FINANCIAL DEVELOPMENT, ECONOMIC GROWTH AND STABILITY: A CASE STUDY OF SOUTH AFRICA'S FINANCIAL REFORM

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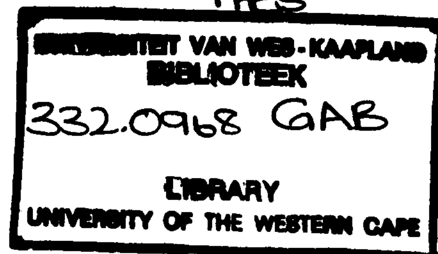
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IVAN MARK GABRIEL

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ABSTRACT

FINANCIAL DEVELOPMENT, ECONOMIC GROWTH AND STABILITY: A CASE STUDY OF SOUTH AFRICA'S FINANCIAL REFORM

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South Africa's unique colonial history, apartheid legacy, and ongoing transition to democratic governance drive the country's determination to attain its development objectives. Embedded in that determination is a broad social and environmental public benefits agenda—that is, a sustainable economic development agenda. Public benefits include, **inter alia**, banking access, black economic empowerment and financial sector stability and efficiency.

The turbulence in international financial markets in the 1980s, and its impact on S.A. banks, gave rise to the notion that academics working in the field of banking and financial regulation might be in a position to make a contribution to the improvement of regulation in South Africa, and thus ultimately to the stability of the entire financial sector. Generally, the South African financial sector, described here as the banking, insurance and securities industries, is regarded as stable and well regulated; indeed it is to the latter that the robustness of the sector has been attributed, in the wake of the Asian and other financial crises.

However, while the recent promulgation of regulatory legislation in each of the industries has resulted in greater compliance with international standards, the adjustment required to meet world-class standards is not yet over. In addition, meeting international standards for compliance and regulation is only one part of the dual pressure facing the sector: the other lies in the growing political and economic imperative to address widespread financial under-provision in South Africa.

In this mini-thesis I will review the literature between financial development and economic growth. Based on the assumption that a positive relationship exists between Financial Development and Economic Growth, a stable financial sector becomes an imperative. I will therefore review the current financial sector stability in South Africa outlining regulation in each industry and also outline and focus specifically on how the new financial sector charter could affect stability and thus affect economic growth. MAY 2004

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DECLARATION

I declare that *FINANCIAL DEVELOPMENT, ECONOMIC GROWTH AND STABILITY: A CASE STUDY OF SOUTH AFRICA'S FINANCIAL REFORM* is my own work, that it has not been submitted before for any degree or examination in any other university, and that all the sources I have used or quoted have been indicated and acknowledged as complete references.

IVAN MARK GABRIEL May 2004

Signed:...............

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CHAPTER 1

INTRODUCTION

Under the combined pressure arising from the common trends of financial globalisation, diversification, innovation and intensification in competition, countries around the world have been forced to refashion the way they regulate and supervise their financial services industries. South Africa is no exception. Therefore, like many other countries, South Africa's financial reforms typically embrace central bank reform, financial liberalization, supervisory reform, and enhanced consumer protection.

On the central banking front, South Africa's clear trend is towards enhancement of central bank independence and the narrowing of operational responsibilities to ensure a clear focus on monetary policy. In connection with the latter, inflation targeting is in the ascendancy, with open market operations the preferred means of securing policy objectives. As in the UK, central banks are being stripped of their supervisory roles; yet, possession of the lender of last resort facility ensures they retain at least some responsibility for ensuring overall financial stability.

Wide-scale financial deregulation has also become a global phenomenon as countries seek to maximize economic efficiency and meet the international challenge of such moves overseas. Typically, such deregulation embraces the liberalization of financial markets and the abolition of interest rate controls.

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Financial liberalization has, in turn, created acute pressures for supervisory reform, the need for which has been accentuated by a dramatic increase in the pace of financial innovation (e.g. the emergence of new markets, financial products and corporate structures) and a fast changing finance industry landscape, due to changes in the legal environment and market pressures for mergers, consolidation and demutualization. The supervisory reforms themselves typically embrace changes in the institutional organization of supervision- the trend is towards the integration and centralization of supervision and away from specialization, a path adopted by the present SA government when it created the Financial Services Authority- as well as changes in the style and *modus operandi* of supervision. The latter are needed to accommodate implementation of the ever- changing international 'rules of the game',

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as set out, for example (as far as banks are concerned), in the Basle Capital Accord, the Basle Concordat, the Basle Committee's Core Principles for Effective Banking Supervision and the related European Union directives, and to raise economic efficiency and improve cost- effectiveness in a very dynamic environment.

Currently the South African regulatory authorities are guided primarily by the International Accounting Standards Committee in respect of accounting rules, to the Bank for International Settlements in respect of banking laws, to the International Organization of Securities Commissioners (IOSCO) and the European Union for securities markets legislation, and to the International Association of Insurance Supervisors (IAIS) and IOSCO for insurance legislation.

Finally, under pressure from both governments, whose ultimate goal is financial stability to improve economic growth, and the consumer protection lobby, various measures have been widely adopted to enhance the protection afforded the consumers of financial products. Typically, these embrace the introduction/improvement of deposit insurance and compensation schemes, the tightening of anti-money laundering measures, improved self- regulation (achieved, through the introduction of industry 'codes of conduct') and the toughening of legal sanctions (to deter fraud, malpractice, market abuse, and insider trading, as examples).

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Furthermore, South Africa's has also adopted an additional approach to its Financial Reform through its development of its Black Economic Empowerment Policy via its new Financial Sector Charter. Here special provision is made for the transfer of ownership from the minority to the majority.

It is important to note, however, that all these reforms are incorporated with the specific goal to stimulate economic growth.

Therefore, the structure of the mini-thesis is as follows: chapter 2 will review the literature regarding the role of financial development in enhancing the economic growth and development of an economy. The financial sector's stability in South Africa will be assessed in Chapter 3, paying special attention to S.A. financial regulation, development and its new financial sector charter. Chapter 4 concludes.

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CHAPTER 2

FINANCIAL DEVELOPMENT AND ECONOMIC GROWTH REVIEW OF THE LITERATURE

Over the last decade, a substantial volume of research has been devoted towards understanding the relation between financial development and economic growth. The causality relationship between financial development and economic growth is a controversial issue. Basically, the debate has been centered on whether it is financial development that leads to economic growth or vice versa (Patrick, 1966).

The financial development – economic growth paradox is complicated by another view that the relationship is dynamic in nature. To date there is no clear-cut solution in which policy-makers could rely upon. Nevertheless, the idea that economic growth is related to financial development and structure dates back to Schumpeter (1911). Schumpeter emphasized the importance of the banking system in economic growth and highlighted circumstances when financial institutions can actively spur innovation and future growth by identifying and funding productive investment.

Recent literature including Goldsmith (1969), McKinnon (1973) and Shaw (1973) had suggested that financial development would raise saving, capital accumulation and hence economic growth. More recent empirical studies such as Greenwood and Jovanoic (1990) and King and Levine (1993a, b) had also shown that a range of financial indicators is robustly positively correlated with economic growth.

There are several hypotheses that tend to explain the relationship between financial development and economic growth. These are:

- Finance led growth
- Growth led finance
- Feedback hypothesis

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Each of these hypotheses will be discussed briefly

2.1 Relationship between financial development and economic growth – leading hypothesis

Finance-led growth – this hypothesis postulates the supply-leading relationship between financial and economic developments. It is argued that the existence of financial sector, as well as functioning financial intermediations in channelling the limited resources thereby leading the other economic sectors in their growth process. Indeed, a number of studies have argued that the development of financial sector has significantly promoted economic development (Levine, 1997)

Growth-led finance- states that a high economic growth may create demand for certain financial instruments and arrangements and the financial markets are effectively responsive to these demand and changes. In other words, this hypothesis suggests a demand following relationship between financial and economic developments. The impact of economic growth on the financial development has been documented in Romer (1990), among others.

The *feedback hypothesis* suggests a two-way causal relationship between financial development and economic performance. In this hypothesis, it is asserted that a country with a well-developed financial system could promote high economic expansion through technological changes, product and service innovation (Schumpeter, 1911). This in turn, will create high demand on the financial arrangements and services (Levine, 1997). As the banking institutions effectively respond to these demands, then these changes will stimulate a higher economic performance. Therefore, both financial development and economic growth are positively interdependent and their relationship could lead to feedback causality.

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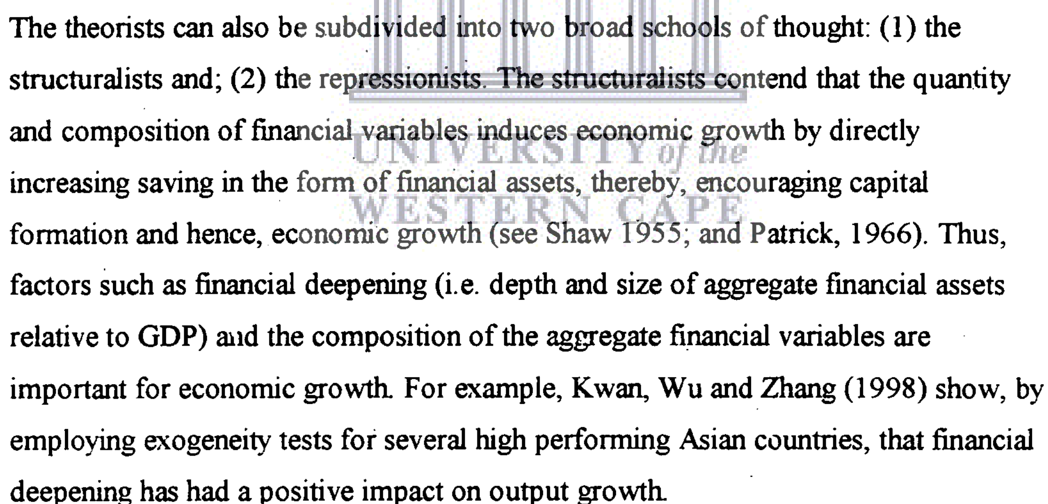
2.2 Channels

Be that as it may, there are a number of channels through which financial liberalization may impact growth. First, foreign investors, enjoying improved diversification benefits, will drive up local equity prices permanently thereby reducing the cost of capital. Henry (2000), marshals evidence that the cost of capital goes down after regulatory reforms. Bekaert et al (2000) show that a capital inflow leads to a permanent positive price effect, leading to increased investment. If the additional investment is efficient, economic growth should increase.

Secondly, there is myriad literature on how financial markets and intermediation can improve growth and financial liberalization may promote financial development. Furthermore, foreign investors may also demand better corporate governance to protect their investments hereby reducing the wedge between the costs of external and internal financial capital



The theorists can also be subdivided into two broad schools of thought: (1) the structuralists and; (2) the repressionists. The structuralists contend that the quantity and composition of financial variables induces economic growth by directly increasing saving in the form of financial assets, thereby, encouraging capital formation and hence, economic growth (see Shaw 1955; and Patrick, 1966). Thus, factors such as financial deepening (i.e. depth and size of aggregate financial assets relative to GDP) and the composition of the aggregate financial variables are important for economic growth. For example, Kwan, Wu and Zhang (1998) show, by employing exogeneity tests for several high performing Asian countries, that financial deepening has had a positive impact on output growth.

The financial repressionists, led by, McKinnon (1973) and Shaw (1973) – often referred to as the "McKinnon–Shaw" hypothesis contend that financial liberalization in the form of an appropriate rate of return on real cash balances is a vehicle of promoting economic growth. The essential tenet of this hypothesis is that a low or

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negative real interest rate will discourage saving. This will reduce the availability of loan able funds for investment, which in turn, will lower the rate of economic growth. Thus, the "McKinnon – Shaw" model posits that a more liberalized financial system will induce an increase in saving and investment and therefore, promote economic growth. Ahmed and Ansari (1995) investigated the "McKinnon – Shaw" hypothesis for Bangladesh and found some, although weak support for their hypothesis. They focus on price variables as the relevant financial factors for growth.

Note however, the structuralists and the repressionists have a common underlying thread; that is, the efficient utilization of resources enhances economic growth. This is achieved via a highly organized, developed and liberated financial system approach. For example, Bencivenga and Smith (1991: 196) employ an overlapping generations model and demonstrate that "an intermediation industry permits an economy to reduce the fraction of its savings held in the form of unproductive liquid assets, and to prevent misallocation of invested capital due to liquidity needs." Thus, economic growth is induced via the capital stock. Greenwood and Jovanovic (1990) employ a general equilibrium approach and conclude that as savers gain confidence in the ability of the financial intermediaries they place an increasing proportion of their savings with intermediaries. Greenwood and Smith (1997) use two models with endogenous growth formation and examine the way banks and stock markets allocate funds to the highest value user(s). King and Levine (1993b), employ an endogenous growth model in which the financial intermediaries obtain information about the quality of individual projects that is not readily available to private investors and public markets. This information advantage enables financial intermediaries to fund innovative products and productive processes, thereby inducing economic growth.

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2.3 Indicators of financial development

One of the most important issues in assessing the relationship between financial development and economic growth is how to obtain a satisfactory empirical measure of financial development. The five[1] most commonly used proxies for financial development are: the ratio of money to income, the ratio of banking deposit liabilities

[1] Only three will be discussed for ease of exposition.

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to income, the ratio of private sector credit to income, the share of private sector credit in domestic credit and the ratio of domestic credit to income. These proxies are considered in turn.

Monetary aggregates provide a set of variables, which may be used to measure the extent of financial development (see for example, Lynch, 1996). In the literature, the most commonly used measure of financial development is a ratio of some broad measure of the money stock, usually M2, to the level of nominal income (King and Levine, 1993a, 1993b). This simple indicator measures the degree of monetization in the economy. The monetization variable is designed to show the real size of the financial sector of a growing economy in which money provides valuable payment and saving services. The 'narrow money' stock best reflects the former - payment services - and 'broad money' the latter, savings function. Narrow money balances should rise in line with economic transactions, but broad money should rise at a faster pace if financial deepening is occurring (Lynch, 1996).

An alternative to a broad money ratio is ratio of bank deposit liabilities to income as a quality proxy for financial development (Luintel and Khan, 1999). In developing countries, a large component of the broad money stock is currency held outside the banking system. In principle a rising ratio of broad money to income may reflect the more extensive use of currency rather than an increase in the volume of bank deposits. Therefore in order to obtain a more representative measure of financial development, currency in circulation should be excluded from the broad money stock. One such proxy is the ratio of bank deposit liabilities to income (BDY).

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The ratio of domestic credit to income (DCY) can be used as another proxy for financial development (Odedokun, 1989). This represents the domestic assets of the financial sector. This is the major item on the asset side of the consolidated balance sheet of the financial sector. It is expected to increase in response to improved price signalling, represented primarily by the establishment of positive real interest rates.

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2.4 Empirical evidence

Financial development also can be a panacea for economic growth (Bensivenga et al 1995). Specifically, financial development by enhancing resource allocation and hence the returns to saving may lower saving rates. Demirgic and Levine (1996) used 44 cross-countries data from 1986 through 1993; found that a positive relationship exists between stock market and financial institutions development.

Levine and Zervos (1998) investigated whether measures of stock market liquidity, size, volatility and integration with world capital markets are correlated with economic growth. Their study provided empirical evidence on the theoretical debates regarding the linkages between stock markets and long-run economic growth. However, their study did not utilize time series model to test the growth relation in a particular country. Instead, they used 47 countries data from 1976 through 1993 by taking the standard cross-country growth regression framework to test the economic growth hypothesis.

Arestis et al (2000) used quarterly data and applied time series model to five developed countries and showed that while both banking sector and stock market development explain subsequent growth, the effect of banking sector development is substantially larger than that of stock market development.

Hsu and Lin (2000) investigated the relation between long-run economic growth and financial development, and also to see whether stock market and financial institutions promote economic growth using Taiwan's data from 1964 through 1996. The empirical method used is the vector autoregressive error-correction model proposed by Johansen and Juselius (1992). They showed that both banking and stock market development are positively related with short run and long-term economic growth. In particular, the financial depth measured by the ratio of the broad monetary aggregate (M2) and GDP has strong effect on the output growth. In addition, they also found that the causality between financial development measures and economic development occurred during the study period (i.e. from 1964 through 1996).

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However, among the empirical studies of economic growth, they neglected the effect of international capital mobility on economic growth. High degree of capital mobility not only affects independence of domestic monetary and fiscal policies, but also adds to complexity of managing saving and investment problems in a country.

Hanson (1994) suggested that a stable macro-economy and domestic financial liberalization to a significant degree are preconditions to international financial liberalization. Johnston et al (1997) examined issues in sequencing and pacing capital account liberalization and draws lessons from experience in Chile, Indonesia, Korea and Thailand. Their results suggested that capital account liberalization should be approached as an integrated part of comprehensive reform strategies and should be paced with the implementation of appropriate macro-economic and exchange rate policies. However, Kim and Suh (1998) suggested that capital account liberalization would enhance the competitiveness and efficiency of financial transactions for Korean corporations. Hence, it cannot further delay the opening of domestic capital market to foreigners as well as the foreign capital markets to domestic residents.

Although there is considerable empirical and theoretical literature that postulates a positive first order relationship between financial sector development and economic growth, it is somewhat surprising that empirical studies which attempt to establish causality by undertaking Granger-causality tests are few and far between. For example, Jung (1986), found bi-directional causality between financial and real variables using post-war data for 56 countries, of which 19 are developed industrial economies. Demetriades and Hussein (1996), conducted causality tests and found little evidence that financial sector development causes economic growth. They found that causality patterns varied across countries.

Therefore, based on the empirical and theoretical literature that postulates a positive first order relationship between financial sector development and economic growth, it would necessitate a sound Financial Sector in South Africa. Put differently, a stable financial system in South Africa will positively affect price stability, which in turn will positively affect economic growth in South Africa. The following chapter will

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review the stability of South Africa's Financial Sector focusing on recent developments in South African's financial reform.

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CHAPTER 3

FINANCIAL REFORM IN SOUTH AFRICA

In recent years globalisation, volatile exchange rates and asset prices and regional financial crises have highlighted the importance of stability in the financial system

Financial system stability can be described as the absence of macroeconomic costs of disturbances in the system of financial exchange between households, businesses and financial service firms [2]. Stability in the financial system would be evidenced by:

- An effective regulatory infrastructure
- Effective and well-developed financial markets and
- Effective and sound financial institutions.

In its pursuit of financial stability the Central Bank must rely on market forces to the fullest possible extent, and therefore any intervention should be at the minimum level needed to contain systemic risk.

Financial instability, conversely, is manifested through banking failures, intense asset-price volatility or a collapse of market liquidity, and ultimately in a disruption in the payment and settlement system. Financial instability has the potential to affect the real sector through significant macroeconomic costs.

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The importance of financial sector stability becomes evident in outlining the sector (together with real estate and business services) in terms of its contribution to GDP for the period 1993-2000. In the year 2000, the financial sector contributed 20 percent of the country's economic product. It is with this background, that the regulatory framework in the sector is examined.

[2] See Central bank of Canada for a complete report of stability disturbances by Engert and Selody.

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Table 1: Contribution of the financial sector to GDP

YEAR	1993	1994	1995	1996	1997	1998	1999	2000
Nominal GDP (Rm)	390 842	440 147	500 354	565 978	625 418	670 383	723 247	793 993
Financial sector* (Rm)	62 861	70 491	82 162	94 116	109 601	123 370	141 929	160 954
Financial sector* contribution to GDP								
Percent (%)	16.1	16.0	16.4	16.6	17.5	18.4	19.6	20.3

**Financial intermediation, insurance, real estate and business services*

Source: SARB Quarterly Bulletin

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3.1 Rationale for a Regulatory Framework for the South African Financial Sector

The economic rationale for regulation and supervision of banks revolves around externalities and market imperfections. Simply stated, the social cost of banking-system failure is too high to be left to a market with imperfections such as inadequate and asymmetric information – consumers are less informed than suppliers of banking services. The market alone can therefore not ensure a sound banking system by adequately penalising banks that are imprudently managed. Banking is by nature heavily dependent on consumer confidence.

Depositors are mostly aware of the fact that banks lend out their deposits to longer-term and risky borrowers. They are only prepared to do this if they have complete

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confidence in the ability of a bank to manage its liquidity and credit risk. This confidence is clearly enhanced by the knowledge that banks are regulated and supervised. In this sense, regulation is a "public good" that cannot be supplied by the market because it cannot be properly priced. Unfortunately, regulation and supervision of banks can also have perverse effects, such as consumers assuming that banks are safe and that they need not take care in selecting banks and products. The emergence of liquidity or solvency problems in a particular bank can threaten confidence not only in that bank, but also, because of the possibility of contagion, in the safety and stability of the system as a whole. Poor judgement by banks or adverse domestic or international economic conditions could lead to the rapid demise of a bank and, due to the degree to which banking activities are interwoven with other economic activities, a number of other financial institutions and/or economic systems – or even the economy as a whole – could be impacted on through contagion. The need to protect the public against the consequences of financial disruption and to limit the risk of contagion and systemic instability provides a further rationale for establishing special mechanisms for the handling of banking crises.

3.2 Current Regulatory Framework of the South African Financial Sector

The achievement of financial stability is dependent on a legal structure, which establishes the framework within which financial institutions operate. Steps to make financial systems less crisis-prone are initially aimed at changes to regulatory measures and legislation. Therefore, in 1999, the Financial Stability Committee (FSC) was established with the specific mandate to strive to enhance financial stability by continuously assessing the stability and efficiency of the financial system, formulating and reviewing appropriate policies for intervention and crisis resolution, and strengthening the key components of the financial system. Furthermore, a Financial Stability Department (FinStab) was established with effect from 1 August 2001 to help monitor the stability of the financial system as a whole by identifying inherent weaknesses and the build-up of risks that may result in financial system disturbances. A key element of the work of FinStab is keeping abreast of international best practice.

South African authorities have debated extensively in recent years the most appropriate regulatory structure for the supervision of South Africa's complex

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financial services groups. An independent regulator regulates each of the three industries that make up the financial sector. In 2001, the Minister of Finance indicated that government intended establishing a single financial regulator covering both banking and non-banking activities. In 2002, the Governor of the Reserve Bank expressed the view that bank supervision should remain part of the Bank's functions. The problems in the banking sector early in 2002 had shown that banking supervision was closely aligned with the Bank's other functions and that close co-operation between the bank regulator and the other parts of the Bank was essential in order to ensure systemic stability, which is essential for price stability. The objective remains sound regulation, whatever the institutional arrangements that will ultimately be decided upon.

The promulgation of regulatory legislation, however, in each of the industries has improved the level of compliance with each of the relevant international standards bodies: the Bank for International Settlements (BIS) in Basle for the banking industry; the International Association of Insurance Supervisors (IAIS) for the insurance industry; and the International Organization of Securities Commissions (IOSCO) for the securities industry. The recent changes in legislation have resulted in a financial sector that largely meets the existing requirements of each of these regulatory authorities.

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In the case of the banks, the Regulator is the Registrar of Banks, who manages the Banking Supervision Department of the South African Reserve Bank. This independent unit was established in 1989 and currently employs over 80 regulatory and prudential staff. The Registrar of Banks allocates banking licenses according to the conditions stipulated in the Banks Act of 1990. This involves the payment of a license fee, submission of a detailed business plan and compliance with the regulations and prudential requirements of the Banks Act. There is no discrimination in the treatment of domestic or foreign applicants for a banking license; however, foreign banks wanting to operate in South Africa must meet the capital requirements without recourse to parent capital offshore

The Financial Services Board Act, 97 of 1990, in 1991, established the Financial Services Board (FSB), as a statutory body. Currently, it has some 160 employees;

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however, on the recommendation of the International Monetary Fund (IMF), it is currently expanding its staff to around 185. It is financed by the financial services industry itself, with no contribution from government. It supervises the control over the activities of non-banking financial services and acts in an advisory capacity to the Minister of Finance.

The FSB supervises such institutions and services in terms of 16 Parliamentary Acts, which entrust regulatory functions to the Registrar of Long-and Short-term Insurance, Friendly Societies, Pension Funds, Unit Trust Companies, Stock Exchanges and Financial Markets. Those functions resort in the office of the Executive Officer acting with other members of the executive and heads of the various departments. Included in such functions are also regulatory control over Insider Trading as well as the participation bonds industry, certain trust and depository institutions and central security depositories responsible for the safe custody of securities. The FSB is also responsible for the financial supervision of the Road Accident Fund. Excluded from the FSB's responsibilities are some areas involving listing requirements or public issues, and takeovers and mergers.

The Executive Officer has wide regulatory powers. Regulatory actions include the cancellation of authorization to supply financial services. He has formal powers of investigation with criminal sanctions in the event of obstruction, and can apply to court for an interdict, mandamus or curatorship of financial institutions if necessary. He can, in certain circumstances, also apply for the winding up or placing under judicial management of certain financial institutions, such as insurers and pension funds. The Executive Officer's regulatory powers come take effect only where the conduct of an authorized financial institution appears to have been made in contravention of the law, or casts doubt on whether it is fit and proper to trade.

The Insider Trading Directorate as well as an advisory board on financial markets, and advisory committees on long- and short-term insurance, pension funds, and unit trusts assists the FSB. It maintains a close relationship with all existing industry associations like those of unit trusts, participation bonds and fund managers. It liases with the international industry and is a member of the International Organisation of

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Securities Commissions (IOSCO) and International Association of Insurance Supervisors (IAIS).

In terms of prudential requirements, banks in South Africa must meet a minimum capital adequacy requirement of R250m or 8 percent of their risk weighted assets. The adequacy requirement is likely to be increased, in line with BIS revisions in 2002, to 10 percent. In South Africa, the loan classification requirement is 120 days, and the foreign exchange risk exposure of a bank, referred to in South Africa as the net open position, may not exceed 10 percent of its capital and reserves. The net open position has recently been tightened (from 15 percent) as from 1 January 2001. While the Lender of Last Resort is available, the Banking Supervision Department points out that this facility is not automatic and certainly precluded where there is suspicion of fraud.

In the insurance industry, prudential requirements differ for the Short-term and Long-term industries. In the case of the short-term insurance industry, the minimum capital requirement is R5 million and a capital adequacy of 15 percent of premiums applies. In the case of the Long-term insurance industry, a minimum capital requirement of R10 million applies and the capital adequacy requirement is determined by a formula dependent on the activities of the insurer. Asset Spread also governs the insurance industry Regulations in terms of the Act. In South Africa, there is no Insolvency Guarantee Scheme in place, although the regulator is considering this. It remains however, 'a long way away'.

In the securities industry, the capital adequacy ratio differs depending on whether brokers handle clients' scrip. In essence, the minimum capital requirement is R400 000 if the broker only trades for clients and does not handle clients' scrip. If the broker handles clients' scrip then the minimum capital requirement is R3 400 000. Capital adequacy is computed on the following general risk categories: member's positions, counter party risk, foreign currency risk and large exposure risk. Generally the JSE's risk computation factors are more demanding than European standards but its minimum capital requirement is a bit lower. Minimum capital is required to cover 13 weeks overheads and overhead structures of the JSE are cheaper than in Europe.

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3.3 Current Stability in each sector [3]

A stable financial environment is essential for the effective functioning of the economy. A sound banking system contributes to the effectiveness of intermediation, maturity transformation (turning short-term savings deposits into long-term loans), payment facilitation, credit allocation and financial discipline. Banks also play an important role as gatherers of savings, allocators of resources and providers of liquidity. Banks remain at the centre of economic and financial activity and, as primary providers of payment services and as a hinge for the implementation of monetary policy. Banks stand apart from other institutions.

The South African banking sector appears to be stable based on the Reserve Bank's macro-prudential analyses (Evans et al 2000)[4]. Comprising 28 registered banks, two mutual banks, 14 local branches of foreign banks and 52 foreign banks with local representative offices, the total banking sector's assets increased to about R1 377,7 billion by the end of December 2003.

Liquid assets as a percentage of total assets (referred to as the liquid-asset ratio), is an asset-based financial soundness indicator that reflects the liquidity available to meet expected and unexpected demands for cash. For the year 2003, the liquid-asset ratio for South African banks varied in a narrow range of 4,1 percent in the beginning of 2003 to 4,7 percent by the end of December 2003.

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[3] Data on the banking sector were obtained from the Bank Supervision Department, unless otherwise indicated.

4 macro-prudential analyses is a tool used to quantify the soundness or vulnerability of the financial system in order to assess the exposure of the system to shocks. It involves monitoring and anticipating potential vulnerabilities and the identification of exposure build-ups and imbalances in the financial system. The analysis employs financial soundness indicators (FSIs), which are barometers of the health and stability of the financial system.

5 Ernst & Young. Financial services banking survey (various issues).

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Banking shares performed fairly well in 2003. Share prices of banks, whose index increased only marginally (2,2 per cent) in 2002, increased more noticeably (8,3 per cent) in 2003. The improvement in bank share prices is a reflection of the improved confidence by market participants in the South African banking system, which bodes very well for overall financial system stability. The increase in confidence in the banking sector was also reflected in the financial services index [6]. The financial services index, which measures the level of confidence in the banking sector, increased from 77 index points in the third quarter of 2003 to 86 index points in the fourth quarter, which could largely be attributed to the fall in the prime overdraft rate, the substantial recovery of share prices on the JSE Securities Exchange SA, continued stability and strength of the exchange rate of the rand.

Both the retail and investment confidence indices[7] also improved. The retail banking confidence index increased by 10 index points to 96 in the fourth quarter of 2003, while the merchant and investment banking confidence index increased from 67 to 76 index points during the same period. The improvement in the retail banking confidence index in the fourth quarter was a combination of higher income and lower expenditure growth, which positively influenced profits of banks. Merchant and investment banks continue to be optimistic about current and future business conditions, with expectations of further growth in interest and investment income.

An analysis of the geographical distribution of loans allows for the monitoring of potential risks to financial system stability arising from exposure to a particular group of countries. Such an analysis can assist in the assessment of the impact of adverse events in those countries on the domestic banking sector. By the end of December 2003, total loans and advances to other parts of the world totalled about R123 billion. 57 per cent of these loans were made to Europe, 33 per cent to North America and 6 per cent to other African countries. Credit to North America increased significantly compared with a year before. Despite the increase in concentration of exposure to certain parts of the world, total foreign exposure of South African banks

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6 Ernst & Young. Financial services banking survey (various issues).

7 Free assets refer to the difference between total assets on the one hand, and the sum of the total liabilities and required capital on the other. Capital-adequacy is defined as the minimum capital required by the Financial Services Board for registration of an insurance company and is equivalent to 13 weeks' worth of operating expenses

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accounts for only a small portion of the banking sector's credit exposure. Also, the current global economic recovery bodes well for debt repayment and financial stability in general.

Insurers and banks have always had mutual exposure in a number of areas. For example, insurance companies cover banks and their customers against the usual range of risks and banks provide insurance companies with liquidity facilities to enable them to pay claims. The ratio of "free assets"[6] to capital-adequacy requirement, that is, the number of times the capital-adequacy requirement is covered by free assets, is commonly used as an indication of the prudential strength of a long-term insurer. An analysis of the latest available data suggests that the majority of insurers are well covered. In fact, more than 70 per cent of insurers recorded a coverage ratio of more than double the capital requirement. Only two insurers' capital requirement was not fully covered by free assets by the end of December 2003. Although many other indicators of the health of insurance companies exist, and some may point to the many challenges the sector faces, there is no cause for concern from a systemic risk[8] perspective.

Rapid growth in the ratio of securities-sector credit to GDP could be an indication of a possible lending boom. Such booms need to be closely monitored as they have preceded financial crises in the past. Domestically, the ratio of credit to private corporations (loans and advances to the security sector were used as a proxy for credit to corporations) as a percentage of GDP is showing a downward trend.
Compared with the third quarter of 2003, this ratio increased marginally, from 17,3 percent to 17,6 percent in the fourth quarter. Growth in securities-sector credit is high relative to the nominal growth rate of the economy. In the fourth quarter of 2003, for example, credit to the corporate sector grew at an annual rate of 9,3 percent while the annual nominal growth of the economy was only 5,6 per cent. The ratio of corporate debt to profit (proxied by the net operating surplus of the securities sector) measures the debt-servicing capacity of businesses and is directly related to the health of the corporate sector. For the fourth quarter of 2003, corporate debt as a percentage of

[8] Systemic risk exists in the financial sector when problems in one institution threaten to affect adversely another otherwise healthy institution.

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corporate profits (net operating surplus of the securities sector was used as a proxy for corporate profits) also increased only marginally, from 108 per cent in the third quarter to 110,7 percent. This ratio has remained more or less on the same level for the past two years.

3.4 International standards framework

As a result of the increased focus on the importance of financial stability worldwide, the international community has been stepping up its efforts in setting minimum standards and principles for strong financial systems. Several international financial institutions have also emphasized the need for concrete steps to make domestic financial systems less crisis-prone. Development, adoption, and successful implementation of these standards yield both national and international benefits.

In April 1999, the Financial Stability Forum (FSF) was convened to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The FSF brings together on a regular basis national authorities responsible for financial stability, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF promotes the adoption of 12 globally accepted key standards[9], set by various international bodies, for sound financial systems. The key standards cover areas ranging from transparency in fiscal and monetary policy, to market infrastructure issues such as insolvency management and core principles for financial supervision.

The implementation of international standards and best practice also assists in the promotion of sound financial systems and international financial stability. It helps to strengthen domestic financial systems by promoting sound regulation and supervision and it brings about an increased level of transparency. Furthermore, it enhances the robustness of financial institutions, markets and infrastructure. Once implemented, it

[9] See Financial Stability Forum (housed at the Bank for International Settlements in Basel, Switzerland) for key standards http://www.fsforum.org/publications/publication_22_61.html

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facilitates improved decisions on lending and investment, improves international perceptions of market integrity and reduces the risk of financial crises and contagion.

South Africa has always adopted the international standards and best practice approach and has also implemented the Basil Capital Accord to strengthen its soundness and stability in its financial sector system.

Furthermore, even though, South Africa is not a member of the Group of Ten (G-10) Committee, it has still opted to adopt the new Capital Accord (commonly known as Basel II) and has committed itself to the Committee's 31 December 2006 deadline for implementation. The Bank Supervision Department, which is tasked with implementing the Basel II requirements within the South African context, is currently investigating the scope of application given the dichotomous nature of the South African economy.

According to the results of Ernst & Young's *Basel II*[10] survey, 66 percent of South African banks were partially prepared for the implementation of Basel II, which comes into effect in January 2007. However, in comparison to a similar study done by Ernst & Young in Luxembourg in 2002, the recent survey results indicate that the South African banking industry has improved its preparedness and is even well ahead of its peers for the introduction of Basel II regulations. It found, however, that banks were only partly prepared at a credit and operational risk level.

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In a nutshell, risk management will become a tough challenge. Banks will need to undertake significant work to get the process of gathering credit and operational risk data up to the standards required by Basel II and to develop appropriate models. The integrity and timelessness of data is a key component of risk measurement process.

However, for the successful implementation of the standards it is imperative to have effective legal and regulatory structures for enforcement in place. The realignment of legislation with international standards and best practice is becoming increasingly

[10] *Addressing the Challenges* survey released 18 June 2003. The survey assessed the readiness of the South African banking industry for implementing the Basel II regulatory framework in seven areas, namely awareness of regulations, organisational structure, reporting ability, compliance with Basel II, capital allocation, action plans, and technology.

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important, taking into account country specifics, consistent and timely implementation, and effective enforcement. Inconsistent application and enforcement of legislation can create considerable uncertainty, which should be avoided.

Financial Sector Institutions in South Africa are extensively regulated through general and specific legislation, directives and self-imposed rules. Surprisingly, A report compiled by The Financial Action Task Force- a global body aimed at stamping out money laundering- and published by the IMF (Business Day 04/05/2004) has found glaring holes in South African legislation to address the problem of money laundering.

It found that SA was mainly deficient in laws governing beneficial ownership, which limited identification of the true owner of property. The Financial Intelligence Centre Act requires a financial institution to verify the client, but there was no general duty to identify the beneficial owner.

The law was limited by requiring only identification of a person with at least 25 percent or more of shares in legal entity, and there being no obligation to identify owners if a company was owned by a second company.

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The report claimed that the many exemptions to the act also undermined the effectiveness of the law. It found that the net result was that South Africa's ability to identify the true owner of property is undermined, and that the regulations should be amended in this respect.

The Task Force did, however, find SA to be largely compliant with most of its recommendations to combat money laundering, but stated that law enforcement and the prosecution of offenders was inadequate. They raised concern that offences of money laundering have not been adequately investigated and prosecuted, and that there have only been two convictions for the money laundering offences since 1996.

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3.5 Financial Services Charter

Like many other countries, South Africa is experiencing a period of increasing regulatory and legislative reform. Implementation of financial reforms often starts with the introduction of new legislation. In 2003, the financial sector saw a surge of new legislation, such as the Financial Advisory and Intermediary Services Act, the Financial Intelligence Centre Act, the Home Loan and Mortgage Disclosure Act, the Banks Amendment Act, the Draft Banks Act Amendment Bill and the Draft Community Reinvestment Bill.

Probably the most controversial, groundbreaking and visionary of the regulatory and legislative reforms is the new financial services charter that seeks to redress imbalances in ownership, procurement, employment and access to financial services.

There has been widespread agreement that a large sector of the South African population is financially excluded from banking services. A report from the largest commercial bank (ABSA, 1999) suggests that only 20% of the country's economically active population of 16.5 million have an 'active banking relationship.' Data on the degree of service provision to different population groups or even different regions are not publicized, either by the four dominant banking groups or by the Reserve Bank, and so the extent of financial exclusion remains estimated.

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The Financial Charter which is commonly referred to as the Black Economic Empowerment charter, provides for increased access to financial services for poor households and communities, and aims to direct billions of rands of investment into transformational infrastructure, agricultural development, low-income housing and small and medium black businesses. The charter has been developed by the sector as a whole, representing banks, long and short-term insurers, black professionals and black business, unit trusts, fund managers and brokerage firms. It is a voluntary commitment, and has been agreed unanimously by 10 industry associations in the financial sector – the Banking Council, the Life Offices' Association, the South African Insurance Association, the Association of Black Securities and Investment Professionals (which also represented the Black Business Council), the Association of

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Collective Investments, the Investment Management Association of SA, the Institute of Retirement Funds, the JSE Securities Exchange SA, Foreign Bankers Association of SA, and the South African Reinsurance Offices' Association. The Bond Exchange of South Africa has also signed it. The commitment of South Africa's financial institutions to the Financial Services Charter will change the face of the country's financial services sector. However, the implications of not having a charter – both for the financial services as well as the country – would have been severe, and Government would have been forced to legislate, which could have resulted in unjustifiable costs to the economy and consumers.

The targets of the charter come into effect on 1st January 2004, and remain in effect until the end of December 2014. Companies will publish annual Black Economic Empowerment reports, including audited scorecards. The first reports, for the year to December 2004, must be completed by March 2005. These achievements, encapsulated in the scorecard and charter rating each year, will be one of the factors measured by government in the award of state tenders, and by businesses in their commercial dealings with each other. There will be a midway review in 2009 of the first five years, and a comprehensive review in 2015, at the end of 10 years. The intention is that, while the charter targets have a finite 10-year life, the principles and commitment to empowerment will live on after 2014.

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The targets are all seen as transformational. An overriding principle and objective of the charter is that the growth and development of the financial sector is central to the successful implementation of black economic empowerment. This means that targets must be achieved consistent with sound business practice.

The charter envisages that companies in the financial sector will be 25 percent black owned by 2010. A minimum of 10 percent must be direct ownership with an option to achieve a maximum of an additional 15percent through direct or indirect ownership. Indirect ownership acknowledges investment by black beneficiaries, through the collective savings schemes (for example through pension funds), which hold significant shareholdings in companies in the sector.

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A key part of the charter, and the determination of a company's rating, is the balanced scorecard. This allows some flexibility. For example a "B" rating requires a score of 70 percent to 80 percent.

The broad-based thrust of the charter is reflected in the fact that 81% of the charter targets relate to the employment, training and promotion of black people, improvement of access to financial services to poor people, targeted investments in projects that address backlogs, underdevelopment and support job creation, and the procurement of services and goods from black businesses
The potential economic and social impact of the charter is substantial, both inside the financial sector and in the companies and communities with which it deals.

The costs implications for implementing the charter will be substantial, as section 2.22.2 of the charter requires a bank to be within a distance of 20 Kms from a community that consists of more than 65 houses. However, the investment will only be worth it if results in development of new markets and long-term sustainability of the sector.

ABSA became the first of the country's big four banks to sell a direct stake to an empowerment consortium, selling a 10 percent stake to Batho Bonke, led by Mvelaphanda chairman Tokyo Sexwale (Business Day 07/ 04/2005). The consortium gets the stake at a discount of up to 37% of Absa's share price in the next three to five years. The minimum it will pay is R3, 5bn if the share price remains at its current level of about R48. According to projections, the share price could climb to R100 or more in the next five years. If this becomes the case, the consortium will pay an option strike price of R69, valuing the deal at more than R5bn.

The new shares carry full voting rights so the empowerment partners will be immediate participants in the group's decision-making process. The options must be converted into ordinary shares over the next three to five years. It was inevitable that shareholders would ultimately foot the bill for black empowerment transactions, but until other banks structured their own deals there was nothing to measure Absa's deal against. Absa stressed that any deal created should make business sense, for the

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country, shareholders and other stakeholders, including customers, clients and those outside the bank.

The options announced yesterday to bring Batho Bonke on board are costing Absa and its shareholders, but the bank says the benefits of introducing empowerment shareholders to the group far outweigh the cost of the options.

The Central Bank found the charter and the Absa deal to contribute to the overall stability of the financial sector domestic market, but found that for the Charter to have international market stability the following needed to be addressed:

- There is a great deal of interest in Europe and concern at understanding Black Economic Empowerment; but unlike South Africa where Black Economic Empowerment is an accepted fact of business, there is still a great deal of uncertainty, if not actual confusion, in respect to Black Economic Empowerment among European businesses. While there is general recognition and acknowledgement of the flexibility of Black Economic Empowerment, it is still seen as undesirably interventionist. There is even uncertainty in the minds of many regarding the rationale for Black Economic Empowerment.

- South Africans – both in the private and public sector – tended to present Black Economic Empowerment in prescriptive and dogmatic terms. Practical examples needed to be given of how Black Economic Empowerment in terms of the Charter will work for European companies. Some examples should also include actual investment opportunities for foreign investors.

- In explaining Charter, South Africans need to be consistent particularly in regards to the rationale for Black Economic Empowerment – because different views are often put forward. Not only do this cause confusion, but one justification also works better from an international point of view. It is imperative to submit the view that Black Economic Empowerment is imperative to levelling the playing fields as a consequence of the discrimination, disparities and inequities resulting from the apartheid era.

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- Promoting Black Economic Empowerment has to be part of promoting South Africa. In other words, Black Economic Empowerment must be seen as part of South Africa as an investment destination. This means also that the element of risk as far as Black Economic Empowerment is concerned should be seen as part of South African country risk.

- South African proponents of Black Economic Empowerment should recognize that there is a strong objective case in favour of doing business in and with South Africa (BEE included), which needs to be made.

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CHAPTER 4.

CONCLUSION

This paper has reviewed whether financial development will result in Economic growth and found that the relationship between the level of development of a country's financial system and its economic growth is not necessary robust. However, the stability of a country's financial system, its institutional structure, notably the respective roles of the banks and the stock market, all can have an important impact on growth. South Africa demonstrated strong evidence of the relevance of domestic financial intermediation in promoting growth when outlining the sector in terms of its contribution to GDP for the period 1993-2000.

However, Regulation can never provide absolute assurance that financial failures will not occur. Nor does the occurrence of a failure necessarily point to the existence of a flaw in the regulatory structure of the financial system. It rather signifies that market discipline is working effectively by removing substandard firms, sometimes even before regulatory authorities realise there are problems or before the process of orderly exit is instituted. Absolute regulation would be far too costly, and worse, it would most likely inhibit valuable market initiatives. In other words, regulation should permit healthy competition between the regulated institutions as far as development of new products, services and competitive strategies are concerned, while ensuring that regulatory objectives are met. Too much regulation can give rise to inefficiencies, inconsistencies, overlaps, duplication and higher administrative costs, which could be as damaging as financial instability. Regulatory objectives are usually limited to aspects of systemic risk, prudential management and proper conduct of business, which objectives, because of market imperfections such as a lack of information, will otherwise not be achieved.

Although regulation may be about changing the conduct of regulated institutions, it is only one component of a regime to create a safe and sound financial system. Regulatory authorities alone cannot achieve the goal of financial stability. Market participants must also act in a manner that enhances the robustness of the financial system.

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However, for the Financial Service Charter to obtain its desired outcomes and for all-round financial stability, it is clear that proper enforcement of the Charter and all other regulations is required.

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