

# Conjuring systemic risk through financial regulation by SADC central banks

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## Abstract

*This article is the first attempt at drawing a picture of the Southern African Development Community (SADC) Central Bank Model Law within the overall frame of regional financial integration and enhanced risk regulation in the financial industry. The SADC Committee of Central Bank Governors (CCBG) in 2009 adopted a Central Bank Model Law whose Chapter VI enshrines central banks' strategies for stabilising financial systems in the SADC region. Chapter VI embodies key principles; it is not binding law, yet it derives a great deal of legitimacy from its origins in the CCBG. The prevention of systemic risk is the central objective of financial regulatory policy and the prism through which the efficiency of the Model Law is to be viewed. This article lays out the tenor of the concept systemic risk and the means to avoid it generally. It then describes the Model Law's specific tools for conjuring that risk. The significance of risk regulation is underscored by recent financial crises and the growing part played by financial institutions in the economic development and integration of SADC. The Model Law's provisions on disclosure, the accommodation of banks, emergency liquidity assistance, and central bankers' banker role, including as lender of last resort, are robust. However, the article's greatest concern is the provision – or, more precisely, the lack thereof – on capital and liquidity standards. The lack of such provision is unjustifiable in an era of economic globalisation and in light of the financial integration objectives of the legal framework of SADC as a regional development community.*

## Introduction

Just like the devil is the pastor's arch-nemesis, so is systemic risk the financial regulator's worst nightmare. The analogy is not far-fetched. In so many ways, systemic risk resembles the idea people have commonly formed of the devil. It is elusive; when it strikes it is devastating; when it enters the heads of those it possesses it seduces them to act with a herd mentality; and it may vanish when faith in the system is strong. It behoves the regulator to devise

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strategies to conjure systemic risk and strengthen faith in the financial system. The Committee of Central Bank Governors (CCBG) in the Southern African Development Community (SADC)<sup>1</sup> adopted a Central Bank Model Law<sup>2</sup> (hereinafter *Model Law*) in 2009 that enshrines a strategy for insuring domestic financial institutions against systemic risk. In order to gauge the readiness of central banks in SADC to prevent a major financial crisis, one needs to know how the subregion has agreed, as a whole, to ward off systemic risks through the Model Law. Against this background, this article unveils the strategy of SADC central bankers to shield their financial sector from systemic risks. That strategy is embodied in Chapter VI of the Model Law, which confers on SADC central banks sweeping supervisory and regulatory functions.<sup>3</sup> The article lays out the tenor of the concept of *systemic risk* and the means to avoid it generally, and then emphasises how Chapter VI of the Model Law specifically tackles those risks.

This is the first attempt to draw a picture of Chapter VI of the Model Law within the overall frame of regional financial integration and enhanced risk regulation. Unsurprisingly, therefore, the legal literature on Chapter VI of the Model Law is virtually non-existent. Moreover, there are few legal writings on the regulation and supervision of financial institutions at SADC level. This article aims to bridge the gap in the legal literature as regards financial regulation within regional economic groupings. The broader concern the article answers is centred on the optimal contents of a financial plan devised at the level of a regional economic grouping for systemic risk management and regional economic integration.

## Systemic risk

### *Why the Model Law?*

The importance of studies on the regional regulation of SADC financial institutions is underscored by recent financial crises, not least of which is the series of measures taken in 2009 in Nigeria to salvage its financial sector by

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1 SADC is a regional economic community made up of 15 countries in southern Africa, namely Angola, Botswana, the Democratic Republic of the Congo (DRC), Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

2 SADC Model Central Bank Law, 2009; available in English, French, and Portuguese at [http://www.sadcbankers.org/SADC/SADC.nsf/LADV/2C7584478FB6CEF842257674003206A8/\\$File/Model+Law%28English2009%29.pdf](http://www.sadcbankers.org/SADC/SADC.nsf/LADV/2C7584478FB6CEF842257674003206A8/$File/Model+Law%28English2009%29.pdf); last accessed 26 March 2011.

3 Model Law, Article 52.

bailing out a few major commercial banks.<sup>4</sup> Even though some analysts may have thought initially that it would spare states parties to the SADC Treaty (member states), the 2008–2009 global credit crunch stifled trade, foreign direct investment (FDI),<sup>5</sup> remittances and development aid to member states. Botswana was the worst affected, recording a negative growth rate of -5,4% in 2009,<sup>6</sup> while in the United States (US), many an expert said that the global financial crisis was the worst depression since the Great Depression.<sup>7</sup> Jurisdictions in North America and Europe are taking stock of their systems of regulating financial institutions after the 2008–2009 global credit crunch. The Model Law came into being in that global economic environment and in the context of intense soul-searching within leading financial centres. This article advances reflections on financial regulation by analysing it from the vantage point of regional integration.

The growing role of financial intermediaries in the economic development and integration of SADC stresses the timeliness of research on financial regulation by regional economic communities. As SADC countries are stepping up investments in the information and communication technology (ICT) and banking sectors, banks and other financial institutions are increasingly serving as inevitable intermediaries in SADC's development and integration. The US\$5.5 billion purchase by the Industrial and Commercial Bank of China (ICBC) of a 20% stake in the largest bank in SADC and Africa, namely Standard Bank, in February 2008 is a perfect example of the growing part played by financial institutions in foreign investment inflows in the region.<sup>8</sup> This Chinese portfolio investment in Standard Bank is strategic as Standard Bank operates in 18 countries in Africa, and in nearly all SADC member

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- 4 See Melik, James. 2011. "Nigeria's top banker wins international recognition". *BBC News*, 6 January; available at <http://www.bbc.co.uk/news/business-12126920>; last accessed 26 March 2011.
  - 5 Investment inflows to southern Africa decreased from US\$28.7 billion in 2008 to US\$21.6 billion in 2009, but the stock of investment inflows increased from US\$101,4 billion in 2008 to US\$165,1 billion in the same year; UNCTAD/United Nations Conference on Trade and Development. 2010. *World Investment Report 2010: Investing in a low-carbon economy*. Geneva: UNCTAD, p 32.
  - 6 CIA/Central Intelligence Agency. *World Factbook 2011: Botswana*. Available at <https://www.cia.gov/library/publications/the-world-factbook/geos/bc.html>; last accessed 3 February 2011.
  - 7 See e.g. Posner, Richard A. 2009. *A failure of capitalism: The crisis of '08 and the descent into depression*. Cambridge, MA: Harvard University Press.
  - 8 For instance, Chinese banks have reportedly made more loan commitments to developing nations in 2010 than the World Bank that same year; Dyer, Geoff & Anderlini, Jamil. 2011. "China's lending hits new heights". *Financial Times*, 17 January; available at <http://www.ft.com/cms/s/0/488c60f4-2281-11e0-b6a2-00144feab49a.html>; last accessed 14 January 2011

states, except Madagascar and Seychelles.<sup>9</sup> The great strategic value of China's investments in Standard Bank is also evident from the fact that the ICBC has used Standard Bank to finance 65 projects in Africa, most notably the Morupule B Power Station in Botswana, Africa's largest power station as of 2010.<sup>10</sup>

Parsing the texture of the Model Law is a superb opportunity for a fresh look on national central banks as they discharge their responsibility to uphold financial stability. Nine of the 15 central banks in SADC supervise all financial regulations,<sup>11</sup> a situation that surely underlines this analytical exercise. In terms of the Bank of Tanzania Act of 2006, one of the principal functions of the central bank in Tanzania is to "supervise banks and financial institutions including mortgage financing, development financing, lease financing, licensing and revocation of licences".<sup>12</sup> National legislation empowers the Bank of Tanzania to keep away systemic risk by licensing banks, issuing prudential regulations, and by otherwise supervising banks.<sup>13</sup>

## **Risk**

Admittedly, the central objective of financial regulation is the prevention of systemic risk.<sup>14</sup> Stated positively, the overarching objective of financial regulation is to guarantee the safety and soundness of the financial system.<sup>15</sup> On a practical plane, one of the ultimate goals of financial regulation is to secure systemic stability in the economy and ensure institutional safety and soundness.<sup>16</sup> While the rationale of financial regulation is crystal clear, the contents of the financial legislation enacted to fulfil this rationale are not so neatly cut. More often than not, the contents of financial legislation did not evolve in a logical or consistent fashion, building instead on historical

9 See Standard Bank. 2011. "Worldwide presence". Available at <http://www.standardbank.com/WorldWide.aspx>; last accessed 14 January 2011.

10 "ICBC cooperates with Standard Bank on 65 projects", *China Daily* (People's Republic of China), 25 May 2009.

11 See CCBG/Committee of Central Bank Governors in SADC. 2009. *Financial systems*. Pretoria: CCBG.

12 Bank of Tanzania Act, 2006, section 5(1).

13 CCBG (2009:227).

14 Scott, Hal S. 2010a. "Reducing systemic risk through the reform of capital regulation". *Journal of International Economic Law*, 13:763.

15 The two goals of financial regulation are to ensure the soundness and safety of the financial system and to foster the growth and development of financial markets; see Pan, Eric J. 2011. "Structural reform of financial regulation". *Transnational Law and Contemporary Problems*, 19:796, 800.

16 Falkena, Hans, Roy Bamber, David Llewellyn & Tim Store. 2001. *Financial regulation in South Africa*. Johannesburg: SA Financial Sector Forum, p 2.

antecedents rather than a systematically logical design.<sup>17</sup> Financial legislation sometimes comes up to the quality of financial intermediaries, sometimes information asymmetries, sometimes market behaviour, and sometimes the market infrastructure.<sup>18</sup>

Notwithstanding the centrality of systemic risk for financial regulation, the Model Law does not define the concept – although it uses it. For example, it lays down that central banks may grant emergency liquidity assistance to a distressed bank at such price as they consider appropriate if they are of the opinion that the distressed bank poses a systemic risk to the banking sector.<sup>19</sup> The use of the concept of *systemic risk* in the Model Law implies either that the Model Law avoids defining a concept that it knows to be a hot potato, or that it erroneously assumes that readers have a common understanding of the concept. In either hypothesis, an analysis of the concepts of *risk* and *systemic risk* is apposite.

In finance, *risk* is an elusive notion that refers to the probability of permanent loss of assets. Risk is often (con)fused with uncertainty. Frank Knight's stance in his book *Risk, uncertainty and profit* is to posit the now widely accepted dichotomy.<sup>20</sup> For Knight, *risk* is the set of calculable possible future outcomes for a relevant performance indicator, a known set of probabilities.<sup>21</sup> Conversely, *uncertainty* is what cannot be known because it is in some fashion unpredictable and, therefore, non-quantifiable.<sup>22</sup> Since then, several scholars have questioned Knight's dichotomy. Three positions have emerged, the first of which contends that risk and uncertainty are distinct.<sup>23</sup> The second position counters that the two are inseparable,<sup>24</sup> while the third adds that the

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17 See Tietje, Christian & Matthias Lehmann. 2010. "The role and prospects of international law in financial regulation and supervision". *Journal of International Economic Law*, 13:663, 665.

18 (ibid.).

19 Model Law, article 47(4)(b).

20 Knight, Frank H. 1921. *Risk, uncertainty and profit*. Chicago: Chicago University Press.

21 White, Colin & Miao Fan. 2006. *Risk and foreign direct investment*. Hampshire: Palgrave Macmillan, p 27.

22 (ibid.).

23 Knight (1921:4); De Graaf, J. 1963. *Theoretical welfare economics*. Cambridge: Cambridge University Press, p 116.

24 *Risk* is uncertainty about the world and all probabilities are subjective assessments of uncertainty; see Aven, Terje. 2003. *Foundations of risk analysis: A knowledge and decision-oriented perspective*. West Sussex: John Wiley & Sons, pp 28, 50. Some relation and some distinction between *risk* and *uncertainty* can be found, but the presumption that risk is quantifiable is rejected; see Miller, KD. 1992. "A framework for integrated risk management in international business". *Journal of International Business Studies*, 23(2):311–331.

two are part of the same continuum.<sup>25</sup> This article takes the latter position, and assumes that risks of losses are inherent in any economic activity and that uncertainty about the future increases the desirability of insuring against risks.

## **Systemic risk**

If *risk* is the probability of asset losses, then *systemic risk* is easily understood as the probability that a system or actors within a system may suffer significant losses. Unfortunately, *systemic risk* is seldom fully understood, and experts talk past one another<sup>26</sup> on the concept because it is not an easily fathomable phenomenon. Two elements are discernible in the various definitions of *systemic risk*, namely the event that touches off significant losses within the financial system, and the consequences of the triggering event. Most renderings of *systemic risk* are linked by their reference to the event that sparks the series of asset losses that spreads like wildfire through the financial sector.<sup>27</sup> The spark or trigger event is an economic shock<sup>28</sup> or an institutional failure,<sup>29</sup> which sets off a sequence of significant losses to financial institutions or substantial (financial) market price volatility – or both.<sup>30</sup> The most spectacular example of a systemic risk with disastrous effects on both financial institutions and markets is the 2008–2009 mortgage crisis in the US. Many an expert believes that the collapse of the investment firm Lehman Brothers touched off the chain of failures within the financial sector that spread throughout the US economy, and that eventually snowballed into a global financial meltdown.

Experts are also not of one mind as to the consequences of the trigger event. Some say the consequence is a series of successive and cumulative losses;<sup>31</sup> others affirm that it is substantial market price volatility, corporate liquidity reductions, and bankruptcies;<sup>32</sup> and yet others insist it is the impact on other interlocking market participants.<sup>33</sup> The Model Law is silent as to its position in these debates, and confines itself to the phrase *systemic risk to the banking*

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25 A continuum exists between pure risk and pure uncertainty; see Meldrum, Duncan H. 2000. "Country risk and foreign direct investment". *Business Economics*, 35:33–34.

26 For more on how definitions of *systemic risks* can be inconsistent, see Schwarcz, Steven L. 2008. "Systemic risk". *Georgetown Law Journal*, 97:193, 197.

27 (ibid.:198).

28 Kupiec, Paul & David Nickerson. 2004. "Assessing systemic risk exposure from banks and GSEs under alternative approaches to capital regulation". *Journal of Real Estate Finance and Economics*, 48:123.

29 See Schwarcz (2008:198).

30 (ibid.).

31 Kaufman, George G. 1996. "Bank failures, systemic risk, and bank regulation". *Cato Journal*, 16:17, 20.

32 Kupiec & Nickerson (2004).

33 See Schwarcz (2008:197).

sector,<sup>34</sup> which can mean any and all of the three consequences mentioned above.

## ***Too big to fail in SADC***

The concept of *systemic risk* needs to account for the region-wide mandate of SADC institutions like the CCBG. This refined comprehension of *systemic risk* involves the recognition that rising financial integration in SADC brings in its fold a more probable danger that a large bank in one country with connections to other banks in other countries may occasion a crisis throughout the region. Accordingly, it involves the conviction that rational financial regulation in a regional integration setting should strive to prevent or at least nip a financial crisis in one member state in the bud before it contaminates other member states in the region. It is a major premise of this article that the contents of an ideal and complete Model Law on central banking explicitly provides for the most efficient devices to combat systemic risk.

The risk of successive institutional failures is seldom carried by the insolvency of one or a few small financial institutions. It is usually the insolvency of financial institutions that are too big and interconnected that threatens the entire financial system.<sup>35</sup> In SADC, South African banks dwarf their regional counterparts, with Standard Bank, ABSA, Nedcor, and FirstRand, in that order, topping the list of the largest banks not only in southern Africa but in the whole of Africa as well.<sup>36</sup> Standard Bank, with its tentacles reaching for markets in almost all of SADC, is the kind of financial institution whose failure might precipitate institutional debacles in the entire region. This risk exists notwithstanding the fact that South African banks have been relatively stable and well capitalised,<sup>37</sup> even during the 2008–2009 financial storm worldwide.

## **Financial institutions and regulation**

Financial institutions are perhaps better conceived by reference to their function, namely financial intermediation, which is the linking of savers and borrowers. Indeed, financial institutions play important roles in the daily life of households and businesses as well as in regional economic development. These institutions are the repository of personal wealth, the principal source of credit for most firms and households, and the catalysts of economic

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34 Model Law, article 4(b).

35 See Avery, Alan W, Kathleen A Scott & Lindsey Carson. 2010. "Dodd-Frank Act attempts to curtail systemic risk". *Banking Law Journal*, 127:766.

36 "Biggest banks in Africa", *Global Finance*, 6 December 2010; available at <http://www.gfmag.com/tools/best-banks/10923-biggest-banks-in-africa-2010.html#axzz1CzFf1mKS>; last accessed 4 February 2011.

37 World Economic Forum. 2009. *The Africa Competitiveness Report 2009*. Geneva: World Economic Forum, pp 52–53.



exchanges. By intensifying resource mobilisation for regional development, financial institutions are one of the areas prioritised by SADC to achieve its finance and investment policies.<sup>38</sup> They are, as exemplified by the ICBC–Standard Bank association in funding infrastructure projects, an emerging model for financing regional economic development in SADC. SADC is concerned about the difficulties that small- and medium-scale enterprises continue to face in accessing credit, despite substantial liberalisation of the financial sector in the region;<sup>39</sup> this is why SADC plans to intensify financial reform, primarily focussing on non-bank financial institutions. Financial institutions also work as advisors and agents for various clients in a variety of other financial transactions.

There are three major types of financial institutions:<sup>40</sup>

- Deposit-taking institutions, e.g. banks, credit unions, and mortgage loan companies
- Insurance companies and insurance funds, and
- Brokers, underwriters and investment funds.

For the purposes of financial supervision, however, the financial industry is traditionally grouped into banks, insurance companies, and securities firms.<sup>41</sup> This is the classic organisation of the industry, even if a great amount of cross-sectoral financial intermediation occurs today.<sup>42</sup> Under the traditional method, each of these three sectors will have its own regulator.<sup>43</sup> The purpose of the financial regulator is to protect investors by preventing financial institutions from taking unacceptably high risks that may endanger the interests of creditors, i.e. depositors and savers.<sup>44</sup>

### ***Four worst-case scenarios***

The institutional failure or economic shock of one firm may set in motion a chain reaction through four channels: interbank deposits, net settlement payment systems, imitative runs, and counterparty risk in derivative transactions.<sup>45</sup>

38 SADC/Southern African Development Community. 2004. *Regional Indicative Strategic Development Plan* 35. Gaborone: SADC.

39 (ibid.:28).

40 Siklos, Pierre. 2001. *Money, banking, and financial institutions: Canada in the global environment*. Toronto: McGraw-Hill Ryerson, p 40.

41 Tietje & Lehmann (2010:666ff).

42 (ibid.:667).

43 (ibid.).

44 Heremans, Dirk. 2000. "Regulation of banking and financial markets". In Bouckaert, Boudewijn & Gerrit de Geest (Eds). *Encyclopaedia of Law and Economics, Volume I. The history and methodology of law and economics*. Cheltenham: Edward Elgar; pp 950, 951.

45 Scott, Hal S. 2010b. "The reduction of systemic risk in the United States financial system". *Harvard Journal of Law & Public Policy*, 33:671, 673ff.



Thus –

- when a bank that holds sizeable deposits of other banks for payment processing purposes, the failure of that bank may cause the other banks to fail as well
- in the net settlement payment system, inter-institution transactions accumulate during the day, and their respective values are set off against one another at the end of the day; if a bank fails to settle its position in a net settlement system for large value payments, the other banks to whom those payments were due may fail<sup>46</sup>
- an imitative run or a ‘run on the bank’ occurs when the failure of one bank leads depositors of other banks, especially those who are not insured, to fear that their banks will also fail and to withdraw their deposits, thus creating a liquidity crisis and, eventually, institutional failure, and<sup>47</sup>
- a counterparty risk in derivative transactions, say credit default swaps (CDSs), may prompt a series of bank failures. Here, if institution A cannot settle its derivative position with institution B, both institutions A and B fail.<sup>48</sup> If institution B in turn cannot settle its position, institution C will fail, and so on.<sup>49</sup> The subprime crisis in the US, which was responsible for the 2008–2009 global financial crisis, is an excellent illustration of counterparty risk in derivative transactions.<sup>50</sup> Subprime borrowers obtained mortgage loans from mortgage banks. Mortgage banks, such as Countrywide Financial, sold subprime mortgages on the secondary market. Securitisers, especially Fannie Mae and Freddie Mac, then purchased subprime mortgages on the secondary market, pooled them, and securitised them, i.e. they sold mortgages as mortgage-backed securities (MBSs) to financial institutions and investors on the open market. Financial institutions sold subprime MBSs to their shareholders, their depositors and to one another. MBSs spread even farther within and outside US financial markets when financial institutions began exchanging CDSs. When the subprime mortgage borrowers started defaulting on their loans, a long chain of institutional failures unravelled nationally and, later, internationally.

## Regulation

Central banks and national authorities intervene to keep off the above four worst-case scenarios. An elaborate system of regulatory interventions applies

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46 (ibid.:674).

47 (ibid.).

48 (ibid.:675).

49 (ibid.).

50 For more on how the US subprime crisis unfolded, see Schiller, Robert J. 2008. *The subprime solution: How today's global financial crisis happened, and what to do about it*. Princeton, NJ: Princeton University Press.

to financial services more than any other sectors in the economy.<sup>51</sup> This more invasive regulatory system, cutting deep into organisational structures,<sup>52</sup> owes itself to the nature of financial services warranting a degree of regulatory control and oversight that is substantially more intrusive and expensive than the legal rules governing other business ventures.<sup>53</sup> The vast majority of legal rules covered in the Model Law also rest on the notion that financial intermediaries are special. More than any other economic sectors, financial intermediaries are concerned with the future and, hence, are characterised by greater risk and uncertainty.<sup>54</sup> They create asymmetric information problems as parties to financial operations have different information, and they are more interdependent than actors in any other sectors.<sup>55</sup>

The principal justification for regulation concerns the propensity of financial intermediaries to take excessive risks if they are not strictly restrained by regulation.<sup>56</sup> It is truly a common justification of risk regulation that government agencies are obliged to protect public investors – e.g. depositors, insurance policy holders and mutual fund shareholders – from risk-taking by financial intermediaries. Investors want to know how much risk is associated with particular investments before they invest, and how those risks compare with the risks associated with other comparable investments.

Current financial regulatory regimes focus on the degree of sophistication of investors. Banks are generally the most regulated financial institutions because the financial regulatory regimes take for granted that investors in banking institutions tend to be less sophisticated than in other sectors of the financial services industry. However, such assumptions of the degree of investors' sophistication are questionable, as in practice most people are ignorant about finance – even among educated people in developed nations.<sup>57</sup> Furthermore, such assumptions changed after the latest global financial crisis adversely affected developed economies because of what was happening in the most sophisticated sector of the financial services industry.

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51 Heremans (2000:951).

52 Tietje & Lehmann (2010:665).

53 See Clark, Robert C. 1975. "Federal income taxation of financial intermediaries". *Yale Law Journal*, 84:1603.

54 Heremans (2000:953).

55 (ibid.).

56 For more on the justifications, see Clark (1975).

57 Surveys conducted in the US in 2007 and in the UK in 2008 established that a substantial proportion of the general public in the English-speaking world is "ignorant of finance"; Ferguson, Niall. 2008. *The ascent of money: A financial history of the world*. New York: The Penguin Press, pp 10ff.

Six basic instruments are used for financial regulation, which represent best practices in the field:

- The first is mandated disclosure, which is often used for securities transactions.
- The second instrument is the prevention of conflicts of interests. In Zambia, the Banking and Financial Services Act of 1994, as amended, places a duty on fiduciaries such as directors and managers to disclose conflicts of interest.<sup>58</sup> Similarly, the 1997 law on financial institutions in Angola tries to fend off conflicts of interest by prohibiting the granting of credit and guarantees by financial institutions to their fiduciaries.<sup>59</sup>
- The third instrument used for financial regulation is mandating required levels of competency, including licences, tests, inspection, and examination. The Model Law similarly permits SADC central banks to license banks and financial institutions.<sup>60</sup>
- The fourth instrument is capital adequacy requirements. That is, if the bank has certain liabilities, it has to have certain assets on hand. Typically, banks are subject to the most stringent and most detailed capital adequacy requirements. Capital adequacy requirements figure in the central bank law of several SADC member states<sup>61</sup> and the Basel Accords II.<sup>62</sup>
- The fifth instrument is portfolio diversification requirements. Financial institutions reduce risks by diversifying portfolio investments.
- The sixth and last tool is consumer protection.

It is apparent from these regulatory tools that financial regulation can be regarded as a continuing set of restrictions on institutional risk-taking. This set of restrictions reflects a trade-off between risk and return that most investors would demand from financial intermediaries if the public could police intermediaries directly.

### **SADC cooperation**

Chapter VI of the Model Law is no ordinary normative system on the regulation of financial institutions by central banks. The Model Law is a showpiece of financial legislative cooperation in the region, as contemplated by the Protocol to the SADC Treaty on Finance and Investment adopted by the SADC Summit of Heads of State and Government in Maseru, Lesotho, in 2006. Financial cooperation is a principle of SADC law that holds that member states are obliged to cooperate and coordinate their policies and strategies in investment,

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58 Banking and Financial Services Act of 1994, section 35.

59 Lei das Instituições de Crédito e Sociedades Financeiras 1997, article 57.

60 Model Law, article 6(2)(a).

61 For example, South Africa, Swaziland and Zimbabwe; see CCBG (2009).

62 Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework. Part 2; hereinafter *Basel Accords II*.

taxation, central banking, and regional capital and financial markets, with a view to achieving economic development and eradicating poverty.<sup>63</sup> The Model Law and its Chapter VI should, therefore, be seen as efforts to accelerate SADC's financial integration.

## The Model Law

A note on the Model Law explains that it embodies general principles to facilitate the operational independence of SADC central banks and the harmonisation of their legal and operational frameworks, and sets standards of accountability and transparency in those frameworks.<sup>64</sup> The long title of the Model Law is to "update and re-enact" the national legislation on the central bank of member states.<sup>65</sup> Thus, it is very likely that, after the adoption of the Model Law in 2009, member states will effect adjustments in the form of amendments or new legislation to conform to the Model Law. However, the fact that SADC member states belong to multiple regional cooperation schemes – including the Common Market for Eastern and Southern Africa (COMESA) and the Southern African Customs Union (SACU) – and the sometimes conflicting obligations that result from such multiple memberships may complicate member states' application of the Model Law.

The Model Law is an all-around corpus of provisions on the operations of a central bank. It addresses the functions and objectives of SADC central banks,<sup>66</sup> local currency,<sup>67</sup> international reserves,<sup>68</sup> payment systems,<sup>69</sup> reporting requirements,<sup>70</sup> the relationship of central banks with government<sup>71</sup> and other financial institutions,<sup>72</sup> monetary policy committees,<sup>73</sup> and institutional arrangements.<sup>74</sup> The following sections bring into closer focus the relationship of central banks and other financial institutions in safeguarding the stability of the financial system.

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63 See Zongwe, Dunia P. 2011. "An introduction to the law of the Southern African Development Community". *GlobaLex*, February; available at [http://www.nyulawglobal.org/Globalex/Southern\\_African\\_Development\\_Community.htm](http://www.nyulawglobal.org/Globalex/Southern_African_Development_Community.htm); last accessed 26 March 2011.

64 Model Law, "Explanatory Note".

65 Model Law, "Central Bank Model Law".

66 Model Law, Chapter I.

67 Model Law, Chapter IV.

68 Model Law, Chapter VII.

69 Model Law, Chapter VIII.

70 Model Law, Chapter IX.

71 Model Law, Chapter V.

72 Model Law, Chapter VI.

73 Model Law, Chapter III.

74 Model Law, Chapter II.

## Functions of SADC central banks

The Model Law retains the twin functions of central banking, namely monetary and financial stability. For the Model Law, the primary objective of a central bank is to “achieve and maintain price stability”.<sup>75</sup> Central banks need to be independent,<sup>76</sup> but may support the general economic policy of the government.<sup>77</sup> In pursuing its primary objective, a central bank has to articulate monetary policy,<sup>78</sup> including exchange rate policies;<sup>79</sup> hold gold and foreign exchange reserves;<sup>80</sup> regulate matters relating to the domestic currency;<sup>81</sup> act as a fiscal agent to the government;<sup>82</sup> and act as a banker to the government and banks alike.<sup>83</sup> This article, however, does not dwell on the role played by SADC central banks in monetary stability but on their role in financial stability.

The role of central banks in the regulation of banking and other financial institutions is chalked out in the Model Law’s Chapter VI, entitled “Relationship with Banks and Other Financial Institutions”. The Model Law entrusts central banks with the power to regulate,<sup>84</sup> supervise and license financial institutions;<sup>85</sup> assist banks in financial difficulty;<sup>86</sup> and participate in international financial institutions that seek financial stability through monetary cooperation.<sup>87</sup> Although Chapter VI of the Model Law is not binding law, it derives a great deal of legitimacy from its origins in the CCBG, which is composed of the 15 central bank governors<sup>88</sup> in SADC.<sup>89</sup> It is a set of default rules that SADC member states can either leave in place or modify to suit local realities. Two types of default rules are distinguishable: market-mimicking, and information-forcing.

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75 Model Law, article 4(1).

76 Model Law, article 5.

77 Model Law, article 4(2).

78 Model Law, article 6(1)(a).

79 Model Law, article 6(1)(b).

80 Model Law, article 6(1)(c).

81 Model Law, article 6(1)(d).

82 Model Law, article 6(1)(f).

83 Model Law, article 6(1)(f) and (g).

84 Model Law, article 6(2)(b).

85 Model Law, article 6(2)(a).

86 Model Law, article 6(2)(m).

87 Model Law, article 6(2)(e).

88 By law, the current members of the CCBG are Rundheersing Bheenick (Mauritius), Martin G Dlamini (Swaziland), Caleb M Fundanga (Zambia), Gideon Gono (Zimbabwe), Ernesto G Gove (Mozambique), Pierre Laporte (Seychelles), Perks M Ligoya (Malawi), Gill Marcus (South Africa), Jean-Claude M Masangu (DRC), José L Massano (Angola), Rets'elisitsoe A Matlanyane (Acting Governor, following the passing of Moeketsi P Senaoana in March 2011; Lesotho), Linah K Mohohlo (Botswana), Benno J Ndulu (Tanzania), Frédéric Rasamoely (Madagascar), and Ipumbu W Shiimi (Namibia).

89 2006 Protocol to the SADC Treaty on Finance and Investment, Article 19; hereinafter *Finance Protocol*.

Market-mimicking default rules are those meant to remain in place by most parties because they represent an efficient allocation of rights and duties.<sup>90</sup> As shown later in this article, most provisions of Chapter VI of the Model Law fall into that category. Information-forcing default rules, on the other hand, only serve to encourage the parties to reach an efficient allocation of rights and are not designed to be maintained.<sup>91</sup>

### **Notable features**

Regarding banks and financial institutions, relevant domestic legislation may endow the central bank with two broad powers: to regulate, and to supervise.<sup>92</sup> *Regulation* is the prescription of rules,<sup>93</sup> whereas *supervision* entails the enforcement of regulatory rules.<sup>94</sup> While the object of Chapter VI of the Model Law is unambiguously financial regulation by SADC central banks, an explanatory note in that chapter states that supervision is an optional function.

Chapter VI of the Model Law contains seven provisions on the regulation of banks and other financial institutions. One provision is on disclosure by banks and other financial institutions. SADC central banks may prescribe, by notice in the national government gazette and to each bank, the way in which banks and lending institutions<sup>95</sup> are obliged to disclose —<sup>96</sup>

- annual interest rates payable on deposits
- the terms for obtaining credit
- fees
- commissions, and
- any such charges payable.

Violation of the terms of those notices is a criminal offence.<sup>97</sup> These notices apply uniformly in the member state whose central bank issued the notices, provided that the notices be permitted to differentiate between banks, credit-extending institutions, other creditors, and classes according to the nature of their business.<sup>98</sup>

The provision on cash reserve requirements<sup>99</sup> for banks is a prominent feature of Chapter VI of the Model Law. SADC central banks may prescribe to the main

90 Crasswell, Richard. 2000. "Contract law: General theories". In Bouckaert & De Geest (2000:950–951).

91 (ibid.:5ff).

92 Model Law, article 52.

93 Scott (2010b:673).

94 See Tietje & Lehmann (2010:664).

95 Model Law, article 50(2).

96 Model Law, article 50(1).

97 Model Law, article 50(4).

98 Model Law, article 50(3).

99 That is, how much of the deposits must be held in equity or equity-like securities.

office of each bank the maintenance by banks of required reserves, including marginal required reserves, against deposit and other similar liabilities of the banks that may be specified for that purpose.<sup>100</sup> They may prescribe different reserve ratios for different classes of deposits and other similar liabilities, and may provide their method of computation.<sup>101</sup> However, there is a proviso that the reserve ratios are to be uniform for all banks in the same class, although the ratios may differ between different classes of banks.<sup>102</sup> The Model Law further lays down that banks may withdraw required reserves from central banks in order to pay existing obligations, clear cheques, and settle balances among themselves, provided that they replenish the withdrawn reserves within the period specified.<sup>103</sup> If banks fail to maintain the required reserves in the appropriate ratios, central banks may impose on those banks a penalty rate higher than the rate officially published by the central banks on the amount of the deficiency as long as it continues.<sup>104</sup>

Another provision of the Model Law is on the accommodation of banks by SADC central banks. Central banks may exchange with banks doing business in their territory certain commercial paper (e.g. bills of exchange and promissory notes), treasury bills, and other instruments approved by the central banks<sup>105</sup> and they may carry out discount operations in favour of the banks.<sup>106</sup> Subject to a number of restrictions,<sup>107</sup> the Model Law allows SADC central banks to grant advances to banks secured by commercial paper and other acceptable instruments.<sup>108</sup>

The bank accommodation provision of the Model Law also envisages emergency liquidity assistance in exceptional circumstances. It empowers central banks to grant advances or contingent commitments to banks if, in the central banks' opinion, such action will preserve the public interest and the financial condition of the bank in distress.<sup>109</sup> In addition, central banks may grant emergency liquidity assistance to a distressed bank at market price if they believe the bank does not constitute a systemic risk to the banking sector, and at such price as the central banks deem fit if they believe the distressed bank constitutes such a risk.<sup>110</sup> However, they may grant such assistance only if the distressed bank will be able to repay it,<sup>111</sup> and only if the finance minister

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100 Model Law, article 49(1)(a).

101 Model Law, article 49(2).

102 Model Law, article 49(2)(a).

103 Model Law, article 49(3).

104 Model Law, article 49(4)(a).

105 Model Law, article 47(1).

106 Model Law, article 47(6) and (7).

107 Model Law, article 47(3).

108 Model Law, article 47(2).

109 Model Law, article 47(4)(a).

110 Model Law, article 47(4)(b).

111 Model Law, article 47(5)(a).



agrees with the advance or commitment<sup>112</sup> and confirms in writing that separate funds or debt securities will be given to cover the advance or commitment.<sup>113</sup>

A further provision of the Model Law affirms the function of the central bank as a bank to bankers. It states that SADC central banks may open accounts for, and accept deposits from, banks doing business in their territory on the terms and conditions that they may determine.<sup>114</sup>

Finally, the Model Law places a duty on SADC central banks to fix and publicly announce from time to time the rates for discounts, rediscounts, advances, loans and overdrafts.<sup>115</sup>

### **General observations**

The text of the Model Law reveals that, although it intends to cover financial institutions as a group, the Model Law is in actual fact preoccupied with banks and banking institutions. This preference for banks should not come as a surprise since banks are the archetype of financial institutions<sup>116</sup> and the type that dominates financial sectors in SADC member states. Financial crises are also likely to be driven through by banks, which may be the reason why banks are also the most regulated type of financial institutions.

The Model Law assumes that the central bank, as opposed to a separate and specialised agency, regulates financial institutions. In the wake of the latest global financial crisis, debates, especially in Europe and the US, have in the main revolved around the question whether enhanced systemic risk regulation requires central banks,<sup>117</sup> a unified regulator,<sup>118</sup> other regulators, or some other institutions to assess risk.<sup>119</sup> In the SADC region, the choice of chief financial

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112 Model Law, article 47(5)(b).

113 Model Law, article 47(5)(c).

114 Model Law, article 46.

115 Model Law, article 48.

116 Tietje & Lehmann (2010:665).

117 The Chancellor of the Exchequer in the United Kingdom announced in July 2010 that the British Financial Services Authority (FSA) would be abolished and that prudential supervisory powers would be returned to the Central Bank of England; see Cleary Gottlieb Steen & Hamilton LLP. 2010. Alert note: "A new approach to financial regulation: The end of the United Kingdom FSA". 1849 PLI/Corp 153. Also available at <http://www.lexology.com/library/detail.aspx?g=ac4a7273-9ff8-4a2b-9d72-8980577ff823>; last accessed 24 March 2011.

118 Mwenda. Kenneth Kaoma. 2006. *Legal aspects of financial services regulation and the concept of a unified regulator*. Washington, DC: World Bank. Although this book was written before the 2008–2009 financial crisis, Mwenda considered the question of whether countries should adopt a unified financial regulator.

119 Karmel, Roberta S. 2010. "The controversy over systemic risk regulation". *Brooklyn Journal of International Law*, 35:823.

regulator is varied. In most SADC countries, it is the central bank that supervises all financial institutions. This is the case in the Democratic Republic of the Congo, Lesotho, Malawi, Mauritius, Mozambique, Seychelles,<sup>120</sup> Tanzania, Zambia and Zimbabwe.<sup>121</sup> In a minority of member states, the central bank supervises banks, while a specialised agency supervises non-bank financial institutions. This is what obtains in Angola, Botswana, Namibia, and South Africa.<sup>122</sup> Finally, there is one peculiar case: Madagascar, where a specialised agency, the Commission de Supervision Bancaire et Financière, supervises all financial institutions.<sup>123</sup> Thus, Chapter VI of the Model Law does not apply to Madagascar, as its central bank is not the financial regulatory authority.

It is somewhat odd, at times disturbing, but in any event noteworthy, that the Model Law does not make use of some basic elements of financial regulation. Portfolio diversification rules do not appear in the Model Law, for example. The same holds true for conduct and conflict rules. Monitoring tools such as examination and inspection are not expressly provided for, even if they can be read into the power granted in the Model Law to central banks to license financial institutions. Regulation of interest rates, albeit not so much a basic tool of financial regulation, is also not among the provisions of the Model Law. A charitable explanation of these omissions is that the CCBG left it to domestic financial legislation to fill in the blanks. Another generous explanation is that the Model Law merely represents 'key principles' as distinct from specific rules. A further explanatory factor is that relevant legislation in some member states may assign the task of using these tools to institutions other than the central bank.

### ***Where the Model Law locks risk***

If, as shown earlier, the prevention of systemic risk is the *raison d'être* of financial regulation, it follows that the ability to avert systemic risks is the touchstone of the Model Law's efficacy. In that connection, the first thing to note is that the Model Law is intentionally overly broad and lacking in specificity – and, thus, incomplete. As a tactical matter, the Model Law's incompleteness is wise, generally speaking, because information asymmetries between the CCBG and national institutions in foreseeing future financial crises and responding to them are significant. Moreover, the CCBG may consider leaving some areas of financial regulation unregulated in order not to hamper the innovative potential of financial actors and intermediaries.<sup>124</sup> The CCBG gains

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120 Central Bank of Seychelles. 2009. *Financial Services Supervision Annual Report 2009*. Mahé: Central Bank of Seychelles, p 10.

121 CCBG (2009).

122 (ibid.).

123 (ibid.:76).

124 Tietje & Lehmann (2010:664).

much by deferring to national institutions in determining the specific obligations of financial institutions before and during systemic crises.

The provision on disclosure is undoubtedly one of the most powerful tools of the Model Law in reducing systemic risk. Indeed, information-asymmetric problems, in the form of adverse selection and moral hazard, explain why the protection of investors is imperative. *Adverse* selection arises before a transaction takes place, while *moral* hazard occurs after the transaction.<sup>125</sup> Adverse selection arises because depositors have inferior and incomplete information about the riskiness of a bank's portfolio, which means they often have inadequate means of telling safe banks from risky ones. With respect to moral hazard, deposits function like an insurance in the bank's favour and, therefore, create a risk for depositors that the bank may embezzle or lose deposits or other depositors' assets in a bad investment. The disclosure principles of the Model Law speak to adverse selection and moral hazard issues.

The discretion of central banks to consult at any time with banking and other financial institutions on any matters if need be<sup>126</sup> should strengthen the Model Law's disclosure principles. In a sense, much of the financial regulatory structure can be conceived of as a collective best guess regarding the form and content of advance disclosure of institutional risk-taking that most investors would demand before they invest. Once it is understood that disclosure promotes transparency, then the merits of transparency in financial regulation attach to the disclosure rules in the Model Law. Those merits are at least threefold:<sup>127</sup> disclosure, by providing legal certainty, would provide the basis for establishing trust in the financial system;<sup>128</sup> would lay open the values and goals of financial policy;<sup>129</sup> and would instil accountability in financial actors.<sup>130</sup>

The emergency liquidity assistance in exceptional circumstances evidently targets situations that may threaten financial stability. This purpose is abundantly evident from the provision that central banks may grant advances to banks if they believe such action will preserve the public interest and the financial condition of distressed banks, and will prevent bank failure from prompting systemic risk.<sup>131</sup> These provisions reinforce the role of central banks as lender of last resort. Lender-of-last resort interventions may overcome liquidity crises with which banks are confronted, thus obviating financial crises,

125 Heremans (2000:953).

126 Model Law, article 51.

127 Kaufmann, Christine & Rolf H Weber. 2010. "The role of transparency in financial regulation". *Journal of International Economic Law*, 13:779.

128 (ibid.:784ff).

129 (ibid.:787ff).

130 (ibid.:791ff).

131 Model Law, article 47(4)(a) and (b).

although these interventions may lead to moral hazard and other concerns.<sup>132</sup> It bears reminding, therefore, that SADC central banks should intercede as ultimate lenders only for financial institutions that are solvent and in conformity with the country's monetary policy, lest they provoke an inflation.<sup>133</sup>

### **Where risk lurks**

The treatment of capital and liquidity standards in the Model Law is disappointing. The Model Law faithfully describes the job of financial regulation in setting cash reserve norms, but it does not specify what those reserve ratios for deposits are. The CCBG should have made that specification. Furthermore, given that capital requirements are arguably one of the most important weapons in the arsenal of systemic risk regulation,<sup>134</sup> the CCBG should also have included a minimum capital requirement. In a similar vein, the CCBG could have worked out a liquidity ratio, a lending limit, or a risk concentration clause, which are all indispensable ingredients of national financial regulation. At the very least, the CCBG could have included those provisions in the Model Law by reference to international norms, primarily the Basel Accords. The inclusion of such provisions in the Model Law is all the more necessary because some of these provisions, such as leverage ratios, are clearly best handled internationally rather than through disparate national requirements.<sup>135</sup> This fact is not foreign to the decision of the Basel Committee on Banking Supervision (Basel Committee) to introduce a leverage ratio, quantitative liquidity ratios, and counter-cyclical capital buffers in the draft Basel III.

In a world of global financial challenges,<sup>136</sup> financial regulation and supervision should be in phase with the ongoing internationalisation process.<sup>137</sup> The internationalisation process entails that municipal law pegs capital adequacy ratios down. Capital adequacy regimes are the single most important set of rules in international and domestic banking law<sup>138</sup> and can cushion the most serious shocks to the banking system as well as forestalling systemic failures.<sup>139</sup>

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132 Heremans (2000:958).

133 (ibid.:961).

134 Leverage ratios are clearly best handled internationally rather than through disparate national standards, according to Scott (2010a:763).

135 (ibid.:769).

136 The most significant trend in banking is globalisation, according to Heath Price Tarbert. 2001. "Rethinking capital adequacy: The Basle Accord and the new framework". *The Business Lawyer*, 56:767, 770.

137 For a similar argument, see Weber, Rolf H. 2010. "Multilayered governance in international financial regulation and supervision". *Journal of International Economic Law*, 13:683.

138 Bhala, Raj. 1997. "Equilibrium Theory, the FICAS Model, and international banking law". *Harvard International Law Journal*, 38:1, 21.

139 "The Great Banking Capital Conundrum", *Retail Banker International*, 30 April 1999, p 17.

Nevertheless, some experts argue that central banks and governments should refrain from fixing capital adequacy ratios and let markets determine them.<sup>140</sup> It is, therefore, still open to question whether the CCBG should have left the specification of capital adequacy requirements out of the Model Law and deferred to national central banks or markets. At the same time, capital adequacy laws are practically identical the world over, thanks to the rules laid down by the Basel Committee,<sup>141</sup> which would suggest that international thresholds, if different from Basel-made rules, are strongly advisable.

All the same, with the growing globalisation of financial institutions, as demonstrated by the global financial crisis, comes the realisation that international standards can conduce financial stability better than national laws alone. This realisation is undergirded by the provision in the Model Law that allows central banks to take part in international financial institutions working to stabilise financial systems,<sup>142</sup> such as the Basel Committee and the Financial Stability Board. What is more, it is hard to see how the CCBG can move SADC to a regional central bank without an agreement on threshold capital requirements. Risk tends to flee from regulated and transparent sectors of the financial industry to sectors that are less so.<sup>143</sup> Today, it is not enough that national governments design near-impregnable financial systems to avoid institutional failures and a resultant financial crisis. It is important that, in addition, they collectively set up standards because of the intermeshed nature of financial institutions in the era of globalisation. By skipping over capital and liquidity standards, the CCBG has maybe missed a chance to legislate against the next crisis in the region.

## Conclusion

Although it is the greatest regional economic group in terms of gross domestic product in sub-Saharan Africa,<sup>144</sup> SADC faces daunting development challenges that call for major public investments. Raising money from banks and other financial institutions, over and above other sources of finance, becomes critical to development in the SADC region. Thus, it is the responsibility of SADC and the CCBG – a sort of regional-level, mini-Basel Committee – to develop the financial industry and to jealously preserve financial stability. SADC and the CCBG know they will not be able to expand financial services and protect financial stability without guarding against systemic risk. It is with

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140 Heath Price Tarbert (2001:773ff).

141 (ibid.:775–776).

142 Model Law, article 6(2)(e).

143 Masters, Brooke & Jeremy Grant. 2011. "Finance: Shadow boxes", Financial Times (UK), 2 February 2011; available at <http://www.ft.com/cms/s/0/6431e2e0-2f09-11e0-88ec-00144feabdc0.html#axzz1HWD1SSon> last accessed 24 March 2011.

144 SADC (2004:9–10).

that knowledge that they have passed a Model Law to fit central bankers in the region with the institutional and legal armoury to defend financial stability and fight risk to financial systems within SADC.

Chapter VI of the Model Law is the part that specifically turns to financial regulation and supervision. It enshrines seven stipulations, namely on –

- disclosure
- publication of information
- cash reserve requirements
- the accommodation of banks by central banks
- emergency liquidity assistance
- the role of central banks as the bank to bankers, and
- consultation between central banks and banks.

The capacity of the Model Law to stem systemic risk is the prism through which its efficiency must be viewed. The Model Law's provisions on disclosure, the accommodation of banks, emergency assistance, and central bankers' banker role, including as the lender of last resort, are robust. The greatest concern is the provision – or, more precisely, the lack thereof – on capital and liquidity requirements. This omission in the Model Law is unjustifiable in an era of economic globalisation and in view of the financial integration objectives of the legal framework of SADC as a regional development community. The drafting of the Model Law was an opportunity before the CCBG to effectively pave the way for a regional central bank by setting strong and common capital standards, but the deference and timidity with which they approached the issue might be the door by which the devil might sneak in the financial system.