South African Institute of International Affairs

Workshop on Global Financial Reform and its effect on SACU Trade in Financial Services

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Introduction

As the global financial crisis evinced, financial services play a fundamental role in the economies of both developed and developing countries. Whilst in SACU only South Africa has the capacity to export financial services, the substantial regional liberalization of the sector in the past decade has created potential for greater intra-regional trade. Botswana in particular has positioned itself as a regional financial centre. Nevertheless, the financial regulatory changes being discussed in the G20 Leaders' Forum may be transmitted to the region via South Africa with uncertain consequences for regional access to and trade in finance. These issues formed the focus for the workshop, with particular reference to findings from interviews conducted in Botswana.

Presentation by Ros Thomas

The presentation started off with a brief overview of the origins of the financial crisis as well as its evolution to the present day. The crisis was caused by a variety of issues, primary among them being macro-economic imbalances; loose monetary policy where mispriced risk and credit led to asset price bubbles; excessive leveraging through pro-cyclical regulation and regulatory arbitrage; as well as the complex, non-transparent derivatives market. As a result of the crisis, there was a massive decline in global trade through demand shocks to international supply chains as orders from developed countries were cancelled and trade finance dried up because banks could no longer trust each other. Corporate finance and infrastructure banking services were also affected, with customers requiring risk management interventions as well as debt restructuring.

The crisis catapulted the G20 to the centre stage of global financial reform issues in place of the G7 and brought with it also, recognition of the role of emerging markets. As part of the reform package, the G20 has encouraged the adoption of Basel III principles which propose reforms to strengthen capital and liquidity requirements; to design a safer framework for subprime assets; regulate and supervise OTC derivatives market; as well as regulate and supervise financial conglomerates without imposing regulatory arbitrage. All the regulation and supervision should capture the full range of activities and risks. While the crisis had a negative impact on the accessibility of trade finance in general, this was partly exacerbated

by Basel II requirements on capital adequacy which are procyclical. In this respect, there are four critical elements: raising the quality, consistency and transparency of the capital base; strengthening the risk coverage of the capital framework, particularly with respect to counterparty credit risk exposures; introducing a *leverage ratio* requirement as an international standard; and, measures to build-up capital buffers in good times that can be drawn on in times of stress, thus introducing a countercyclical component to address the concern that existing capital requirements are pro-cyclical.

The Basel III proposals address many of the weaknesses of Basel II but they are also likely to affect the financial services sector in ways that regulators may not have envisaged. In particular, two types of assets will become more expensive for banks to hold on the balance sheet. These are long-term loans in infrastructure and mortgage loans as well as equity related exposures. The net effect will be a limitation on asset growth with investment banks shifting their focus towards short-term financing, and the development of risk management products and services.

The presentation also sought to measure the impact of the financial crisis and the proposed regulatory reforms on the SADC financial services sector. At the height of the crisis, the IMF forecast a drop in growth for sub-Saharan countries and giving South Africa and Botswana as examples, it was shown that this, indeed, is what happened. In Botswana, real GDP growth declined to 2.9% at the end of 2008, down from a previous (+40 years) high of 10%. From December 2008, the Bank of Botswana (BOB) reduced its main interest rate by 400 basis points to stimulate the economy. While the financial sector had remained relatively sound, it 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. In South Africa, the economy ran out of steam in 2008 and the country experienced its first contractions in GDP in a decade. In 2009, the country went into recession. Exports fell by 24% in Q1 of 2009, adding more pressure to the current account deficit. The Reserve Bank (SARB) began trimming rates in December 2008 to boost the economy, allowing several cuts by August 2010, down to 6.5%.

The structure of the financial services sector in Southern Africa is such that South Africa dominates, with banks making up the largest segment with assets representing 120% of GDP. All banks are operating on Basel II. Insurance companies hold assets accounting for 80% of GDP at the end of 2007 and with an insurance penetration that is the highest globally at 16% of GDP. The Johannesburg Stock Exchange (JSE) is the largest among emerging markets by market capitalization, while the Bond Exchange (BESA) is a leader among emerging markets with annual liquidity of 38 times its market capitalization. South Africa is therefore considered a net exporter of financial services in the region.

The SADC draft Protocol on Trade in Services was adopted in July 2009 but has yet to be signed. In November 2009 SADC adopted negotiating guidelines for trade in services negotiations. Four approaches to negotiating liberalization of national financial systems apply: (i) the unilateral route – similar to that which was achieved under IMF structural adjustment programmes; (ii) the bilateral approach, as with agreements between a member country and a third country; (iii) the multilateral approach as would happen under the SADC negotiations; and (iv) the multilateral non-regional route via the WTO. The SADC negotiations have to be viewed within the context of an unprecedented international regulatory reform agenda driven by G20 and, with South Africa as a member of the G20, its macro-prudential & micro-prudential regulations are likely to be substantially strengthened. This is likely to complicate negotiations on services trade liberalization.

Some of the anticipated difficulties that might possibly be brought about by the Basel III reforms include:

- Apart for Botswana and Mauritius, reforms under discussion have little relevance for most countries in the region;
- Most trade is unidirectional from SA to the rest of the region;
- SA is likely to dominate discussions on trade in financial services;
- SA as a G20 member will follow the global approach, except where national dispensations permit or rules are not relevant;
- Botswana is already embracing much of the regulatory reform agenda influenced by global developments; whereas foreign banks will embrace the rules of the home state ; and,
- The impact is mainly on Investment Banks – on structured (including trade), corporate & project financing.

Apart from South Africa's sophisticated first world financial services sector and those of Botswana and Mauritius; the reforms driven by the G20 countries have little relevance for the rest of the countries in the region. Nonetheless, because of South Africa's involvement in the G20, these reforms will impact on the provision of finance in both South Africa and the region, and create new "barriers" to trade: by reducing leverage in the banking system, & pushing for Tier 1 (common equity) – viewed as a negative bias of Basel III - will lead to reduced funding in Africa as riskier prospects attract higher capital requirements; less appetite for Infrastructure financing; and, bias in favour of better rated countries. 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.

First Discussant – Prof Daniel Bradlow: University of Pretoria

The first discussant, **Professor Daniel Bradlow**, focused on the regulation aspects of the presentation. The issue is about regulation at a global level, focusing on the G20, and the relevance to SACU and SADC. **Prof Bradlow** was of the opinion that regulatory failures were far worse than discussed by **Ros Thomas**. There is a general agreement that one of the key causes of the global financial crisis was regulatory failure. This leads to the question of what regulatory failure is. He mentioned three levels of regulatory failure.

The first level is that of gaps at national level. This relates primarily to capital adequacy. Most big banks exceeded legislated capital requirements but only quantitatively and not qualitatively. This was compounded by the lack of regulation of derivatives. This lack of regulation was a political choice more than anything else: In the US, there was a political debate in the 1990s on whether to regulate hedge funds and other shadow banking systems and the tide went against regulation.

The second level is that of governance failure. The regulatory institutions failed to regulate and there was also the issue of the privatisation of regulation e.g. Basel which was not always translated into national regulation. The collapse of AIG, one of the biggest collapses brought about by the financial crisis, is a classic example of regulatory agencies failing to do their job. The failure of regulatory institutions is a difficult and more serious problem that is not getting the attention it deserves. There is a general sense that the financial sector knew what it was doing and could be counted on to guide itself. This was not happening and the shadow banking systems encouraged rent seeking activities.

The third level of failure relates to global regulation which is in the form of soft regulation with no enforcement measures. For example, the United States had not yet implemented Basel II at the time of the financial crisis. There is also a lack of clarity on how and who to regulate at the global level.

Having identified these three levels of failure, what remains is that the issue not being debated enough is the breakdown of supervisory structures both globally and nationally. The structures did not work as they were supposed to. Unfortunately financial regulatory reform in the US has not clarified or simplified the regulation of the financial sector. In other countries, the issues are only being thought about tangentially level.

As regards relevance to SACU and SADC, there are three levels:

Firstly, there is the issue of incorporation – how global developments get incorporated in Southern Africa. Are financial institutions applying global standards? There is also the question of whether the SADC Financial Protocol will take global developments into account. Related to this is the issue of incorporation at sub-regional level, for example,

whether South Africa is implementing global standards. Even if such incorporation is not taking place officially, it is taking place through private channels where foreign banks are bringing in Basel III and other standards into domestic banking.

Secondly, how relevant are these standards? The level and standard of banking in the region renders some of the global reforms irrelevant. Capacity and skills gaps compound these problems.

Thirdly, global reforms could affect corporate and project funding in the region. Currently, the banking sector does not serve the developmental needs of the region well. Southern Africa is not unique in this respect and finds a parallel in Latin America. Nonetheless, South Africa has come up with such initiatives as the National Credit Act and the Mzansi Account as well as mobile banking and these should be looked at from a global perspective.

In conclusion, **Prof Bradlow** urged some thought on the dynamics currently playing out in global regulatory reform. At the G20, it is the G7 interests that are taking centre stage. For example, issues like the regulation of credit card transactions are mostly of concern to the developed world. Asians institutions' agenda on the topic are different to what is playing out in the G20. It will be a while before such countries impact the discussions at a global level.

Second Discussant - Peter Van der Merwe: ABSA

Mr Van der Merwe chose to focus, in his discussion, on the unintended consequences of what is currently happening on the regulatory reform front. Banking is moving, to some extent, outside of traditional banking. Owing to the crisis the banks are being more tightly regulated but other parts of the financial services industry are not. The question therefore is what is to be done about those aspects of traditional banking that are moving elsewhere. There has to be someone to do something about it and, if not the banks, then who is going to be the provider of the finance needed?

Banks and pension funds are the biggest players in the finance industry. Pension funds are big investors specialising in long-term finance. As for banks, providing credit is not their sole domain; they also support lending between persons or private equity. Private equity equals private credit and looking to the future, how is regulation going to address that? Growth of private credit is one of the by-products of the greater regulatory focus on banking but there are no concomitant trends in respect of regulation. There should therefore be more focus on the unintended consequences of what is happening. In particular, more attention should be paid to where risk is moving to and who is going to pick up the slack. Looking at the differences between banks and pension funds, pension funds have long-term liabilities as opposed to banks. A lot of pension funds are managed by asset managers and asset

managers do not have origination capabilities. Asset managers are therefore now looking into getting into origination.

On the other hand, origination technologies reside with the banks. Banks have experience in providing loans, undertaking credit risk, compliance etc. However, they do not have pension funds as direct clients. This means that as far as pension funds are concerned, banks are originating assets that do not go to their balance sheet but go straight through to investment managers. There is therefore an element of mediation and brokering that is not regulated.

In conclusion, the answer of who is going to fund project finance is somewhere in the murky space of finance sector players. A major concern is disintermediation of bank balance sheets as regulation encourages them to move away from traditional banking activities.

Third Discussant - Keith Jefferies

Keith Jefferies commended the presentation by **Ros Thomas**, noting that he had no major disagreements but more of elaborating comments. He also noted that disintermediation of bank balance sheets is not a new process; in developed countries for example companies were increasingly resorting to corporate bond markets rather than traditional bank loans prior to the onset of the crisis.

On the issue of risk, there is the perception that African countries are disadvantaged by current regulatory reform because they will make risk/credit more expensive. However, the picture is more complex than that. The financial crisis saw the disappearance of risk appetite. The rand crashed because of risk aversion but has recently strengthened due to short-term credit/capital inflows. The fact is that risk is higher in the UK, US and Greece rather than emerging markets.

As for the impact of the global crisis on financial sector development in the region, the crisis and regulatory response everywhere has imposed a huge supervisory responsibility on SADC countries. Macro-prudential regulation is a departure from developing country focus on financial institutions. This departure requires skills which central banks do not have because it cuts across many areas, including practical ones like how to do stress tests. The burden on central banks is quite large. This however creates a lot of scope for regional cooperation.

The supervision of cross-border financial institutions or conglomerates is another issue. This is a challenge because there are no established mechanisms in the region for information sharing. Such information sharing is mostly informal and smaller countries in the region struggle to be heard. For example, South African banks operate in 17 African countries but SARB only has MOUs with 2 African countries. There is a tendency by SARB to look up to the G20 and not down to the region. SADC could take a leaf out of the EAC's book – they have

developed a model MOU and all member states have signed bilateral MOUs based on the model agreement.

Speaking to global regulation, **Dr Jefferies** opined that before the crisis Basel II was more optional. The demands on regulators are huge but in general, Basel II is not suited to developing countries and therefore many did not adopt its recommendations

As for the issue of the liberalisation of financial services trade in Southern Africa, services in general and particularly financial services are highly protected in the region. The willingness to remove trade barriers is very limited. An example is the SADC stock exchange where there is not much will to harmonise stock exchanges. Underpinning this is a general fear of SA dominance. In addition there is a case to be made for smaller countries to offer more liberal regulatory environments in order to attract financial sector investment into their economies.

Generally, the area of non-bank regulation is a key area, and an area that is extremely weak. This area poses challenges in terms of capacity constraints and skills shortage. For example, stock exchange, bond management etc require a broad and diverse range of activities which also requires a broad range of regulations and skills, which skills still need to be developed. This is very difficult in developing countries where skills are not readily available. If every small country wants non-bank regulation, then the cost of such regulation would be very high.

Finally, the fear that financial services trade in SADC would be one way is true to a large degree but not completely. There is some banking innovation taking place outside of South Africa. A good example is mobile banking which is taking place largely outside of South Africa, in Kenya especially, since an appropriate regulatory framework has not yet been developed in South Africa. There is plenty scope for trade *to* South Africa and not just *from* South Africa.

Question and Answer Session

Are the institutions in the developed world too big to regulate?

These institutions are an example of how not to regulate banks. The institutions in the US provide an excellent way of learning American history. Each development in history brings in new regulation that supplements existing regulation and does not supersede existing regulation, leading to a very complex regulatory system. This led to the evolution of too big institutions that are too difficult to regulate. Surprisingly, no one is talking about competition law being used to break up these institutions.

Do countries in the region have any option besides complying with Basel III?

Before the crisis, there was a perception that if a country was not up to date with the regulation then it had something to hide. There was a moral pressure to keep up with the latest versions of Basel. Now there are two kinds of pressures facing the region: moral pressure, and pressure from the big global banking entities. In Botswana, for instance, more than 90% of the banking sector is held by four big banks with international parents. These banks therefore have a dual regulatory obligation: host-country regulation and home-country regulation. Such banks might therefore lobby for movement to the latest version of the regulations in Botswana.

However, for countries like Botswana trying to establish financial centres, it is not so much banking regulation that will make an impact but rather money laundering. Countries will want to implement Anti-Money Laundering regulations because they do not want to be seen as tax havens. In this regard, transparency has become a big deal and that is where the pressure to implement Basel III will come from.

What is it that shielded the South African banking sector from the financial crisis?

There is an argument that South Africa was protected from the negative effects of the financial crisis by default because of Exchange Controls. However, there is more to this than that. First, the South African banking system is small by international standards and therefore easier to regulate. Furthermore, regulations are robust and tightly enforced. Finally, the reason South African banks were not engaged in toxic assets is because the domestic market is dominated by four banks and it is quite easy for them so they do not feel compelled to chase business elsewhere.

What will be the role of credit rating agencies in the region?

The Financial Services Board will stringently regulate them. However, the inherent use of credit rating agencies was reduced because of their role in the financial crisis.

Is there any scope for regional cooperation to regulate non-banking institutions and, considering that SA is very dominant in the region, how will this play out?

It makes sense for countries in the region to establish a common regulator as opposed to piggy backing on South Africa. This will of course entail common regulations that South Africa has to agree to. This is also important because the challenges for setting fully-fledged regulatory national bodies are huge. For example, Lesotho cannot afford setting this up. Also, what the smaller countries intend to regulate is completely different from the South African context.

Such consideration at the regional level also helps decide how to deal with Basel II or III and whether they should or should not adopt these regulations.

ASEAN countries are developing harmonisation of financial regulations but their countries are very different in terms of the development levels of the financial industries. For example, Singapore is well developed and using Basel III but ASEAN allows for a three tier system of liberalisation or regional integration. Is SADC looking at such examples and learning from them?

The SADC Finance and Investment protocol does talk about harmonisation and cooperation in financial services. There is an annexure on payments, CESSNA (non-banking regulators) are also looking at harmonising their regulations.

In calling for more regulations, does that not limit the options for African countries for creating wealth using the banking industry?

Most of the money made by big banks does not trickle down to the economy but the banks are trading among themselves and encouraging rent seeking. Therefore, such regulations would not be a hindering factor in the creation of wealth.

The answer to this question is actually the question itself because as a result of lack of regulation the wealth that can be created can also be easily wiped out as seen in the current financial crisis.