

THE SOUTH AFRICAN RESERVE BANK: BLOWING WINDS OF CHANGE (PART 2)

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III THE GLOBAL FINANCIAL CRISIS

The global financial crisis, which started in about August 2007 and appears to have peaked in September 2008, could be regarded as a phase of the evolution of financial markets under the radical financial deregulation process that began in the late 1970s, predominantly in overseas countries.

(a) *General*

This evolution took the form of cycles in which deregulation, accompanied by rapid financial innovation, stimulated powerful financial booms that ended in crisis. Government bailouts in response to these crises caused new expansions, resulting in larger financial markets and larger financial crises, threatening whole financial systems and societies.⁵⁹

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** Part 1 of this article described the substantial changes to the South African Reserve Bank Act 90 of 1989 (SARB Act) that were introduced by the South African Reserve Bank Amendment Act 4 of 2010 (Amendment Act). Thus the concept of 'associates' prevents shareholders from circumventing the limits of shareholding by individuals. The revised structure of the SARB Board, though increasing governmental control, broadens the knowledge and skills base of the Board and allows for public nomination of elected directors of the Bank. To clarify the duties of the Bank directors, the SARB Act imposes on, and defines a duty of care and skill for, these directors. A panel called by the Governor of the Bank evaluates nominees as potential non-executive directors of the Bank. Grounds for disqualification of directors now appear in the SARB Act. In addition, following modern trends, the Board is responsible for implementing measures pertaining to corporate governance while the executive officers (the Governors), exercising vast decentralised original powers, manage the day-to-day business of the Bank.

⁵⁹ See James Crotty 'Structural causes of the global financial crisis: A critical assessment of the "new financial architecture"' (2009) 33(4) *Cambridge Journal of Economics* 563; Stephanie Blankenburg & José Gabriel Palma 'Introduction: The global financial crisis' (2009) 33(4)

The most recent global financial crisis was rooted in global imbalances in savings and consumption characterised by large savings in emerging economies and unsustainable levels of debt-financed consumption in some advanced economies, coupled with rapid rises in asset prices (especially in the housing market). In many countries, but particularly in the United States of America, abundant credit and scant regulation led to debt rising to unsound levels. The risks in indiscriminate credit extension were amplified by the innovation of sophisticated financial products and inappropriate risk management systems. Through securitisation, mortgage-related products were repackaged into securities that were sold to investors throughout the world, and toxic mortgages became deeply rooted in the global financial system. When the housing bubble finally burst, the total exposure of financial institutions worldwide because of mortgage-backed securities ran into trillions of dollars. As a result of the ensuing panic and uncertainty, financial institutions became unwilling to lend to each other, and liquidity in the interbank funding market dried up. Stock markets around the world collapsed, household wealth was virtually wiped out, and interbank lending and lending to corporations came to a grinding halt. It very nearly led to the widespread collapse of financial systems worldwide.⁶⁰

(b) Effect on Central Banks

The financial crisis constituted a sharp reminder of how much a well-functioning economy depends on a stable financial infrastructure and how fragile this infrastructure is. Its stability depends largely on the preservation of confidence in different elements, such as maintaining the value of the currency, the reliability of payment and settlement mechanisms, and the ability of financial intermediaries to provide, without disruption, intermediation between borrowers and lenders at costs that reasonably reflect risks. Authorities were reminded that they needed to consider all these requirements simultaneously and continuously, should they wish to conduct adequate regulation and supervision.⁶¹

Cambridge Journal of Economics 531; Claudio Borio & Ilhyok Shim 'What can (macro)prudential policy do to support monetary policy?' (2007) *BIS Working Paper No. 242* (December 2007) 8; Erland Walter Nier 'Financial stability frameworks and the role of central banks: Lessons from the crisis' (2009) *IMF Working Paper WP/09/70* 7.

⁶⁰ National Treasury of the Republic of South Africa *A Safer Financial Sector to Serve South Africa Better* (2011) 9.

⁶¹ H Davies & David Green *Banking on the Future: The Fall and Rise of Central Banking* (2010) 285.

Historically, central banks usually had three main functional roles. The first was that of maintaining price stability, subject to the monetary regime in operation at a particular time, for example, the gold standard, a pegged exchange rate or inflation target. The second role was to maintain financial stability and to foster financial development more broadly. And the third was to support the financing needs of the state in times of crisis, but in normal times to constrain the misuse of the financial powers of the government. In order to fulfil their duty of conducting monetary policy with the primary objective of reaching price stability, central banks generally were granted independence from government interference. With regard to prudential supervision, there was less homogeneity within the central bank community, although it was generally accepted that central banks needed to play a role in maintaining financial stability by assuming a macro-prudential responsibility. But their mandate in this regard was not defined with precision.⁶²

Although in the years prior to the financial crisis, central banks appeared to have almost perfected the conduct of monetary policy by means of the standard regime of inflation targeting, the crisis indicated that the achievement of price stability alone did not guarantee financial stability. This realisation resulted in a critical evaluation globally of the price stability goal of central banks. Concerns appear to be that central banks, by focussing excessively on pursuing a narrow price stability objective, may have done so at the expense of other important objectives. In the process, central banks are said to have failed to invest enough energy into the development of macro-prudential tools that may, together with monetary policy, be used to address the build-up of exposures to aggregate risks. In cases where they also acted as prudential supervisors, central banks are alleged to have failed in developing and applying higher prudential standards for large and complex institutions whose failure could have a major disruptive effect on financial markets. It is said that central banks have sometimes failed to promote systemically robust procedures for the clearing and settlement of trades in rapidly evolving financial markets. Moreover, their overall framework did not always appear to have been fully conducive to achieving their

⁶² See C A E Goodhart 'The changing role of central banks' (2010) 4, a paper delivered at the Annual BIS Research Conference held in Luzern, Switzerland, on 24 June 2010, available at www.bis.org/events/conf100624/goodhartpaper.pdf, accessed on 6 February 2013; C Murat Baykal 'Evolving statutory mandates and governance structures of central banks' 2, a paper delivered at the Legal Issues in Central Banking Seminar in Ankara, Turkey, 8–10 November 2012; and Davies & Green op cit note 61 at 298.

objectives, often leaving ill defined the responsibilities and tools of central banks in their pursuit of financial stability.⁶³

(c) Remedial measures

Considerable efforts are currently focused on overhauling the financial architecture of many countries in an effort to address perceived fundamental weaknesses. These efforts include various policy debates covering wide-ranging issues such as far-reaching regulatory reforms to strengthen the foundations of financial stability, achieve more efficient financial markets and determine the mandates of central banks with greater certainty.⁶⁴

In principle, with regard to central banks in general, the main considerations appear to be centred on the need to readdress the role of monetary policy in contributing to the success of financial stability policies, not just by softening the impact of the unwinding of financial imbalances, but also by containing their increase. This topic involves a renewed focus on managing system-wide risks across the entire financial sector. This macro-prudential approach entails the analysis of macro-economic trends and the manner in which they interact with the prudential soundness and stability of financial institutions and the financial system. The question that needs to be answered is how and to what extent existing monetary policy frameworks may need to be adjusted or supplemented, so that future central bank frameworks can more explicitly take account of financial stability objectives.⁶⁵

(d) Difficulties

(i) Undefined concept

A material difficulty with the concept of financial stability is that, despite its extensive use, it has no clear definition. Despite various efforts in this regard, it is widely acknowledged that the concept is vague and difficult to define.⁶⁶ This uncertainty of exact meaning may give rise to considerable heterogeneity in how central banks perceive their financial stability objective, which may lead to a lack of clarity in the accountability and oversight of the function. This could contrast sharply with the focussed arrangements in terms of which central banks achieve the monetary

⁶³ Davies & Green op cit note 61 at 285 and Nier op cit note 59 at 3.

⁶⁴ Baykal op cit note 62 at 9.

⁶⁵ Nier op cit note 59 at 7.

⁶⁶ Davies & Green op cit note 61 at 55.

policy goal. Many central banks conduct monetary policy by means of an inflation-targeting framework within a designated target range. In contrast to the apparent certainty in measuring price stability, determining a suitable mechanism by means of which a central bank's contribution towards ensuring financial stability may be measured is likely to prove difficult.⁶⁷

(ii) Interaction between policies

Substantial practical questions remain on how to integrate financial and price stability.⁶⁸ A key challenge is to determine how macro-prudential and monetary policies and their respective instruments should relate to each other. At first blush, this should be dictated by the extent to which monetary and financial stability may be regarded as linked, an issue on which conflicting views exist. One view is that there should be a clear delineation between the mandate and instruments of monetary policy and the task and instruments of financial stability.⁶⁹ It is suggested that in order to deal effectively with both price and financial stability, for monetary policy purposes one needs to focus on the core function of maintaining price stability, while financial stability is best served by ensuring a robust and efficient financial system through strong regulation and effective supervision.⁷⁰ Another view is that in recent years the concepts of monetary and financial stability have been allowed to drift apart in ways that have made them seem independent of each other. It is suggested that this dichotomy has been used to indicate that the two stabilities could be separately assessed and that the tools used to implement or address the one were not related to the other. Since monetary policy takes effect only through financial markets, and financial firms and markets are in turn critically dependent on what is happening in the real economy, it is suggested that no clear dividing line

⁶⁷ Johann de Jager 'The South African Reserve Bank: An evaluation of the origin, evolution and status of a central bank (part 1)' (2006) 18 *SA Merc LJ* 159 at 165. In the light of these definitional and measurement problems, few central banks have a clear statutory duty to pursue financial stability, even though many now describe it as one of their core purposes or critical responsibilities: Davies & Green op cit note 61 at 59.

⁶⁸ Davies & Green op cit note 61 at 298.

⁶⁹ Monetary policy should be conducted taking financial policy into account, and financial policy should be conducted taking monetary policy into account: Lars E O Svensson 'The relation between monetary policy and financial policy' (2012) 8 *International Journal of Central Banking* 293. Goodhart suggests that a separate additional set of macro-prudential regulatory instruments will need to be developed for the specific purpose of maintaining financial stability: op cit note 62 at 18.

⁷⁰ Baykal op cit note 62 at 16; Svensson op cit note 69 at 295.

exists between monetary and financial stability and that they are inextricably linked.⁷¹

Moreover, it is acknowledged that micro-prudential objectives may conflict with the macro-economic objectives of a central bank. This may lead to a compromise of the conduct of monetary policy. This situation may arise in particular when the banking system is under stress and the monetary authority (central bank) may be hesitant to impose the appropriate degree of financial tightening through concern for the solvency of the banks that it supervises.⁷² In addition, if a central bank has only the short-term interest rate as a tool, the question arises whether it makes sense to impose on a central bank what may be perceived as two potentially conflicting objectives such as price and financial stability.⁷³

(iii) Independence

Although central banks are unable to prevent an undesirable outcome absolutely, or to ensure a desirable one, the way in which they have been allocated decision-making authority within the countries they serve makes some policy outcomes more probable and others less likely. Ultimately, the authority and scope of action of a central bank depend on the government, and the functions of this bank depend on the degree of autonomy granted to it. Central bank independence constitutes one of the means by which a government can choose the strength of its commitment to price stability. Although most governments recognise the long-term benefit of price stability, other goals often loom larger in the short term. Thus, assuring price stability usually requires ensuring that a central bank cannot be forced to perform functions beneficial to the government in the short term, at least not when they are of an inflationary nature. Civilised governments therefore normally pass laws and follow customs that grant their central banks authority and autonomy to pursue price stability, even when it conflicts with other objectives of the authorities. Thus this concept of vesting a central bank with the mandate to independently maintain price stability benefits the economy and the government in various ways.⁷⁴

⁷¹ Davies & Green op cit note 61 at 52 and 289.

⁷² Nier op cit note 59 at 15.

⁷³ Davies & Green op cit note 61 at 21.

⁷⁴ Alex Cukierman, Steven B Webb & Bilin Neyapti 'Measuring the independence of central banks and its effect on policy outcomes' (1992) 6 *The World Bank Economic Review* 353 at 354. Davies & Green regard the terminology 'central bank independence' as imprecise. They prefer 'central bank autonomy': op cit note 61 at 149.

Owing to the comprehensive nature of the concept of financial stability, central banks may be called upon to become involved in the resolution of individual systematically important institutions undergoing particular liquidity stress. Although this may include important banking institutions, such resolution by a central bank may go beyond this traditional class of institution to include other non-banking classes of institutions whose failures could disrupt the broader financial system. If the liquidation of such institutions cannot be allowed and (in the case of liquidity problems) the market proves unwilling or unable to provide more capital, central banks may have to revert to taxpayers' funds to provide relief. Use of taxpayers' funds implies that governments, on behalf of taxpayers, share a concern and role in resolution policies and mechanisms implemented by central banks. Accordingly, for as long as a potential resolution process involves taxpayers' funds or the possibility of nationalisation, the relevant government minister needs to be involved at all times.⁷⁵

The close involvement and responsibility of the government in issues pertaining to financial stability could potentially impair the independence of central banks. In practice, especially during times of widespread financial turmoil, it appears evident that the same level of separation and independence from governments afforded to central banks with regard to their conduct of monetary policy cannot realistically be replicated when it comes to their pursuing their objective of financial stability.⁷⁶ It is suggested that in these circumstances, instead of central bank subservience to government, an even-handed partnership between governments and central banks should be maintained.⁷⁷

IV THE POSITION IN THE REPUBLIC OF SOUTH AFRICA

Although the financial sector in the RSA appears to have weathered the global financial crisis successfully, the government committed to important obligations, informed by our own domestic situation, to attempt to prevent a similar financial crisis in future. In the G20, the President committed the RSA to a global financial regulatory reform agenda aimed at strengthening financial stability.

⁷⁵ Goodhart op cit note 62 at 27 and Nier op cit note 59 at 17.

⁷⁶ Goodhart op cit note 62 at 23.

⁷⁷ Idem at 34.

(a) Government policy

This commitment relates to a stronger regulatory framework, effective supervision, crisis resolution and addressing systemic institutions as well as regular international assessments and peer review. Against this background, the government structured as policy objectives financial stability, consumer protection and market conduct, expanded access through financial inclusion, and combating financial crime.⁷⁸

With regard to financial stability, the government acknowledged the potential deficiencies in the conduct of supervision on a micro-prudential basis (which mostly concern the soundness of individual institutions or groups), in identifying and addressing stability risks arising from wider inter-linkages between different institutions in the financial system. A system-wide macro-prudential approach to financial stability and regulation will therefore be adopted in the RSA, including a shift to a so-called ‘twin peaks’ approach to regulation.⁷⁹

(b) Role of the South African Reserve Bank

Following the governmental approach to the introduction of a revised policy framework for regulating the financial system in the RSA, the Minister designated the SARB as the systemic regulator of that system. The Bank is required to supervise and monitor the financial system to give effect to the objective of financial stability. In this vein, the implicit responsibility of the Bank for monitoring macro-economic risks was explicitly confirmed in a letter from the Minister to the Governor on 16 February 2010. Under the twin peaks model of regulation, the prudential regulator will operate within the Bank, and the market conduct regulator will operate within a restructured Financial Services Board (FSB).⁸⁰

Against this background, the potential effect and consequences of these developments on the primary objective and independence of the

⁷⁸ National Treasury of the Republic of South Africa op cit note 60 at 4.

⁷⁹ South Africa’s system of financial regulation was broadly modelled on countries to which it was historically linked, particularly the United Kingdom (UK) and other former British colonies such as Australia and Canada. In the three decades before the global financial crisis, regulatory systems diverged significantly. Australia adopted the twin peaks approach, and the UK opted for a single regulator. After the financial crisis broke out in about 2007, a global shift away from the single regulator approach towards a twin peaks model occurred: National Treasury of the Republic of South Africa op cit note 60 at 28. See also Johannes Jurgens de Jager *The Management of Banks in South Africa: Legal and Governance Principles* (LLD thesis, Rand Afrikaans University, 2000) 568.

⁸⁰ Financial Regulatory Steering Committee *Implementing a Twin Peaks Model of Financial Regulation in South Africa* (1 February 2013) 6; National Treasury of the Republic of South Africa op cit note 60 at 31.

SARB, as well as its current regulatory framework, are discussed and evaluated.

(i) *Primary objective*

In principle, the construction of any institution to undertake certain functions should involve specifying the objectives underlying these functions. Charging an institution with the pursuit of specific objectives should map directly into the choice and availability of functions. Functions and objectives are therefore integrated. Historically, it appears that central banks have been understood more in terms of their functions than their objectives. Consequently, functions that are widely regarded as core elements of central banking are not always tied to statements of the relevant objectives. An example appears to be the objectives associated with the important financial stability function of the Bank, which is typically less well specified than its monetary policy objective in the SARB Act.⁸¹ An important concern in this regard relates to the fact that the Bank is a creature of statute and therefore must operate within the proverbial four corners of the SARB Act.⁸² For these reasons, it is important to determine whether financial stability may be accommodated within the scope and ambit of the objective of the Bank as stated in the SARB Act. In other words, it needs to be determined whether the explicitly stated macro-prudential responsibility of the Bank aimed at financial stability and its primary objective aimed at price stability are so inextricably linked that both may be pursued within the parameters set by the SARB Act, or whether that Act needs to be amended again.

The primary objective of the Bank is stated as the protection of the value of the currency of the RSA, in the interest of balanced and

⁸¹ Baykal op cit 62 at 5.

⁸² The Bank is a creature of statute and has no powers beyond those granted by the statute creating it. The Bank has no inherent powers or jurisdiction and cannot claim authority that cannot be found within the four corners of its constituent Act. But this does not mean that the Bank has no powers that are not stated in so many words in the SARB Act, or that it is necessary to give its stated powers such a restrictive interpretation that this leads to a miscarriage of justice. Authority may be implied as well as expressed. Whenever an Act gives powers to a person with a specific objective in mind, that objective should not be defeated because the ancillary powers that are necessary to enforce it have not been specifically mentioned. See *De Villiers v The Pretoria Municipality* 1912 TPD 626 at 645; *Johannesburg Consolidated Investment Co Ltd v Marshall's Township Syndicate Ltd* 1917 AD 662; *Middelburg Municipality v Gertzen* 1914 AD 544; *Bloemfontein Town Council v Richter* 1938 AD 195 at 227; *Government of KwaZulu v Government of the Republic of South Africa* 1982 (4) SA 387 (D); *Ensor NO v The Master* 1983 (1) SA 843 (A); and *Roux v Minister van Wet en Orde en Andere* 1989 (3) SA 46 (T).

sustainable economic growth in this country.⁸³ In principle, it means the same as achieving and maintaining price stability, and it aligns the SARB, in respect of its primary goal, with most central banks worldwide.⁸⁴ Price stability is pursued by the SARB within the monetary policy framework of inflation targeting.⁸⁵ Monetary policy is normally geared towards price stability, defined over a horizon of no longer than two years. Broadly speaking, macro-prudential policy is seen as aimed at financial stability.⁸⁶

It is said that a nation's monetary order reflects everything that a nation wants, does, suffers and is. At the same time, a nation's monetary order has a considerable influence on the way it acts and on its very fate.⁸⁷ Monetary policy takes effect through financial institutions and markets, and they are in turn critically dependent on developments in the real economy.⁸⁸ Monetary policy conducted by the Bank must thus not be judged in isolation from other economic measures, since it forms part of the greater whole of the economy and has the same final objective as the other components of total macro-economic policy.⁸⁹ By delivering price stability, monetary policy contributes to the efficient functioning of the real economy and to economic growth and welfare through various means.⁹⁰ Price stability protects the real purchasing power of money, enhances the proper functioning of markets by eliminating uncertainty created by high and volatile inflation rates, and

⁸³ Section 3 of the SARB Act, read with s 224 of the Constitution of the Republic of South Africa, 1996 (the Constitution).

⁸⁴ See the mandate of the Bank on its website at <http://www.resbank.co.za/AboutUs/Mandate/Pages/Mandate-Home.aspx>, accessed on 11 March 2013 (SARB Mandate), and De Jager op cit note 67 at 165.

⁸⁵ Jannie Rossouw & Vishnu Padayachee *An Analysis of Inflation from a Central Banking Perspective: The South African Experience Since 1921* (2008) 24.

⁸⁶ Gabriele Galati & Richhild Moessner 'Macroprudential policy – a literature review' (February 2011) *BIS Working Papers* No 337 at 6.

⁸⁷ Lucas Papademos 'Price Stability, Financial Stability and Efficiency, and Monetary Policy' (2006) 1, a speech delivered in his capacity as Vice President of the European Central Bank at the third conference of the Monetary Stability Foundation on Challenges to the Financial System – Ageing on Low Growth held in Frankfurt am Main, Germany, on 7 July 2006, available at <http://www.ecb.int/press/key/date/2006/html/sp060707.en.html>, accessed on 11 March 2013.

⁸⁸ Financial policy affects the operation of financial markets and thereby the monetary policy transmission mechanism: Svensson op cit note 69 at 295.

⁸⁹ Monetary policy may broadly be defined as all deliberate actions by the SARB to influence the monetary aggregates, the availability of credit and interest as well as exchange rates with the view of affecting the demand, income, output and balance of payments: De Jager op cit note 67 at 164.

⁹⁰ The ultimate objectives of monetary policy are widely held to be some combination of relative stability of the price level (price stability), balance of payments equilibrium, optimal and relatively stable economic growth, a high and relative stable level of employment and the utilisation of resources in general: De Jager op cit note 67 at 164.

facilitates long-term planning and contracting so that people can safely rely on money as a measure of value. By eliminating market distortions and uncertainties arising from inflation and by anchoring inflation expectations, price stability also contributes to financial stability and financial efficiency in various ways.⁹¹ Since monetary policy affects activity in the real economy and the rate of default amongst firms and thereby credit losses on these loans, as well as asset prices and balance sheets, it affects financial stability.⁹²

According to the SARB mandate, the achievement of price stability is underpinned by the stability of the financial system and financial markets. For this reason, the Bank is obliged to pursue financial stability as one of the important determinants of financial system stability. The wording in the mandate mentioned may be construed as recognition by the SARB that financial stability could be regarded as integrated with or linked into the Bank's goal of price stability. Having regard to the vague and relatively undefined concept of financial stability, the unspecified nature of the SARB's mandate in this regard and the ostensibly close link between price and financial stability, it seems a legitimate interpretation that financial stability falls within the scope and ambit of the primary goal of the Bank as stated in the SARB Act.⁹³ On the basis that the SARB's duty to protect the value of the currency of the RSA includes the pursuit of financial stability, the Bank should be vested with all expressed powers in terms of legislation and the common law (as well as all ancillary powers that may necessarily be implied from them) in order to achieve its primary objective.⁹⁴

⁹¹ First, a direct efficiency enhancing effect of price stability is the reduction of risk premiums in interest rates as a result of diminished uncertainty about future inflation and future policy rates. Secondly, by improving the transparency of price movements in financial markets and anchoring inflation expectations, price stability reduces the likelihood of misperceptions about future asset returns. This lowers the risk of misalignments between asset prices and economic fundamentals, which fosters both the stability and efficiency of financial markets. Thirdly, by maintaining price stability, monetary policy allows banks and borrowers to avoid potential balance sheet problems relating to unexpected and persisting deflation. Finally, a monetary policy that is credibly geared to achieving price stability also avoids creating moral hazard problems and, as a result, excessive risk taking: Papademos op cit note 87 at 11.

⁹² Svensson op cit note 69 at 294.

⁹³ How the pursuit of monetary and macro-prudential policies should be co-ordinated in practice is uncertain: see Galati & Moessler op cit note 86 at 25.

⁹⁴ Instruments of monetary policy include, in normal circumstances, the policy rate and communication, including the publication of forecasts of inflation, the real economy, and the policy rate. In times of crisis, more unconventional instruments include fixed rate lending at longer maturities, adjustment of the size or composition of central bank assets to affect longer interest rates and expectations of future short rates, and foreign exchange intervention to prevent currency appreciation or even to induce currency depreciation. In normal circum-

Against this background, it appears evident that the Bank will be required to pursue a monetary policy framework that takes more explicit account of objectives of financial stability. Potential methods of achieving this may be that the monetary policy objective could include financial stability as an explicit secondary objective to complement the primary objective of price stability; monetary policy targets could take explicit account of certain asset prices or developments in financial markets; or the horizon over which the monetary policy target is intended to be met could be extended.⁹⁵ A noteworthy development in this regard is the recognition that inflation targeting may be utilised as a framework for affording a central bank limited freedom, subject to a strong commitment to controlling inflation, to exercise a constrained discretion in addressing other financial instabilities.⁹⁶ It is suggested that by applying a forward-looking flexible inflation-targeting approach, a central bank could take cognisance of longer-term consequences of asset price bubbles and financial imbalances on macro-economic variables in the setting of current interest rates, without the need for an additional response of monetary policy.⁹⁷ On the basis that successful macro-prudential policy makes it easier to conduct monetary policy, it is suggested that this does not imply any significant modification of the existing framework of monetary policy.⁹⁸

(ii) Independence

As stated in the Constitution, the SARB, in pursuit of its primary objective, must perform its functions independently and without fear,

stances, instruments pertaining to financial stability include supervision, regulation (including capital and liquidity requirements), financial stability reports with analysis and leading indicators that may provide early warnings of stability threats. In times of crisis, authorities may use instruments such as lender of last resort, variable rate lending at longer maturities (credit policy, credit easing), special resolution regimes for insolvent financial firms, government lending guarantees and government capital injection: Svensson op cit note 69 at 294.

⁹⁵ Nier op cit note 59 at 9.

⁹⁶ Ben S Bernanke 'A Perspective on Inflation Targeting' (2003) 2, an address at the Annual Washington Policy Conference of the National Association of Business Economists, Washington DC, on 25 March 2003, available at <http://www.federalreserve.gov/boarddocs/speeches/2003/20030325/default.htm>, accessed on 11 March 2013. Bernanke considers that currently strict inflation targeting has lacked significant practical relevance. He states that he is not aware of any real-world central bank (the language of its mandate notwithstanding) that does not treat the stabilisation of employment and output as an important policy objective (at 6).

⁹⁷ C R Bean 'Asset Prices, Financial Imbalances and Monetary Policy: Are Inflation Targets Enough?' in Anthony J Richards & T J C Robinson *Asset Prices and Monetary Policy* (2003) 48.

⁹⁸ L Aucremanne & Stefaan Ide 'Lessons from the crisis: Monetary policy and financial stability' (2010) 1, Swedish Business School EconPapers, available at <http://econpapers.repec.org/article/nbbeccart/y-3a2010-3am3aseptember-3ai-3aii-3>, accessed on 12 March 2013.

favour or prejudice, but there must be regular consultation between the Bank and the Minister. The Constitution also determines that the powers and functions of the SARB are those customarily exercised and performed by central banks, and that these powers and functions must be determined by an Act of Parliament and be exercised or performed subject to the conditions prescribed in terms of that Act.⁹⁹ In practice, the SARB conducts monetary policy within an inflation-targeting framework in terms of which it seeks to maintain the consumer price index inflation within a designated target range. The government lays down the broad outline and essential character of both fiscal and monetary authority (as part of its overall economic policy) and therefore sets the explicit inflation target for the economy. The SARB is entrusted with the authority and independence of action required to operate freely in order to achieve the target. In central bank terms, this qualifies as instrument independence.¹⁰⁰

The role of the Bank in implementing monetary policy and acting both as lender of last resort and the provider of emergency liquidity assistance, provides the Bank with unique insight into the workings of the entire financial sector and the macro-economy. The SARB was therefore regarded as the only institution with appropriate capacity to perform the role of a macro-prudential supervisor and, accordingly, vested by the government with that task.¹⁰¹ However, the uncertain concept of financial stability casts its net widely over the financial sector to include a vast number of players, practices, financial systems, and institutions. Owing to the wide and diverse nature of financial stability, it is evident that the SARB, despite its ultimate responsibility and dominant role in this regard, will need to co-operate at times with other parties to fulfil its role adequately. In practice, proper oversight and regulation of financial stability may often require joint efforts by authorities that go beyond a single entity such as the Bank.¹⁰² In these circumstances, it evidently calls for the design of a co-ordination mechanism to derive synergies between macro-prudential, micro-

⁹⁹ Sections 224(2) and 225 of the Constitution. See also Bernard Bekink & Christo Botha 'The role of a modern central bank in managing consumer bankruptcies and corporate failures: A South African public-law angle of incidence' (2009) 21 *SA Merc LJ* 74 at 78.

¹⁰⁰ Johann de Jager 'The South African Reserve Bank: An evaluation of the origin, evolution and status of a central bank (part 2)' (2006) 18 *SA Merc LJ* 274 at 284.

¹⁰¹ National Treasury of the Republic of South Africa op cit note 60 at 31.

¹⁰² While the mandate of financial stability lies with the SARB, other regulators such as the market conduct regulators and the National Credit Regulator must also take account of the financial stability implications of their activities and assess as well as all systemic risks potentially arising from any institution that they may be supervising: National Treasury of the Republic of South Africa op cit note 60 at 32.

prudential and monetary policy for the purposes of identifying and making effective use of policy tools available to all authorities vested with responsibilities for matters that may affect financial stability.¹⁰³ Moreover, any approach to financial stability needs to acknowledge that ultimate responsibility for quasi-fiscal costs incurred in the resolution of financial institutions vests with the government.¹⁰⁴

As indicated before, factors related to the issues mentioned above could potentially impair the independence of a central bank, especially where the independence of the bank is less secure.¹⁰⁵ In considering the independence of the SARB against this background, it seems practical to distinguish between the monetary policy role of the Bank and its financial stability role. When it involves the conduct of monetary policy by the SARB, the position seems reasonably secure. The Constitution vests the Bank with the authority and independence of action required to conduct its operations independently and without interference within the existing monetary policy framework in pursuit of its primary goal. But when it comes to the financial stability role of the SARB, the position appears less secure. Nevertheless, it seems justified to infer that monetary policy conducted by the Bank within a monetary policy framework that takes more explicit account of financial stability objectives generally ought not to affect the independence of the SARB. In principle, such an approach should not imply any significant modification of the existing monetary policy framework of the Bank.¹⁰⁶ In cases outside the monetary policy framework, where financial stability issues may have to be addressed by the Bank in a joint effort with other authorities, its dominant role is of relevance and not its independence, since efforts of this nature presuppose co-operation and joint decision-making among the affected parties rather than autonomous actions by the SARB. This remains subject to the caveat that where taxpayers' money is at risk, decisions to use fiscal resources must be taken by the Minister.¹⁰⁷

¹⁰³ Shri Deepak Mohanty 'Price stability and financial stability: An emerging market perspective' (2012) 4, address as Executive Director of the Reserve Bank of India, at the 2012 Central Bank of Nigeria Board Retreat, Cape Town, on 27 June 2012, available at <http://www.rbi.org.in/scripts/BS-SpeechesView.aspx?id=697>, accessed on 12 March 2013.

¹⁰⁴ Nier op cit note 59 at 5.

¹⁰⁵ Idem at 17. See also para III(d)(iii) supra.

¹⁰⁶ It is necessary that monetary policy take full account of its impact on the risk-taking behaviour of the various economic agents. In addition, greater importance should be attributed to analysis of the formation of financial imbalances. That is not at odds with the priority of the price-stability mandate, because the crisis clearly indicated that risks to financial stability in the longer term also imply risks to price stability: Aucremanne & Ide op cit note 98 at 1.

¹⁰⁷ Financial Regulatory Steering Committee op cit note 80 at 11.

In so far as it may be argued that the involvement of the Minister (especially in cases where preventative and remedial measures are involved after a crisis) may potentially impair the independence of the SARB from the government, the position has not really changed. As evidenced by the global financial crisis, the potential for a crisis of that nature to undermine the independence of a central bank may be strong, irrespective of whether the central bank is accorded a formal role in financial stability. Moreover, even the mere involvement of a central bank in providing remedial measures to a bank in terms of the lender of last resort concept (which normally involves quasi-fiscal costs) renders the bank susceptible to government influence.¹⁰⁸

The current consensus among policymakers and practitioners with regard to the role and independence of central banks is that the primary responsibility of a central bank is to assure price stability and financial stability. Without prejudice to these objectives, the central bank should support the economic policies of the government. To achieve its main objective, the central bank must be afforded instrument independence.¹⁰⁹ As indicated above, the SARB meets these requirements, and any perceived greater interaction between the government and the Bank on matters concerning financial stability appears unlikely to impede its operational independence in respect of the pursuit of its primary objective.

(iii) Regulatory framework

The SARB is vested with the responsibility of regulating and supervising the South African banking¹¹⁰ and payment systems.¹¹¹ The Office for Banks, functioning as a department in the Bank styled the Bank Supervision Department (BSD), is responsible for the regulation and supervision of banks.¹¹² The Registrar of Banks, designated by the SARB (with the approval of the Minister) from among its employees, functions as the Head of the BSD and performs his or her functions under the

¹⁰⁸ JJ de Jager 'Central bank, lender of last resort assistance: An elusive concept?' (2010) 43 *De Jure* 228 at 241.

¹⁰⁹ A Cukierman 'Central bank independence and monetary policymaking institutions – past, present and future' (2005), a lecture at the Annual Meeting of the Chilean Economic Society, Vina del Mar, Chile as quoted in Davies & Green op cit note 61 at 145.

¹¹⁰ The Banks Act 94 of 1990 provides the structure for the regulation and supervision of banks. Mutual banks registered in terms of the Mutual Banks Act 124 of 1993, and co-operative banks registered in terms of the Co-operative Banks Act 40 of 2007, also fall within the supervisory authority of the SARB.

¹¹¹ The National Payment System Act 78 of 1998 (NPS Act) provides the structure for the regulation and supervision of the payment system.

¹¹² Section 3 of the Banks Act.

control of the SARB.¹¹³ The mission of the BSD is to promote the soundness of the banking system and to contribute to financial stability. It follows a risk-based approach to banking supervision, with due regard to regulatory and supervisory standards issued by international standard-setting bodies such as the Basle Committee on Banking Supervision (BIS) and the Financial Stability Board.¹¹⁴ A department in the SARB, styled the National Payment Systems Department (NPS), is responsible for the monitoring, regulation and supervision of the safety and soundness of the payment, clearing and settlement system applied in the RSA.¹¹⁵ The SARB is assisted and enabled in overseeing the affairs of the NPS by a payment-system management body styled the Payment Association of South Africa (PASA), which is responsible for the organisation, management and regulation of the participation of its members in the NPS.¹¹⁶

As early as September 1992 a need was identified to review the existing regulatory environment, which was loosely modelled on that of the United Kingdom, Australia and Canada, in order to designate a framework most appropriate for the effective financial regulation in the RSA. Before the global financial crisis, regulatory systems diverged considerably. At the time, an important issue was whether there should be a single mega-regulator encompassing all aspects of regulation, or whether different agencies, which might or might not include the central bank, should be responsible for different aspects of regulation and supervision.¹¹⁷ In the aftermath of the global financial crisis, a twin peaks model of regulation appears to be preferred that is said to address the challenges posed by the single integrated regulator whilst retaining that model's benefits.¹¹⁸

The traditional twin peaks model of regulation has only two agencies – a conduct regulator and a systemic risk regulator, the latter integrated

¹¹³ Section 4(1) of the Banks Act. In terms of s 4(2) of the Banks Act, four Deputy Registrars may be designated by the SARB, with the approval of the Minister.

¹¹⁴ SARB *Bank Supervision Annual Report 2011* (2012) 1; De Jager op cit note 100 at 280. On the Bank for International Settlements (BIS), see W G Schulze 'The sources of South African banking law – A twenty-first century perspective (part I)' (2002) 14 *SA Merc LJ* 438 at 441. The Financial Stability Board, an international standard-setting body, is not to be confused with the Financial Services Board, which is a domestic financial services supervisory body.

¹¹⁵ Section 3(2)(c) of the NPS Act, read with s 10(1)(c)(iii) and (iv) of the SARB Act. See F R Malan & J T Pretorius 'The Reserve Bank, banks and clearing houses in South African law: part 2' (2001) 13 *SA Merc LJ* 163 and Vivienne Lawack-Davids 'The legal and regulatory framework of mobile payments in South Africa: A trade-off?' (2012) 24 *SA Merc LJ* 77 at 80.

¹¹⁶ Section 3 of the NPS Act.

¹¹⁷ De Jager op cit note 100 at 280 and National Treasury of the Republic of South Africa op cit note 60 at 28. See also De Jager op cit note 79 at 568.

¹¹⁸ Nier op cit note 59 at 43.

in the central bank. The systemic risk regulator accepts responsibility for prudential regulation of all potentially systemic institutions and oversight of systemically important payment and settlement systems. The business conduct regulator accepts responsibility for the conduct of business regulation across all sectors of financial services (banking, insurance and securities services), including both wholesale (regulation of exchanges) and retail services.¹¹⁹

In the South African context, the prudential regulation peak will fall under the SARB and the market conduct regulation peak under the FSB. The Bank will assume the responsibility for prudential regulation and supervision of regulated financial institutions, such as banks, long-term and short-term insurers. The SARB will also be responsible for maintaining overall financial stability with the assistance of the market conduct regulator and for overseeing systemic risk that may arise from key financial markets infrastructure. The Bank will also be responsible for the provision of emergency liquidity and suitable response to relevant macro-economic developments. The FSB will be transformed into a focused market conduct regulator responsible for protecting consumers of financial services and promoting confidence in the South African financial system. It will be responsible for regulating and supervising the market conduct of the financial services, including banks, insurers, financial advisers, financial intermediaries, investment institutions and the broader financial markets.¹²⁰

The twin peaks model is planned to be implemented in two phases. In the first phase, which is envisaged to run during 2013 and 2014, it is planned that supporting legislation will be developed and tabled in Parliament to enable both the SARB and the FSB to assume their additional responsibilities. Implementation of the twin peaks model will also require the transfer of resources and staff that are currently responsible for prudential regulation in the FSB to the Bank. The second phase is due to be implemented over the next several years, and will consist of the broader harmonisation process of specific financial sector regulatory and supervisory systems and frameworks.¹²¹

¹¹⁹ Ibid. The twin peaks approach recognises the different skill sets required for prudential and market conduct regulation. Prudential regulation is designed to maintain safety, soundness and solvency of funds or financial institutions. Market conduct regulation approaches supervision from the perspective of the behaviour of financial institutions towards customers or in the market. See National Treasury of the Republic of South Africa op cit note 60 at 28.

¹²⁰ Financial Regulatory Steering Committee op cit note 80 at 14.

¹²¹ Idem at 13.

V CONCLUSION

Over time, central banks have learnt that knowledge of prevalent and prospective developments in the economy is usually incomplete. They have therefore constantly evolved in an endeavour to meet the challenges posed by developments (sometimes unforeseen) in their own economies and worldwide. In this vein, the SARB is committed to continuous evolution and change in response to public interest needs and demands related to the economy of the RSA. Previously, actions by shareholders of the Bank indicative of the renunciation of their public interest governance role for the sake of motives of self-interest, the potential future abolition of exchange control, and the possibility of a revised supervisory framework were identified as issues that could give rise to substantial changes to the structure and activities of the Bank. These issues, excluding the perceived abolition of exchange control (which did not materialise), were addressed, or are intended to be addressed by means of legislation.

Risks emanating from private shareholding in the Bank greatly diminished when the Amendment Act was implemented in 2010. The introduction of the concept of associates in respect of shareholders or potential shareholders of the SARB not only prohibits the circumvention of the limits on shareholding by individuals, but also prevents the undue concentration of shares and votes within the control of single persons. The Panel's evaluation process of potential directors is likely to strengthen the effectiveness of the Board by ensuring that shareholders elect only persons who qualify as fit and proper to serve in that capacity. This evaluation process is therefore limited to the evaluation of persons nominated either by the general public, shareholders or serving directors for election to the Board by shareholders, and does not apply to any person appointed by the government. These measures further emphasise the limited role of shareholders in the SARB and largely minimise the threat posed by undue shareholder influence on the operations and activities of the SARB. Moreover, the potential influence of shareholders was further reduced by the addition to the Board of one more director appointed by the government.

In respect of directors of the Bank, the amendments provide more clarity in that the disqualifications of directors as well as their fiduciary duty and duty of care and skill are now addressed in the SARB Act. The level required with regard to these duties in each particular case is limited to a minimum level of care and skill that could reasonably be expected from a director holding the same position in the Bank under the same circumstances. A subjective test will now apply only if the

director in question holds a higher level of skill than the minimum level that may be required in terms of the objective test. This amendment improves on the generally uncertain position at common law in this regard and brings the level of care and skill required from directors into line with the business demands of the SARB.

In the past, the hierarchical power structure of the Bank suggested that the Governors were vested with deconcentrated delegated powers of management only. However, Governors as the executive managers of the SARB exercise a much wider role in the operations of the SARB than mere functionaries who manage the day-to-day business of the entity on behalf and under the control of the Board. This concept of deconcentrated delegated powers on the part of the Governors also did not accord with the prevalent practice in companies. The top management of companies is normally vested with such wide original powers of management that it may rightfully be inferred that management powers have shifted from the board to the managing directors. The Amendment Act changed the archaic power structure of the Bank by limiting the authority of the Board mainly to supervisory (corporate governance) powers and by vesting the Governors with decentralised original powers of management. This clear delineation of powers between the Board and the Governors provides a measure of certainty, more accurately reflects the actual devolution of powers in the Bank, and accords with generally accepted principles of corporate governance.

Objectively viewed, it appears evident that the amendments introduced by the Amendment Act ought to prove beneficial to the future operations of the SARB in all respects, possibly with the exception of the provision that provides for a flexible appointment of Governors. Since Governors may now on reappointment (after having served their initial term of five years) be appointed for a term of less than five years, the change does introduce the risk of this provision being utilised by the government in a manner that may compromise the independence of the SARB.

Despite their continuous evolution, it appeared in the past few decades that a more focused concept of the role and responsibilities of central banks had emerged. This led to the perception that the objective and role of central banks, especially with regard to monetary policy, had been established with reasonable certainty. However, the global financial crisis brought various unsettled issues to the fore and renewed some uncertainties about the shape of central banks' role and objectives. It resulted in considerable efforts worldwide aimed at addressing perceived fundamental weaknesses. As a central bank, the SARB has not escaped

these proverbial winds of change currently blowing over central banks and financial systems worldwide.

A direct consequence of the financial crisis is that the long-foreseen changes to the regulatory and supervisory structures in the RSA will shortly become a reality and that the Bank has now been vested with the implicit responsibility of monitoring macro-economic risks. The twin peaks model of regulation designated as the new model for the RSA, under which the prudential regulator will operate within the Bank and the market conduct regulator will operate within a restructured FSB, may be regarded as a major overhaul of the current fractured system of regulation conducted in this country. Since implementation of the model is currently subject to the promulgation of enabling legislation, it remains to be seen how and with what measure of success this model will operate in practice.

With regard to the SARB's macro-economic responsibility, the position is equally uncertain. An important issue that will need to be addressed is how the pursuit of monetary and macro-prudential policies should be co-ordinated in practice, especially in cases of potential conflict. Under normal circumstances, though, the indications are that where monetary policy is conducted by the Bank within a monetary policy framework that takes more explicit account of financial stability objectives, it should generally not imply any significant modification of the existing monetary policy framework of the Bank. Under these circumstances, the SARB should be able to continue functioning independently.

If financial stability issues are addressed by the Bank outside the monetary policy framework, this development could require a concerted effort with other relevant parties. In practice, especially during times of widespread financial turmoil, it appears evident that the same level of separation and independence from the government afforded to the SARB with regard to its conduct of monetary policy cannot realistically be replicated under such circumstances. Where taxpayers' money is at risk, decisions to use fiscal resources must be taken by the Minister. A co-ordination mechanism to derive synergies between macro-prudential, micro-prudential and monetary policy for the purposes of identifying and making effective use of policy tools available to all authorities vested with responsibilities for matters that may affect financial stability will therefore have to be developed and maintained. Whatever the nature of this mechanism, sound principles of central banking law dictate that an even-handed partnership between the government and the Bank should as far as reasonably possible always form its basis.

The primary responsibility of the SARB is to assure price stability and financial stability. Without prejudice to these objectives, the Bank supports the economic policies of the government. In order to pursue its main objective, the SARB is afforded instrument independence. These concepts accord with internationally recognised principles of central banking, and should be maintained at all times in the interest of the economy and the general public in the RSA. This country will be best served if the proposed new regulatory structure, including any interaction between the government, the Bank and other regulatory authorities, on matters concerning financial stability, takes due consideration of these principles.
