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Trade in Financial Services in Southern Africa: What Room for Negotiators post-2008 Financial Crisis?

Rosalind Thomas

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ABBREVIATIONS AND ACRONYMS

ABC	African Banking Corporation
Absa	Amalgamated Bank of South Africa
AML	Anti-Money Laundering (Act)
AVC	Asset Value Correlation
BAFT	Bankers' Association for Finance and Trade
BCBS	Basel Committee on Banking Supervision (also Basel Committee)
BESA	Bond Exchange of South Africa Limited
BIS	Bank for International Settlements
BOB	Bank of Botswana
BOBC	Bank of Botswana Certificate
bp	basis points
BSE	Botswana Stock Exchange
BWP	Botswana pula
CCP	central counterparty
CDS	credit default swap
CISNA	Committee of Insurance, Securities and Non-banking Financial Authorities
CPPS	Committee on Payment and Settlement Systems
DFI	Development Financial Institution
EU	European Union
FAIS	Financial Advisory and Intermediary Services
FDI	foreign direct investment
FG	financial guarantee
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSB–SA	South Africa's Financial Services Board
FSSA	Financial System Stability Assessment
G20	Group of Twenty
G30	Group of Thirty
GATS	General Agreement on Trade in Services
GDP	gross domestic product
IAIS	International Association of Insurance Supervisors
ICBC	Industrial and Commercial Bank of China
IFC	International Finance Corporation
IFI	international financial institution
IFSA	International Financial Services Association
IFSC	International Financial Services Centre
IIF	Institute of International Finance
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
JSE	Johannesburg Stock Exchange
M&A	mergers and acquisitions

MFN	most favoured nation
MOF	ministry of finance
MOU	memoranda of understanding
NBFI	non-banking financial institution
NBFIRA	Non Bank Financial Institutions Regulatory Authority
OECD	Organisation for Economic Co-operation and Development
OTC	over-the-counter
PIIGS	Portugal, Iceland, Italy, Greece and Spain
PPP	public–private partnership
RWA	risk weighted assets
SADC	Southern African Development Community
SARB	South African Reserve Bank
TNF	Trade Negotiating Forum
TNF–Services	Trade Negotiating Forum–Services
WTO	World Trade Organization
ZAR	South Africa rand

EXECUTIVE SUMMARY

This study examines the impact of the financial crisis and of Group of Twenty (G20) reform on trade in financial services in the Southern African Development Community (SADC) region, focusing specifically on corporate, trade and project finance from the standpoint of the biggest banks in South Africa. The objective is to understand the effects, if any, on the SADC services negotiations, taking Botswana as a case study.

Trade in financial services

Financial services are a dynamic and growing sector of services trade globally, and provide a valuable source of revenues for the financial institutions engaged in these activities. They represent over 50% of the gross domestic product (GDP) for Botswana and South Africa.

As barriers to services trade are generally regulatory in nature, the liberalisation of laws and regulations will form the greater part of negotiations among the 15 SADC countries. Complicating these negotiations is the unprecedented agenda for reform of the global financial system in the aftermath of the crisis. As a member of the G20, South Africa will provide the conduit through which these reforms are likely to be absorbed into the region, as potential new barriers to trade, that will not be open to reduction via trade negotiations.

Who sets these international rules?

The globalisation of financial markets has always posed challenges for the regulation and supervision of economic actors, given the weaknesses inherent in existing international financial structures. The G20 have focused attention on improving the roles of these institutions, many of which will have implications for the SADC services trade agenda.

What is the role of the World Trade Organization in relation to financial services?

The World Trade Organization's (WTO) role has been one of advocacy aimed at keeping the wheels of trade turning.

The General Agreement on Trade in Services

Three legal documents that cover trade in financial services are the General Agreement on Trade in Services (GATS), the GATS Annex on Financial Services and the Understanding on Commitments in Financial Services. Of the four modes of supply, the relevant ones relate to cross-border provision of services (mode 1) and commercial presence (mode 3).

The SADC draft protocol on trade in services

The draft protocol was finalised in December 2007 and is yet to be adopted by the SADC Summit. Four approaches to negotiating the liberalisation of national financial systems apply: (i) the unilateral route – similar to that achieved under the International Monetary Fund (IMF) structural adjustment programmes; (ii) the bilateral approach, where a member country has agreements with a third country; (iii) the multilateral approach, as would happen under the SADC negotiations; and (iv) the multilateral, non-regional route via the WTO. Within SADC, the third approach is currently being negotiated, although,

complicating the negotiations, some countries have also implemented a unitary track or negotiated bilateral arrangements.

Overview of SADC negotiations on trade in services

The 14th Trade Negotiating Forum–Services (TNF–Services) meeting, held on 11 November 2009, adopted guidelines to facilitate negotiations and achieve specific goals. However, the negotiations are yet to begin. The region is now preparing for the first round, with member states exchanging initial requests at the end of the first quarter in 2011. It is anticipated that global reforms will impact on these discussions and create additional barriers that may not be negotiable at the regional level.

The global meltdown: A tale of two African economies

The Lehman Brothers' collapse in 2008 ushered in the worst phase of the financial crisis, affecting global trade in particular. Trade finance immediately dried up as the demand for goods and services ceased. No country was left unaffected. The IMF forecasts negative growth for advanced economies and a drop in growth for sub-Saharan countries.

Botswana

As Botswana felt the impact of the crisis, real GDP growth declined to 2.9% at the end of 2008, down from a previous (+40 years) high of 10%. Diamond revenues dropped as production ground to a halt. The sector contracted by 38.4% in the first nine months of 2009, to 24% of GDP, down from 41.2% in 2008. Trade receipts declined while diamond exports fell. However, imports remained high due to government spending as part of a stimulus package. From December 2008, the Bank of Botswana (BOB) reduced its main interest rate by 400 basis points to stimulate the economy. The financial sector remained relatively sound, but also suffered from second-round effects. The number of non-performing loans rose in late 2008 and early 2009, and growth in credit fell from 27.7% in December 2008 to 15.2% in December 2009, due to a slowdown in lending to business.

South Africa

As the economy ran out of steam in 2008, the crisis ended the longest upward trend in the business cycle in South Africa. The economy experienced its first GDP contractions in a decade. Mining sector output shrank by 33% in the fourth quarter of 2008, while manufacturing shrank by 22%. The level of GDP output shrank by 3% in the third and fourth quarters of 2009, reflecting the impact of the global recession on the country. While exchange controls protected the financial sector from the worst of the crisis, the real economy could not avoid its impact. Exports fell by 24% in the first quarter of 2009, adding more pressure to the current account deficit. The South African Reserve Bank (SARB) began trimming rates in December 2008 to boost the economy, allowing several cuts; by August 2010, the rate was down to 6.5%.

The financial services sector in Southern Africa

These include the full range of banking and non-banking financial services, which South Africa dominates in the SADC region. Banks make up the largest segment, with assets representing 120% of GDP, and all banks operate on Basel II. Insurance companies held

assets accounting for 80% of GDP at the end of 2007, and have the highest insurance penetration globally at 16% of GDP.

The Johannesburg Stock Exchange (JSE) is the largest among emerging markets by market capitalisation, while the Bond Exchange of South Africa Limited (BESA) is a leader among emerging markets with annual liquidity of 38 times its market capitalisation. South Africa is therefore considered a net exporter of financial services in the region.

Botswana's financial sector is well diversified, has grown since the late 1990s, and covers a range of institutions. By asset size, the pension funds and banks are the most important. Apart from big foreign banks, which are all Basel II compliant, the smaller foreign and local banks operate on Basel I. This is because BOB is also still on Basel I.

Over the past 10 years, the Botswana Stock Exchange (BSE), institutional investors and the pensions industry have grown rapidly, demonstrating substantial accumulation and a high degree of liquidity.

A new regulator, the Non Bank Financial Institutions Regulatory Authority (NBFIRA) was established in 2008 to address concerns relating to market conduct, consumer protection and portfolio vulnerabilities. The IMF's 2008 assessment notes the need for an overarching national strategic framework and better co-ordination between BOB and the ministry of finance (MOF), as well as greater capacity development and support.

The impact of the crisis on the financial sector in Southern Africa

The first-round impacts of the financial crisis missed the South African banks, but the second-round effects on trade (after the collapse of Lehman Brothers) were instantaneous. The latter was a crisis in confidence and liquidity, as banks became nervous and stopped lending. There was little or no appetite for emerging market risk, apart from short-term loans on onerous terms. South African banks turned to non-traditional sources (e.g. Asia) to raise funds. Similarly, South Africa's export insurance agencies saw an increase in claims as imports and exports were affected.

As the market witnessed a deceleration in business activities, corporate finance was likewise impacted through increases of the risk premium on bonds. Mergers and acquisitions (M&A) activity collapsed and only recovered in mid-2009. Institutional investors and hedge funds experienced a fall in business and consequently in fees earned.

Project financing suffered from cancellations or the delaying of projects by African governments. Many deals had gone through the tendering process, but few reached financial closure. Syndication of deals gave way to club transactions with more onerous contractual terms. Public–private partnerships (PPPs) dropped sharply in 2008 and 2009, down from a previous high spanning 2003–2007. As aversion to counterparty risk grew (post-Lehman Brothers collapse), originators could no longer distribute the debt from these projects via the secondary markets. The market is seeing increased involvement of Brazilian and Chinese investors and has begun to pick up since 2010, but terms and conditions are still difficult.

In Botswana, bank credit especially for corporate finance froze in 2009, as foreign banks eased off on credit in the wake of the crisis and due to uncertainty in the diamond industry. However, recovery is now taking off. BOB cut the bank rate to 10%. New banks have since entered the market. The main client of project finance is the government. The Morupule Power B project closed with support from the Standard Bank of South Africa and the Industrial and Commercial Bank of China.

Ex-post regulatory reform in Southern Africa

Of the long list of regulatory reform issues on the agenda at the G20, only those addressing (i) capital adequacy and liquidity; (ii) complex financial instruments; and (iii) systemically important financial institutions will be addressed in this study.

Strengthening and harmonising capital and liquidity standards

These reforms address changes to bank capital requirements, and specifically Tier 1 and Tier 2 capital, simplifying the same and disqualifying innovative hybrid instruments. They re-emphasise the importance of common equity, introduce specific liquidity tests (namely: a liquidity cover ratio and a net stable funding ratio) and monitoring tools for reporting to supervisors. At SADC level, the central bank governors have set up a subcommittee to focus on issues relating to core principles for effective banking.

The Bankers' Association for Finance and Trade (BAFT) and the Institute of International Finance (IIF) have argued that these capital adequacy and liquidity reforms will have a major impact on the lending of banks, and would result in a drop in GDP growth for many economies. However, two further studies by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) demonstrate that these reforms would have only modest costs and, in fact, would bring benefits to the economy.

South African banks are concerned about the unintended consequences of these reforms and have made inputs to the South African government.

Expanding the transparency of complex financial instruments

The use of credit default swap (CDS) instruments and financial guarantees contributed to major gaps in market regulation. The Joint Forum on Financial Conglomerates (the Joint Forum) found that inadequate risk governance and risk management practices were to blame, together with inadequate collateral and a lack of transparency.

In April 2008, SARB carried out an exercise to assess the status of securitisation activities in the banking sector and found that assets were of a high level of transparency, and that risks relating to these instruments were appropriately managed. Recommendations discussed and adopted by the International Organization of Securities Commissions (IOSCO) are under consideration in South Africa.

Regulating systemically important financial institutions

This has been raised as a concern at the G20. The three banks interviewed for this study fall into this category. The Joint Forum's January 2010 report focuses on these institutions, *inter alia*, for purposes of calculating capital adequacy requirements where the group comprises both regulated and unregulated entities. Several recommendations are put forward to address especially cross-border activities, and to ensure common standards to capture fully the risks these entities face. As a member of the Joint Forum (and its constituent bodies), issues of co-operation, co-ordination and information sharing through supervisory colleges are important for South Africa.

At the regional level, legislation to facilitate this oversight is due in 2012. Via SADC structures, however, co-operation occurs through the SADC Finance and Investment Protocol, and steps are underway to harmonise approaches.

Botswana benefits from this regional co-operation via the Committee of Insurance, Securities and Non-banking Financial Authorities (CISNA). While NBFIRA has little

capacity at present to manage its portfolio of responsibilities, the World Bank is assisting it to acquire this capability. The country is strengthening its securities legislation in line with global developments, strengthening its anti-money laundering legislation and redressing a perception that it is a tax haven.

Will global influences impact upon the SADC trade negotiations on financial services?

The reforms driven by the G20 countries have little relevance for countries in the SADC region, apart from South Africa's sophisticated first-world financial services sector and those of Botswana and Mauritius. Trade in financial services is probably going to be in one direction – from South Africa to the rest of the region. Therefore, given its involvement with the G20 process, South Africa is expected to influence the discussions in the SADC TNF–Services. Botswana's regulatory reform is already influenced by the G20 agenda. It is likely that all reforms implemented in South Africa will influence the regional agenda and would be difficult to amend in the forthcoming trade negotiations.

South African banks' perceptions of the arduous nature of capital and liquidity requirements for long- and short-term investments, and therefore their appetite for the same, is likely to influence how and where they invest, resulting in a reduction in cross-border lending, or lending on more onerous terms and greater barriers to cross-border trade in financial services.

CHAPTER 1

INTRODUCTION

This study assesses the impact of the financial crisis and G20 discussions on regulatory reform and trade in financial services in the SADC region, with a specific focus on its effect on corporate, trade and project financing from the standpoint of the biggest banks in South Africa. The intention is to understand the impacts, if any, on the SADC services negotiations, taking Botswana as a case study.

An explanation includes trade in financial services at both the multilateral (WTO) and the regional (SADC) levels, and outlines the international architecture governing financial services – the Bank for International Settlements (BIS), BCBS, FSB, IOSCO, the Joint Forum on Financial Conglomerates (the Joint Forum) and others – before comparing their role with that of the WTO.

Thereafter, the paper explores the impact of the financial crisis on the economies of Botswana and South Africa, reviews the financial sectors of both countries, analyses the effects of the financial crisis on the financial services sector as well as on financing of trade, corporate and project finance, and then examines regulatory developments. The final part of the paper attempts to answer the questions posed and concludes that the international regulatory reform agenda will certainly drive the content of and approach to the SADC negotiations in respect of financial services trade, and thus may constitute a barrier to such trade.

CHAPTER 2

TRADE IN FINANCIAL SERVICES

Financial services represent a dynamic and growing sector of international trade in services, providing a valuable source of revenues for the financial institutions engaged in these activities, as well as for their national economies.[1] Table 1 demonstrates the significance of services in the economies of Botswana and South Africa, while Box 1 explains the significance of services globally to most economies.

Table 1: Percentage share of services sector of GDP

	2002	2003	2004	2005	2006	2007	2008
South Africa	62.2	63.1	63.5	63.8	64.5	65.0	65.6
Botswana	47.7	46.5	46.6	47.5	47.0	48.6	51.4

Source: Extract from WTO SACU Trade Policy Review 2009

Box 1: The importance of services in the economy

The services industry covers a wide range of intangible and diverse products and activities, including transport, telecommunication and computer services, construction, financial services, wholesale and retail distribution, hotel and catering, insurance, real estate, health and education, professional, marketing and other business support, government, community, audiovisual, recreational, and domestic services. Services have a significant impact on growth and efficiency across a wide range of user industries and on overall economic performance. For instance, sectors such as transport, telecommunications and financial services are key determinants of the conditions in which persons, merchandise, services and capital flow.

Services currently represent more than two-thirds of the world's GDP. The share of services value added in GDP tends to rise significantly with the country's level of income, standing at 72% on average in high-income countries (76% in the US), against 54% and 45% respectively in middle- and low-income countries.

Source: Cf. WTO, *Measuring Trade in Services*, December 2008

Financial services essentially include, but are not limited to, acceptance of deposits, provision of loan financing, payment services, securities trading, asset management, financial advice, settlement, and clearing services. When engaging in these activities with non-residents, financial institutions are conducting international trade in financial

services. In the Southern African region, trade in financial services is governed or implemented at three different levels of governance: (i) internationally via the WTO; (ii) regionally, via the SADC draft protocol on trade in services; and, (iii) nationally, through domestic legislation, practices and trade usages. This section discusses the first two within the framework of global developments in the financial sector.

Barriers to trade in services are generally regulatory in nature and include measures to restrict market access by foreign firms. Liberalisation of such trade would require the reduction of regulatory barriers to market access and discriminatory national treatment across all four modes of supply.[2] The national laws and regulations of the 15 countries that make up the SADC region provide barriers to regional financial services trade and, therefore, will be subject to negotiations going forward.

Due to the globalisation of financial services, a potential complicating factor for these negotiations is the unprecedented international regulatory reform agenda created by recent economic developments. In light of South Africa's G20 membership and the integration of its financial sector into the global system, both macro-prudential and micro-prudential regulations will probably be substantially strengthened, which may affect the provision of finance in both South Africa and the region, creating new 'barriers' to trade. Further, these reforms may need to be considered in the context of regional responses to the financial crisis and, as such, may not be amenable to reduction through trade negotiations.[3]

Therefore, the negotiations on trade in financial services need to be viewed against the structure and diversity of the international legal and regulatory system relevant to international banking and finance, and the changes that are looming on the horizon as a consequence of the financial crisis. Financial activities will be made subject to, *inter alia,* more extensive, complex and often cumulative, regulatory policies and structures relating to systemic oversight, financial stability, customer and investor protection, market integrity, and corporate governance.[4] However, the reform agenda still needs to address more coherently the supervisory function and the institutional architecture for implementing the new framework that is being put into place.[5]

WHO SETS THESE INTERNATIONAL RULES?

Due to systemic risk and the threat of contagion, the globalisation of financial markets has always posed regulatory and supervisory challenges in the banking and non-banking financial sectors, given the weaknesses inherent in existing structures.[6] Thus, after the 1997 Asian financial crisis, strident calls were made for reform of the international financial architecture.

The 2008/2009 crisis has been no different, with the G20 members focusing attention once again, and more radically, on reform.[7] Over the past four decades, starting in the 1970s, several institutions or committees were established to address policymakers' concerns regarding shortcomings in domestic regulation and the international spillover effects of financial crises. These include, BIS, BCBS, IOSCO, the International Association of Insurance Supervisors (IAIS), and the Joint Forum[8] set up in 1996 (see Box 2 on page 15).

Box 2: Institutions overseeing the international financial system

BCBS was set up under BIS at the end of 1974. It formulates broad supervisory standards and guidelines and recommends statements of best practice. The committee reports to central bank governors and heads of supervision of member countries.

IOSCO is an association of financial services institutions that regulates the world's securities and futures markets. Established in 1983, its member agencies have agreed to co-operate on internationally recognised and consistent standards of regulation and oversight of efficient and transparent markets, in order to: address systemic risks; enhance investor protection and confidence in the securities markets; and exchange information on their experiences to assist the development of markets, strengthen market infrastructure and implement appropriate regulation.

IAIS was created in 1994 and is based at BIS. Its objectives are to promote co-operation amongst insurance supervisors, develop the insurance market and contribute to financial stability.

The **Joint Forum** was established in 1996 and incorporates BCBS, IOSCO and IAIS. It deals with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.

The establishment of **FSB** was announced in April 2009 at the London Summit. It replaces the Financial Stability Forum, which was founded in 1999 after the Asian financial crisis, to promote international financial stability. FSB has a larger membership including major emerging market economies and a stronger mandate to co-ordinate and monitor progress in strengthening financial regulation.

Finally, the G20 has turned to the **IMF** to act as a research and advisory body on their behalf, looking for its support in three areas: technical advice, surveillance, and research. Surveillance means regular oversight of both member countries and the global financial and economic system. In addition, the IMF is collaborating with the FSB on an early warning exercise and proposals for regulating systemically important financial institutions. It has also been systematically tracking the implementation of G20 commitments and issuing stocktaking notes of responses to the crisis before selected summits.

Additionally, in the search for international solutions to systemic risks, several international bodies were either created or mandated to oversee the sector. They include the FSB, formerly the Financial Stability Forum, which was enlarged and given a stronger mandate to co-ordinate and monitor progress in strengthening financial regulation.

Similarly, in April 2009 at the G20 summit, leaders reaffirmed the role of the IMF in helping to combat the global economic crisis and reinforce the financial system, noting that its resources would be tripled to $750 billion, including $100 billion each from Japan

and the European Union (EU). The IMF would use the money to buttress countries affected by the global downturn. It was also mandated to make a new general allocation of special drawing rights to inject $250 billion into the world economy and increase global liquidity.[9]

How these various bodies interact and what reforms they will be sponsoring within the context of their mandates, together with any potential effects on the regional trade agenda, is discussed and analysed below.

WHAT IS THE ROLE OF THE WORLD TRADE ORGANIZATION IN RELATION TO FINANCIAL SERVICES?

The WTO provides an international forum for governments to negotiate trade agreements and settle their trade disputes. Through the various WTO agreements on goods, services and intellectual property, the WTO oversees and manages the commitments of member states to lower customs tariffs and other trade barriers, and to open and keep open services markets. They spell out the principles of liberalisation, the permitted exceptions, and lay down procedures for settling disputes, ensuring that governments make their trade policies transparent. Thus, the WTO Secretariat periodically scrutinises the trade policies and practices of all WTO members.[10]

With the financial crisis, the WTO has taken a specific interest in monitoring and facilitating the availability of trade finance in all regions of the world, to ensure the recovery of world trade. Consequently, its director general regularly hosts a meeting for trade finance bankers, international financial institutions and regulators. In this way, the WTO also plays a clear advocacy function in support of keeping 'the wheels of trade turning'.[11]

THE GENERAL AGREEMENT ON TRADE IN SERVICES

The WTO rules governing trade in financial services are found in three legal instruments: (i) GATS[12] (Article I to XXIX); (ii) the GATS Annex on Financial Services; and (iii) the Understanding on Commitments in Financial Services. Article 5a of the Annex is considered quite comprehensive and lists the banking and securities services covered by GATS (see Box 3 on page 17).

Maki states that financial services are predominantly supplied via 'commercial presence'[13] (i.e. mode 3)[14]; while Gkoutzinis considers both modes 1 and 3 to be important: 'the most important modes of trade in banking and other financial services are, by far, modes 1 and 3 that, respectively, cover the cross-border provision of services and the establishment of branches and other forms of commercial presence overseas'.[15] In GATS parlance, commercial presence means:[16]

> any type of business or professional establishment, including through the constitution, acquisition or maintenance of a juridical person, or the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supplying a service.

Box 3: GATS Annex on Financial Services: Banking and other financial services, excluding insurance (Article 5a)

The GATS annex lists the following banking and securities services:

(V) Acceptance of deposits and other repayable funds from the public;
(VI) Lending;
(VII) Financial leasing;
(VIII) All payment and money transmission services;
(IX) Guarantees and commitments;
(X) Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:
  (a) Money market instruments;
  (b) Foreign exchange;
  (c) Derivative products including, but not limited to, futures and options;
  (d) Exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;
  (e) Transferable securities; and
  (f) Other negotiable instruments and financial assets, including bullion.
(XI) Participation in … securities, including underwriting and placement as agent…;
(XII) Money broking;
(XIII) Asset management…;
(XIV) Settlement and clearing services…;
(XV) Provision and transfer of financial information;
(XVI) Advisory, intermediation and other auxiliary financial services….

Commercial presence is also referred to as 'factor trade' because it involves the movement of one of the factors of production (i.e. capital) across borders.[17] On the other hand, mode 1 means that, in providing the service, the financial institution remains outside the territory of the consumer, and the consumer remains inside his territory of residence (thus providing a cross-border service). For purposes of this paper, this will be the extent of the evaluation of how GATS operates.

THE SADC DRAFT PROTOCOL ON TRADE IN SERVICES

Article 23 of the SADC Protocol on Trade recognises the significance of trade in services to economic development and the importance of ensuring its conformity with GATS. A draft Protocol on Trade in Services was finalised in December 2007, but still has to be adopted and signed by member states. Article 16 of the draft protocol identifies six priority sectors under services, including financial services.[18] SADC has also concluded and adopted a Protocol on Finance and Investment, which has yet to enter into force and, likewise, addresses the integration of financial markets, specifically the cross-border movement of

capital, albeit as foreign direct investment (FDI). There is very little co-ordination between these two protocols and, although trade officials were fully consulted on the protocol's Investment Annex,[19] there has been little or no consultation with treasury officials on the development and negotiation of the Protocol on Trade in Services.[20]

Achieving financial integration requires the elimination of legal barriers obstructing cross-border flows of capital, financial services, and financial institutions, in order to establish an integrated market. Through co-operation of economic and technological capacities that facilitate cross-border financial activities, everyone within the integrated area is considered a resident with respect to finance.[21]

There are four (not mutually exclusive) approaches to achieving institutional reform that countries can use to negotiate the liberalisation of their financial systems:

1 The unilateral route is where unilateral domestic reform results in the abolition of legal barriers. In the SADC region, this has usually happened within the framework of World Bank/IMF-sponsored policy reforms.
2 The bilateral approach occurs when two countries conclude a reciprocal agreement to eliminate barriers to their bilateral trade. An example would be the agreement between South Africa and the US.[22]
3 The multilateral regional approach is when a number of countries in the same region form a free trade area (as in the SADC region), with the objective of abolishing internal frontiers that obstruct the circulation of specified classes of goods, services, persons, and capital transactions.
4 The multilateral, non-regional approach to reform via the WTO, in which the free trade area aims to achieve a truly global coverage.[23]

The third approach to achieving institutional reform is currently under negotiation within the SADC region, although certain member states have also pursued either a unitary track, under the Bretton Woods institutions, or a bilateral track between a member state and a third-party country. This can only complicate the negotiations and adds to the difficulty of achieving an integrated financial market in such a diverse region.

OVERVIEW OF SADC NEGOTIATIONS ON TRADE IN SERVICES

Member states adopted negotiating guidelines at the 14th TNF–Services meeting, held in Gaborone, Botswana on 11 November 2009. Under these, negotiations are to be initiated on the basis of measured liberalisation, so as to achieve a harmonious, balanced and equitable development of the region. The aim is to achieve progressively higher levels of liberalisation and to promote the interests of all participants on a mutually advantageous basis. The first round of negotiations is to be concluded no later than three years after the adoption of the protocol, and the results are expected to enter into force immediately afterwards. According to the guidelines:

- The starting point for the negotiation of specific commitments shall be members' existing GATS schedules, including the horizontal section and sectoral commitments.

Where a state is not a member of the WTO, the starting point for the negotiations shall be a blank schedule of commitments.

- The modalities for negotiation are based on a request and offer approach, at the conclusion of which each member state shall offer some improvement to its existing GATS commitments, for each of the six priority sectors.
- Measures inconsistent with paragraph 1 of Article 4 (most favoured nation – MFN – treatment) that a state wishes to maintain shall be included in an MFN exemption list. The agreed lists of MFN exemptions shall be annexed to the protocol. The TNF–Services shall regularly review MFN exemptions to determine which can be eliminated.
- States, who so wish, may already in the first round of negotiations take commitments beyond the six priority sectors. Subsequent negotiations will include all services sectors covered by the SADC Protocol on Trade in Services.[24]

According to the staff of the SADC Secretariat, negotiations have not yet progressed to the substantive request and offer phase, despite the adoption of the draft protocol by trade ministers on 3 July 2009. This is because the protocol has not yet been submitted to the summit for signature, as its adoption by ministers at their 2009 meeting coincided with the meeting of justice ministers and attorneys general who are responsible for clearing all legal documents for submission to the Council of Ministers and Summit. Similarly, the document will not be submitted to the council and summit in 2010, as the justice ministers cancelled their meeting scheduled to take place in the Democratic Republic of Congo, and will not be meeting again in 2010. SADC is now preparing for the first round of negotiations on commitments covering the six sectors marked for intra-SADC liberalisation. Member states are expected to prepare and exchange initial requests at the end of the first quarter of 2011.[25] However, what still needs to be assessed is whether the G20 (global) discussions on reform and regulation of financial services will affect these services trade negotiations and create new 'barriers' to trade.

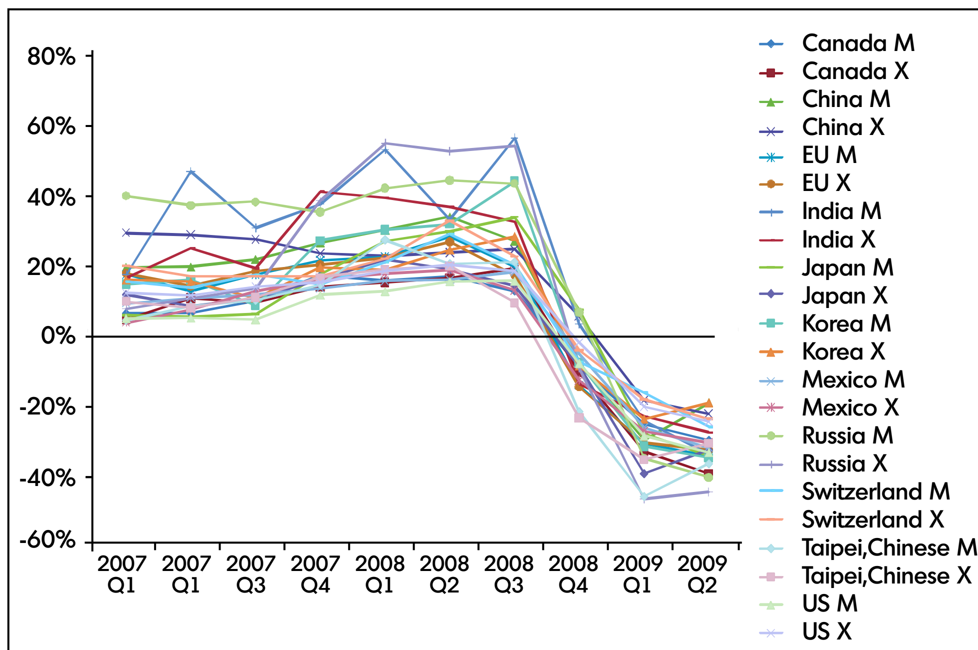
The next section explores the impact of the financial crisis on the economies of Botswana and South Africa, reviews the financial sectors of both countries, analyses the effects of the financial crisis on the financial services sector as well as on financing of trade, corporate and project finance, and then examines regulatory developments.

CHAPTER 3

THE GLOBAL MELTDOWN: A TALE OF TWO AFRICAN ECONOMIES

In September 2008, the collapse of Lehman Brothers ushered in what is widely recognised as the worst phase of the financial crisis, following the unwinding of the complex derivatives market in the US. Financial markets were paralysed by the event and by the realisation that the weaknesses in counterparties were even worse than expected. The concept 'too big to fail' had no real value. Liquidity instantly dried up, as banks no longer trusted each other. The immediate casualty was global trade, as simultaneously short-term trade finance dried up and trade flows – both imports and exports – collapsed.[26] Figure 1 depicts this catastrophic event.

Figure 1: The great trade collapse, 2008 Q3 to 2009 Q2



Sources: Eichengreen B & K O'Rourke, in Baldwin R, (ed.) *The Great Trade Collapse: Causes, Consequences and Prospects*. Geneva: Centre for Economic Policy Research, 2009, www.voxeu.org/reports/great_trade_collapse.pdf

While the start of the global meltdown can be traced to the 'subprime' crisis, some of the main underlying causes were macroeconomic imbalances (reflected in large current account surpluses in Asian and oil-exporting countries, as well as fiscal and current

account deficits in the US, UK and Euro-zone), loose monetary policy (leading to mispricing of risk and credit), excessive leveraging of banks (facilitated by pro-cyclical regulation), and regulatory arbitrage.[27] No country was left unscathed. For 2009, the IMF forecast negative growth of -2% in all advanced industrial economies, while in sub-Saharan Africa growth projections were revised downwards from 6.8% to 3.5%.[28] The effects of the crisis on Botswana and South Africa, the two economies at the centre of this paper, are discussed below.

BOTSWANA

According to an IMF report, from 1960 to 2008 Botswana's real GDP growth averaged almost 10% per annum, supported by the mining sector and more recently by stronger growth in the non-mining economy. As a result, real per capita income increased from $250 in 1960 to $4,800 by 2008 (in constant 2,000 dollars).[29] Botswana's prudent management of its diamond revenues saw large fiscal and external surpluses, with international reserves amounting to 21 months of imports by the end of 2008. However, that year saw real GDP growth decline to 2.9%, as Botswana's economy felt the impact of the global financial meltdown beginning in the last quarter of 2008.

The crisis affected mainly the mining industry, which contributes approximately 40% to GDP. At the beginning of 2009, diamond production in the country ground to a halt, as mining was suspended between December 2008 and April 2009. As a result, the sector contracted by 38.4% in the first nine months of 2009, and accounted for only 24% of GDP that year, down from 41.2% for 2008.

Trade receipts for 2009 declined by 26.5% from Botswana pula (BWP) 32.5 billion to BWP 23.9 billion, although imports remained high due to government spending. Diamond exports (in terms of volumes and prices) fell from BWP 20.8 billion in 2008 to BWP 15.2 billion, a drop of 26.7%. From December 2008, BOB reduced its main interest rate by 400 basis points (bp) in an attempt to stimulate economic activity in the country.[30]

Botswana's financial sector remained relatively sound, although it too suffered from the second-round impacts of the crisis, brought about chiefly by the collapse in the mining sector. The number of non-performing loans rose in late 2008 and early 2009. Growth in commercial bank credit fell from 27.7% in December 2008 to 15.2% in December 2009, due to a deceleration in lending to the business sector (from 36.9% to 12.3% in the same period). Lending to households fell slightly from 21.5% to 17.4%.[31] The analysis on the financial sector, with a Southern African perspective, continues below.

SOUTH AFRICA

The advent of the crisis ended the longest upward trend in South Africa's business cycle, which had started in September 1999 and terminated in November 2007.[32]According to SARB, the economy ran out of steam in 2008, initially due to the interruptions in energy supply and a cooling off of household-level consumption spending. The drop in export volumes towards the end of 2008 exacerbated the situation and, in the first half of 2009, South Africa experienced its first contractions in real GDP in a decade. The latter declined

at a seasonally adjusted and annualised rate of 1.8% in the fourth quarter of 2008 and contracted even further in the first half of 2009 at an annualised rate of 4.5%.[33] This was attributed to the sharp and synchronised decline in global trade (see Figure 1 on page 20), which continued into the first half of 2009.

However, like in Botswana, government consumption expenditure continued to rise through public procurement. As public corporations and government spent on infrastructure, fixed capital formation increased, rising to almost 25% of GDP – the highest ratio in more than 25 years. Most of this expenditure had been planned years previously, as part of the country's strategy to remove bottlenecks and raise productivity, but also as part of preparations for the FIFA World Cup. With hindsight, this spending was fortuitous from a countercyclical perspective.

In the second half of 2008, during the height of the financial crisis, the net outflow of portfolio capital was neutralised by direct and other investment inflows. In the first half of 2009, as global aversion eased, South Africa again attracted net inflows of portfolio investments.[34] FDI inflows also continued into mining and telecommunications. The country's balance of payments continued to record modest surpluses reflected in increased accumulation of foreign currency reserves by SARB. In 2008, the rand exchange rate depreciated due to the large current account deficit and following the sale of domestic securities by non-residents. However, from late 2009, the rand gained ground following the renewed inflow of portfolio capital and FDI and the narrowing of the deficit.

Compared with the same period in the previous year, the level of real GDP output in the second half of 2009 shrank by 3%, reflecting the impact of the deep global recession on the economy. While global credit tightened, commodity prices fell and demand shrank.[35] Output in the mining sector shrank by 33% in the fourth quarter of 2008, its biggest decrease on record.[36] The manufacturing sector shrank by 22%,[37] and more than 21% of factory productive capacity stood idle.[38] Consumer spending shrank by almost 5%, its biggest contraction for 13 years,[39] company failures rose by 47% in the first four months of 2009, and household debt rose to about 80% of disposable income (up from around 50% six years previously).[40]

While exchange controls had protected the South African financial sector from the worst of the crisis in global financial markets, the real economy could not avoid the effects of the subsequent global recession. In the first quarter of 2009, South Africa's exports fell by 24%, putting further pressure on to the current account deficit, which had grown to 7% of GDP.[41]

To boost economic growth, SARB began trimming interest rates in December 2008. By 11 August 2010, it had cut its main interest rate by 550 bp (allowing for several cuts between December 2008 and August 2010), down to 6.5%, the lowest level in at least a decade. As a consequence, by 2010, foreign investors have been net buyers of South African rand (ZAR) 57.6 billion ($7.9 billion) of South African bonds and a further ZAR 21.5 billion of stocks, according to data from the JSE. Data compiled by Bloomberg shows that such inflows have helped the rand rally more than 29% against the dollar since the start of 2009, providing the second-best carry trade return among the world's major currencies after the Brazilian real. Peter Attard Montalto, an analyst at Nomura International Plc in London, has said: 'We expect bond flow to continue through to September as markets look for further rate-cutting by the South African Reserve Bank.'[42] The government implemented a three-year ZAR 787 billion ($98 billion) public

infrastructure expansion programme, focusing on upgrading and expanding transport infrastructure, boosting electricity production and provision, repairing a deteriorating public health system and expanding the provision of water and sanitation. Thus the main growth momentum has come from public spending, which accelerated to 6.4% in the first quarter of 2010.[43] By the end of 2009, according to Statistics South Africa, the economy appeared to come out of the recession,[44] although its executive manager of national accounts sounded a word of caution, noting that: 'GDP has returned to positive growth, but the underlying trend is still negative'.

The next section provides overviews of the South African and Botswana financial sectors. Thereafter, the impact of the global financial crisis on these two financial sectors and the reform agendas being pursued will be reviewed.

THE FINANCIAL SERVICES SECTOR IN SOUTHERN AFRICA

Financial services include both the full range of banking (commercial, retail, corporate, investment and development) and other non-banking financial services (pension funds, provident funds, insurance houses, life companies such as Old Mutual and Liberty, asset management, funds management, private equity funds, lease financing, brokerage firms, credit guarantee services, etc). In the SADC region, South Africa dominates the financial services sector with a highly sophisticated, diversified financial system, which spans a broad range of activities.[45]

Table 2: Size of the South African private banking sector

	June 2008		June 2009	
	Number of institutions	Total assets ZAR billions	Number of institutions	Total assets ZAR billions
Locally controlled banks	13	2,035	13	2,128
Foreign controlled banks	6	683	6	706
Mutual banks	2	1	2	1
South African branches of foreign banks	14	227	14	185
Total registered banks	**35**	**2,946**	**35**	**3,020**

Source: SARB Annual Report 2008/2009

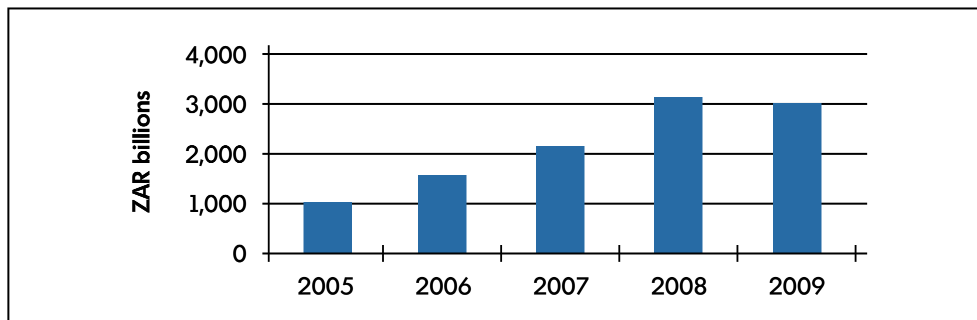
According to the Financial Sector Assessment Program (FSAP),[46] a recent joint report of the IMF and World Bank, commercial banks in South Africa make up the largest segment of the financial sector, with assets representing some 120% of GDP. Of these, the largest in the country are the Amalgamated Bank of South Africa (Absa), FirstRand Bank, Nedbank, and Standard Bank, holding 85% of total assets and demonstrating a significant

international presence.[47] All banks are operating on Basel II, and most have done so since 2006/7. Besides their strong position in the domestic market, they have experienced rapid expansion into Africa, contributing both to their profitability and diversification. They therefore hold a substantial share of the market in Botswana, Mozambique, Namibia and Zimbabwe. Notably, foreign investment in two of these banks has been evident with the substantial takeover in 2005 of Absa by Barclays Bank (UK); and a 20% stake in Standard Bank at the end of 2007 by the Industrial and Commercial Bank of China (ICBC). Similarly, discussions are currently underway on a takeover of Nedbank by HSBC, the world's fourth largest bank.[48]

Insurance companies are major players in the South African financial sector, with assets accounting for 80% of GDP at the end of 2007, and the highest insurance penetration globally at 16% of GDP.[49] Citing Butterworth and Malherbe, Ndulo *et al.* assert that South Africa accounts for three-quarters of the insurance market in sub-Saharan Africa.[50] In their estimation, if it were not for the presence of South Africa as a focal point, most foreign insurers would not enter the region. Similarly, pension and provident funds are highly developed with 13 000 funds in 2005, holding total assets that exceeded ZAR 2 trillion by 2008.[51]

In terms of market capitalisation, the JSE is the largest among emerging markets.[52] Its main function is to facilitate the raising of capital by re-channelling cash resources into productive economic activity. As of 30 September 2006, the JSE's market capitalisation was $579.1 billion. The JSE is presently the 16th largest stock exchange worldwide. Its non-resident sourced turnover accounts for about one-fifth of the total on the JSE. But stock market liquidity is limited relative to other emerging markets because of the few large listings and the buy-to-hold strategy of domestic institutional investors. The JSE uses the Johannesburg Equities Trading System, and is planning to construct a pan-African exchange by allowing investors to trade in shares from Ghana, Namibia, Zimbabwe, and Zambia, with the intention of including the rest of Africa at a later date.[53] It provides an effective and efficient price determination facility and risk-pricing management mechanism.

Figure 2: JSE value traded, years ended 31 March



Source: Financial Services Board, Annual Report 2009

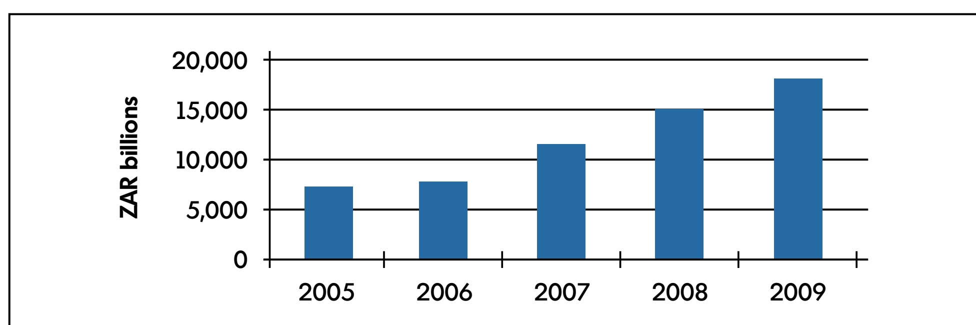
It houses, under one roof, four different markets:

1 An equities market, including stocks from the Main Board and the small to mid-cap Alternative Exchange;
2 An interest rate market;
3 An active financial derivatives market; and
4 An agricultural products market.

BESA is an independent, licensed exchange, constituted as a public company, and responsible for operating and regulating the debt securities and interest-rate derivatives markets in South Africa. The South African bond market is a leader among emerging-market economies.

In 2008, turnover reported on BESA reached a record ZAR 19.2 trillion. BESA enjoys an annual liquidity of 38 times the market capitalisation, making it one of the most liquid emerging bond markets in the world. It complies with all the Group of 30 (G30)[54] recommendations on clearing and settlements.[55]

Figure 3: BESA turnover, years ended 31 March



Source: Financial Services Board, Annual Report 2009

Given its dominance in the sector, South Africa is therefore considered a net exporter of financial services to the region.

Aside from South Africa, both Mauritius and Botswana also have sizeable financial sectors. However, many countries in the SADC region do not have the infrastructure to support activities at a domestic level in many of the sub-sectors mentioned above.[56]

A joint IMF/World Bank Financial Sector Assessment of Botswana's financial sector, conducted in 2008, notes that the sector has diversified and grown over the past decade, with a range of financial institutions now in existence. Among these, pension funds and banks make up the most important sub-sectors by asset size. In the banking sector, the following are the main players: Barclays Bank (UK); Standard Chartered (UK), Stanbic Bank (South Africa) and First National Bank (South Africa). At the next level are the African Banking Corporation (ABC), Capital Bank and the Bank of Baroda. The first four are all Basel II compliant, and will adopt Basel III when necessary, as they are governed by what happens at head office in their countries of origin. According to First National Bank, the main banks comply with the requirements of both the host and their home state regulators.

BOB is operating on Basel I. Basel II will only be introduced into Botswana in 2011/2012. ABC, Capital Bank and the Bank of Baroda are not Basel II compliant.

When measured by assets-to-GDP (see Tables 3, 4 and 5), the FSAP finds that banks, BSE and institutional investors, especially the pensions industry, have grown rapidly over the last 10 years, reflecting the substantial accumulation of national financial resources and the associated high degree of liquidity in the economy, particularly in the financial system.[57]

However, bank portfolios are also changing, due to the vulnerability of the sector to the impact of a global economic downturn, affecting in particular the diamond export revenues. Profits grew at a faster rate than GDP in the five years since 2003, supported mainly by high interest rates. Growth in lending to the corporate sector lagged behind the growth in household and mortgage credits and investments into high yielding Bank of Botswana Certificates (BOBCs).

Table 3: Banking sector in Botswana

	2006			2005			2004		
	No of institutions	Total assets (in BWP bills)	Total assets (% GDP)	No of institutions	Total assets (in BWP bills)	Total assets (% GDP)	No of institutions	Total assets (in BWP bills)	Total assets (% GDP)
Banking system	11	33.17	53.15	10	21.50	37.93	10	17.16	35.20
Commercial banks	7	28.68	45.96	6	17.15	30.25	6	14.56	29.86
Domestic	1	0.30	0.49	1	0.27	0.48	1	0.25	0.52
Private	0	0.00	0.00	0	0.00	0.00	0	0.0	0.00
State	1	0.30	0.49	1	0.27	0.48	1	0.25	0.52
Foreign	6	28.38	45.48	5	16.88	29.77	5	14.30	29.34
Other banks	4	4.48	7.19	4	4.35	7.68	4	2.61	5.34
Development financial institutions	3	3.61	5.78	3	3.47	6.12	3	2.07	4.24
Merchant bank	1	0.88	1.40	1	0.88	1.55	1	0.54	1.10

Source: IMF/World Bank FSAP Botswana, 2008

The recent growth in unsecured household and mortgage credit represents a material and untested source of risk to the sector's financial stability, as the lack of credit information on borrowers means their leverage levels cannot be assessed.

Table 4: Non-banking financial institutions (NFBIs) and institutional investors

	2006			2005			2004		
	No of institu-tions	Total assets (in BWP bills)	Total assets (% GDP)	No of institu-tions	Total assets (in BWP bills)	Total assets (% GDP)	No of institu-tions	Total assets (in BWP bills)	Total assets (% GDP)
Institutional investors	**129**	**38.57**	**63.35**	**129**	**31.88**	**56.23**	**124**	**24.19**	**49.61**
Insurance companies[1]	14	9.55	16.85	14	9.55	16.85	13	8.46	17.35
Pension funds	115	29.02	46.50	115	22.33	39.38	111	15.73	32.26
NBFI	**39**	**3.58**	**5.74**	**31**	**2.50**	**4.41**	**31**	**0.94**	**1.92**
Leasing & factoring	0	0.00	0.00	0	0.00	0.00	0	0.00	0.00
Mortgage & housing	2	2.77	4.45	2	2.38	4.20	2	0.82	1.68
Savings/credit co-ops & CUs	36	0.13	0.21	28	0.12	0.20	28	0.11	0.23
Insurance premium	**0**	**1.90**	**3.35**	**0**	**1.90**	**3.35**	**0**	**1.20**	**2.45**

1 Data on insurance for 2006 is not available. Therefore, data as of 2005 is reported.

Source: IMF/World Bank FSAP Botswana, 2008

Table 5: Botswana Stock Exchange

	2006			2005			2004		
	No of institu-tions	Total assets (in BWP bills)	Total assets (% GDP)	No of institu-tions	Total assets (in BWP bills)	Total assets (% GDP)	No of institu-tions	Total assets (in BWP bills)	Total assets (% GDP)
BSE	–	27.76	44.49	–	n.a.	n.a.	–	n.a.	n.a.
Stock market[1]	19	23.78	38.10	19	13.42	23.66	n.a.	10.88	22.31
Bond market	23	3.99	6.39	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Bond market issuance[2]	0	0.00	0.00	5	0.24	0.41	13	1.73	3.54

1 Domestic listed companies.

2 Listed bonds as of end-2006 (bonds that matured before end-2006 are not included).

Source: IMF/World Bank FSAP Botswana, 2008

The FSAP pays particular attention to the sizable cross-border investments of pension funds, and finds that an underestimation of the risks in that area cannot be discounted. However, a new regulator, the NBFIRA,[58] is intended to address some of the concerns relating to market conduct, consumer protection, and the potential for portfolio-related vulnerabilities in the NBFI sector. The NBFIRA became operational in 2008 and its roles and responsibilities are addressed below.[59]

The FSAP argues that further improvement of Botswana's capital market will require meeting a set of pre-conditions and facilitating expansion in the supply of securities. Prerequisites include replacing Botswana's outdated securities regulation and improving the market infrastructure. Several options are put forward for increasing the supply and tenure of securities, including through the issuance of government bonds, securitisation, and planned privatisation listings on the BSE. Additional options include partnerships with the private sector and accelerating the calendar of planned privatisations of statutory financial institutions. The latter are considered important steps in the medium term for improving the country's capital market.[60]

Finally, the FSAP calls for the formulation of an overarching national strategic framework to guide the financial sector reform process, especially as the development of the financial services is an integral part of the country's overall plan for economic diversification. While the strong policy focus on macroeconomic stability offers an encouraging setting for reform, a lot more needs to be done to improve the depth, efficiency, and competitiveness of the financial sector. Further, excessive liquidity in the market coupled with high policy interest rates (as set by the Central Bank), is a key challenge and results in higher interest rates on credit, creating the potential for distortions in budgetary allocations, which in turn discourages productive investments. However, addressing these issues is dependent upon further improvements to the financial management of diamond earnings, government disbursements, and sovereign (reserve) assets.[61]

To achieve this, better inter-agency co-ordination and partnership between the Central Bank and MOF is required. Overhauling the financial oversight framework thus needs strong cross-support through other policies. The current approach to liquidity management through the BOBC needs to be jointly re-examined by the ministry and BOB, given their apparent use as an investment vehicle by financial institutions.

On the capacity side, FSAP notes the absence of a strong body of skilled and trained accountants, actuaries and other experts with proficiency in finance and recommends that, if the government is to facilitate financial sector reform, this capacity constraint must be addressed. While the act provides stringent regulatory oversight of the industry, NBFIRA's executive management acknowledges that the institution does not at present have access to the right skills, and so will be unable to have proper oversight of relevant institutions at this point in time.

THE IMPACT OF THE CRISIS ON THE FINANCIAL SECTOR IN SOUTHERN AFRICA

The first-round impacts of the global financial crisis largely missed the South African banking sector, which was not significantly exposed to subprime-related products in the US. However, as noted above, after the collapse of Lehman Brothers, the impact of the

crisis on global economic activity was instantaneous. Trade finance dried up and with falling demand, especially for investment goods and manufactured products such as motor vehicles, trade volumes collapsed.[62] For example, in 2009 it proved difficult to syndicate the pre-export financing for Ghana's cocoa crop.[63] Around 90% of the $14 trillion of world trade is financed by trade credits.

These effects and how they affected the business of three of the largest banks in the country was the subject of interviews held with the banks in July and early August 2010.[64]

As in previous financial crises (e.g. the 1997 Asian crisis), the second-round effects of the 2008 crisis were related to confidence and liquidity: banks became nervous of the risks that other banks posed for them in the system. According to Standard Bank, the common practice is for banks to finance each other when they require funds for their retail, corporate or wholesale businesses. In such cases, banks raise large syndicated loans to fund their activities. After what had happened in Europe and in the US, the large Tier 1 banks (e.g. Deutsche Bank, Commerzbank and Citibank) had no appetite for emerging markets, and were not even funding each other. Any appetite they had was for short-term (12 month) funding, and only at extremely high pricing. As a consequence, globally, banks generally stopped lending to each other, and the risk premium on the interbank borrowing rate shot up from close to zero to 500 bp. Holding funds in banks also became risky, so much so that the funding mismatch (also referred to as the assets/liability mismatch) was put under pressure, as banks sought to hold only short-term funds.

Standard Bank was able to raise what funding it needed over this period as a result of its relationships with Asian banks, which at the time held significant reserves and were able to replace Standard Bank's traditional European or US lenders. Standard Bank also engaged with the International Finance Corporation (IFC) to negotiate a trade financing facility. The IFC established a two-year credit line totalling $400 million to enable the bank to finance trade only in sub-Saharan Africa.

Similarly, Absa Capital drew attention to the impact of the crisis on access to trade finance. Financial institution limits were called in overnight, resulting in a direct knock-on effect and therefore a shortage of risk capital for trade. A lot of African trade usually financed through European banks was diverted to Absa Capital, who acknowledges that exchange controls meant that they could not react fast enough and therefore lost an opportunity to capture the business being offered. They witnessed the overnight pulling of limits and country bank limits in capital markets in specific countries, Nigeria being a good example. Overseas banks were differentiating risk and had decided that it cost more to do business in Africa, so they focused on preserving cash and a 'flight to quality' occurred.

As a manifestation of the problems with trade finance over 2008–2009, South Africa's Credit Guarantee Insurance Corporation, which provides short-term insurance on approximately ZAR 500 billion of domestic and export trade annually, experienced a sharp and sudden escalation of notifications of non-payment and a high increase in claims. Its 2009 annual report reveals that soaring business failures and defaults saw claims rise by a massive 164.5% – escalating from ZAR 209 million in 2008 to ZAR 552.8 million for 2009, most being paid on defaulting South African debtors.

Substantial export claims were also paid, as importers defaulted elsewhere in the world, with the majority of defaults being for transactions with Canadian and US based businesses.[65] The worst claims were in the first and second quarters of 2009, primarily from commercial losses – where companies failed, went bankrupt, or could not pay

because of banks cutting trade finance. Recoveries on claims also took a knock, with salvages dropping by 20.6% from ZAR 88.2 million in 2008 to ZAR 70 million in 2009.

Likewise, the Export Credit Insurance Corporation of South Africa, which provides medium to long-term credit insurance and guarantees, mainly on infrastructure and mining projects, recorded disappointing results for 2009, posting an under-writing profit of ZAR 82.9 million, down from ZAR 327.8 million in the previous year. Reasons given for the company's poor performance included the need for increased provisioning in the wake of the global financial crisis. This was due either to projects being in distress or to sponsors battling to complete projects. Moreover, the fall in share prices constrained the capacity of project sponsors to raise the required capital to bring projects to technical and financial completion.

However, as trade finance is relatively simple and deals are clearly collateralised with the cargoes that they fund, the sector has rebounded in 2010, despite the meltdown in other parts of the credit markets.[66]

In respect of corporate finance, the risk premium on corporate bonds shot up to 600 bp, and the corporate sector virtually stopped borrowing. As the crisis hit, African companies that had been looking to international markets to raise capital saw a huge deceleration in this activity.[67] In South Africa, the collapse in first-world economies had knock-on effects for business, with a resultant drop in demand for products. By the end of 2008 and in early to mid-2009, companies were right-sizing their inventories, resulting in losses to business and corporate defaults. The impacts were not considered as severe as everywhere else.[68]

As equity markets bottomed out, the market for M&A collapsed for a year until about April 2009. M&A activity largely focused on companies wanting to make acquisitions in Africa, rather than outside of Africa. However, risk appetite to fund these sorts of deals declined among investment banks across the board. Nevertheless, since then the South African economy has rebounded, moving from negative growth to positive forecasts.

Institutional investors and hedge funds stopped paying a large premium for Africa's growth assets; consequently there were fewer fees to earn. This was exacerbated by certain investors pulling their lines of commitment to some private equity funds, leaving these funds with less money to make the acquisitions (further depressing asset prices). However, things have also started to pick up in this sub-sector, as clients seem to be willing to transact more and potentially even to pay a small premium for growth prospects. Noticeably, the profile of the buyers has changed from Western to Middle Eastern and East Asian countries. Concerns around Basel III's impact are only having a marginal impact on corporate financing.

In Botswana, the BSE was affected by the crisis and, for the first time in 2008 the domestic company index, which measures price movements, declined by 16.5%. However, this was not as severe as in other markets; for example, the JSE declined by 30.5% between 13 September and 20 November 2008.

As for project financing, during this period Standard Bank saw a commensurate reduction in expansion plans and in the construction of plants and capacity, which affected project and infrastructure finance. Dollar term liquidity became substantially more expensive, which again restricted the flow of project and infrastructure finance deals. As a consequence, large infrastructure and other capital expenditure projects were shelved.

Across Africa, where huge infrastructure challenges exist, the impact on project

financing can be attributed to two factors: first, the sharp increase in the cost of long-term financing. Project finance is the longest term financing, with a lot of pressure at the end of the liability curve (also called the 'yield curve'). Many project financed deals are in the long-term US dollar market. With the advent of the crisis, governments became wary of financing long-term infrastructure projects and so they cancelled or delayed them. At that point, while a lot of deals had already gone through the tendering stage, not many of them reached financial closure. Although in project financing the potential is considered huge and the pipeline big, the closing of deals is considerably slow. What the banks are seeing in project financing is increased interaction from Brazilian and Chinese investors, supported by export credits. For example, Standard Bank decided that they could not finance the Morupule B Power Station project in Botswana on their own, so they brought in their shareholder, ICBC.[69] International financial institutions (IFIs) and regional Development Financial Institutions (DFIs)[70] are also stepping in to play a stronger financing role, as a stop-gap measure.[71]

Second, at the height of the crisis, syndication of loans had become impossible and banks interested in infrastructure were only prepared to do so under 'club' arrangements.[72] With syndicated loans, one or two lead arrangers reach agreement with a borrower on the size and pricing of a loan and then syndicate parts of the loan to banks or other investors. As the crisis took effect, many projects began to involve costly and protracted club arrangements where borrowers had to negotiate with a set of potential lenders to put together a total financing package. If there was appetite for the deal, borrowers had to accept lower 'lender hold' levels, shorter terms, higher pricing and increased demand for sponsor equity. In addition, the earlier, more amenable agreements gave way to more burdensome contracts with legal boilerplate clauses that protect lenders from market changes but also reduce borrower certainty about the final cost and terms of financing. 'Market flex' arrangements became a feature of these agreements, allowing lenders to adjust prices and other terms at the time of financial closure and even afterwards.[73]

Investment commitments relating to PPPs in infrastructure dropped sharply in 2008 and again in 2009, from a previous high spanning 2003–2007 – a period that saw a steep rise in the use of project finance in a variety of sectors, in both developing and developed countries.[74] The international project finance market grew at least four-fold during this time. Leigland and Russell[75] explain this growth in activity. Driving this trend were changes in banking practices, which resulted in huge increases in liquidity in developed markets. Banks had shifted from 'originate and hold' practices to 'originate and distribute' strategies: project loans would be booked and then quickly distributed into the market through syndications, securitisation, secondary market sales, and other techniques. In Europe, the rapidly growing use of credit ratings on loans supported the emergence of a secondary market in loans. These ratings made investors more comfortable about buying project loans. They therefore dispensed with carrying out a proper due diligence on the borrowers or the underlying projects. Like other regions in the world, large projects in Africa benefited from this development.

The main route for international banks to raise money for project finance was the interbank borrowing market. When that market was disrupted, as the subprime crisis and Lehman Brothers' collapse fed doubts about counterparties' ability to repay their own debts, the distribution of project finance ceased. The mechanism for generating this liquidity also collapsed, so that by early 2009, the 'originate and distribute' model was

no longer working because originators could no longer distribute project loans into the market. The secondary market for this debt collapsed because credit ratings of loans also lost credibility.

Nonetheless, according to Standard Bank, infrastructure project financing using US dollar term liquidity funding is slowly picking up. Banks need to deploy their excess cash levels, but the covenants and/or security in the deals are tighter than prior to the crisis and have not come down from the peak of the crisis levels.

From a treasury management perspective (and to some extent echoing the views expressed by Standard Bank), the last of the three large banks interviewed – FirstRand – confirmed that there had been no primary impact on South African Banks, but the secondary effects had been severe. According to a FirstRand Bank executive, over 60% of the South African banking sector's funding comes from the local wholesale market, particularly from pension, provident, and money market funds, as well as from the life companies (such as Old Mutual and Liberty Life), and large corporates (e.g. South African Breweries; MTN and Anglo American).[76] Only about 5% of total funding comes from off-shore and is therefore considered an immaterial funding source. Since banks raise most of their funding in the domestic wholesale market, when the financial crisis hit, the funding curve or liquidity premium[77] went up two to six times higher than the norm, depending on the maturity bucket. So, if the swap rate was equivalent to the interbank rate, they normally paid 20 bp over the mid-swap rate for five-year money. However, following the crisis, this went up to 180 bp and became more expensive. Since July 2010, it has dropped to 120–130 bp.

The IMF's *Financial System Stability Assessment Report* of 2008, however, found that global market turmoil did not pose any serious challenges to the management of domestic liquidity in South Africa – there was no recourse to SARB's standing facilities or repo operations and the money market showed no abnormal signs of strain.[78]

On the liabilities side, and once the crisis hit, from a risk premium perspective, the banks' institutional investors were comparing their yields to off-shore markets, mainly in Europe, which should not have been relevant as those rates were applicable only in the Euro-zone in view of crises in that market.[79] Funding, therefore, became much more expensive than was warranted. FirstRand Bank's treasury department did not consider this a liquidity event, but rather a 'price of liquidity' or 'term funding' event.

Because South African banks only raised 5% of their funding requirements off-shore, they didn't need to go abroad to raise US dollars. They were, therefore, not exposed to the sovereign bonds of the PIIGS[80] countries, although they might be exposed to G7 bonds through the national treasury and those banks holding T-Bills[81] and Treasury Bonds[82] – but the total industry had less than $30 million in exposure to the PIIGS countries.

On the whole, market-related losses have been limited and banks have been able to secure funding without much difficulty, as their liabilities are largely generated domestically and rand denominated. Nevertheless, South African banks were exposed to significant liquidity risks associated with a heavy reliance on domestic wholesale corporate deposits. The latter resulting in part from long-standing limitations on capital outflows of corporate and institutional investors.[83]

In the securities and insurance sectors, South Africa's Financial Services Board's (FSB–SA) 2009 annual report reported that in the first half of 2008, their insurance division ascertained that local insurance companies had little direct exposure to the subprime mortgage assets

held in the US and elsewhere in Europe. Following the sharp declines in global and domestic markets, the FSB–SA engaged in a series of stress test initiatives with systemically significant local insurance groups. The results demonstrated that these major companies remained financially sound under a range of severe asset price and interest rate shocks.

In the 2009 FSB–SA annual report, the chairman notes that a reduction in inflows into savings generally and into pension benefit arrangements, collective schemes and insurance products is anticipated. Likewise, they expect to see an increase in claims, lapses, surrenders and withdrawals. However, when compared with other economies, the regulatory system has stood up well to global market turbulence, while the non-banking financial sectors have been buffeted for several reasons, including: stringent prudential regulations, prudential investment guidelines limiting the extent of assets that could be invested off-shore, foreign exchange controls and the National Credit Act. The IMF/World Bank 2008 *Financial System Stability Assessment Report* had affirmed the country's regulatory framework.[84]

In Botswana, according to economist Keith Jeffries, bank credit generally froze in 2009 and was more severe and lasted longer in corporate finance credits than household financing. This was due to a combination of pressures from bank head offices in South Africa and the UK, which decided to ease off on corporate and other financing as a consequence of collapse in the diamond market and uncertainty in Botswana.

Botswana's balance of payments went into deficit and the country had to draw down on its reserves. It also obtained a sizeable loan, from the African Development Bank for budgetary support, of $1.5 billion and at a pricing of LIBOR + 20 bp with a five-year capital grace period. The government has already drawn down the first and second tranches totalling $1 billion. As a result of these developments, Standard & Poor's downgraded Botswana's credit rating in early February 2010; Moody's issued a 'negative outlook' on the country but did not downgrade.[85]

However, recovery in the economy has taken off in 2010, with the country showing remarkable growth. Households recovered cautiously and the credit quality to the business sector has not deteriorated. BOB dramatically loosened monetary policy between November 2008 and December 2009 and cut the bank rate from 15.5% to 10%.

New banks have entered the market, including ABN Amro, through two banking institutions: one based offshore in the International Financial Services Centre (IFSC); and the other, a domestic bank with a commercial banking licence that has been established to serve the diamond industry. Absa made an offer for Namibian financial services firm Capricorn Investment Holdings, which is the majority shareholder in Bank Windhoek and Bank Gaborone. The merger was subject to several conditions that included shareholder backing from Capricorn Investment Holdings and regulatory approvals from BOB, Bank of Namibia and SARB. However, in early July 2010, the Bank of Namibia declined the acquisition, citing the market dominance of South African banks and a desire to keep the bank in Namibian ownership.[86]

Despite the crisis, the banking sector in Botswana is pretty healthy with a 15% capital adequacy ratio in place (Basel II requires 8%). The banks' loan to deposits ratio is 50%. The only merchant bank in the country, ABC Botswana (of Zimbabwean origin), which is headquartered in Botswana, has its biggest subsidiary in Zimbabwe and smaller banks in Zambia, Mozambique and Tanzania. ABC has since obtained a commercial banking licence from BOB to do retail banking and leasing but, as yet, has no branches.

As far as project financing is concerned, most of which is government sponsored, the banks in Botswana are too small to take up most government projects. This is because prudential risk policies mean that no loans from private banks can be more than 30% of unimpaired capital. Thus, for example, the Botswana Power Corporation's Morupule B Power Station project, which required a $825 million loan, had to be financed through Stanbic Bank Botswana, together with its parent bank, Standard Bank South Africa, and ICBC. Stanbic Bank on its own could not have taken up the entire loan.

EX-POST REGULATORY REFORM IN SOUTHERN AFRICA

Going forward, the major regulatory and policy reforms on the global agenda, which could have an impact on regulation of the financial services sector in Southern Africa, include changes to the following:

- strengthening and harmonising capital and liquidity standards;
- expanding the transparency of complex financial instruments;
- regulating all systemically important financial institutions;
- new global accounting standards;
- deposit insurance;
- reassessing banker compensation;
- regulating credit rating agencies, and
- fighting illicit financial activity.

Given the constraints of this study, only three of the above issues for regulatory consideration will be investigated in any detail in this section and include: (i) strengthening and harmonising capital and liquidity standards; (ii) expanding the transparency of complex financial instruments; and (iii) regulating all systemically important financial institutions.

The banking sector recognises that, given the causes of the global financial crisis, changes are needed in the approach to a number of these issues.[87] From a global regulatory perspective, the bankers interviewed thought that politicians in developed markets rightly felt the need to respond. However, they noted that, while regulators can control some things through regulation, regulatory reform would not be an appropriate response in all circumstances.[88]

Strengthening and harmonising capital and liquidity standards

The concerns regarding capital and liquidity are particularly germane. In December 2009, the Basel Committee issued two consultative documents proposing reforms to bank capital and liquidity regulations. The first, *Strengthening the Resilience of the Banking Sector*,[89] proposes essential changes to bank capital requirements. It significantly revises and simplifies the definitions of Tier 1 and Tier 2 Capital and disqualifies from Tier 1 Capital status innovative capital instruments, including securities and other instruments considered to be debt for tax purposes. It also re-emphasises that common equity is the 'predominant' element of Tier 1 Capital by (i) adding a minimum common equity to

risk-weighted assets ratio, with the ratio itself to be determined based on the outcome of an impact study that the committee is conducting, and (ii) requiring that goodwill, general intangibles and certain other items that currently must be deducted from Tier 1 Capital be deducted instead from common equity as a component of Tier 1 Capital.

The second document, *International Framework for Liquidity Risk Measurement, Standards and Monitoring*,[90] proposes specific liquidity tests that would be required by regulation.[91] Two measures of liquidity risk exposure are imposed, one based on a 30-day time horizon and the other that addresses longer term structural liquidity mismatches over a period of one year. Comments on both proposals were due by 16 April 2010. These proposals contain three key components: a 'liquidity coverage ratio', designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute liquidity stress scenario specified by supervisors; a 'net stable funding ratio', designed to promote more medium- and long-term funding of the assets and activities of banks over a one-year period; and a set of common 'monitoring tools' that the BCBS indicates should be considered as the minimum types of information that banks should report to supervisors, as applicable, and supervisors should use in monitoring the liquidity risk profiles of supervised entities.

Compliance with the liquidity coverage ratio, the net stable funding ratio and the monitoring tools would be mandatory for all internationally active banks. The proposals note that these ratios and monitoring tools may be used for other banks and for any subset of subsidiaries of internationally active banks that supervisors may choose.

What is the rationale behind capital adequacy rules? Essentially, shareholder equity in banks is, on average, comparatively small when compared to their borrowings and deposits. Thus, banks are very highly leveraged and operate on a higher level of borrowings compared to average business enterprises.[92] Large corporates will characteristically borrow funds that are about equal to their net worth. Even bigger, multinational companies will gear about three times their capital base. However, banks usually have liabilities exceeding 10 times their equity capital (for international banks this can amount to 40–60 times their capital base, while South Africa's banks have on average about 17 times their equity capital), with the bulk of these liabilities representing deposits received on trust from the public. According to Welikala, given (i) the risks inherent in the way banks fund their operations, (ii) their systemic importance, and (iii) the high economic and social costs of their failure, as a matter of public policy, banks are required to operate with a high degree of commercial prudence and under strict regulation.[93]

Specifically, and given the above risks, capital adequacy regulations require banks to hold a minimum level of equity (i.e. Tier 1 Capital – also known as common equity) as a percentage of their loans and other risk weighted assets (RWA). This minimum level of capital is to protect the bank against unanticipated losses and provide confidence to depositors who accept the risk of asymmetric information. As depositors would not know whether a bank has taken on risks beyond its capacity to absorb them, they rely on the cushion of capital held against RWA, as well as on close regulatory supervision, independent audits and sound credit ratings to reassure them of the stability of the banking sector.[94]

The movement towards banks holding greater capital against RWA would mean that South African banks would have less leverage and lower gearing ratios. Thus, for example,

in respect of what accounts for Tier 1 core capital – i.e. the best capital that a bank can hold – all of the banks interviewed noted that they had always followed a prudent approach and that South Africa banks had set the benchmark at 9.75% even though Basel II's global standard was 8% for Tier 1 and 2 Capital.

In respect of liquidity, the discussion was around having greater liquidity to handle such a crisis and the number of ratios to be used. Standard Bank noted that banks generally had difficulty with the proposals for Basel II reform made in December 2009. In mid-April 2010, the larger global banks responded to these proposals, asserting that the capital and liquidity requirements were too onerous and would be counterproductive, a view supported by work coming out of IIF[95] and BAFT[96]. As a consequence, there was a major push back on the Basel III proposals, and the final capital adequacy reforms will, they believe, be different from what was in the original proposal.

In June 2010, the IIF issued a report, which argued that phasing in an increase in capital requirements of as little as two percentage points would lead to a 3% drop in GDP in the G3[97] economies.[98] The studies assumed a larger increase in the lending rate, reflecting the withdrawal of implicit government support and no changes in dividends, compensation policies and operational efficiency. They did not take account of the benefits coming from a more resilient financial system, including the lower funding premiums that safer banks need to pay.[99]

However, the Basel Committee and FSB's Macroeconomic Assessment Group[100] carried out two studies recently that assessed the macroeconomic effects of the transition to strengthened capital and liquidity regulations. The *Basel Committee on Banking Supervision 2010* looks at the long-term impact of stronger capital and liquidity requirements, while the *Macroeconomic Assessment Group 2010* examines the transitional economic impact as the new standards are phased in.[101] The studies demonstrate that stronger capital and liquidity requirements, while having only modest costs, bring substantial benefits to the economy.

According to Standard Bank, it is not clear how much of the reforms being discussed would filter through to the sector from SARB. The financial crisis and an intention to restore stability in the financial sector were the underlying causes for Basel III and the principles being developed. However, as the problems causing the crisis were not evident in South Africa, Asia, Latin America or Australia, improving regulation in these countries was considered unnecessary. Banks in these countries are making individual contributions to the debate that continues to rage. Standard Bank and Absa Capital have made proposals at the highest levels, to the South African National Treasury, warning of the unintended consequences of such reform.

What are these consequences? As far as the banks interviewed are concerned, several come to mind. First, there is not as much depth at the end of the long-term yield curve, i.e. not enough in terms of trade volumes and liquidity in the instruments that are traded in that part of the yield curve (e.g. 10-year debt instruments). Banks are therefore working through the banking association and individually to express their concerns on this matter.

Another concern is how trade finance would be treated, in particular the proposed global bank tax that certain regions would have to pay. Banks in South Africa do not see why they should be subject to this measure when they did not have problems and did not need to be bailed out. In a discussion, a senior official at the South African National Treasury[102] clearly stated that South Africa rejects the proposal for taxes against the banks,

which the Europeans in the G20 (specifically France and Germany) were pushing strongly. Instead, South Africa's preference is to strengthen contingencies and ensure higher international reserves and financial safety nets or instruments to protect against systemic risk and collapse, for example through SARB payments system.

According to the same treasury official, reform, especially of the capital adequacy rules, is considered necessary because policymakers realised that the Basel II Accords give too much leeway for banks to determine their own RWA for capital adequacy purposes. Basel I had done this for them and had followed a rules-based approach by pre-determining clusters or asset groups for the banks. Basel II on the other hand, was more of a principle and risk-based approach, which had not been properly followed by the international banks.

An executive from FirstRand Bank noted that South Africa's banking sector has complied with Basel II since January 2006, and with the International Financial Reporting Standards since 2005, and that the sector will probably adopt Basel III on solvency. The latter will increase the quality of capital to absorb losses and prevent the use of debt as equity. In South Africa, the quality of capital had never been an issue.[103] To explain what is at issue here, perhaps a reference to the UK experience is warranted. In respect of the UK banks, David Miles, member of the Bank of England's Monetary Policy Committee, acknowledged that the quality of banks' capital had deteriorated in recent years.[104] Banks, he said, had exploited the availability of new hybrid capital instruments which had the tax advantages of debt, but which in practice did not absorb banks' losses despite being treated as equity by the regulations.

The liquidity of banks, as measured by the ratio of their most liquid assets (central bank reserves, gilts and treasury bills) relative to total assets, was a fraction of what had been normal 20 years previously and a tiny fraction of what had been normal prior to the 1970s. Banks had also become larger, and their assets had grown very rapidly relative to the size of the economy and to GDP – they had roughly doubled in the 10 years up to 2007. When fears about the value of its assets increased, the UK banking sector had low capital, illiquid assets and was very large. The combination of these factors thus accounted for the scale of the damage that ensued. Therefore, many of the proposals to make banks less fragile meant they would need to hold more equity capital. Miles supported this, saying that he believed it to be the most fundamental response to banking fragility because it dealt directly with solvency problems – i.e. the risk that people who have lent money will not get it back.

Within SADC, SARB's Bank Supervision Department is represented on the Committee of Central Bank Governors, and has set up a subcommittee that focuses on issues relating to the core principles for effective banking by supervisors in the region, on training of supervisors and on the effective implementation of risk-based supervision.

At an international level, the Validation Subgroup of the Standards Implementation Group, a subcommittee of the Basel Committee, focuses on issues related to the validation of systems used by banks to generate the ratings and parameters that are inputs into the internal ratings based approach to credit risk. The Trading Book Group focuses on ascertaining appropriate and practical ways for calculating capital for the risk of *obligor* default. Finally, the Basel II Capital Monitoring Group shares national experiences in monitoring capital requirements and ensuring banks have a solid capital base throughout the economic cycle.[105]

Expanding the transparency of complex financial instruments

The inadequate management of risks associated with various types of credit derivative products designed to transfer credit risk (particularly on collateralised debt obligations, such as the mortgage bonds at the heart of the subprime crisis) contributed significantly to the financial crisis, resulted in severe losses to and the collapse of several institutions, including Lehman Brothers, Merrill Lynch[106] and Iceland's Landsbanki[107].

The use of CDS and financial guarantee (FG) insurance were identified as contributing to major gaps in market practices or effective regulation.[108] The CDS market is largely unregulated, although their use is subject to supervision and regulation only when their buyers and sellers are themselves regulated institutions.

Analysis by the Joint Forum found that the following problems were common to both these types of credit risk transfer products.

- Inadequate risk governance – i.e. sellers did not (and often could not) adequately measure the potential losses on their credit risk transfer activities.
- Inadequate risk management practices – poor management of large counterparty credit risk exposures with these products contributed to financial instability and eroded market confidence.
- Insufficient use of collateral – the lack of any collateral posting requirements for highly rated protection sellers such as the AAA monoline insurers in the US, which allowed these firms to amass huge portfolios of over-the-counter (OTC) derivatives, and thus created excessive credit exposures.
- Lack of transparency – in CDS and FG markets, low transparency made it difficult for supervisors and other market participants to understand the extent to which credit risk was concentrated across the financial system and within individual firms. There was no ability to gauge the level of credit risk assumed by both buyers and sellers.
- Vulnerable market infrastructure – the concentration of credit risk in a small number of participants created the situation where the failure of one systemically important firm (e.g. Lehman Brothers) raised the possibility of others also failing.

In April 2008, the Bank Supervision Department at SARB began an exercise to determine the status of securitisation activities in the banking sector. The auditing firm contracted to conduct the study submitted its findings in November 2008,[109] reporting that securitisation in South Africa was not as complicated as in the US and in Europe, and that assets held in South African schemes were of a high level of transparency. They found that securitised products were subjected to the same credit approval processes as the banks' own credit exposures, and risks associated with these schemes were generally appropriately managed. Further, that Tier 1 banks on average sourced only 4% of their total funding from securitisation. Regulatory compliance was generally acceptable. The recommendations, made to improve oversight and governance, were aimed at reducing risks that could arise from such schemes. On the basis of this report, SARB decided to enter into discussions with the banking sector on areas where potential regulatory changes might be effected.[110]

At the international level, the recommendations for regulation of this sub-sector cover both national and international supervision and regulation and have been discussed at length within IOSCO.[111] They include the following for supervisors:[112]

- Recommendation No. 13: Encourage or require greater transparency for both CDS and FG insurance.
- Recommendation No. 14: Continue to work together closely to foster information sharing and regulatory co-operation, across sectors and jurisdictions, regarding CDS market information and regulatory issues, and on the potential cross-sectoral and systemic risks raised by stress and scenario testing of FG insurers.
- Recommendation No. 15: Continue to review prudential requirements for CDS and FG insurance and take action when needed.
- Recommendation No. 16: Continue to promote current international and domestic efforts to strengthen market infrastructure, such as supervised/regulated central counterparties (CCPs) and/or exchanges. This should include encouraging greater standardisation of CDS contracts to facilitate more organised trading and CCP clearing. There should be better dialogue among supervisors of CCPs regarding applicable standards and oversight mechanisms.

IOSCO has since revised its regulation principles for securities, which have grown from 30 to 38 principles. While influenced by the financial crisis, the work had already started before the crisis broke. One principle concerns systemic risk and prudential regulation and provides that IOSCO and the Basel Committee must play an active role in managing systemic risk and the derivative instruments being issued. Further, and to curb the type of contagion caused by securitisation products, these regulators want the originators (i.e. the banks) who package these products to retain 5–10% of the risk in these products.[113]

From the South African standpoint, FSB–SA notes that the G20's concern about credit derivatives was due to the subprime mortgage crisis, but South Africa did not have this exact problem. However, South Africa does have a large derivatives market and, as part of the G20 and Basel and party to IOSCO, is committed to looking at riskier products in the derivatives market. FSB–SA has regulatory oversight of the market through the Financial Advisory and Intermediary Services (FAIS) Act, 2002, which regulates market conduct in respect to financial products such as securities.

Many derivatives are traded on the JSE's single stock futures market, which is the biggest market in the world by volume, although much smaller in value terms than several other exchanges, including India's national stock exchange and the Eurex derivatives exchange.[114] At the end of 2008, the JSE tightened its rules on single stock future trading, due to client defaults that forced Absa to buy stakes in four firms.[115] Absa acts as a clearing agent on the futures market and had to buy stakes in four JSE-listed firms for ZAR 1.4 billion, after clients defaulted on single stock futures contracts.

Rand Merchant Bank (RMB), the investment banking unit of FirstRand was also affected by problems with single stock futures, after derivatives broker Dealstream collapsed in 2008. RMB was a clearing agent for Dealstream's trades. These two cases raised concerns that South Africa's banks, which had escaped the worst of the global financial crisis and had healthy balance sheets relative to many global banks, would face further problems related to derivative losses. Thus, the JSE was obliged to strengthen its trading rules, to improve liquidity in some shares and reduce the risk of investors taking too large a position in some companies.[116]

Most regulated securities are not traded on exchange but as OTC products. These derivatives are protected when bought and sold through intermediaries. However, the

regulatory scope of FAIS does not cover a situation where there is no intermediary – e.g. there is no surveillance and no reporting when derivatives are bought from a bank or an underwriter or a company. This market is referred to as a 'shadow market' (as opposed to a 'formal market') because it is unregulated and, according to FSB–SA, is enormous, running into trillions of rands.

Regulating all systemically important financial institutions

Within the G20, concerns have also been raised about financial conglomerates that offer services across banking, securities and insurance sectors. They are viewed as capable of threatening financial stability at local and global levels. The three banks interviewed for this report fall into this category.

For regulators, this mix of services blurs the traditional supervisory and regulatory boundaries among the sub-sectors of the financial services sector. It is believed that these groups rely on a network of legal entities and structures – some of which are unregulated – to derive synergies and cost savings, and to take advantage of regulatory arbitrage (differences in taxation, supervision and regulation).[117] As an illustration, FirstRand Limited was listed on the JSE but was not a regulated bank until 1 July 2010, when the situation was normalised and the bank is now regulated by SARB.

The three main operations falling under the FirstRand Group include:

- FirstRand Bank – regulated under SARB;
- Outsurance – regulated by FSB–SA; and
- The Momentum Group – also regulated by FSB–SA.

One of the international institutions established with regulatory and oversight responsibilities over the past 40 years is the Joint Forum, which began in 1996 under the aegis of BCBS, IOSCO and IAIS. It consists of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency.[118] Initially referred to as 'the Joint Forum on Financial Conglomerates', in 1999 its name was shortened to 'the Joint Forum', in recognition of its new mandate that went beyond issues related to financial conglomerates, extending also to issues of common interest to all three sectors. The Joint Forum thus has the following specific mandates:

- To study financial conglomerate structures that may impair effective supervision or otherwise be problematic, and, having regard to the findings of that study, if appropriate, develop guidance and principles and/or identify best practices; and
- To assess the appropriateness of group-wide methods of supervision, and, having regard to the findings of that assessment, if appropriate, develop guidance and principles and/or identify best practices.

The January 2010 report of the Joint Forum[119] focuses, in part, on the differences in treatment of (i) unregulated entities when calculating capital adequacy; (ii) intra-group transactions and exposures, including those involving unregulated entities; and (iii) unregulated entities, particularly parent companies of regulated entities.

In relation to the first concern, supervisors have problems calculating group capital

adequacy ratios and assessing risk for the group, which results in gaps when unregulated entities are used to lower capital requirements of individual regulated entities in the group. In the case of the second issue, intra-group transactions can create contagion and unintended risks across the group and/or individual legal entities, as Lehman Brothers showed.

The differences in approach to supervision and regulation can make it difficult for supervisors to assess risks to the sustainability of the business models of the group as a whole and the separate legal entities.

Finally, the third concern relates to situations where an unregulated parent holding company controls a regulated entity located in a separate jurisdiction. The holding company's jurisdiction may not have related regulated entities, or have legal authority to exercise oversight over unregulated entities. The unregulated company is thus under no obligation to provide information to unrelated parties such as foreign supervisors. Existing protocols do not address unregulated entities that are higher in the organisational hierarchy of ownership. A case in point is the collapse of the Icelandic Kaupthing and Landsbanki Banks and the resultant impact on UK customers and regulators.

The Joint Forum's view is that all financial groups, especially those active across borders, should be subject to supervision and regulation that capture the full range of their activities and risks. The supervision and regulation of these groups did not fully capture the potential costs of the risks faced because of the different regulatory frameworks and approaches. Therefore, the Joint Forum is calling for common cross-sectoral standards (to be developed when justified), which should be clear and applied consistently, and cover all financial activities and risks within the groups, irrespective of their origin or whether they are conducted through regulated or unregulated bodies. More importantly, where a group or an entity within a group is identified as systemically important, these standards should be applied with particular rigour.

The recommendations put forward by the Joint Forum include the following:[120]

- Recommendation No. 4: Policymakers should ensure that all financial groups (especially those providing cross-border services) are subject to supervision and regulation that capture the full spectrum of their activities and risks.
- Recommendation No. 5: The 1999 Joint Forum principles on the supervision of financial conglomerates should be reviewed and updated. These are defined as any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (banking, securities, and insurance). The recommended review should focus, *inter alia*, on the supervisory powers over unregulated parent holding companies, the oversight and access to information of unregulated entities within a group, and the calculation of capital adequacy on a group basis with regard to unregulated entities and activities (such as special purpose vehicles).
- Recommendation No. 6: BCBS, IOSCO and IAIS should work together to enhance the consistency of supervisory colleges across sectors and ensure that cross-sectoral issues are effectively reviewed within supervisory colleges, where needed and not already in place. Supervisory colleges have been identified as a major tool to improve supervisory co-ordination and co-operation. The Joint Forum recognises that work is being done on a sectoral basis, but is of the view that there is also merit in developing

colleges of a cross-sectoral nature or in directing supervisory colleges to consider cross-sectoral issues.

As a member of IOSCO, and because of South Africa's involvement in the G20, the FSB–SA attends the meetings of the Joint Forum, at which issues of co-operation, co-ordination and information sharing among regulators and supervisory colleges are considered important developments. The London G20 Summit in April 2009 influenced these developments, and the first supervisory college was held at the end of 2009. Much of the processes were put in place by November 2009 in the UK. According to FSB–SA, these developments were influenced by both IAIS and the G20.

From South Africa's perspective, co-operation through supervisory colleges is germane, especially as one of the country's biggest conglomerates – the Old Mutual plc group – has a dual listing on the London FTSE and the JSE. Thus, the Financial Services Association (FSA) is the lead regulator for Old Mutual. For practical purposes, the lead regulator will hold a 'supervisory college' of all the regulators in the different jurisdictions where the group operates, to compare notes and take a global view on the risks and exposures faced by the group, and where concerns lie. IAIS introduced this approach, which was not influenced by G20 developments, and it is acknowledged that the G20 recommendations on this were a parallel development.[121]

According to FSB–SA, a similar approach is also taken for the Standard Bank Group. While the banking sector regulators (i.e. the central banks) regulate the bank, as the financial conglomerate also owns Liberty Holdings and subsidiaries, SARB (Banking Supervision Section) and FSB–SA both oversee risk and exposures at the local level and hold a supervisory college for this purpose.

At the regional (SADC) level, FSB–SA does not have legislation to supervise groups in the same way. Instead, supervision is currently being done on a 'moral suasion' basis, but legislation is due in 2012. FSB–SA is the regulator for some groups, such as the Sanlam Group. Therefore, as the lead regulator, FSB invites and hosts regulators from Botswana, India and other countries where the group has a presence.

FSB–SA has bilateral memoranda of understanding (MOU) with other regulators outside of Southern Africa. In SADC, a multilateral MOU for sharing information has been concluded within the framework of the Protocol on Finance and Investment. However, the MOU does not cover every SADC country, as signatories must be an IOSCO approved member or a member of CISNA.[122] Within CISNA, efforts are being made to revise the regional strategic plan so as to focus on all these issues of common concern coming out of the G20 discussions, the Joint Forum, IOSCO and IAIS. A harmonisation process, based on international practice, is being considered. The emphasis within SADC is that all members of CISNA must join IOSCO and IAIS before 2015 (see Annex 10 of the protocol).[123]

The chief executive officer (CEO) of Botswana's NBFIRA intimated that the establishment of NBFIRA in 2008 was in part an acknowledgment by the Botswana government of the need to take supervision seriously. MOF had supervisory authority over everything that BOB did not have oversight on. There was, however, recognition that MOF should not have been involved in such oversight functions.

Since its establishment, NBFIRA has become a member of CISNA, which is trying to drive unified regulations and laws across the region.[118] However, as CEO of NBFIRA points out, each country's laws will determine the pace of harmonisation, and the

regulatory framework in South Africa and Mauritius is streets ahead of everyone else. Botswana is learning from the other countries (South Africa/Namibia/Mauritius) through CISNA structures, and strong co-operation and political will exist within institutions to share information and experiences. In response to the G20 proposals on financial sector reforms, Botswana is currently reviewing its pension laws (at an advanced stage), collective investment undertakings (i.e. unit trusts) and insurances (at an advanced stage). The draft legislation will be tabled with the attorney general's office prior to submission to parliament.

According to MOF, at present NBFIRA does not have the capacity to manage its portfolio, which is being built with the assistance of the World Bank Group. NBFIRA is supposed to charge supervisory levies for all licensed activities and will work closely with IFSC in overseeing institutions.[125]

NBFIRA issues licenses for all financial institutions except the banks that are the responsibility of BOB. IFSC evaluates applications and makes recommendations on the establishment of financial institutions. It also monitors the trading of IFSC entities to ensure their compliance with the tax certificates granted. Any concerns are reported to the Certification Committee, established under the Income Tax Act. Technically, a company can trade as an offshore company within IFSC, even without a tax certificate that entitles them to a tax regime of 15%. If they do not hold a tax certificate, they pay 25% corporate tax as an ordinary company.[126]

The NBFIRA Act addresses several of the prudential regulatory concerns raised in the G20 Declaration. The ministry confirmed that harmonisation talks are in progress as a regional strategy in CISNA and that regulators are moving towards risk-based supervision. Some member countries of SADC are also parties to the East African Securities Regulatory Authorities.[127]

Botswana is drafting a new securities bill, which is almost complete and is intended to strengthen capital markets. They intend establishing a commodities exchange and so use an extended definition of securities to include commodities. The project started in 2006 and did not begin because of, but has been influenced by, the financial crisis. The regulations for the commodities exchange were completed and published in 2008, but they have yet to be tabled with the attorney general's office.

Lastly, although not a topic for detailed discussion in this paper, the ministry highlighted developments in Botswana's regulatory framework regarding 'tax havens' and international standards. OECD is carrying out a Phase 1 Assessment of Botswana,[128] after the country received an adverse report from OECD in May 2010 because of, *inter alia*, the secrecy provisions in the Anti-Money Laundering (AML) Act and deficiencies in its Income Tax Act, which is considered inward looking. Botswana's Proceeds of Serious Crimes Act requires banks to report any suspicious transactions and to take action or be cautioned. MOF representatives appeared before a Peer Review Group in the Bahamas in June 2010, to report on steps taken to amend this and other laws, to bring them in line with international standards. OECD's review had resulted in a blacklisting for Botswana. The organisation felt that the provisions of the AML Act and Regulations needed improvement, so these are being amended. Amendments to the Income Tax Act have also been put before cabinet. Each of the above developments was driven by recommendations coming out of the G20. The ministry did not want Botswana to be considered a 'tax haven', and is prioritising a regulatory report in the interests of maintaining the country's low-risk credit rating and to ensure that Botswana is again put on the 'white' list.[129]

CHAPTER 4

CONCLUSION

WILL GLOBAL INFLUENCES IMPACT UPON SADC TRADE NEGOTIATIONS ON FINANCIAL SERVICES?

The question is whether the international regulatory reform agenda fashioned by recent economic developments will complicate SADC services trade negotiations. Furthermore, will these reforms affect the provision of finance in both South Africa and the region and create new 'barriers' to trade? Finally, if these reforms are considered as regional responses to the financial crisis, will they, therefore, not be amenable to reduction via a trade negotiation?[130]

It is clear that, apart from South Africa which has a sophisticated first-world financial services sector, the reforms under discussion within the global regulatory bodies have little relevance for most countries in the region, barring Botswana and Mauritius, which both host international banks and have an off-shore financial services sector.

Furthermore, as most trade in financial services will be unidirectional emanating from South Africa into the rest of SADC – ignoring those institutions of Zimbabwean origin that have established a presence in Botswana and in other parts of the SADC region (and again some institutions in Botswana and Mauritius) – South Africa is likely to dominate any discussions on regional financial regulations and their liberalisation in the SADC Trade Negotiating Forum. This means that, if financial services trade between South Africa and the rest of the region is to take place, much of the global agenda on regulatory reform and financial sector stability, which South Africa (as member of the G20) is obliged to adopt, will have to be accommodated.

The G20 agenda is already influencing Botswana's regulatory reform, independent of any South African influence (apart from the harmonisation of regulations, systems and practices under CISNA and as dictated by IOSCO). So, it is likely that reforms implemented in South Africa in both the banking and non-banking sector will be considered as regional reforms and will not be open to amendments in the forthcoming trade negotiations.

The answer to the question of whether the reforms will affect the provision of finance in both South Africa and the SADC region is 'it depends'. It depends on what the final Basel III Accords will look like, and how they will affect both the capital adequacy and liquidity provisions influencing the banks' appetite for short-term (trade finance) and long-term (infrastructure project financing) investments.

Much will also depend on whether, and if, South Africa (through SARB) takes up the national dispensation allowance for national regulators that will be permitted under Basel III. This latter indulgence is to allow for more favourable treatment of trade finance transactions. The UK's FSA has granted this dispensation to banks in the UK, but SARB has declined to make use of this exemption. The South African banks interviewed believe

that the playing field in Africa is not level, as FSA's exclusion means that they are in unfair competition with, for example, Standard Chartered Bank UK, which operates in many SADC countries.

The regulatory reforms will mainly affect investment banks engaged in structured and corporate finance, project financing and (to some considerable extent) trade finance, with little appreciable impact envisaged on retail banking. Whether or not the Basel Committee and FSB's studies are correct about the minimal effect that the regulations will have on banks' activities and on affected countries' growth prospects, the perception amongst banks (whether real or not) is that Basel III will be too punitive. The prognosis is not positive, given the gap in financing for infrastructure in the region and elsewhere in Africa[131] and the need for trade finance, which has been described by the director general of the WTO, Pascal Lamy, as 'the oil that keeps the wheels of global trade running'. Banks are likely to revise their funding strategies, at least in the short-term.

Absa Capital for example, appears to be reviewing its appetite for long-term infrastructure investments, arguing in a white paper prepared for discussion with policymakers that the new capital adequacy rules will mean certain assets, including long-term loans (necessary for infrastructure and mortgage financing), will become more expensive for banks to hold on their balance sheet.[132] As a result, banks are becoming more selective about where they decide to invest.

Pietro Calice draws a similar conclusion for the continent as a whole,[133] arguing that the possible negative bias of Basel II against developing economies might be reinforced by significantly reducing leverage in the banking system of advanced economies (and South Africa may embrace a similar direction given its role in the G20), and pushing their banks to replace hybrid capital with common equity, and particularly by reducing cross-border lending to African countries. This would strengthen an old criticism of Basel II: that as regulatory capital becomes more correlated with risk, this may lead to portfolio reallocation from low-rated borrowers to high-rated ones.

African counterparties are perceived to be riskier prospects for lending and, therefore, will attract higher capital requirements. In turn, this will reduce capital flows to and within the continent. In addition to a general reduction in cross-border flows, the reforms could also increase selectivity in lending. Calice points out that in the past five years, two-thirds of total cross-border lending in Africa went to five countries: Botswana, Egypt, Morocco, South Africa and Tunisia, all of which are rated investment grade. He suggests that the reforms to Basel II will reinforce this trend, with negative connotations for the rest of the continent.

Given this discouraging prognosis, the only conclusion that can be drawn, regarding the SADC region's future negotiations, is that the international regulatory reforms will effectively create a barrier to trade in financial services in the near term.

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