accept more market risk than banks. Historically the financing of risky business always took place primarily in the capital markets (i.e. equities or bonds)⁴⁸.
- Direct financing through securities markets implies a direct knowledge link between ultimate lenders and SMME funds. Accordingly investors can have a direct say in how their investments are to be utilised.
- The rating of SMME funds, i.e. in terms of the quality of their paper, can be done by private rating agencies and the investing public can select funds according to their desired risk profile.
- By stipulating that SMME bonds should be traded on a regulated investment exchange (e.g. the BESA), standard investor safety features can be secured.
- By making SMME bonds negotiable, investors can obtain a relatively liquid investment instrument that directly reflects the markets' sentiment and in turn disciplines the lending operations of SMME funds.
- Foreign development agencies, trade unions, local communities, etc. may be more inclined to invest directly in socially acceptable projects.
- By increasing the competition between banks and securities markets, prices for debt are likely to reflect better relative scarcity.
- From the viewpoint of systemic stability the strength of the financial system is improved if the securities markets are comparable in size to financial institutions.

However, there are a number of disadvantages to this approach. Financing SMMEs partially through the securities markets will have the natural setbacks of any instrument traded in these markets, such as:

- The market for SMME bonds may lack sufficient

liquidity because the investing public shows too little interest.

- The yield on SMME bonds may fluctuate too sharply during periods of financial instability.
- Financing through the securities markets requires a higher degree of financial sophistication on the part of investors than a plain bank deposit.
- Particularly if the investing public is uneducated, disclosure rules and a critical financial press are of crucial importance.

However, all these disadvantages are not of a principle nature and the authorities can address them by promoting the securities markets in general. Accordingly, to support the intermediate goal of promoting the securities markets as an alternative to financial intermediation, the following regulatory targets can be identified:

- *Remove constraints on commercial paper and corporate bond issues from the Banks Act:* The authorities can only consider this step after pending legislation to improve consumer protection has been passed by Parliament.
- *Promote the engineering and implementation of an SMME bond instrument:* This instrument should be designed and developed by the private sector, but its initiation, development and the establishment of a market need to be supported actively by the authorities.

3.6 Regulatory effectiveness, efficiency and economy

The UK is an example of a country where the quality of regulation is one of the major strengths of its financial system. For instance, wholesale business in the UK is leniently regulated to ensure international competitiveness, but retail business is tightly controlled in order to protect the British consumer. By contrast, the Securities and Exchange Commission (SEC) in the US does not differentiate as efficiently and effectively as the UK between wholesale and retail business, which in turn so easily results in the over-regulation of wholesale markets. In fact, the undifferentiated regime in the

⁴⁸ Indeed, wars can be financed by selling war bonds, but not by demanding war deposits! The upliftment of the poor in South Africa is no less a battle than a major war, in terms of effort and dedication.

US is one of the reasons that their major investment banks⁴⁹ operate largely from the UK.

As trading in foreign markets becomes increasingly indistinguishable from domestic trading, the competition between regulatory agencies heats up correspondingly. Although South Africa is still somewhat isolated in this respect, it is unlikely to stay in this position for much longer because its top companies are rapidly diversifying abroad. Some of South Africa's blue chip companies have already obtained primary listings in the UK recently, and the JSE struggles to remain competitive with the London market in terms of its ability to raise financial and human capital more cheaply. Exchange controls and the location of corporate head offices in "rough neighbourhoods" are other hinderances for South African companies with major foreign operations. During the period 1998–2000 the JSE lost about a third of its primary listing market capitalisation (i.e. if companies with secondary listings are excluded from the JSE market capitalisation). Although the JSE is obviously not pleased to see its best equity counters listed on competitive exchanges, there is ultimately not that much that the JSE, or the government, can do about it. Indeed, any South African company with major interests abroad could split off its foreign operations in a separate company abroad, if permission to list abroad were to be withheld by the National Treasury.

To avoid competition in regulatory laxity (i.e. the "dive to the bottom" in regulation), two different approaches have been developed in the European Union. The first device is "harmonisation" in terms of which national regulators adhere to certain minimum standards, and the second device is the "mutual recognition" of one another's regulatory regimes (and their differences). This mutual recognition results, in turn, in concepts such as the "single passport", "home"

and "host" regulators, and "remote trading" regimes. The single passport implies that any financial institution can deliver its services throughout the EU without incurring regulation from different jurisdictions. The home regulator keeps an eye on the soundness of, say, a bank, while the host regulator is concerned with the bank's business practices. Host regulators must recognise the competence of home regulators in the EU. Remote trading is an extension of the home versus host regulatory regime. Again the home country regulates the remote trader, while the host country must allow remote electronic foreign participation on its exchanges.

Outside the EU the host country can of course refuse to recognise the home country as the prudential regulator, but this becomes difficult if the home country is the US, France, Germany or the UK which have sound financial systems⁵⁰. Accordingly, internationally, the tendency is increasingly to *deregulate* the exchanges in full (and thus to regulate them more or less like the OTC markets) and instead to concentrate more on institutions such as banks, securities firms and fund managers. The argument is that with the development of professional fund management firms, the need to protect the retail client on the stock exchange has largely fallen away. Nonetheless the inherent danger of such a development is that the equity markets may split into a first tier of blue chip companies and a second tier of low-capitalised companies. These smaller companies would struggle more to generate capital on such "formalised OTC" stock markets.

To support the intermediate goal of regulatory effectiveness, efficiency and economy the following regulatory targets can be identified:

- *Establish co-ordination agreements among*

⁴⁹ The large US investment banks, e.g. Merrill Lynch, Goldman Sachs and P.J. Morgan, already operate as truly international companies, rather than US firms. Positioning their head offices in London rather than New York would not be a big issue of principle (except for tax reasons).

⁵⁰ One way to deal with the issue of the quality of the home regulator is to subject the national regulators and supervisors to a rating procedure. For instance, host regulators could be asked to compile a checklist on how they determine the competence of home supervisors. The BIS has already formally declined to be involved in such a rating process, but the IMF may still decide to do so.

domestic regulatory agencies: unless such agreements are in place, the authorities may be confronted with regulatory gaps in the supervision of complex financial groups.

- *Establish harmonisation agreements between home and host regulators*: without harmonisation in this area it would be difficult to effectively supervise global financial conglomerates and hedge funds in offshore financial centres.
- *Stipulate regulatory cost-benefit analysis*: the danger of over-regulation can only effectively be addressed if the authorities do detailed cost-benefit analyses.
- *Establish a regulatory audit agency*: such an agency would go a long way towards ensuring that appropriate accountability takes place on the part of the regulators. In most countries, parliamentary scrutiny and accountability require more attention: i.e. the select parliamentary committees have not reached their full potential yet.
- *Establish ratings of national regulatory agencies*: international bodies, like the IMF or the World Bank, could perform this task.

3.7 Proper risk assessment

The major risk components of a financial firm are market risk, credit risk, liquidity risk, counterparty risk and operational risk. The aim of the new capital-adequacy regime of the Basel Committee is to back all these risks with sufficient capital by 2001. The original Basel capital accord of 1988 mainly addressed counterparty risk, and was aimed primarily at: stopping the sharp fall in the capital adequacy of internationally active banks; reducing the competitive inequalities among countries; and establishing minimum standards (though this minimum soon became a universal standard). In 1995 the capital agreement was extended to include market risk. The proposed new capital accord tries to address all the other risk exposures of banks in greater detail.

To evaluate credit risk, two approaches are proposed by the Basel Committee: a standardised approach that

is reliant on external ratings⁵¹ or an internal ratings approach for qualifying banks.⁵² Obviously the industry believes that internal ratings offer the right way forward (as bankers think they know their own business better than agencies). Banks hope that portfolio credit-risk models, which promise a more accurate estimation of credit risk than the standardised approach, will soon be acceptable for regulatory capital purposes. There are however two major hurdles to be overcome: data limitations and the lack of credible back testing. Over the medium term these issues will, no doubt, be addressed as better default and loss data are accumulated.

A more serious problem over the long term is the absolute level of capital required for banks. Rewarding good risk management and a more differentiated calibration of credit risks are likely to result in an absolute decrease in the overall level of regulatory capital in the banking system. The Basel Committee thinks that this is undesirable, it would rather see the capital standard raised to 10 or even 12 per cent of risk-weighted assets.⁵³ Regulators want to factor in something – in their minds if not in their models – for the unexpected. The justification for an arbitrary minimum capital requirement emanates directly from this need to cover the unexpected. Accordingly, they propose an explicit charge for other banking risks that at the moment are taken into account only implicitly, particularly interest rate risk arising from the banking

⁵¹ By credit rating agencies such as Standard & Poor's or Moody's.

⁵² However, both these methods rely on the opinions of parties who may have an incentive to underestimate that risk exposure. By contrast, the advantage of the prescription of subordinated debt as a form of regulatory bank capital would be that these opinions are replaced by market forces and thus a reliance on private agents' behaviour. The potential use of subordinated debt is to bring market forces to bear on the operations of large financial institutions and to protect the deposit-insurance funds. See Evanoff, D.D. and L.D. Wall, "Subordinated debt as bank capital: a proposal for regulatory reform", in *Economic Perspectives*, Federal Reserve Bank of Chicago, second quarter 2000, pp. 40–53.

⁵³ The current minimum capital requirement for large internationally active banks of 8 per cent of risk-weighted assets may be too low for South African retail banks, which are relatively small and operate primarily in a developing country environment.

book, and operational risk such as computer-related or legal risk. However, the industry has many concerns about such “add-ons”. Moreover, it is still not clear how the internal rating approach could be made comparable across countries that have different banking legacies as well as different bankruptcy and accounting regimes. To ensure that the new capital regime does not give a competitive edge to non-banks, the Joint Forum⁵⁴ has to investigate the impact thereof on the banks’ counterparts in the securities and insurance businesses.

Sound risk-management systems require close co-operation between the regulator and the regulated. Ideally the regulatory framework should be as simple as possible, though managements’ own control superstructure can be as complex as they wish to make it, subject to its being open to supervisory scrutiny. Good management and good regulators seldom have reason to fall out. The latest discussions on credit risk models between the Basel Committee and the industry are progressing satisfactorily in this philosophical context.

Proper risk management for systemic purposes does not stop with financial institutions though. Also of importance are the risk exposures of hedge funds. After the US Federal Reserve had to launch a large-scale rescue operation for the largest hedge fund in the world, Long Term Capital Management, the risk-management procedures of hedge funds and their impact on financial stability came under the regulatory spotlight in 1998. Hedge funds are by their very nature highly geared, non-financial offshore institutions. This makes them very difficult to regulate directly. In 2000 the Financial Stability Forum at the BIS recommended that hedge funds should not be placed under direct regulatory supervision, but that more disclosure should be demanded from both them and their bankers (who

usually grant the credit to them and thus largely allow their high degree of gearing). As a result, many bankers have compelled their hedge fund clients to use value-at-risk models, which in turn resulted in a massive de-gearing of those funds. As market liquidity started to fall in line with less credit being made available, the largest of the hedge funds, after showing significant trading losses in 1999, withdrew from the market in 2000. In quick succession some of the larger funds, such as Tiger Fund, Quantum Fund and Quota Fund, closed for business. The danger of such a development is that it may cause a vicious circle: as banks provide less liquidity, markets become more volatile, forcing them to make further cuts in the amount of capital they devote to trading, making markets even less liquid, and so on. In the end, the hedging of open positions is becoming increasingly difficult. Although the South African regulatory authorities are not really engaged with hedge funds (exchange controls prohibit this type of bank lending), the recommendations of the Financial Stability Forum are to be implemented nonetheless.

To support the intermediate goal of proper risk management, the following regulatory targets can be identified:

- *Promote accurate value-at-risk models*: Ideally, all risk exposures within a firm have to be quantified on a fully integrated basis. The building of such enterprise-wide risk management (ERM) simulation models needs to be supported by the authorities.
- *Stipulate consolidated supervision*: Without proper accounting consolidation, the double counting of regulatory capital is bound to take place.
- *Appoint specific non-executive board members to supervise risk management and management control systems*: Ultimately the authorities would like to make one specific director at board level responsible (and perhaps even accountable in a private capacity⁵⁵) for the firm’s risk-management procedures.

⁵⁴ The Joint Forum (formerly known as the Joint Forum on Financial Conglomerates) was established in early 1996 by the Basel Committee on Banking Supervision (Basel Committee), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), to take forward the work of a predecessor group, the Tripartite Group, in examining supervisory issues relating to financial conglomerates.

⁵⁵ This policy is currently enforced in New Zealand.

- *Appoint accredited private rating agencies:* Paper traded in the securities markets has to be rated for risk-management purposes. This task can be left to the private sector but the ratings need to be recognised by the authorities for regulatory purposes.
- *Promote unsecured subordinated debt as a rating tool:* Bank risk-management is structurally improved if the interests of subordinated debt creditors are closely aligned with those of the bank supervisors.
- *Adhere to minimum accounting and audit standards:* There cannot be proper disclosure without proper accounting and audit standards.
- *Adhere to minimum capital standards:* Competition in regulatory laxity emerges if no international minimum standards are set in this area.
- *Adhere to corporate governance standards:* These standards promote high-quality leadership in firms.
- *Adhere to compliance standards:* With increased reliance on market discipline and monitoring, the compliance function within firms becomes crucial in ensuring proper in-house supervision.

3.8 Proper financial institutional infrastructure and suitability standards

A proper financial infrastructure is one of three major structural pillars of a stable financial system⁵⁶. From a regulatory point of view, improvements in the financial infrastructure usually go hand in hand with raising the minimum standards. These standards, in turn, entail accounting, audit, capital, governance and compliance standards. As the process of international standard-setting is one based on mutual agreement, it can only be on the basis of consensus. Such a common approach is based on a “bottom-up”, rather than a “top-down” approach, which by its nature will be an evolutionary process. In recent years major progress has been made: e.g. international accounting standards were endorsed by IOSCO in 2000, the OECD is currently considering more uniform governance rules for industrial countries, while the BIS is working on a new capital accord.

In the South African context, segments of financial infrastructure, need urgent attention. For example: the transparency of the OTC markets (particularly off-market trade) and nominee companies; internal governance in relation to pyramid companies and non-voting shares; and capacity for investigating commercial crime and prosecuting offenders effectively in the justice system.

To support the intermediate goal of a proper financial infrastructure, the following regulatory targets can be identified:

- *Establish an infrastructure for the verification of a firms’ risk and control systems:* Verification, as a type of auditing process, has to ensure that the simulation models and control systems used, will live up to expectations.
- *Establish an industry register of doubtful and bad debts:* To improve credit risk-management procedures, the creation of a credit register – where bank loans are classified in terms of size and rated by independent rating agencies on an industry-wide basis – is recommended.
- *Stipulate suitability standards for directors and senior management:* Unless top management is knowledgeable, battle-hardened and generally “fit and proper” no company can face the global competitive forces head-on in today’s financial world for long.

3.9 Global institutional competitiveness and competitive neutrality

A basic problem faced by all global firms is that their activities are constrained by national regulation. In the absence of a global government, how are regulators to create a system of mutually interdependent and reliant supervisors in which companies can compete on a level playing field? Too much self-regulation may result in regulatory laxity or regulatory capture, while too much official regulation from the top may stifle competition. In the end the relationship between the supervised and the supervisor is symbiotic, and so it is vital to encourage industry leaders to help develop the

⁵⁶ The other pillars are sound financial institutions and liquid markets.

appropriate standards, including codes of conduct and prudential standards.

On the competitive front the Internet, hand in hand with digital cash, is bound to have a strong influence in future. From a regulatory perspective the Internet is often seen as just another form of media. Although, in a narrow sense, this is logically correct, the Internet nonetheless undermines current regulation and practices. One reason is that electronic documents are different from their paper equivalents⁵⁷. More fundamental are the problems of jurisdiction (e.g. investment advice given in London may be read in Johannesburg, which in turn impacts on local legislation covering investment advice) and home country supervision (will foreign investors using a website in, say, the United States have recourse to US law for redress?). Financial scams are another potential problem on the Internet. Because information on the Internet is cheap to distribute and therefore reaches a vast number of people, even a small response makes it an ideal medium for “get-rich-quick” schemes (e.g. pyramid selling). Ultimately consumers can directly control their regulatory environment simply by “voting with their feet” for the jurisdiction they like. Without geographic barriers, consumers can elect the type of protection they need by choosing their preferred Internet regulator. This implies that unpopular regulation, even with good intentions, will be difficult, if not impossible to enforce in the long run. It seems, accordingly, that the regulator of the Internet will be no more than the well-informed consumer.

The regulatory response to all these Internet challenges still needs to be worked out by international task groups. It will be a daunting task, particularly considering that national sovereignty, and thus pride, is at stake. Therefore no quick answers can be expected. Even as a minimum involvement, South African regulators will have to follow these international developments closely.

Most of the basic issues underlying global

⁵⁷ For instance, typical problems are that Web pages change too quickly; are easy to browse, but difficult to read; while “small print” can be skipped too easily through the use of hypertext links.

competition have already been discussed in one way or another above. Generally, South African companies are globally competitive, but it is worth repeating that exchange control regulations are still a major hindrance as capital mobility has increased so much in the last two decades. Therefore, to support the intermediate goal of global competitiveness and competitive neutrality, the following regulatory targets are of particular importance:

- *Abolish foreign exchange controls as soon as possible:* The free flow of capital underlies competitive forces in the global economy.
- *Adhere to international agreements on regulatory minimum standards:* These standards aim at avoiding competition in regulatory laxity.
- *Encourage a functional approach to regulation:* With the emergence of global financial conglomerates it is of crucial importance that functional regulation across various financial sectors should be properly co-ordinated with traditional institutional regulation.
- *Encourage competitive neutrality between commerce and e-commerce:* The Internet may well prove to be the vehicle that makes the “*caveat emptor*” approach in regulation more sustainable.

3.10 Integrity, fairness and competence

Within the firm the compliance office deals with the day-to-day issues of suitability. In the end it is the compliance officer’s responsibility to ensure that only people with integrity are appointed (called the “gate-keeper’s” function), that the clients are dealt with fairly and that staff is competent to do the work. However, who guards the guards? To date, no mechanisms for systematically assessing compliance procedures have been developed⁵⁸.

To support the intermediate goal of integrity, fairness and competence the following regulatory targets can be identified:

⁵⁸ At the national level the IMF and the World Bank have put together compliance assessment teams to conduct financial assessment programmes. The national supervisors may have to do the same at the corporate level.

- *Encourage a code of corporate governance:* The major responsibilities in this area rest with the board of directors.
- *Encourage a code of business conduct:* Industry associations usually compile this code. It is already in place in South Africa for the local banking, insurance and unit trust industries.
- *Establish a policy to reduce financial crime and money laundering:* Without such a policy South Africa could become an undesirable business place. Cabinet approval of the Financial Intelligence Centre Bill, which deals with money laundering control, is being awaited.
- *Encourage effective compliance manuals:* These manuals can be seen as an incentive contract between the regulator and the regulated and may accordingly differ among financial firms. The quality of the compliance manuals may have to be certified by the external auditors of the firm in consultation with the regulator.
- *Stipulate “fit and proper” standards for the compliance office:* The external auditors and regulators have to audit the quality of the compliance office to ensure these guardians fulfil standards themselves.

3.11 Adequate product and service competitiveness

Protective feelings on the part of the authorities often mean that they want to protect both their home turf and their colleagues in the public sector. The result is trade restrictions of various kinds against foreigners and the exclusion of standard regulations for the public sector. Both policies can prove extremely expensive in the long term.

Public involvement in the financial sector can create socio-economic benefits. For instance, a government bank, like the Postbank, can provide effective competition at the cutting edge in a market dominated by private banks. Likewise, the Land Bank can assist where the private sector may hesitate, because of its longer-term commitment to agricultural development. However, it would for a number of reasons be bad policy to

exclude such enterprises from the standard prudential requirements (like capital adequacy or disclosure) or even from the industry’s code of conduct requirements (including the code of corporate governance policies). Firstly, even if the government stands behind its enterprises through thick and thin, the political election cycle is far shorter than the average life cycle of a public enterprise. A newly elected government may not want to inherit over-stretched public sector budgets for political aims they did not subscribe to, or face the legal consequences of the bad financial advice given by public servants. Secondly, efficiencies in the public enterprises can only be measured between competing entities on a level playing field. For example, the fact that the Land Bank has a zero-cost capital base, is untaxed and has a preferential creditor status to compete in the commercial markets, results in serious market distortions. Thirdly, without prudential requirements the taxpayer may once again be asked to bail out, whereas winding-down would have been the logical policy. Lastly, the financial regulator should be careful when dealing with general government, as historical evidence shows time and again that state failure is far more expensive and painful to society than market failure (see Chapter 4, Section 3.7).

To support the intermediate goal of product competitiveness, the following regulatory targets can be identified:

- *Remove constraints on competitive foreign products:* True competition usually only flows from different countries, different cultures, different languages and different regulatory regimes.
- *Remove regulatory exclusions granted to parastatals or public corporations:* Only by placing the enterprises of the state on a equal footing with private-sector equivalents can inefficiencies and unacceptable risk exposures be detected.

3.12 Transparency and disclosure

Disclosure and profitability do not necessarily always sit comfortably together. For instance, a company may obtain valuable marketing benefits by giving the impression of being ethically involved in “socially responsible investments” (SRI), while in reality its

expenses in this area are primarily for advertising. Ultimately, all predation is based on the fine differentiation between the apparent and the real, and the hunt for profit is no exception. In the end, investors want to know how much of their funds is used for SRI corporate goals. In order to make this type of information more transparent, specific disclosure rules should be considered. For instance, in July 2000, the British made it compulsory for pension funds to disclose whether they take account of the environmental, ethical and social impact of their investments. The aim of this regulation is not so much to interfere in the investment patterns of pension funds, but rather to ensure proper information flows to investors and policy holders.

It is crucial for the authorities and industry associations to make information, which is sufficiently benchmarked, available to the press. Ultimately the link between financial markets and consumers is the financial press. The press plays a critical role in any financial system and has to be educated and supplied with relevant and updated information about market conditions, investment patterns and the relative importance of the various classes of investors and borrowers. Questions like “who is really supporting small businesses?” and “how much of the funds are employed for SRI projects?” are not only of interest to pressure groups and politicians, but also to market participants in a broader sense. Disclosure is a powerful instrument, provided it is used properly – i.e. no information overflow. The disclosure of selected benchmarked information is the key to success.

To support the intermediate goal of transparency and disclosure, the following regulatory targets can be identified:

- *Adhere to an international code of corporate governance:* Disclosure and transparency are in essence components of internal governance. Although every nation may have different ideas about what appropriate disclosure means, it is helpful for international investors if at least the minimum standards are met in this respect.
- *Establish government-defined benchmarks for*

better consumer information: Often consumers find it difficult to compare prices because of a lack of standardisation. Officially agreed benchmarks, including the cost of a “basic bank account”, will better address consumer grievances. The regulatory authorities, including the industry associations, can do more to enhance the supply of competitive information, *inter alia* via the Internet.

- *Inform the financial press.* The regulatory authorities should establish a practical, mutually effective, working relationship with senior financial journalists in order to promote better communication with the public at large.

3.13 Adequate access to retail financial services

As emphasised by the Cruikshank Commission in the UK, the uncompetitive behaviour of banks is often a result of too-high capital charges for new entrants as well as the banks’ cartel position in the payments system. Likewise, for example, the practice where banks charge non-clients significantly more for the use of cash machines is perceived as a lack of competitiveness. To lower entry barriers, the authorities could consider establishing different types of banks, and participation in the payments system should be opened, in principle, to any financial institution materially involved in payments.

In the past, specific licences were granted in South Africa to different classes of banks such as commercial banks, savings banks, general banks and building societies (which were effectively mortgage banks). Over the years all these distinctions were eliminated because the functional borderlines between these institutions became increasingly blurred. In terms of the 1990 Banks Act only one definition for a bank remained.⁵⁹ However, to assist the “unbanked” the authorities could define a “core

⁵⁹ The Mutual Banks Act (1993) is similar to the Banks Act (1990) except on two points: (i) a mutual bank is of course exempted from the requirement that a bank has to be a limited company; and (ii) its minimum capital is R50 million, but for a bank it is proposed that it should be increased to R250 million.

bank”, being a bank that accepts deposits from the general public and invests all its assets in money-market paper of top quality (i.e. a core bank has no credit risk). Core banks would have a lower capital requirement than other, more universal banks because their risk profile would be fundamentally lower. In essence, a core bank’s deposit rates would be determined by money-market rates minus operating expenses. Retailers that currently provide limited banking services could then be granted a full core-banking licence and direct membership of the national payments system (rather than as a bank’s agent), which in turn would be bound simultaneously to increase financial services to the poor and improve competition in the banking sector.

A basic problem in the South African context remains the conflicts of interest faced by the authorities in ensuring prudential regulation and compliance with international standards, and the interests of Parliament in providing banking services to the entire population. The danger of maintaining international standards in a developing country is that local banks participating in the international markets may find that the costs of capital demanded by those standards are just too high for the returns that can be earned in the low-income markets. So the local banks tend to contract out of the very markets that Parliament would like to see them expanding into.

To support the intermediate goal of adequate access to retail financial services, the following regulatory targets can be identified:

- *Establish core banks in the retail trading sector:* A one-size-fits-all banking structure is unlikely to be satisfactory to both wealthy and poor retail clients.
- *Open the payments system to non-bank financial institutions:* Core banks can only really compete with established banks if there is a level playing field in the inter-bank market and in the national payment system⁶⁰.

⁶⁰ Subject of course to the earlier observations of level playing fields, settlement risk and contribution to the costs of the existing infrastructure.

3.14 Protection of retail funds

The issue of protecting retail funds is closely related to the issue of financial soundness and financial stability in general (as discussed in Chapter 5, Section 3.5.2). In essence it implies that the authorities ensure proper risk-management systems in firms (e.g. in respect of operational risks) and maintain macroeconomic stability. In this context the emphasis is increasingly being placed on the market monitoring and discipline⁶¹.

Generally, investments made by the public at large are poorly protected in South Africa. If an investment fund should go under as a result of, for instance, gross negligence, usually no compensation is paid to the investors.⁶² In respect of bank deposits, the authorities are currently investigating the possibility of an investor protection scheme that will pay limited compensation to depositors.

Besides the Reserve Bank’s investigation into bank-deposit insurance, the FSB is currently investigating whether other retail investment funds should receive similar protection. No doubt this is a challenging investigation, as the current situation can be roughly summarised as follows: to date no official protection against operational or default risks is given by the private sector (whether they are banks, insurance, pension or unit trust funds), and most of the public contributions to the public sector’s funds have long since disappeared. For instance, the Department of Labour is responsible for the Unemployment Insurance Fund and the Workmen’s Compensation Fund. Both these funds are effectively bankrupt. The Department of Transport is responsible for the Road Accident Fund. The actuarial shortfall of this fund runs into billions of rands. The Department of Health is responsible for

⁶¹ One of the regulatory reforms that powerfully support market discipline is a greater role for subordinated debt as a form of bank capital.

⁶² The official excuse is usually along the lines of “let the buyer beware”, despite the fact that investors often lack even the most basic information. Moreover some of these investments are made compulsory like the Road Accident Fund or the Unemployment Insurance Fund.

medical aid schemes⁶³. The majority of these schemes are in dire straits, although a few of them are still actuarially sound. Considering the possibly huge medical costs of Aids, TB and malaria, medical aid schemes are probably one of the most risky forms of insurance at present. The only exception in the public sector seems to be the SA Special Risk Insurance Association (SASRIA) managed by the National Treasury that accumulated a massive surplus of some R8 billion, more or less by mistake.⁶⁴

The dilemma faced by government is that most of these investment funds are used as instruments of social engineering, though in a truly free market any cross-subsidising between fund members is impossible. Furthermore, prudential considerations require that “the wishbone should never replace the backbone”. Accordingly, these public sector funds have to be appropriately financed for the benefit of their paying members.

To promote better protection of retail funds in future, the South African authorities could focus on the following regulatory targets:

- *Establish a Structured Early Intervention and Resolution regime*: Without timely and adequate provisions, firms may fail in appropriate credit-risk management.
- *Stipulate acceptable operational risk-management systems*: Major computer system failure and/or fraud are an important reason for bankruptcy in the financial industry.
- *Limit the use of retail investment funds as an instrument of social engineering*: Even with the best social intentions, the investment funds will face ruin in South Africa unless payouts are based on actuarial principles.

⁶³ This regulatory arrangement came about in 1975 when the supervision of medical aid schemes was transferred from the, then, Department of Finance to the Department of Health. Considering the current financial problems of medical aid schemes and the dynamic interaction with medical insurance in general, it seems that this arrangement has probably passed its due date.

⁶⁴ As the Government was the sole underwriter of the SASRIA scheme, it took the lion’s share of the surplus from this fund by means of the Conversion of SASRIA Act, 1998.

3.15 Retail compensation schemes

Compensation to a wronged investor should not be viewed as a type of generosity on the part of the financial institution (as so often happens in practice), but rather as a basic right of such a client. Compensation can flow through various channels and can be triggered by various means. The easiest case is where the client complains about a wrong action on the part of the firm and is compensated immediately as a consequence thereof. If the firm refuses to compensate, the client can take his case to the industry’s ombudsman who will reconsider the case. If the client is still unhappy about the rulings of the industry’s adjudicator, the case can be brought before a court of law.

Since the late 1990s market conduct regulation has been improved significantly in South Africa. Today, banks have a strict code of market conduct; an effective and independent redress mechanism for customers; and an industry adjudicator (operative effectively since early 2000). Similar developments are eventually envisaged for the insurance industry, but as yet they have not materialised. In the securities business, the compensation of wronged investors ultimately flows from the exchanges’ fidelity or guarantee funds. The compensation is usually limited though. In the case of banks, the adjudicator can demand compensation up to R500 000, but the compensation of the long-term insurance ombudsman is limited to R250 000. The Guarantee Fund of the BESA limits payouts to a maximum of R100 million for all clients of defaulting members; the Guarantee Fund of the JSE compensates to a maximum of R5 million per client, and the Fidelity Fund of SAFEX limits itself to R1 million per client⁶⁵.

One fundamental problem remaining in South Africa is that not all market conduct is vested in one single specialist regulator for all market-conduct issues. Currently the Department of Trade and Industry, rather than the National Treasury, deals with issues such as the investor protection provisions of the Companies

⁶⁵ In the case of SAFEX its clearing members accept full responsibility for the credit risks of its clients.

Act, corporate governance standards and possible claims arising from the Usury Act. Ensuring co-ordination among the various government departments has proven difficult in practice and is clearly not to the advantage of the wronged consumer.

To support the intermediate goal of adequate compensation schemes, the following regulatory targets can be identified:

- *Stipulate ombudsmen arrangements*: This is one of the most cost-efficient and effective ways to compensate wronged investors.
- *Stipulate fidelity fund arrangements*: A necessary arrangement if brokers are operating in an individual capacity and are therefore relatively thinly capitalised.
- *Establish a bank deposit-insurance scheme*: Although not without inherent problems (mainly conflicts of interest and moral hazard issues), these schemes usually operate as compensation schemes for small depositors only. In effect they only replace implicit compensation contracts with an explicit contract.
- *Establish a single regulator for all market-conduct rulings*: Only by centralising the regulation of market conduct activities can oversight and responsibility be enhanced in this area. Better compensation mechanisms will result from a better organisational structure.

4. Conclusion

4.1 Summary

The dualistic underlying nature of the South African economy is very evident in its financial sector. On the one hand there is a highly sophisticated financial industry serving the daily needs of *inter alia* multinational companies, the government and wealthy households, while on the other hand this same industry is unable to assist in a meaningful way upcoming small businesses and poorer households.

For a lower-middle-income country⁶⁶ South Africa's

financial industry is clearly one of its crown jewels. The industry assists in a major way to bridge the national savings gap by ensuring adequate capital inflows from abroad. Any attempts to pluck this goose extensively will affect its health, and in turn the international investor confidence that is so crucial for supporting sustainable economic growth in South Africa.

International competition forces the big banks to focus on high-yielding business and stringent cost controls (and thus the elimination of cross-subsidising). However, international competition still does not exclude the possibility of a lack of sufficient competition in the domestic markets. To service the financial needs of the small business sector and lower-income households, the authorities may have to consider a number of fundamental steps to increase competitiveness in local markets. For example: the deregulation of the commercial paper and corporate bond markets; removal of the regulatory barriers against foreign banks; opening the national payment system to non-bank financial institutions; and the creation of core banks. Likewise, the authorities could increase the degree of competition in the local insurance market. It could do so, for instance, by allowing foreign insurers to sell their policies in South Africa on a branch basis, rather than forcing these insurers to establish local subsidiaries.⁶⁷

When considering the long-term economic prospects for South Africa in an Aids scenario, the regulatory authorities cannot close their eyes to its socio-economic impact in the next few years. The consequential costs of Aids may badly affect the local banking and insurance businesses. How badly is still an open question, because this uncertainty cannot be properly quantified with current value-at-risk models (as there is simply no meaningful local data or back-tracking possibilities). However, to cope with this higher degree of uncertainty, the authorities may consider decreasing the financial gearing of financial

⁶⁶ Based on the World Bank's classification.

⁶⁷ In such a case South African insurance regulators would become host regulators to such foreign insurers, implying that the local authorities would have to be satisfied with the standards of the home regulators.

institutions in general. The banks' and securities firms' capital ratios may have to be increased from 8 per cent to 10 or even 12 per cent of risk-weighted assets. Similarly, the insurance regulator may have to re-evaluate the implied financial gearing of insurers.

South Africa's current financial infrastructure is quite good, but not so good that it fulfils all the prudential principles set by the Basel Committee, IOSCO and IAIS. Implementing more fully all these international minimum standards (or principles) may take a few more years. The Policy Board for Financial Services and Regulation, the South African Reserve Bank and the Financial Services Board are fully aware of the work still to be done in this area. Likewise, the King Commission has started its second report on corporate governance in South Africa. The Commission's recommendations on how to harmonise local governance issues with international minimum standards are expected later in 2001.

The optimal regulatory architecture is a topic that needs urgent attention in South Africa. The co-operation and co-ordination among the various domestic regulators and between home and host regulators has to be investigated more carefully. In a similar vein, co-ordination between the various markets (both formal and OTC) in terms of their cross-market risks needs to be addressed. Last but not least, the regulatory authorities have to ensure that retail investment funds are properly protected against abuse and actuarially sound, which in turn involves close interaction with other government departments. To ensure that the authorities themselves operate efficiently and effectively, consideration should also be given to the establishment of a regulatory audit agency.

Particularly in a world likely to be increasingly dominated by e-commerce, consumers have to be fully aware that they operate in this area exclusively on a *caveat emptor* basis. To ensure integrity, fairness and competence in these e-markets, disclosure and transparency are of crucial importance to consumers. The authorities have to assist the consumer and the financial press by benchmarking the flood of financial information. Moreover, even if the decapping of

insurance commissions proves difficult in the medium term, consumers have to be aware of these commission payments (i.e. the plain disclosure of service fees). Capped insurance commissions are not controlled prices, but simply maximums. The authorities should encourage price negotiations, competition and possibly lower commissions.

In line with the recommendations of the Basel Committee, the South African Reserve Bank has established a Financial Stability Committee (and Unit) that will closely investigate the interaction between macroeconomic policy, macroprudential and microprudential requirements. Of particular importance will be the precise roles of the central bank as lender of last resort, and its *de facto* role as forward-coverer of last resort and guarantor of the payments system. Much work still has to be done in this new area. For instance, the involvement of the central bank in financial stability policy may require a new look at the traditional regime of fixed minimum capital requirements for banks. To stabilise liquidity conditions in the markets over the business cycle – and thus avoid possible asset bubbles, property crashes and the like – the monetary authorities may well have to adjust the minimum capital ratios during different stages of the business cycle.

Liquidity management may also involve fiscal policy; as for instance the current transaction taxes levied on securities trade undermine the competitiveness of the local markets *vis-à-vis* overseas markets. In fact, the interaction between monetary policy and financial regulation is likely to become even closer in future, particularly considering the outstanding issues of exchange controls, lender-of-last-resort facilities, banks' exit policies, Structured Early Intervention and Resolution regimes, and possibly cyclically adjusted minimum capital standards that all impact in a major way on the financial regulatory regime.

4.2 The way forward

All the above issues are incorporated into the targets developed in Section 3. As these targets are intended to address South African financial regulation for the 2000s

it may be necessary to make an early start in allocating these targets to task forces for further investigation. For example, one such task force could investigate those targets that are associated with competition.⁶⁸

All the targets identified in Section 3 are summarised in Table 7.2.

⁶⁸ This task force could conduct similar research to that of the Cruickshank Commission in the UK.

Table 7.2: Summary of regulatory targets for the 2000s

Systemic stability

1. Competitive market infrastructure
 - Establish a payments system open to all financial institutions
 - Promote competitive trading, clearing and settlement systems
 - Promote competitive listing requirements
 - Stipulate minimum infrastructural standards
 - Establish interrelated and competitive markets
 - Establish regulatory neutrality towards foreign participants
2. Acceptable maturity and currency mismatches
 - Promote accurate value-at-risk systems
 - Promote the management of the forward currency book by the private sector
 - Promote prudent debt-management systems in the public sector
3. Acceptable cross-market exposures
 - Establish cross-market risk-management, clearing and settlement facilities
 - Establish legally binding netting agreements between markets
4. Sufficient market liquidity
 - Establish a financial stability unit at central bank
 - Formalise the standby facilities of central bank
 - Remove (tax) constraints on market turnover
 - Promote foreign participation in local markets
5. Securities markets as an alternative to financial intermediation
 - Remove constraints on commercial paper and corporate bond issues from the Banks Act
 - Promote the engineering and implementation of an SMME bond instrument
6. Regulatory effectiveness, efficiency and economy
 - Establish co-ordination agreements among domestic regulatory agencies
 - Establish harmonisation agreements between home and host regulators
 - Stipulate regulatory cost-benefit analysis
 - Establish a regulatory audit agency
 - Establish ratings of national regulatory agencies

Table 7.2: Summary of regulatory targets for the 2000s (continued)

Institutional safety and soundness

7. Proper risk assessment
 - Promote accurate value-at-risk systems
 - Stipulate consolidated supervision
 - Appoint specific non-executive board members to supervise risk-management and management control systems
 - Appoint accredited private rating agencies
 - Promote unsecured subordinated debt as a rating tool
8. Proper financial institutional infrastructure and suitability standards
 - Adhere to minimum accounting and audit standards
 - Adhere to minimum capital standards
 - Adhere to corporate governance standards
 - Adhere to compliance standards
 - Establish an infrastructure for the verification of firms' risk and control systems
 - Establish an industry register of doubtful and bad debts
 - Stipulate suitability standards for directors and senior management
9. Global institutional competitiveness and competitive neutrality
 - Abolish foreign exchange controls as soon as possible
 - Adhere to international agreements on regulatory minimum standards
 - Encourage a functional approach to regulation
 - Encourage competitive neutrality between commerce and e-commerce

Table 7.2: Summary of regulatory targets for the 2000s (continued)

Consumer protection

10. Integrity, fairness and competence
 - Encourage a code of corporate governance
 - Encourage a code of business conduct
 - Establish a policy to reduce financial crime and money laundering
 - Encourage effective compliance manuals
 - Stipulate “fit and proper” standards for the compliance office
11. Adequate product/service competitiveness
 - Remove constraints on competitive foreign products
 - Remove regulatory exclusions granted to parastatals or public corporations
12. Transparency and disclosure
 - Adhere to an international code of corporate governance
 - Establish government-defined benchmarks for better consumer information
 - Inform the financial press
13. Adequate access to retail financial services
 - Establish core banks in retail trading sector
 - Open the payments system to non-bank financial institutions
14. Protection of retail funds
 - Establish a Structured Early Intervention and Resolution regime
 - Stipulate acceptable operational risk-management systems
 - Limit the use of retail investment funds as an instrument of social engineering
15. Retail compensation schemes
 - Stipulate ombudsmen arrangements
 - Stipulate fidelity fund arrangements
 - Establish a bank deposit-insurance scheme
 - Establish a single regulator for all market-conduct rulings

INDEX

- access to retail financial services, 22, 182
- accountability, 115
- accountability of financial regulators, 153
- accounting consolidation, 96
- accounting rules, 167
- adverse selection, 11, 16
- agency diversification, 52
- agents, 143
- asset price collapses, 85
- asymmetric information, 22
- auction-driven markets, 127
- audit agency, regulatory, 69
- audit rules, 167
- automated-trading system, 131, 132
- autonomy, 95
- bank supervision, 103
 - core principles, 74
 - political dimension, 105
- bank-deposit insurance requirement, 58
- banks, 140
- basic markets, 125
- brokers, 142, 143
- building blocks, 116
- business conduct requirements, 55
- capital adequacy, 54, 112, 168
- capital inflows, 85
- causes of financial crises, 84, 86
- circuit breakers, 167
- clearing systems, 166
- commercial paper, 160
- commercial paper market, 166
- compensation scheme requirement, 57
- competence, 21
- competition, 20
 - competitive market infrastructure, 18
 - financial intermediaries and securities markets, 91
 - global institutional, 19
 - neutrality, 19
- competition and contestability, 4
- competitive neutrality, 19, 168, 178
- complex group supervision, 97
- complex groups, 97, 168
- compliance, 30
 - and data examination requirements, 63
 - culture, 30
 - incentives, 62
 - non-compliance, 21
- components and instruments of the regulatory regime, 31
- conduct of business regulation, 12
- conduct of business requirements, 55
- conduct of investment business, 55
- conflict-conciliatory principles, 42
- connected lending, 87
- connected parties, 94
- consolidated regulation, 95, 96
- consolidated supervision, 93, 96
- consumer confidence, 15
- consumer demand for regulation, 15
- consumer protection, 2, 11, 19, 25
 - competence, 21
 - integrity and fairness, 21
 - protection of retail funds, 22
 - retail compensation schemes, 22
 - transparency and disclosure, 21
- contagion across markets and countries, 85
- contestability, 3, 4, 5
- contestability and merger and acquisitions, 5
- contract regulation, 27, 113
- corporate bond market, 166
- corporate governance, 36, 40, 67, 68, 153, 167
 - and the regulator, 69
- cost of regulation, 70
- credit rating
 - capital market assessment, 66
 - recognition of agencies, 65
- credit risk, 64
- cross-market exposures, 171
- cross-market netting, 167
- cross-market risk management, 167
- dealers, 143
- deposit-insurance scheme, 110
- deregulation, 76, 78, 79, 81
- deregulation and reregulation, 76
- derivative markets, 124
- direct and indirect costs of regulation, 70
- discipline on and accountability of regulators, 37, 40, 69
- discipline on financial regulators, 153
- disclosure. *See* transparency
- disclosure and advice, 46, 47
- diversification, 51, 52
- double gearing of capital, 94
- dual capacity, 132
- dual-capacity trading rule, 133
- Dutch auction, 127

economic regulation, 1
 economies of scale in monitoring, 13
 e-exchanges, 167
 effective banking supervision, 74
 effective regulation, 1
 efficient regulation, 1
 enforcement, 93
 English auction, 127
 enhanced lead regulation, 103
 Enterprise-wide Risk Management, 64
 entry and standards constraints, 45, 146
 entry barriers, 67
 entry requirements, 46
 entry standards, 46
 ethos of regulation, 81
 exchange controls, 168
 exchange rate regimes, 85
 execution, clearing and settlement functions, 138
 exit policy, 110
 exposures, cross-market, 18
 external auditors role, 64
 externalities, 12
 failure, institutional. *See* financial crises
 financial advisers, 142
 financial conglomerates, 49
 financial crises
 asset price collapses, 85
 capital inflows, 85
 contagion, 85
 exchange rate regimes, 85
 financial liberalisation, 87
 incentives, 87
 liquidity, 86
 macroeconomic causes, 84
 macroeconomic volatility, 85
 regulatory causes, 86
 regulatory responses, 88
 social and individual cost of bankruptcy, 13
 financial distress. *See* financial crises
 financial engineering, 116
 financial fraud, 168
 financial infrastructure, 159, 161, 167
 financial innovation, 78
 financial institutions, 157, 160, 163
 financial instruments, 116
 definition and nature, 116
 issue standards, 48
 regulatory matrix, 119
 regulatory regime, 116

financial intermediation, 141, 173
 financial market participants, 140, 144
 accountability of regulators, 153
 banks, 140
 brokers, 142
 corporate governance, 153
 financial advisers, 142
 incentive contracts and structures, 152
 institutional investors, 140
 intervention and sanctions, 151
 investment firms, 140
 market monitoring and discipline, 152
 official monitoring and supervision, 151
 OTC markets, 140
 regulated market, 143
 regulatory matrix, 147
 regulatory regime, 144
 rules and regulations, 146
 traders, 140
 financial markets, 118
 auction driven, 127
 basic markets, 125
 defining, 118
 derivative markets, 124
 formalising OTC markets, 122
 instruments traded, 123
 order driven, 128
 OTC markets, 121
 primary markets, 126
 quote driven, 128
 regulated markets, 121
 regulation, 126
 regulatory matrix, 135
 regulatory regime, 133
 secondary markets, 126
 single/dual-capacity trading, 133
 spot markets, 123
 trading systems, 129
 financial press, 67, 99
 financial products and services, nature of, 14
 financial stability, 100, 101
 financial stability policy, 102, 168
 financing through securities markets, 91
 first price auction, 127
 fit and proper standards, 45
 for individuals, 45
 suitable directors and management, 19
 floor-trading system, 130
 formal market, 134

functional activity constraints, 50, 146
 functional activity restrictions, 50
 functional approach, 7
 functional regulation, 103
 generic types of regulation, 12
 global financial distress. *See* financial crises
 global institutional competitiveness, 19
 governance and the regulator, 69
 gridlock, 11, 16
 harmonising regulatory arrangements, 71
 hazards in regulation, 17
 highly geared off-shore institutions, 98
 home regulatory arrangements, 168
 host regulatory arrangements, 168
 implicit contracts, 17
 incentive contracts and structures, 33, 39, 61, 152
 incentives, 61, 114
 incentives for management, 62
 incentives for owners, 61
 incentives to contain systemic and business risks, 63
 incentives to create a sound compliance culture, 62
 infrastructure
 financial institutional infrastructure, 19
 financial system, 88
 international standards, 90
 institutional approach, 7
 institutional competitiveness, 178
 institutional failure. *See* financial crises
 institutional infrastructure, 178
 institutional investors, 140
 institutional safety and soundness, 2, 18, 24
 instruments of regulation, 37
 accountability of regulators, 40
 corporate governance, 40
 incentive contracts and structures, 39
 intervention and sanctions, 39
 market monitoring and discipline, 39
 official monitoring and supervision, 38
 rules and regulations, 38
 integrity, fairness and competence, 21, 179
 intermediate goals of regulation, 18, 23, 42
 intermediation
 competition with securities markets, 91
 securities markets as an alternative, 18, 173
 international regulatory standards, 90
 international standards, 90
 intervention and sanctions, 32, 39, 60, 151
 investment firms, 140
 issuance standards, 48
 jurisdiction, 53
 jurisdictional constraints, 52, 148
 lack of market liquidity, 86
 lead regulation, 103
 lender of last resort, 107
 lending booms, 85
 lifeboat facility, 110
 liquidity management, 167
 liquidity risk, 64, 98
 listed financial instruments, 138
 macroeconomic volatility, 85
 market depth and liquidity, 18
 market discipline, 34, 91
 assessment, 35
 market imperfections and failures, 12
 market infrastructure, 169
 market liquidity, 172
 market maker market, 128
 market makers, 143
 market monitoring and discipline, 34, 39, 64, 152, 168
 market regulators, 136
 market risk, 64
 market specialists, 143
 maturity and currency mismatches, 18, 86, 170
 merger and acquisitions, 5
 methods of regulation, 81
 minimum standards, 46, 48
 monetary stability, 100
 monitoring
 capabilities, 92
 economies of scale, 13
 moral hazard, 11, 16
 nature of financial products and services, 14
 non-compliance, 21
 novation, 72, 117, 137
 objectives of regulation, 2, 18
 objectives, intermediate goals and targets of regulation, 17
 official monitoring and supervision, 32, 38, 59, 151
 offshore institutions, 98
 operational constraints, 53, 148
 operational risk, 64
 order book driven markets, 128
 order driven market system, 130
 order driven markets, 128
 over the counter (OTC) market, 121, 134
 own service diversification, 51
 ownership constraints, 49, 146
 philosophy of regulation, 1

- platforms
 - execution, clearing and settlement functions, 138
- pricing constraints, 53, 148
- primary securities markets, 126
- principal traders, 143
- principles of regulation, 3
 - conflict-conciliatory, 6
 - efficiency related, 3
 - general, 8
 - regulatory structure, 7
 - stability related, 5
- product competitiveness, 180
- protection of retail funds, 182
- prudential regulation, 12, 54
- pyramid holding companies, 50
- quote driven dealership market, 128
- quote driven markets, 128, 129
- rating agencies, 65
- ratings, 168
- rationale for regulation, 11
- regulated market, 121
- regulatory accountability, 168
- regulatory arbitrage, 94
- regulatory architecture
 - basic function authorities, 137
 - market regulators, 136
 - single authority per basic market, 137
 - South Africa, 139
 - specialised authorities, 137
- regulatory audit agency, 69
- regulatory co-ordination, 71
- regulatory effectiveness, efficiency and economy, 18, 174
- regulatory gaps, 169
- regulatory instruments. *See* instruments of regulation
- regulatory matrix, 42
 - alignment of instruments to goals, 43
 - financial instruments, 119
 - financial market participants, 147
 - financial markets, 135
 - impact of deregulation, 77
- regulatory objectives, 2, 18
 - intermediate goals of regulation, 18
- regulatory philosophy, 1
- regulatory principles, 3
- regulatory regime, 26, 42, 154
 - accountability of regulators, 37, 69
 - alternative approaches, 26
 - components and instruments, 31
 - corporate governance, 36, 67
 - financial instruments, 116
 - financial market participants, 144
 - formal markets, 134
 - incentive contracts and structures, 33, 61
 - intervention and sanctions, 32, 60
 - market discipline, 91
 - market monitoring and discipline, 34, 64
 - official monitoring and supervision, 32, 59
 - OTC markets, 134
 - rules and regulations, 45. *See* rules and regulations
 - structure of financial markets, 133
- regulatory regime in South Africa, 154
 - alternative to intermediation, 173
 - compensation schemes, 183
 - competitive neutrality, 178
 - cross-market exposures, 171
 - disclosure, 180
 - in 1980s, 157
 - in 1990s, 159
 - in 2000s, 162
 - fit and proper standards, 178
 - global competitiveness, 178
 - integrity, fairness and competence, 179
 - market infrastructure, 169
 - market liquidity, 172
 - maturity and currency mismatches, 170
 - product and service competitiveness, 180
 - regulatory effectiveness, 174
 - retail funds protection, 182
 - risk assessment, 176
 - service access, 181
 - targets and gaps, 169
 - the way forward, 185
- regulatory regime paradigm, 113
- regulatory strategy, 26, 28, 41
 - strategy matrix, 42
- regulatory targets, 22, 169, 186
- remote trading, 167
- reregulation, 76, 80
- reregulation and self-regulation, 80
- retail compensation schemes, 183
- risk
 - incentives to contain systemic and business risks, 63
 - risk assessment, 19, 176
- rules and regulations, 31, 38, 45, 146
 - entry and standards constraints, 45
 - entry and standards requirements, 31
 - functional activity constraints, 31, 50
 - jurisdictional constraints, 31, 53

operational constraints, 31, 53
 ownership constraints, 31, 49
 pricing constraints, 31, 53
 safety net arrangements, 106, 168
 deposit-insurance scheme, 110
 lender of last resort, 107
 lifeboat, 110
 sanctions, 91
 screen-trading system, 131
 secondary securities markets, 126
 second price auction, 127
 securities markets, 91, 92, 158, 160, 164, 173
 Securities Regulation Panel, 161
 securitised asset markets, 166
 self-regulation, 80
 self-regulatory organisations (SROs), 80
 separate regulation, 95, 96
 settlement systems, 166
 single capacity, 132
 single regulatory authority, 73, 137
 single-capacity trading requirement, 56
 single-capacity trading rule, 133
 social and individual cost of bankruptcy, 13
 socio-economic environment, 155
 solo plus, 96
 solo plus regulation, 96
 South African financial system, 116
 specialist regulatory authorities, 137
 spot markets, 123

 stability, 2, 18, 23
 and central banks, 101
 externalities, 12
 financial, 100
 monetary, 100
 stock adjustment, 79
 strategic framework for regulation, 41
 goals and operational targets, 41
 objectives, 41
 regulatory regime, 41
 strategy matrix, 42
 structure of financial markets, 133
 structure of regulation, 81, 136
 Structured Early Intervention and Resolution
 arrangements, 60
 suitability standards, 178
 super-regulatory agency, 168
 supervision capabilities, 92
 systemic bank restructuring, 111
 systemic stability. *See* stability
 target-instrument approach, 41, 42
 targets of regulation, 22, 186
 tâtonnement auction, 127
 telephone/screen-quotation trading system, 130
 traders, 140
 trading requirements, 56
 trading systems, 129
 transparency, 22, 97, 114, 167, 180
 value-at-risk systems, 168
 warehousing securities, 140