AN ANALYSIS OF THE BASEL ACCORDS AND HOW THEY ARE IMPLEMENTED IN BOTSWANA AND SOUTH AFRICA IN THE RECESSION

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DECLARATION

I declare that this Mini-Dissertation which is hereby submitted for the award of Legum Magister (LL.M) in Trade and Investment at International Development Law Unit, Faculty of Law, University of Pretoria, is my original work and it has not been previously submitted for the award of a degree at this or any other tertiary institution.

TSHEPO E. DIPATANE

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DEDICATION

To my late mom, **Salome B. Dipatane,** a woman who raised me with love and gave me a vision for life.

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Research

The "great recession" has given way to a dizzying array of international agreements aimed at strengthening the prudential oversight and supervision of market participants[1]. As financial markets continue to tumble and as national economies sink deeper into recession it is clear that the meltdown has developed into a global economic crisis.[2] To revive credibility in securities markets, international standard setters are in the process of proposing new standards for executive compensation and the regulation and oversight of credit rating agencies.[3] Meanwhile banking authorities are evaluating new capital adequacy standards for national and multi-national financial institutions in the hope that these standards will bolster institutions' ability to weather future financial crisis.[4] However the soft law nature of financial law remains in contention with its proponents arguing that the informal quality thereof helps spur agreements between countries by limiting the risks of often uncertain costs and benefits accompanying any regulatory standard.[5] On the flipside critics argue that the absence of any formal obligations enables cheap exit from commitments and potential opportunism by countries, as defections carries no reputational risks.[6] These arguments will be traversed in the paper especially when analysing the nature of the Basel Accords in Chapter 4 below.

International financial infrastructure comprise of international standard setting bodies, that is global institutions in which most if not few national authorities meet regularly to coordinate and articulate common financial policy approaches. Two are especially central to international financial regulation; the Group of Twenty Finance Ministers and Central Bank

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[1] C Brummer How international financial law works (and how it doesn't) (2011), Georgetown University Law Journal 257.

[2] n 1 above 257;the 2011 National Treasury Policy Document; "A Safer Financial Sector to serve South Africa Better" 3.

[3] n 2 above 257; Financial Stability Forum, FSF Principles for Sound Compensation Practices (2009), http://www.financialstabilityboard.org/publications/r_0904b.pdf.

[4] n 3 above 258; Rob Davies, Q&A: Basel Committee's Walter outlines Basel II Reform Agenda, Risk.Net (17 June 2009), http://www.risknews.net/public/showPage.html?page=862933 (last accessed 3 December 2011); Basel III which serves as a comprehensive set of reform measures developed by the Basel Committee on Banking Supervision to strengthen the regulation, supervision and risk management of the banking sector.

[5] n 4 above 261.

[6] n 5 above 261.

Governors (G-20) and the newly established Financial Stability Board (FSB).[7] Furthermore, to facilitate global coordination, the Managing Director of the International Monetary Fund (IMF) and the President of the World Bank also participate in G-20 meetings on an ex-officio basis.[8] Alongside, the G-20 are its standard setters. The best known and oldest of the international standard setters is the Basel Committee on Banking Supervision (Basel Committee), a group composed solely of central banks governors and national bank regulators of the G-20 countries, which seeks to improve the quality of banking worldwide by adopting international standards of prudential supervision covering such issues as capital adequacy and consolidated supervision of a bank's cross border supervision.[9]

The focus of this paper will be on Basel Committee's Accords (i.e Basel I, II and III) with marginal reference to other related standards where they are relevant. These Accords are international agreements aimed at strengthening the prudential oversight and supervision of banks. There are two main reasons for this approach. One, banks occupy a vital position in any modern economy.[10] If anything, this has been emphasised by the depth of the recession which gripped much of the rest of the world in 2008/2009. Secondly, the recession was more pronounced in part because the banking industry was in many respects its source, and declining confidence in the stability of these institutions had a major adverse impact on public trust in the financial system as a whole.[11]

There may be many factors to be mentioned for the cause of the recession but a few of these were; a monetary policy of poor interest rates, poor supervision of depository institutions, poor prudential supervision of broker/dealers, the failure of the US Congress to address issues related to Freddy Mae and Freddy Mac, unethical mortgage loan brokers, poor mortgage loan underwriting standards, poor assessment of securitisation by rating agencies, false statements by mortgage borrowers, and poor risk management.[12]

[7] n 6 above 275; Communiqués', G-20, http://www.g20.org/pub_communiques.aspx.last (accessed on 3 December 2011); P.R. Wood; Regulation of international finance, 1st edition, London Sweet & Maxwell (2007) 46.
[8] n 7 above 276.
[9] n 8 above 277;QD Rendon The formal regulatory approach to banking regulation, Journal of International Banking Regulation (2001) 24.
[10] C Proctor The law and practice of international banking (2010) 117; National Treasury Report n 2 above 1
[11] n 10 above 117.
[12] ET Patrikis Patrikis,'Striking changes in US banking supervision and regulation' in Giovanoli, M and Devos, D (eds) (2010) International monetary and financial law: The global crisis, 205.

In South Africa banks are public companies incorporated under the Companies Act and registered under the Banks Act.[13] The main purpose of the Banks Act[14] is to provide for the regulation and supervision of the business of public companies taking deposits from the public.[15] It aims at creating a framework for the regulation of the business of accepting and employing deposits by government, individuals, companies and institutions.[16] The South African Reserve Bank, a central bank of the Republic of South Africa is responsible for bank regulation and supervision in South Africa. The Reserve Bank administers both the Banks Act and the Mutual Banks Act[17] The purpose is to achieve a sound efficient banking system in the interest of depositors of banks and the economy as a whole[18] This function is performed by issuing banking licences to banking institutions, and monitoring their activities in terms of either the Banks Act or the Mutual Banks Act.[19]

Botswana is not a member of the G20 or the Basel Committee and was strongly hit by the 2008/9 recession.[20] The Bank of Botswana (BoB), is responsible for bank regulation and is established in terms of section 3 of the Bank of Botswana Act.[21] The principal objective of BoB is to promote and maintain monetary stability, an efficient payment mechanism and the liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system in Botswana[22]

BoB regulates banks through the Banking Act of Botswana[23] In terms of section 3(1) of the Banking Act of Botswana, no person shall transact banking business in Botswana without a licence issued by the central bank. Sections 13-17 of the Banking Act of Botswana provides for capital structure, financial requirement and limitations for banks operating in Botswana.

South Africa's tight banking regulations have drawn praise for shielding the sector from the worst of the financial crisis that claimed iconic institutions such as Lehman Brothers two years ago. Both countries' compliance with the Basel Accords will be discussed against the

[13] J Moorcroft & LR Raath Banking law and practice (2011) 2-1.
[14] Banks Act 94 of 1990.
[15] MW Jones & HC Schoeman An introduction to South African banking and credit law (2006) 11.
[16] n 15 above 12.
[17] Act 124 of 1993 as amended by the Mutual Banks Amendment Acts of 1994 and 54 0f 1999. In terms of section 19(1) and (2) of that Act a mutual bank formerly a permanent building society, is a juristic person but not a company registered in terms of the Companies Act.
[18] C Wille Principles of financial law (2007) 15.2
[19] n 18 above 152.
[20] CIA: World Factbook (2011): Botswana available on https://www.cia.gov/library/publications/the-world-factbook/geos/bc:html. (accessed on 24 February 2012)
[21] Act 19 of 1996.
[22] Sec 4(1)(a) of the BOB Act.
[23] Act 13 of 1995.

instruments aforesaid and the challenges which they face with a comparative analysis drawn in Botswana.

1.2 Research Question

The purpose of this study is to analyse the evolution and nature of the Basel Accords and how they are implemented in South Africa and Botswana. In analysing the subject matter the study will establish the challenges faced by the two countries in implementing the Accords and suggest measures to be taken to achieve that. The study will further investigate whether the Accords are flawless or whether they are portrayed as a single solution to current and future recessions. This inquiry will be fulfilled by analysing whether the two countries have taken further legislative measures in order to complement the Accords or draw inspiration from some of the principles embodied in the Accords to tailor make their banking laws to their needs. The study notes that South Africa is a member of the Basel Committee and Botswana is not. This observation arouses a need to discuss the benefits associated with membership of the Committee.

1.3 Thesis Statement

The Basel Accords are promulgated by inter-agency forums with ambiguous legal status and the commitments made by the participating regulatory agencies are conditional, non-binding and have no legal effect as a matter of international law. Parties therefore retain flexibilities in managing their own affairs since no legal obligations are assumed and some parties are given opportunity to learn about the impacts of certain policy choices over time. The Accords, although soft in nature, are relied upon by many countries including non-members of the Basel Committee and provide persuasive model standards to be applied by all banks. They are hailed by most to have protected the countries that employ them fully or partially from the negative impacts of the current recession. This study however supports the argument that the predominance of the Accords in banking law does not however imply that they are flawless particularly with regards to their full compliance. The study will therefore point out structural deficiencies of the Accords in the countries of study and demonstrate initiatives that should be taken to complement them in order to create resilience against financial crisis.[24]

[24] C Brummer, Why soft law dominates international finance- and not trade, Georgetown University Journal (2010) 624.

1.4 Significance of Study.

The study draws a comparative research on the measures undertaken by South Africa, a member of the Committee and Botswana as a non-member to implement the Basel Accords. The study will therefore demonstrate how Accords albeit soft in nature are embodied in the countries' national banking legislation and identify the challenges associated with the implementation thereof.

1.5 Literature Review

Many authors[25] have written widely about the international financial standards, the financial crisis, final institutions and the regulation thereof. However there is limited literature on the relevance of these standards to Africa and the need to address impacts thereof within the African context. Most writers almost always discuss the international financial standards within the context of advanced economies.

The 2011 International Monetary Fund Global Financial Stability Report[26] states that financial stability risks have increased substantially and that weaker growth prospects adversely affect both public and private balance sheet and heighten the challenge of coping with heavy debt burdens[27]. The priorities in advanced economies are to address the legacy of the crisis and conclude financial regulatory reforms as soon as possible in order to improve the resilience of the system. Emerging markets must limit the build-up of financial imbalances while laying the foundation of a more robust financial framework.[28] There is constant reference to advanced economies with minimal reference to Africa's developing and least developed economies.

However, the South African Finance Minister Pravin J. Gordhan made the following foreword in the 2011 National Treasury Policy Document;

"While the recession is over, the crisis and the result of the crisis still linger as financial stability is not yet secured internationally. In South Africa, our financial sector successfully weathered the crisis, but a million people still lost their jobs. Recognising the need for coordinated international effort to secure global financial and economic stability, we have

[25] C Brummer, DQ Rendon, PR Wood, above to mention a few.
[26] Executive Summary of the September IMF Global Financial Stability Report, Grappling with Crisis Legacies (2011).
[27] National Treasury Report (2011) n 10 above 3.
[28] n 27 above 3.

committed to important obligations to try and prevent a similar crisis in the future. These commitments are also informed by our own domestic situation.[29]" The Minister makes important remarks that demonstrate how interconnected South Africa is.

This paper will therefore seek to contribute to the literature on the relevance of international banking standards within the South African and Botswana context which may also be the case with other Africa countries.

1.6 Methodology

The study will entail an analysis and investigation into the research question on the implementation of the Basel Accords in South Africa and Botswana and the challenges associated therewith. The research will therefore describe, analyse and critique to material information available on the topic under this study and propose the necessary legal reform in Botswana and possibly South Africa to protect these countries again the impacts of financial crisis.

1.7 Delineation and Limitations of Study

The topic on Basel Accords is a dynamic subject precipitated by the dire need to prevent the international banking sector from the ripple effects of the recessions. Therefore the subject requires updated information in order to safely sustain an argument. It has been stated that the very Accords are soft but technical in nature and seek to provide for today's sophisticated banking products. Technical information will therefore be used throughout the study. The Accords are applied by both members and non-members of the Basel Committee and it is therefore not easy to trace how they lend onto the countries legislation. Further there hasn't been a lot written in the area within the African context. There will be limited material within the African context to unpack the subject matter.

1.8 Outline of Chapters

This study will be organised in six chapters. Chapter 1 will lay the foundation or brief background to the research question, thesis statement, significance of study and delineation of study. Chapter 2 will provide a detailed analysis of Basel I and II by providing an account on the historical background, evolution and achievements and shortcomings thereof. This chapter will therefore look into the pillars that are embodied in the two Accords and how and

[29] n 28 above Foreword.

what precipitated their development with time. Chapter 3 will discuss Basel III, the latest Accords and measures it seeks to introduce in order to address the shortcomings of Basel I and II. It goes without saying that a comparison of the Accords will be traversed in this chapter. Chapter 4 will discuss the soft law nature of the Accords and enforceability thereof. Chapter 5 will zero in by discussing how the Accords are implemented in Botswana and South Africa and the challenges associated therewith. Chapter 6 will be the final chapter and will give a summary of findings, conclusion and recommendations.

Chapter 2

From Nothing to Basel I and II- An Analysis of the Evolution of the Basel Accords

2.1 Introduction

As discussed in Chapter 1 above, the so called agenda setters *viz* the G20 alongside the newly formed FSB (originally christened the Financial Stability Forum) generally implement their broad regulatory agendas through the so called standard setters.[30] Created in 1974 by the G10 central governors, in the aftermath of the Herstatt collapse, the Basel Committee is the oldest, arguably prominent and well known standard setter in banking parlance. It is thus important for purposes of this study to recite how it came about as an organisation with no powers, constitution or even legal existence but to be such a dominant power in banking law.

2.2 Historical Background

As international markets internationalised in the 1970s, it became increasingly clear to banking regulatory authorities and supervisors in different jurisdictions that some form of cooperation will be needed between them in order to supervise the larger banks.[31] A classical incident occurred on the 26 June 1974, when the German *Bundesaufsichtsamt fur das Kreditwesen* withdrew the banking licence of Bankhaus Herstatt, a small bank in Cologne active in the foreign exchange market, and ordered it into liquidation during the banking day, but after the close of the interbank payment system in Germany. Prior to the announcement of Bankhaus Herstatt's closure, several of its counterparties had, through branches and correspondents, paid Deutschmark to Bankhaus Herstatt on that day through the German payment system, against anticipated receipts of US dollars later the same day in New York in respect of maturing and spot forward transactions. Upon the termination of Bankhaus Herstatt's business at 10:30 am New York time (15:30 pm Frankfurt time) on 26 June 1974, Bankhaus Herstatt's correspondent bank suspended outgoing US dollar payments from Bankhaus Herstatt account. This action left Bankhaus Herstatt's counterparty banks exposed for the full value of the Deutschmark deliveries made (credit risk and liquidity risk). Moreover banks which had entered into forward trades with Bankhaus Herstatt not yet due

[30] Brummer n 7 above 257.
[31] S Gleeson International regulation of banking: Basel II: capital and risk requirements (2010) 33; Rendon n 25 above 29.

for settlement lost money in replacing the contracts in the market (replacement risk), while others had deposits with Bankhaus Herstatt (traditional counterparty risk).[32]

The failure of Bankhaus Herstatt was the event which triggered the establishment of an entity for this purpose.[33] Thus towards the end of 1974 the governors of the central banks of the Group of 10 countries plus Luxembourg and Switzerland established the Basle (later Basel) Committee whose objectives was to seek different ways to achieve global financial stability and to promote the adoption of global concerted actions aimed at obtaining financial stability.[34] The Basel Committee was afforded a secretariat by the Bank of International Settlements, which existed to manage payments between central banks and based in Basel, Switzerland. The key point here is that since the Committee was formed by the central bank governors, who at the time were responsible for bank supervision, and therefore could not be given any formal role or status, and remained entirely an informal body.[35] Although therefore lacking any formal or legal authority, the standards which it sets have generally been accepted as appropriate for banks which are active in the cross-border sphere.[36] This discussion will be amplified below in Chapter 4.

2.3 Basel I

Each jurisdiction had different rules for what counted as capital and what requirements should apply to what type of assets and many countries, particularly European countries, operated a system whereby the capital requirements imposed on each individual bank was simply a matter of judgment of each regulator. At the same time banks were increasingly trying to improve on their return on equity by balancing themselves with a wider range of instruments and by reducing the equity proportion of their balance sheet.[37] Thus there was considerable concern among regulators that a race to the bottom could only be averted if the regulatory community established and promulgated a common standard.[38] The result of this initiative was the widely acclaimed Basel Accord of 1988 (Basle I).[39] This standard and the

[32] TF Huertas & RM Lastra 'The perimeter issue: To what extent should *lex specialis* be extended to systematically significant financial institutions? An exit strategy from too big big to fail' in RM Lastra (ed) Cross-border bank insolvency (2011) 277; D Zaring, Informal procedure, hard and soft, in international administration, Chicago Journal of International Law (2005) 696.
[33] Gleeson n 31 above 33; Huertas & Lastra n 32 above 277.
[34] Gleeson n 33 above 33, Proctor ibid 119, Rendon n 31 above 29.
[35] Gleeson n 34 above 33; Brummer n 30 above 273.
[36] Proctor n 10 above 119.
[37] Gleeson n 35 above 34.
[38] n 37 above 34.
[39] n 38 above 34; Brummer n 35 above 257; R McCormick Legal risk in the financial markets (2006) 13.

principles upon which it is founded were embodied in a paper entitled "International Convergence of Capital Measurements and Capital Standards", better known as the Basle Accord on Capital Adequacy.[40] This Accord required banks of member countries to hold a certain amount of capital in their books and set out a simple weighting system for different types of assets, standardised rules as to what should count as capital and set out the basic requirement that banks must maintain an amount of Tier One (broad equity) capital equals to 4 per cent of their risk-weighted asset value, and an amount of Tier One and Tier Two equal to 8 per cent of their risk weighted assets.[41]

The Basel Committee designated Basle I as a simple standard so that it could be applied to many banks in many jurisdictions. It required banks to divide exposure up into a few broad classes reflecting similar types of borrowers. Exposures to the same kind of borrower, such as all exposures to corporate borrowers, were subject to the same capital requirement, regardless of potential differences in the creditworthiness and risk that each individual borrower might pose.[42]

Basle I was initially applied only to internationally active banks in the G10 countries, but quickly became acknowledged as a benchmark measure of a bank's solvency and is believed to have been adopted in some form by over one hundred countries.[43] The Basel Committee supplemented Basle I's original focus on credit risk with the requirements for exposures to market risk in 1996.[44]

It can therefore be summarised that Basel I was the first step or attempt to create a framework of international capital standards for banks. Such a framework has two advantages, viz firstly to impose minimum standards which would help to ensure the stability of the international financial system as whole and secondly to ensure that banks could not secure a competitive advantage as a result of the imposition of softer capital requirements by its own home State.[45]

The imposition of minimum capital requirements requires a consideration of various factors, including;

(i) What constitutes "capital";

[40] Rendon n 34 above 35.
[41] Gleeson n 38 above 34; W W Eubanks, The status of Basel III capital adequacy Accord 1.
[42] Gleeson n 41 above 34.
[43] The World Bank and the IMF's Financial Sector Assessment Handbook*:* (2005), 120.
[44] Gleeson n 42 above 34; Proctor n 34 above 119.
[45] Proctor n 44 above 119.

(ii) What percentage of the bank's risks (assets) should be covered by capital;

(iii) How are the bank assets to be valued in terms of the likelihood of loss or default?[46]

2.5 Shortcoming of Basel I

Basle I is credited with providing stability to the international banking system, both through defining consistent safety and soundness standards and by promoting better coordination among regulators and financial supervisors in participating countries.[47] However, Basle I had the following shortcomings;

2.5.1 Globalisation: As a result of the rapid increases in international trade, investment and financing flows, the limitations imposed by physical borders and geography had less of an effect on the flow of money.

2.5.2 Technological advances: Breath-taking advances in computing speeds, storage capacity, networks and communication enabled advances and changes in virtually every facet of everyday life.

2.5.3 Financial engineering: Increasingly complex financial products are being developed to cater for more detailed and complex needs.[48]

Member countries then developed and issued Basel II because it had become clear to regulators that the methods used to calculate the requirement in Basel I were not sufficiently sensitive in measuring risk exposures.[49]

However it is important to note that although Basel II was arguably presented as a radical reform of capital adequacy rules for international banks, it should be borne in mind that some of the essential principles remain the same. The following specific observations are made;

(i) The rules set out in Basel I as to what constitute a bank's "capital" have not changed in any material way;

[46] n 45 above 119.
[47] Eubanks n 41 above 1.
[48] Proctor n 45 above 119; E Kruger Basel II, introduction and implementation in South Africa, (2005), South African Reserve Bank,3 available at www.sarb.co.za (last accessed 18 April 2012).
[49] Eubanks n 47 above 1, Proctor n 48 above 120.

(ii) The percentage of the bank's risks to be covered by a bank's capital was set at a minimum of 8 per cent under both Basel I and II;

(iii) The key change brought by Basel II is in the calculation and valuation of the assets which are subject to the capital requirement (a process called "risk weighting").[50]

Within the benefit of this background, it is thus important to discuss the revised framework, Basel II.

2.6 Basel II- "International Convergence of Capital Measurements and Capital Standards-A Revised Framework",

Basel II was issued in June 2004 and countries were expected to implement by January 2007, although there was discretion to extend for a year. By 2006, the European Union implemented Basel II in most of its member countries through the Capital Requirement Directive approved in 2005, while the United States of America operated under Basle I.[51] The US federal regulators published the final regulations for implementing Basel II in 1st April 2008, six months into the most severe economic recession in more than 70 years which originated from that country.[52] Therefore Federal regulatory agencies turned their attention to stabilising the economy with the Emergency Economic Stabilisation Act of 2008, and the implementation of its programs, the Troubled Asset Relief Program and the Federal Deposit Insurance Corporation's Temporary Liquid Guarantee Program amongst other government assistance programs to the financial system, including the placing of Fannie Mae and Freddie Mac under the US Treasury's conservatorship.[53] Basel II was therefore not fully implemented in the US.

As stated in paragraph 4 of Basel II introduction, its fundamental objectives in seeking to revise Basel I were:

(i) To develop a framework that would strengthen the soundness and stability of the international banking system;

[50] Proctor n 49 above 120.
[51] Eubanks n 49 above 1; Proctor n 50 above 121.
[52] Eubanks n 51 above 1.
[53] n 52 above 2.

(ii) To maintain sufficient consistency to ensure that capital adequacy would not be a source of competitive inequality among banks; and

(iii) To promote the adoption of stronger risk management practices by the banking industry

This means that banks will need less capital if they can demonstrate that they have in place robust and effective risk management techniques. As explained above these flexibilities were not available under the fairly rigid parameters of Basle I, and the Basel Committee saw this particular change as one of the major benefits of Basel II.[54] By way of an overview, the Basel II framework is based on three key 'Pillars', as follows:

(i) The first pillar, titled "Minimum Capital Adequacy" which sets out the calculation of eligible capital and the quantification of counterparty and other risks which that capital must cover.

(ii) The second pillar which is titled "The Supervisory Review Process" addresses supervision generally and a bank's access to higher grades of review under the internal based approach. The internal based approach involves more sophisticated and capital efficient methods of measuring a bank's customer exposures.

(iii) The third pillar titled "Market Discipline" deals with the requirement for banks to publish information concerning their capital structures and risks that are inherent in their business. This is in a sense a quid pro quo for the greater flexibility afforded to banks under Basel II as a whole.[55]

Basle II deals extensively with capital adequacy but does not really address the problems which occurred from 2007 onwards in the context of the financial crisis namely liquidity problems and the sources of funds used by a bank to run its business.[56] Basel II also depends to a certain extend on credit assessments made by rating agencies or in some cases, made by

[54] Proctor n 51 above 121.
[55] Proctor n 54 above 122.
[56] n 55 above 122 and 136.

the banks internally. Once again the recent event meant that the wisdom of that approach warranted reconsideration.

It is important to discuss the said pillars upon which Basel II is based separately below;

2.6.1 Pillar 1- Eligible Capital

As indicated above the rules relating to the required ratio and ascertainment of eligible capital have not been materially varied from those contained in Basel I. Paragraph 40 of Basel II confirms that the total capital ratio must be not less than 8 per cent, whilst paragraph 41 thereof confirms that, subject to various revisions, the definition of eligible regulatory capital remains as set out in Basel I.[57] But it nevertheless still remain to consider how a bank's eligible capital is calculated.

In this context it is thus helpful to take note of the following points:

(i) For capital adequacy purposes the concept of "capital" is not limited to equity share capital as that expression is generally understood. From a regulatory perspective "capital" is represented by the funds or assets which will be available to meet losses and in the event of liquidation will thus be distributed to creditors before any payment is made to the bank's shareholders.[58]

(ii) In line with this philosophy, Basle I allowed for three 'tiers' capital which could be taken into account in calculating the "eligible regulatory capital" side of the equation.

(iii) Tier One, (or Core) capital must account for at least 5 per cent of the total regulatory capital requirement. Tier One capital consists of (1) permanent share capital, which generally refers to ordinary shares including any share premium account representing any amount received by a bank on an issue of its shares, over and above the nominal value, (2) perpetual non-cumulative preference shares in terms of which the right to a dividend is lost if it cannot be paid in any particular year and the redemption option is exercisable only by the issuer, and (3) innovative Tier One instruments which must exclude any

[57] n 56 above 122.
[58] n 57 above 122.

right for the holder to take any form of insolvency proceedings and must not be required to be taken into account in considering the solvent of issuing institution, in other words, they must share some of the main characteristics of equity share capital.

(iv) Tier Two capital is divided into an upper and lower Tier, and the upper Tier must constitute 50 per cent of the total of Tier Two Capital.

(v) Upper Tier Two capital consists of (1) perpetual cumulative preferential shares , which involves a continuing obligation to meet the dividend payment, in contrast to Tier One‘s non-cumulative preference shares, (2) perpetual subordinate debt and similar securities, (3) revaluation reserves and (3) certain general and surplus provisions.

(vi) Lower Tier Two capital includes (1) fixed term preference shares; (2) long term subordinated debt, and (3) fixed term subordinated securities.

(vii) At this stage of calculation, certain deductions must be made from the total of Tier One and Tier Two capital, including the value of investments in subsidiaries and associates, securitisation positions and the value of any capital instrument issued by other banks or financial institutions.

(viii) Upper Tier Three capital consists of short term subordinated debt which must be included only if (1) it has an original maturity of at least two years, or a two year notice period and (2) payments in respect of the instrument are only permitted if the bank would remain in compliance with its solvency ratio. Tier Three capital is made up of the net interim grading book profit and loss.

(ix) Deductions from the resultant figure includes (1) the excess trading book position, which comprise of the excess of the bank’s net trading book positions in shares or subordinated debt of other banks or financial institutions.[59]

[59] n 58 above 123-124.

The figure resulting from this calculation is the bank's **eligible regulatory capital**. The bank is required to monitor its regulating capital at all times to ensure that it is in compliance with the Pillar One capital requirements[60] In broad terms, it is the figure which must constitute at least **8 per cent** of the bank's risk weighted assets.

Finally it should be appreciated that the eligible regulatory capital figure is not quite as straightforward as paragraphs (i)-(ix) above may seek to suggest. For example, there are various restrictions on the manner in which particular parts of tiers of eligible capital can be used to meet particular requirements. However the above discussion provides a sufficient overview of the elements which make up of the eligible regulatory capital necessary to sustain any argument in this study.[61] It is important to emphasise that the assessment of capital adequacy is a dynamic process under Basel II and the national legislation which has implemented it, with the result that the amount of capital to be attributed to a particular transaction may fluctuate significantly throughout its life.[62] The practical difficulty is that, credit quality deteriorates and more capital has to be ascribed to transactions already on a bank's books. This inevitably reduces a bank's ability to take new business, and thus tends to restrict the ability of banks to provide credit during a recessionary period.[63]

2.6.1.1 Risk-Weighted Assets

In order to provide a for a more sophisticated approach to risk assessment and the calculation of risk weighted assets, Basel II contemplates two main systems for banks viz;

(i) The Standardised Approach, where risk weighting are to a significant extent based on the assessment of External Credit Assessment Institutions such as Moodys, Standard & Poors and Fitch-IBCA whose approach is based on standardised credit risk exposure classes;[64] A bank may nominate more than one institutions to use across its product range, but may not "cherry pick" different ratings for different

[60] n 59 above 124.
[61] The rules of calculation and composition for eligible regulatory capital have been developed by the United Kingdom's Financial Services Authority and found in chapter 2 of the Recast Banking Consolidation Directive that are transposed into General Prudential Source books.
[62] Proctor n 60 above 126.
[63] n 62 above 126.
[64] n 63 above 125; Gleeson n 44 above 82.

purposes.[65] The use of different institution ratings must be consistent. It is a condition for the use of an institution ratings that it takes into account both principal and accrued interest, in other words, it looks at the risk of default on interest as opposed to mere recovery of principal.[66] Once an institution has been recognised by a regulator it is obliged to carry out a mapping process under which the ratings of the institution will be attributed to these credit quality steps.[67]

(ii) The Internal Ratings-Based Approach, where banks can use their own assessment of borrower/counterparty risk provided that they can persuade the the regulator of the quality of their risk management systems.[68] In the United Kingdom the Internal Ratings-Based approach is subject to the prior approval of the Financial Service Authority and such approval will only be forthcoming if the bank's internal system systems for the management and rating of credit risk are sound and implemented with integrity. They must meet certain minimum standards particularly (1) that the bank's rating system must provide for meaningful assessment of obligor/transaction characteristics, (2) the internal rating and default/loss estimates used in the calculation of the capital requirements must play an essential role in the credit approval, capital allocation, and corporate governance of the bank, (3) the bank's rating systems are managed by a credit risk control unit which is appropriately independent and free from undue influence, (4) the bank collects and stores all data necessary to provide effective support for its credit risk process and (5) the rating systems are documented and validated.[69]

A bank using the Internal Rating-Based approach must assign its exposure classes, including claims on governments, institutions, corporates and retail customers.

[65] Gleeson n 62 above 82.
[66] n 65 above 83.
[67] n 66 above 84; Annex 2 of the Basel II Accord sets out a description of the approach to be taken into account in performing the mapping process.
[68] Proctor n 63 above 125, Gleeson n 67 above 126.
[69] Proctor ibid 126; Financial Services Authority prudential source book for banks, building societies and investment firms.

2.6.1.2 Credit Risk Mitigation

Credit risk is the risk that a counterparty will fail to perform its financial obligations fully. It includes the risk of default on a loan or bond obligation, as well as the risk of a guarantor or derivative counterparty failing to meet its obligation. This risk is present to some extent in all businesses including non-financial businesses.[70]In good and bad times banks will inevitably seek to use their capital in the most effective and efficient way and this may enable them to price their transactions more competitively or alternatively allow them to make enhanced profits on individual transactions.[71] It has been noted above that Basle I provided only very limited instances in which the availability of security or guarantees could be taken into account in reducing capital allocation requirements. This is another area in which Basel II has introduced significant reforms. This is perhaps also the area in which lawyers are most likely to be involved, partly because the relevant requirements involve security or guarantees and partly because the capital mitigation effect is only achieved if relevant arrangements are legally robust.[72]

In general credit exposure is managed through a process of imposing exposure limits, to individual borrower, to counterparties and group of connected counterparties, to particular economic sectors, geographical regions and specific products.[73]

Such limits are generally based at least in part on the internal credit grading scale. Banks price credits in such a way to recover all of the embedded costs and compensate them for the risk incurred. However the approach to price credit is by no means always the same as the approach used to assess the exposure of the bank. Finally in general banks assess the profitability of particular business areas by charging the cost of their use of capital by adjusting their apparent profitability to reflect the amount of risk and risk

[70] Gleeson n 69 above 8.
[71] Proctor n 66 above 128; K P Follack, The Basel Committee and EU banking regulation, international monetary and financial law (2010) 189 and 275.
[72] Proctor n 71 above 128; McCormick n 39 above 254.
[73] Gleeson n 70 above 8.

capital which they absorb. Thus a business which generates high margin loans to high-risk borrowers can be compared with a business which generates lower margin loans to higher quality borrowers.[74]

2.6.2 Market Risk

Banks are also required to take account of the market risk in calculating their capital adequacy requirements. This requires banks to ascertain a position risk requirement (PRR) in relation to their trading books positions. In essence, a bank is required to ascribe capital to the risk of loss through fluctuations in interest rates, equities, commodities, foreign currencies and options.[75] In the light of the recession which began in 2007, it was realised that the market risk rules failed to capture some of the key risks in a bank's trading books. The Basel Committee has thus introduced an incremental capital change for un-securitised credit products and new stress testing requirements. The latter stems from the fact that losses from bank trading books have significantly exceeded the minimum capital requirements under the existing market risk under Pillar I.[76]

2.6.3 Operational Risk

The requirement to apply capital to account for operational risk is a new aspect of the capital adequacy regime introduced by Basel II. Operational risk is the risk of loss resulting from the inadequate or failed internal process, people and systems or from external events including legal risk.[77] The key to understanding the operational risk charge is to distinguish between it and Pillar Two charge. The Pillar Two charge is intended to constitute, inter alia an assessment by the regulators of the effectiveness of control system within the bank. The operational risk is intended to be a quantification of the effectiveness of the bank systems.[78] Put simply, Pillar Two assess the risk that the bank will make the wrong commercial decision, and the operational risk charge assesses the risk that the decision will be incompetently executed in such a way as to lose money for the bank.[79] Basel II puts in place a mechanism by which the level of

[74] n 73 above 9.
[75] Proctor n 70 above 133.
[76] n 75 above 133; Revision to the Basel II market Risk Framework: Basel Committee on Banking Supervision, (2009); Guidelines for computing capital for incremental risk in trading book: Basel Committee, (2009).
[77] Gleeson n 74 above 261; Proctor n 76 above 133; McCormick n72 above 254.
[78] Gleeson n 77 above 261.
[79] n 78 above 261.

operational risk that a bank is exposed to should be measured and the two are complementary.[80]

2.7 Pillar Two-Supervisory Review

Pillar Two of Basel II creates a requirement for a supervisory review process, under which national regulators are required to verify the sufficiency of a bank's systems and controls for the measurement and management of its exposures. The supervisory process rests on the following provisions;

(i) An on-going, "Internal Capital Adequacy Assessment" by the bank itself. In the United Kingdom, this requires a continuous review of the bank's financial resources and of risk to which it is exposed, and includes an obligation to conduct periodic stress testing;

(ii) The regulator will review the "Internal Capital Adequacy Assessment" and require adjustment to them if necessary. The regulator may also give guidance to a bank on the level of capital which it believes should be required in the circumstances of a particular bank;

(iii) In the event the bank is unable or is unwilling to bring its capital into line with the regulator's requirement of that subject, then the ultimate sanction is the variation of the banks deposit taking permission to as to compel it to comply.[81]

2.8 Pillar Three -Market Discipline

Basel II introduced transparency requirements under Pillar Three. Banks are required under this pillar to disclose certain details of their internal and technical processes and policies in return of the flexibilities afforded to them by the capital adequacy rules contained in Basel II. In particular banks must publicise;

(i) Its management objectives and policies for each separate category of risk to which the bank is exposed, including details of strategies, processes, reporting and management systems;

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[80] n 79 above 262.
[81] Proctor n 77 above 134.

(ii) Certain accounting details with respect to capital adequacy;

(iii) Details of the calculation of the bank's capital resources;

(iv) Information regulating audit risk, dilution risk, market, and operational risk.[82]

As will be apparent, Pillar Three of Basel II involves a series of disclosure rules but does not involve any use or attribution of the bank's capital resources.

2.9 Concluding Remarks

The Basel Committee notes a move from Basel I to Basel II that it had "…sought to arrive at significantly more risk-sensitive capital requirements that are conceptually sound…" Whilst Basel II records that it has retained the key elements of Basel I in terms of the definition of eligible capital and the key 8 per cent ratio, it reviewed the definition of eligible capital in the longer term.[83] Further changes also provided for a regulatory approach based on banks' internal risk modes, provided that issues about reliability, validation and competitive equality can be met[84].

It is important to note a few general observations about the capital resources rules stated above. First of all, it noted that capital was required to absorb potential losses which may be incurred by the bank. Applying this test, Tier One (core) capital meets the necessary criteria because it is permanent, available to meet losses, ranks for payment after all other debts and liabilities and has no fixed costs, since dividends are only paid out of profits.[85]

In contrast Tier Two capital is not necessarily permanent, and will carry some fixed funding costs, but will usually at least display a medium to long term element.[86]

Tier Three capital is a further rung down the ladder, consisting of debt which, although subordinated, has a relatively short maturity and of trading book profits which will not have been externally verified.[87] The success or failure of Basel II was severely tested during the 2008/9 recession. This will be discussed below.

[82] n 81 above 135.
[83] para 17 of the Introduction, Basel II Accord.
[84] para 18 n 83 above.
[85] Proctor n 82 above 124.
[86] n 85 above 124.
[87] n 86 above 124.

Chapter 3

Basel III- The New Reform

3.1 Introduction

The global financial crisis of 2008/9 revealed very serious shortcomings, not only within the financial markets, but also in the part of the regulatory and supervisory authorities, including at international level. As a consequence, a number of initiatives have been taken to generally reform the International Financial Architecture to try to make it more effective in preventing or mitigating future crisis.[88]

This chapter will seek to interrogate the latest reform of the Basel Accords which are a direct product of the points raised at the G-20 London Summit of April 2009, wherein the Leaders' Statement stated inter *alia* that, the international framework for prudential regulation should be improved by building up capital and liquidity buffers, mitigating pro-cyclicality and risk management of securitisation.[89] As noted above, one of the misfortunes of Basel II was that it was introduced when the world was on the cusp of a major recession, which is seen to be having its origin in the financial markets themselves. As part of an effort to learn the lessons of this disaster and in an effort to buttress capital adequacy, the Basel Committee published a consultative document entitled "Basel III, Strengthening the Resilience of the Banking Sector" that was first promulgated on 17 December 2009 by the Basel Committee at the Bank of International Settlements (BIS) in Basel, Switzerland.[90]

Basel III, and as the full name thereof suggest is a more resilient framework and introduces various reforms based on the shortcomings of its predecessor Basel II. It contains inter *alia* the new formula for defining Capital and Buffers, Risk Coverage, Capital Conservation Buffers, Countercyclical Buffers, and Leverage Ratio. However the reforms cannot all be discussed in detail hereunder.

[88] M Giovanoli 'The international financial architecture' in M Giovanoli & D Devos (eds) International monetary and financial law: The global crisis (2010), 6.

[89] London Summit-Leaders' Statement- The global plan for recovery and reform, 2 April 2009, available at http://www.g20.org (accessed on 24 February 2012).
[90] http://www.bis.org/publ/Basel Committee164.htm (accessed on the 24 February 2012).

3.2 Basel III- Learning from the Crisis, a Slightly Different Approach

It is important to note at the outset that Basel III is a work in progress that is far from completion with a goal to strengthen global capital and liquidity rules in order to promote a more resilient banking sector. The objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spill-over from the financial sector to the real economy.[91] It is the most recent international effort to establish a new capital standard for banks to remedy the regulatory and liquidity failures that resulted in the 2007-2009 global financial crisis. Specifically and like its predecessors, Basel I and II, it is an agreement of capital requirements among member countries' central banks and bank supervisory authorities.

While the Accord has focused on revising and increasing capital standards, it has taken other steps to deal more directly with the reason to have such standards — that is, to do something to minimize systemic risk to the global financial markets. Accordingly, while all the Basel Accords have increased the amount of core capital and common equity that banks must keep on hand against their loans (at least, compared to the pre-Basel requirements in most countries), the committee has taken the opportunity in Basel III to go further. Systemically important financial institutions will receive more attention from regulators in the future under the Basel III Accord[92]

Basel III has also endorsed the addition of countercyclical capital buffers, though that is a matter for regulatory encouragement. It has also ventured into loss-given-default risk estimates, executive compensation strictures, and other tools of modern financial supervision.[93]

As stated above Basel III is an expanded and updated version of Basel II, which is built in a three-pillared framework. The first pillar viz Capital Adequacy, which provides the methodology for calculating the minimum capital requirements for various categories of banks and banking instruments draws the most attention. The central part of Basel III regulatory reform package is to establish the minimum regulatory capital and liquidity

[91] para 1 of the Introduction of Basel III: A global regulatory framework for more resilient banks and banking systems December 2010 (rev June 2011) available on http://www.bis.org/publ/Basel Committee164.htm (accessed on the 24 February 2012). D Zaring Finding Legal Principle in Global Financial Regulation (2012) Virginia University Journal of International Law volume 52 number 3, 696.
[92] Zaring n 91 above 696.
[93] n 92 above 697.

requirements that banks must hold to absorb unexpected losses. It redefines regulatory capital.[94]

These reforms will raise capital requirements for the trading book and complex securitisation exposures, a major source of losses for many internationally active banks. The enhanced treatment introduces a stressed value-at-risk (VaR) capital requirement based on a continuous 12-month period of significant financial stress. In addition, the Committee has introduced higher capital requirements for so-called re-securitisations in both the banking and the trading book. The reforms also raise the standards of the Pillar 2 supervisory review process and strengthen Pillar 3 disclosures. The Pillar 1 and Pillar 3 enhancements must be implemented by the end of 2011; the Pillar 2 standards became effective when they were introduced in July 2009. The Committee is also conducting a fundamental review of the trading book. The work on the fundamental review of the trading book is targeted for completion by year-end 2011.[95]

3.3 A Redefined Capital under Basel III

To raise the quality, consistency and transparency of regulatory capital, the committee determined that Tier 1 capital must consist predominantly of common equity and retained earnings. Under current standards, there are two types of capital counted in meeting the capital adequacy rules under Basel I—core capital and supplementary capital. Tier 1 is core capital and is made up of mainly common shareholders' equity (issued and fully paid), disclosed reserves, most retained earnings, and perpetual non-cumulative preferred stocks. Supplementary or Tier 2 capital consists of subordinated debt, limited-life preferred stocks and loan loss reserves, and goodwill. Banks can hold as little as 2% of common equity to risk-weighted assets. Consequently, banks can display strong Tier 1 capital containing a limited amount of tangible common equity. The financial crisis demonstrated that the resources to cushion against credit losses and write-downs came out of retained earnings, which is a part of a bank's tangible equity base. Under the Basel III framework Tier 1 capital is adjusted to narrow it as close as possible to bank tangible common shares. Goodwill and preferred stocks, as well as other assets, should not be included in the new Tier 1 capital.[96]

Until the 12th September 2010 meeting, the committee had not set the percentage of risk-weighted assets that banks must hold in the form of the new Tier 1 capital. At the meeting,

[94] Eubanks n 53 above 4, Proctor n 87 above135.
[95] para 12, Basel III n 91 above.
[96] Eubanks n 94 above 4;para 14, Basel III n 95 above.

the central bank governors approved a capital requirement policy that would increase the minimum common equity that banks must hold as capital from the current two to four point five per cent (2% to 4.5 %) by 2015. However, instead of just tangible common equity, the central bank governors added mortgage servicing rights (MSRs), deferred tax assets (DTAs), and holdings in other financial institutions (HIOFIs) to be part of Tier 1.[97]

The banks argued that MSRs, which are contractual agreements in which the rights to service existing mortgages can be easily sold to offset unexpected losses, should be considered Tier 1 capital. DTAs, assets that are used to reduce the amount of taxes that a company will pay in a later tax period, were also added to Tier 1 capital. Bankers argued that DTAs are very liquid assets that can be used to offset unexpected losses. Finally, HIOFIs were considered by bankers as equivalent to the bank's own common equities and could be easily sold to offset losses. These three added assets, however, should not exceed in aggregate more than fifteen per cent (15%) of a bank's Tier 1 capital, which limits dilution of the amount of common tangible equity in Tier 1 capital. The total minimum total capital plus capital conservation buffer would be eight per cent (8.0%) on 1st January 2015.[98]

Between 1st January 2016, and 1st January 2019, there would be a two point five per cent (2.5%) increase in the minimum total capital and conservation buffer at a rate of zero point six two five per cent (0.625%) per year, which would total ten point five per cent (10.5%) on 1st January 2019. Almost sixty per cent (60%) of the minimum total capital plus conservation buffer would be Tier 1 capital. Tier 1 Capital would consist of common equity capital after adjustments and would be increased to six per cent (6.0%) beginning 1st January 2015.[99]

3.4 Capital Conservation Buffer- A New Initiative under Basel III

At the onset of the financial crisis, a number of banks continued to make large distributions in the form of dividends, share buy backs and generous compensation payments even though their individual financial condition and the outlook for the sector were deteriorating. Much of this activity was driven by a collective action problem, where reductions in distributions were perceived as sending a signal of weakness. However, these actions made individual banks and the sector as a whole less resilient. Many banks soon returned to profitability but did not

[97] Eubanks n 96 above 4; paras 16-17, Basel III n 96 above.
[98] Eubanks n 97 above 4
[99] Eubanks n 98 above 4 & 9; Basel III Minimum Capital Requirements and Phase in Arrangements, Basel Committee on Banking Supervision, Group of Governors and Heads of Supervision Announcement of Higher Global Minimum Standard, September 2010 available on www.bis.org. (accessed on 24 February 2012)

do enough to rebuild their capital buffers to support new lending activity. Taken together, this dynamic has increased the pro-cyclicality of the system.[100]

To ensure that banks build up capital buffers outside periods of financial stress that can be drawn down when losses are incurred, the Committee established capital conservation buffer that banks must maintain. Efforts should be made to rebuild buffers the more they have been depleted. Therefore, in the absence of raising capital in the private sector, the share of earnings retained by banks for the purpose of rebuilding their capital buffers should increase the nearer their actual capital levels are to the minimum capital requirement.[101]

The framework reduces the discretion of banks which have depleted their capital buffers to further reduce them through generous distributions of earnings. In doing so, the framework will strengthen their ability to withstand adverse environments. Implementation of the framework through internationally agreed capital conservation rules will help increase sector resilience both going into a downturn, and provide the mechanism for rebuilding capital during the early stages of economic recovery. Retaining a greater proportion of earnings during a downturn will help ensure that capital remains available to support the on-going business operations of banks through the period of stress. In this way the framework should help reduce pro-cyclicality[102]

3.5 Countercyclical Capital Buffer- A New Initiative

One of the most destabilising elements of the crisis has been the pro-cyclical amplification of financial shocks throughout the banking system, financial markets and the broader economy. The tendency of market participants to behave in a pro-cyclical manner has been amplified through a variety of channels, including through accounting standards for both mark-to-market assets and held-to-maturity loans, margining practices, and through the build- up and release of leverage among financial institutions, firms, and consumers. The Basel Committee is introducing a number of measures to make banks more resilient to such pro-cyclical dynamics. These measures will help ensure that the banking sector serves as a shock absorber, instead of a transmitter of risk to the financial system and broader economy.[103]

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[100] para 27, Basel III n 97 above.
[101] para 125, n 100 above.
[102] para 128, n 101 above.
[103] para 18, n 102 above.

Pro-cyclicality means that banks are able to disproportionately expand lending when economic activity is expanding and disproportionately contract lending when economic activity is contracting. During economic expansions, lending is less risky and the Basel framework would recommend less need for capital. In economic contractions when lending tends to be more risky, the framework would recommend higher levels of capital, slowing or possible preventing banks from lending.

The countercyclical buffer therefore aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate. The countercyclical buffer regime consists of the following elements:

(a) National authorities will monitor credit growth and other indicators that may signal a build-up of system-wide risk and make assessments of whether credit growth is excessive and is leading to the build-up of system-wide risk. Based on this assessment they will put in place a countercyclical buffer requirement when circumstances warrant. This requirement will be released when system-wide risk crystallises or dissipates.

(b) Internationally active banks will look at the geographic location of their private sector credit exposures and calculate their bank specific countercyclical capital buffer requirement as a weighted average of the requirements that are being applied in jurisdictions to which they have credit exposures.

(c) The countercyclical buffer requirement to which a bank is subject will extend the size of the capital conservation buffer. Banks will be subject to restrictions on distributions if they do not meet the requirement.[104]

The Basel accords' pro-cyclicality also works against monetary policy. Monetary policy tries to ease credit and expand lending to reverse a contraction, or to tighten credit and slow lending when the economy is over heated and likely to become inflationary. Pro-cyclicality, in other words, has a destabilizing tendency on the economy.[105]

On the 12th September 2010, the central bank governors approved a policy on counter-cyclical buffers that essentially left it up to the national regulatory authorities to determine when excess credit growth poses a risk to the stability of the financial system. The governors

[104] para 138, n 103 above.
[105] Eubanks n 99 above 5

agreed that the countercyclical buffer should be between zero per cent (0%) and two point five per cent (2.5%) of total risk-weighted assets consisting of common equity or other fully loss absorbing capital. The governors did not set a deadline for meeting this requirement, which would allow national governments to implement the countercyclical buffer according to national economic circumstances. In an economic expansion the buffer would grow and in an economic contraction it would decrease. National governments may also introduce asset-specific countercyclical requirements under financial oversight policy against rapid growth in financial assets during economic expansions. For example, if corporate bonds become increasingly risky, the government could set a higher capital requirement on corporate bonds, which would discourage banks' acquisition of corporate bonds in an economic expansion.[106]

According the Basel III schedule, if national governments require their banks to start adding capital for the countercyclical buffer at the rate of zero point six two five per cent (0.625%) of their risk-weighted assets per year between 1st January 2016, and 13th December 2018, a countercyclical capital buffer of two point five per cent (2.5%) would be on 1st January 2019.

In the mean-time, banks may use their current Tier 1 and Tier 2 or higher capital under Basel II to meet the total minimum capital requirement of eight per cent (8%).

Of importance to discuss with more detail under this frame-framework the main aim of which is to reduce pro-cyclicality and the promotion of countercyclical buffers, are two items viz (1) Excess Credit Growth and (2) Addressing issues of Systemic risk and interconnectedness. The importance of these will be embodied in the discussions thereof.

3.6 Excess Credit Growth

The Basel Committee under this Accord is introducing a regime which will adjust the capital buffer range, established through the capital conservation mechanism outlined in the previous section, when there are signs that credit has grown to excessive levels. The purpose of the countercyclical buffer is to achieve the broader macro-prudential goal of protecting the banking sector in periods of excess aggregate credit growth.[107]

The measures to address pro-cyclicality are designed to complement each other. The initiatives on provisioning focus on strengthening the banking system against expected losses, while the capital measures focus on unexpected losses. Among the capital measures, there is

[106] n 105 above 6
[107] para 30, Basel III n 104 above.

a distinction between addressing the cyclicality of the minimum and building additional buffers above that minimum. Indeed, strong capital buffers above the minimum requirement have proven to be critical, even in the absence of a cyclical minimum.[108]

Finally, the requirement to address excess credit growth is set at zero in normal times and only increases during periods of excessive credit availability. However, even in the absence of a credit bubble, supervisors expect the banking sector to build a buffer above the minimum to protect it against plausibly severe shocks, which could emanate from many sources.[109]

3.7 Addressing Systemic Risk and Interconnectedness

While pro-cyclicality amplified shocks over the time dimension, excessive inter-connectedness among systemically important banks also transmitted shocks across the financial system and economy. Systemically important banks should have loss absorbing capacity beyond the minimum standards and the work on this issue is on-going. The Basel Committee and the Financial Stability Board are developing a well-integrated approach to systemically important financial institutions which could include combinations of capital surcharges, contingent capital and bail-in debt. As part of this effort, the Basel Committee is developing a proposal on a methodology comprising both quantitative and qualitative indicators to assess the systemic importance of financial institutions at a global level. The Committee is also conducting a study of the magnitude of additional loss absorbency that globally systemic financial institutions should have, along with an assessment of the extent of going concern loss absorbency which could be provided by the various proposed instruments. The Committee's analysis has also covered further measures to mitigate the risks or externalities associated with systemic banks, including liquidity surcharges, tighter large exposure restrictions and enhanced supervision. It will continue its work on these issues in the first half of 2011 in accordance with the processes and timelines set out in the Financial Stability Board recommendations.[110]

Several of the capital requirements introduced by the Committee to mitigate the risks arising from firm-level exposures among global financial institutions will also help to address systemic risk and interconnectedness. These include:

[108] para 31, n 107 above.
[109] para 31, n 108 above.
[110] para 32,n 108 above.

- capital incentives for banks to use central counterparties for over-the-counter derivatives;
- higher capital requirements for trading and derivative activities, as well as complex securitisations and off-balance sheet exposures (e.g. structured investment vehicles);
- higher capital requirements for inter-financial sector exposures; and
- the introduction of liquidity requirements that penalise excessive reliance on short term, interbank funding to support longer dated assets.[111]

3.8 A New Liquidity Requirement- A Harmonised Standard under Basel III

Basel III introduced a new global liquidity standard to be internationally harmonized. The committee's standard establishes a minimum liquidity requirement along the lines of the minimum capital requirement of the Basel capital accords. The rapid reversal of the liquidity market in 2008 placed the banking system under severe stress, which required central bank actions to support both the functioning of money markets and individual institutions. The committee developed two minimum standards for funding liquidity. These standards have been developed to achieve two separate but complementary objectives. The first objective is to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high quality liquid resources to survive an acute stress scenario lasting for one month. The Committee developed the Liquidity Coverage Ratio (LCR) to achieve this objective. The second objective is to promote resilience over a longer time horizon by creating additional incentives for a bank to fund its activities with more stable sources of funding on an on-going structural basis. The Net Stable Funding Ratio (NSFR) has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities. [112]

On 12 September 2010, the central bank governors approved the introduction of the liquidity coverage ratio requirement effective in 2015 after an observation period beginning in 2011 and ending in December 2014. In the observation period, the committee plans to put in place

[111] para 33, n 110 above.
[112] para 38, n 111 above; Eubanks n 106 above 6.

rigorous reporting processes to monitor the ratio and continue to review the implications of the liquidity coverage ratio for financial markets, credit extensions and economic growth.[113]

3.9 Introduction of a Global Leverage Ratio

One lesson learned from the financial crisis is that there was a build-up of excessive on-and off balance sheet leverage (undercapitalized lending) in the banking system, even though banks were able to meet their regulatory risk-weighted assets capital requirements. However, it was only when the banks were forced by market conditions to reduce their leverage that the system increased the downward pressure in asset prices. This exacerbated the decline in bank capital and the contraction in available credit. To prevent the excessive deleveraging from happening again, the Basel Committee agreed to introduce a simple, transparent, non-risk based leverage ratio that is calibrated to act as a credible supplementary measure to the risk based capital requirements. The leverage ratio is intended to achieve the following objectives:

- constrain the build-up of leverage in the banking sector, helping to avoid the destabilizing and deleveraging processes which can damage the broader financial system and the economy; and

- reinforce the risk-based requirements with a simple non-risk-based "backstop" measure based on gross exposure based on gross expenditure.[114]

The basis of calculation is the average of the monthly leverage ratio over the quarter based on the definitions of capital (the capital measure)[115] and total exposure (the exposure measure).[116]Promoters of this ratio argue that it is a more objective measure than a risk-weighted ratio because it takes away discretionary supervision from banking regulators. Risk-weighted capital requirements depend on the regulators determining the weights.[117]

On 26 July 2010, the phased-in arrangement was announced by the Basel Committee's group of governors and heads of Supervision. However, the governors did not approve a specific leverage ratio, leaving it up to each member country for its determination. The supervisory monitoring period will begin 1 January 2011, and the parallel run, in which both old and new requirements are operating at the same time to determine the differences, would begin 1

[113] Eubanks n 112 above 6.
[114] paras 151-152, Basel III n 112 above.
[115] paras 154-156, n 114 above.
[116] paras 157-164, n 115 above.
[117] Eubanks n 113 above 7.

January 2013, until 1January 2015. Based on the results of the parallel-run period, adjustment will be made in the first half of 2017 and the minimum leverage ratio will be determined and applied in 1January 2018.[118]

3.10 Withdrawal of Government Capital Injections

As a result of the 2007-2009 financial crisis, many European and American banks are operating with their governments' capital injections. Without this financial assistance, some banks would have failed during the crisis. Even with government capital injections, the troubled-bank list in the United States has now exceeded 800. The governments injected capital into the banks by buying common and preferred stocks of undercapitalized banks. At the Basel III meeting, the central banks' governors agreed to grandfather existing government capital injections into the banking sector by January 1, 2018.[119] Government capital instruments that no longer qualify as non-common equity Tier1 capital or Tier 2 capital will be phased-out over a 10-year period beginning on January 1, 2013. Beginning in 2013, the recognition of these instruments as qualifying capital will be capped at 90% of the nominal amount of such instruments outstanding, with the cap declining by 10% in each subsequent year. This agreement could mean, for some countries, that taxpayers could suffer losses as a result of their government's capital injections in these banks because the amount or the value of the government capital injections would be reduced over time[120]

3.11 Reliance on Rating Agencies

The inflated ratings by rating agencies such as Fitch, Moody's and Standard & Poors helped create the U.S housing bubble by giving mortgage related securities investment grades that they did not deserve, which was a critical determinant of the financial crisis.[121]

In order to address reliance on external credit ratings, the Committee assessed a number of measures to mitigate the reliance on external ratings of the Basel II framework. The measures include requirements for banks to perform their own internal assessments of externally rated securitisation exposures, the elimination of certain "cliff effects" associated with credit risk mitigation practices, and the incorporation of key elements of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies into the Committee's eligibility criteria for the use

[118] Annex 4, Basel III n 116 above; Eubanks n 117 above 7.
[119] Annex 4, Basel III n 118 above.
[120] Eubanks n 118 above 8.
[121] n 120 above 11.

of external ratings in the capital framework. The Committee also is conducting a more fundamental review of the securitisation framework, including its reliance on external ratings.[122]

3.12 Concluding Remarks

In conclusion Basel Committee through the Basel III Accord has proposed that the minimum requirements for core Tier 1 be raised, and that elements of capital that are not available to bear loss, such as deferred tax assets and goodwill, be deducted from Tier 1 Capital. This will strengthen the quality of capital and raise its amount. Both will lower the probability that intervention will be required.[123]

It is also proposed under this framework that banks be required to maintain a buffer of capital above the minimum requirements that will enable the bank to absorb losses without requiring intervention. Although banks can use this buffer, they will not be able to pay dividends, buy back stock or make other distributions unless the bank's capital exceeds the minimum requirement plus the buffer. The buffer will be set as a proportion of the minimum capital requirement and may be scaled up, if the macro-prudential regulator judges that there is a need to constrain credit growth in the economy.[124]

In addition, the Basel Committee will consider a proposition that would require non-core Tier 1 and Tier 2 Capital to be convertible into common equity or be subject to write-down at the point of intervention (determination of non-viability). This will set stage for the reform of resolution as discussed above. Finally, the Basel Committee is proposing to introduce a leverage ratio as a backdrop to the risk-based regime.[125]

The Basel Committee is also proposing to set a global standard for liquidity as there is none currently. This would take two forms; a liquidity coverage ratio that would require banks to hold a buffer of liquid assets sufficient to offset a pre-designated short term liquid stress, and a net stable funding ratio that would require banks to fund the bulk of their assets with liabilities of similar maturity and/or liabilities that are highly likely to roll over at maturity.

[122] para 118, Basel III n 119 above.
[123] Huertas & Lastra n 33 above; Eubanks n 121 above 4.
[124] Huertas & Lastra n 123 above 268; Eubanks n 124 above 5.
[125] Huertas & Lastra n 124 above 268.

Together, the liquidity coverage ratio and net funding ratio would limit for the first time the liquidity risk that banks could assume.[126]

Such capital and liquidity regulation is intended for all banks. Consideration is also being given to requiring that systemic banks hold extra capital and extra liquidity so as to reduce more substantially the probability that such systemic banks would require intervention. The proposal for such systemic surcharges give recognition to the importance of resolution: if a bank is resolvable, the systemic surcharge can resolvable.[127]

[126] n 125 above 269; Eubanks n 124 above 6.
[127] Huertas & Lastra n 126 above 269.

Chapter 4

The Soft Law Nature of the Basel Accords and their Power of Influence on National Banking Legislations (Members and Non-members)

4.1 Introduction

In the wake of what is inaptly called the credit crunch (inapt because the crunch turned into a major crisis) the international financial system has been subjected to intense scrutiny. There have been widespread calls for what are broadly, if not vaguely, called higher standards in the financial service industry, and no doubt the development of the Basel Accord as discussed above serves as proof thereof.[128] These standards, it has been said, are a set of minimum global financial rules aimed essentially at preventing or at least mitigation risk. Since their development is 1975, the standards take the form of recommendations embodying widely accepted principles, practices or guidelines, which have been adopted by most countries through incorporation into national legislation, although the standards themselves as such are not legally binding.[129]

The purpose of this chapter is to analyse the soft law[130] nature of the Basel Accords and explore how same have crystallised onto powerful instruments in influencing reforms in banking law at national level. The chapter will therefore look at how the standards influence and find their way into national legislations, for both members and non-members. This chapter will lay a good foundation to Chapter 5 which will zero-in by specifically discussing how the standards are implemented in Botswana and South Africa. The view will be expressed here that the Accords have played a meaningful role in shaping global financial law and preventing risks associated therewith.

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[128] W Blair 'Standards and the rule of law after the global financial crisis' in M Giovanoli & D Devos (eds) n 88 above 97

[129] n 128 above 5 & 34

[130] Soft law is the expression commonly used to describe codes of conduct, rules, guidance, statements of approved practice, etc that emanate from various agencies, associations, and other institutions and have sufficient authority in the market to influence participants and their advisors' responses to legal and other questions, and, possibly to influence the courts but do not in themselves constitute 'law' (ie do not have the force or status of law, such as statute, regulation or case law-the former being traditionally known in this context as 'hard law'). The terms is also applied to market practice habits that typically originate from accepted interpretations of law or views on best practice which derive from professional bodies and 'committees of the wise' or otherwise become part of the 'folklore' that influences how financial lawyers perceive certain well-known legal issues; McCormick n 77 above 145.

It will however also be argued that the standards themselves are not a panacea. The pre-dominance of the standards in financial law does not imply that it is not flawed. While there is still a problem of lack of implementation by some jurisdictions even within the developed countries, the standards themselves do not provide a complete solution to the current and future financial crisis. This became evident with Basel II which was introduced a few years before the 2008-9 financial crisis and thus failed to prevent same. It is up to global community to aggressively enforce and/or modify the standards to suit their national need in such a way that the crisis may be avoided. This may be done by enacting such legislation, drawing inspiration from the standards and Accords but tailor made to deal with consumer behaviour and regulation of investment products issued by financial institutions at national level.

Whatever the quality of the principles embodied in the standards, they will only be effective to the extent that they are implemented. Thus obviously the proper implementation of the standards which is essentially left to the discretion of the various single jurisdictions is a major issue.[131]

It has been stated that international financial law is in many variables a peculiar instrument of global economic affairs. Professor Brummer observes that unlike international trade and monetary affairs, where global coordination is directed through formal international organisations, international financial law arises through inter-agency institutions with ambiguous legal status.[132] Furthermore the commitments made by regulatory officials participating in such forums are non-binding.[133] It is therefore important in order to understand soft law's value as a coordinating mechanism, to make an institutional assessment on how it works. As stated above, since their formation in 1975 the standards have been largely private and depart from traditional public international law notions of informality and are infact harder than soft law quality suggest.

[131] M Giovanoli International financial architecture in Giovanoli & Devos (n 129 above) 31; Brummer n 24 above 632; Brummer n 39 above 283.
[132] Brummer n 24 above 623.
[133] n 132 above 624; M Giovanoli (n 131 above) 34.

4.2 A Glance on the Intentions of the Founding Members Regarding the Enforceability of the Standards

The central bank governors of the G-10, Luxembourg, and Switzerland declared, via a press release on 12 February 1975,[134] that the primary purpose of the committee would be to provide its members with a regular forum for airing cooperative approaches to the supervision of multinational banks. Since its founding, the committee, pursuant to this mandate, has served both as the venue for the exchange of information about supervisory practices, and as the mechanism for the promulgation of hard standards to which all members of the committee must subscribe.[135]

The Basle Committee's organizational structure is fluid and it acts informally. It rotates its chairmanship and operates through consensus. Although the committee has recently held a number of comment periods for matters related to the revision of its capital accord, it has not subjected itself to open-meeting requirements or submitted its promulgations for review by an international adjudicative tribunal.[136] It has traditionally maintained a low profile. As former committee chairman Huib J. Muller observed, "We don't like publicity. We prefer, I might say, our hidden secret world of the supervisory continent." In fact, the details of the Basle Committee's 1975 founding agreement were not released to the public until over five years after the central bankers adopted it.[137]

Times have changed for the Committee though– to some extent. The Committee now does publicly circulate many of its decisions, as well as research conducted under its aegis, although it has been cagey about detailing its governing instruments.[138]

However, its meetings, which occur four times per year in Basle, remain closed to the public, although the Committee has adopted the practice of issuing ex post brief press releases describing the approximate agenda of these gatherings. It has also announced the opening of comment periods on consultative documents, also by press release, accompanied by a rough schedule for further action.

For example, for the Basel II accord, the Committee had welcomed comments, which it has concluded, "will be helpful to the Committee as it makes the final modifications to its

[134] Press Communiqué of the Bank for International Settlements (Feb. 12, 1975).
[135] Zaring n 92 above 7.
[136] Zaring n 135 above 7
[137] n 136 above 8
[138] n 136 above 8; M Giovanoli n 133 above 29; cf Brummer n 133 above 629.

proposal for a new capital adequacy framework."[139] When issuing statements about the progress of the accord, the Committee has also tended to issue a timetable: for the capital accord.[140]

The use of press releases to announce an organization's purpose and activity is rather far removed from a conventional international legal treaty and accompanying annals of drafting, and it illustrates how far the Basle Committee is from a formally constituted international organization. It has promulgated no by-laws, its founding instrument is sparse, and it has no facilities of its own.[141]

The *Economist* has characterized it as nothing more than an "*international club for banking regulators*." The Committee does not even have its own staff; its secretariat is comprised of twelve professional supervisors on temporary secondment from member banks to the Bank for International Settlements (BIS) – a private bank mostly owned and operated by the central banks of 31 countries, including the Federal Reserve -- in Basle.[142]

Moreover, many of the Basle Committee's promulgations do not look very law-like. In striking comparison to the length of domestic banking regulations, its initial concordat was less than ten pages long, its first capital accord 28 pages long. Promulgations such as its Principles of Banking Supervision are worded un-specifically and flexibly.[143]

The Committee itself avows that it "does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to, have legal force." Instead, it

[139] Zaring n 138 above 8; http://www.bis.org/publ/bcbsca.htm (last accessed on 07 April 2012); http://www.bis.org/press/p010625.htm; "The Committee intends to continue promoting an open dialogue as its work continues and believes that such efforts will help to ensure that the new Accord meets its objectives."). Further and under the Basel III Accord the Committee has received a number of interpretation questions related to the 16 December 2010 publication of the Basel III regulatory frameworks for capital and liquidity and the 13 January 2011 press release on the loss absorbency of capital at the point of non-viability. To help ensure a consistent global implementation of Basel III, the Committee has agreed to periodically review frequently asked questions and publish answers along with any technical elaboration of the rules text and interpretative guidance that may be necessary. In November 2011 the Committee released a document titled "Basel III Counterparty Credit Risk: Frequently Asked Questions" which sets out the first set of frequently asked questions that relate to the counterparty credit risk sections of the Basel III rules text. The questions and answers are grouped according to the relevant paragraphs of the rules text. This publication is available on www.bis.org (accessed on 24 February 2012)
[140] Annex 4 Basel III n 122 above.
[141] Zaring n 139 above 8.
[142] n 141 above 9
[143] n 142 above 9

"reports to the central bank Governors of the Group of Twenty countries and seeks the Governors' endorsement for its major initiatives."[144]

Moreover, in the Basle regime, monitoring noncompliance is a decentralized, largely self-reported task. Neither the BIS nor any other international organization takes on a monitoring role, although the Committee has vowed in the past that it "intends to monitor and review the application of … [its agreements] in the period ahead with a view to achieving ever greater consistency" and now surveys its members on their progress with implementation.[145]

Do, then, the members of the Committee experience the agreements reached therein as binding? The reports of some participants suggest that they do. Former supervisor Charles Freeland claims that "[w]ithout in any way approaching the legal status of a treaty . . . [an] agreement is considered to be binding on its members." BIS supervisor Andrew Crockett similarly concludes that even though Basle Committee recommendations "have no legal force," because "they have been adopted by consensus," they have been "applied in all countries represented on the Committee" and "almost universally applied in non-member countries."[146]

For example, American banking regulators have generally treated the Committee's theoretically voluntary proposals as the basis for quick domestic regulatory action. The banking regulators have quickly adopted rules implementing the Basle Committee's capital accord for American banks and bank holding companies.[147]

In September 1996, U.S. bank regulators issued a final rule based on the Basle Committee's January 1996 amendment to the Basle Accord. That rule required that banks use their own internal models to provide a measure of the institutions' "value at risk," subject to regulatory modelling criteria.[148] Within the European Union the contents of the major international financial standards have been integrated into European directives, the implementation of which is compulsory for the 27 member countries.[149] In South Africa, the financial sector took appropriate and conservative risk management measures at domestic banks. The experience of the small banking crisis in 2002 and the adoption and implementation of the Basel II Capital Accords in 2008 have led to the improved risk management practices and

[144] n 143 above 9
[145] n 144 above 9
[146] n 145 above 10
[147] n 145 above 10
[148] n 147 above 10.
[149] M Giovanoli n 138 above 34.

stronger crisis management arrangement in South Africa.[150] As will be seen in Chapter 4 below by 2009 South Africa had fully implemented the Basel II Accord by 2009 by incorporation of the principle thereof into national legislation.

The widespread implementation of the capital accord has been both acclaimed for its real impact and accused of the usual sorts of inefficiencies laissez-faire aficionados attribute to hard regulations. Andrew Crockett, General Manager of the BIS and Chairman of the Financial Stability Forum, believes that "the absence of significant difficulties in the banking systems of Europe and America in the past couple of years, despite significant economic shocks, owes much to the strengthening of risk management that has taken place under the aegis of the Basle Committee's standards."[151]

Others agree that the Committee has affected banking supervision, but argue that it has done so in insalubrious ways. Hal Scott has contended that the uniform rules of the Accord have been bad for competition. Jonathan Macey similarly believes that the sort of regulatory globalization required by the accord has done little good to the financial markets. Instead, he argues that it is simply a reflection of the inclinations of bureaucrats to maximize power.[152] To what extent these arguments can be sustained will be tested against the impacts that the standards have on the banking laws at national level for both members and non-members and the current development to ensure implementation of the standards which will be discussed below. As stated above the standards are not a solution for all.

4.3 Legal Nature and Characteristics of the Accords

It has been overstated above that the international financial standards have in principle the nature of soft law. This is confirmed by the intentions of the founding members. Indeed, as the various international standard-setting bodies have no legislative power, their

[150] National Treasury Report (2011) n 27 above 14.
[151] Lecture by Andrew Crockett, General Manager of the BIS and Chairman of the Financial Stability Forum, at the Cass Business School, City University, London, 5 February 2003. The speech is available on http://www.bis.org/speeches/sp030205.htm; Zaring n 148 above 11.
[152] Zaring n 151 above 11; Macey argues that efforts to achieve regulatory globalization occur in the following three contexts: (1) in order to permit regulators to act in a cartel-like fashion, so as to prevent regulatory arbitrage, which occurs when firms migrate to foreign jurisdictions to avoid the grasp of a domestic regulator ("regulatory cartelization"); (2) in circumstances where governmental actors or regulators can increase their power by persuading or forcing other countries to adopt regulations favoured by the first country ("regulatory imperialism"); and (3) in circumstances where an administrative agency lacks domestic political support for a favoured policy, and uses regulatory globalization to make it more difficult for local political rivals to block that policy ("regulatory policy lever").JR Macey, Regulatory Globalization as a Response to Regulatory Competition, 52 EMORY L.J. 1353,1353-54
(2003).

recommendations do not have any legal force on their own and in order to become legally binding rules, they need to be incorporated into domestic legislation, regulation and administrative practice by the relevant national legislators of each jurisdiction.[153] The standards are not based on an international treaty and thus, at least in theory, their implementation by national authorities is 'voluntary'.[154] The international financial standards are also not part of international customary law, according to the prevailing view, as there is no consensus on their compulsory nature (*opinio juris*).[155] Symptomatically, the standard-setting bodies themselves (as well as the G20 and the Financial Stability Board) carefully endeavour to avoid any language which might be interpreted as suggesting legally binding character for their activities. The bodies use expressions like "standards" and "codes of conduct", rather than "rules" or "regulations", "ownership" rather than "legitimacy", "implementation" rather than "enforcement" and "concordat" rather than "agreement" or "treaty". Many of them leave their legal status more or less undefined, for instance, the Charter of the FSB, which endeavours to clarify a number of institutional features of that body, states that the instrument 'is not intended to create any legal rights or obligations.[156]

Nevertheless, there is little doubt about the international financial standards' bearing on regulations, codes of conduct, administrative practices –and their relevance for the interpretation of and closing the gaps in legislation-as the standards represent a consensus (and perhaps even a commitment) of supervisors or experts from the jurisdictions of the major financial centres.[157] Professor McCormick argues that soft law can be extremely useful.[158] He submits that it fills the gaps left by the unavoidable uncertainties that are produced from time to time by the common law system and constantly changing market practice which produces a parallel constantly changing list of legal questions requiring answers.[159] It also helps to address the impracticality of expecting every market participant to get its own detailed legal advice, and compare it with advice obtained from other participants , on every issue that may come up for consideration including amendments to market documents that are already extremely complex. It is also part and parcel of the lobbying

[153] M Giovanoli n 149 above 34; Brummer n 138 above 627.
[154] M Giovanoli n 153 above 34; Brummer n 153 above 628; Proctor n 94 above 119.
[155] M Giovanoli n 154 above 34; Brummer n 154 above 628.
[156] M Giovanoli n 155 above 19 & 34; Brummer n 155 above 632.
[157] M Giovanoli 156 above 35.
[158] McCormick n 130 above 146; Giovanoli & Devos n 157 above 35.
[159] McCormick n 158 above 146; Giovani & Devos n 158 above 35; Proctor n 154 above 119.

process and "bridge to the judiciary" that is now recognised as necessary if we are to keep financial law up to date and responsive to legitimate market expectations.[160]

It should also be noted that the financial intermediaries are not directly the addressees of the 'recommendations' contained in the international financial standards, which are rather aimed at national legislators, regulators, and supervisors who are 'invited' to implement them in their respective jurisdictions. Unlike in the case of domestic soft law, there is no threat of legislative intervention in case of non-compliance with the standards.[161]

Generally soft law provides a decisively cheaper means of agreement making and carries what can be thought of as low bargaining costs due to informal status. Perhaps most important, it does not necessarily require extensive participation by heads of state or lengthy ratification procedures. Instead agreements can be entered into between administrative agencies and technocrats, with relatively little interference from outsiders. As a result, the universe of interests becomes more finite, easing negotiation. Parties can also, because of the flexibility afforded by soft law, amend accords relatively easily, so long as agreement among parties exists.[162]

Soft law additionally involves far fewer 'sovereignty costs' or constraints that may limit the ability of a state to follow its own national prerogatives. Sovereignty costs arise, at a most basic level, any time countries are no longer able to follow their national prerogatives. Hard law is, often extremely restrictive, retaliation, reciprocal noncompliance, and reputation act as important disciplines for most countries. Together, or on their own, each of these consequences can affect a country's ability to secure its policy preferences once a treaty is signed. Treaty signatories thus find themselves more constrained with regards to the range of conduct practically available to them and their ability to secure their own policy preferences and welfare.[163]

Where organizations are informal, no delegation of power is made to independent supranational authorities. And because agreements are not legally binding, financial regulators can choose not to adopt certain elements of the international legislation. This of course applies not only to policy suggestions proffered by reports, but also to more prescriptive terms spelled out in instruments laying out best practices. Additionally, even

[160] McCormick n 159 above 146.
[161] M Giovanoli n 159 above 35; Brummer n 156 above 631.
[162] Brummer n 161 above 631.
[163] n 162 above 632.

where they may signal intent to pursue a particular course of action, they may defect from such soft commitments if later circumstances suggest that compliance would not be in the best interests of the signatories. These defections from their commitments will not, international theorists predict, carry reputational consequences insofar as no 'legal' obligations exist. Parties have thus not committed to anything that could harm or erode a state's national reputation. Regulators retain flexibility in managing their own affairs since no legal obligations are assumed and parties are given the opportunity to learn about the impact of certain policy choices over time.[164]

4.4 Current Measures to Enforce the Implementation International Financial Standards

The implementation of financial standards is 'encouraged by a number of initiatives, both formal and market initiatives. Furthermore, the members of the FSB have committed to pursue the maintenance of financial stability to implement the standards and to undergo periodic peer reviews and assessment programmes.[165]

Although discrete monitoring activities are at times carried out by other organizations, two institutions, the IMF and the World Bank have been of traditional importance as global regulatory actors. Although not generally tasked with devising sector-specific standards for finance per se, their missions have evolved over the years to primarily include the monitoring of financial codes and standards. They are also, notably, the only international institutions in the international financial architecture whose founding documents—their respective articles of agreement—are formally recognized hard law.[166] They extend far beyond the range of traditional treaty based intergovernmental institutions to include entities that under traditional analysis are not subjects of international law. Yet many such entities set formal and informal standards to determine practice and expectations in markets and in some cases are incorporated into other sets of standards or supervisory mechanisms or made binding or cognizable by formal agreements or national law.[167]

Surveillance has at least traditionally been executed through the World Bank and IMF, including semi-regular (usually annual or biannual) consultations the IMF undertakes with

[164] n 163 above 632.
[165] M Giovanoli n 161 above 5 & 35; Brummer n 164 above 280.
[166] Brummer n 165 above 280; M Giovanoli n 165 above 17-18
[167] B Kingsbury, Global administrative law in the institutional practice of global regulatory governance in DB Bradlow et al International financial institutions and global governance (2012), 4

each of its members as called for under Article IV of IMF's Articles of Agreement. Increasingly, however, the institutions rely on other vehicles for surveillance.[168] The most important is the Financial Sector Assessment Program, an initiative administered jointly by the IMF and the World Bank. This program is more rigorous than traditional IMF consultations, and undertakes financial sector examinations (or more officially "Financial Sector Assessment Programme-FSAPs") to identify developmental and technical assistance needs of the jurisdiction in question, determine the risks its practices pose to the international system, and help prioritize policy development and coordination efforts with the local regulator. Included in financial sector assessments—where, again, experts from international standard-setting bodies, national supervisory agencies, and central bank authorities examine a country's market stability—are World Bank and IMF Reports on Observance of Standards and Codes ("observance reports" or, more officially, ROSCs), reports that focus on countries' adherence to targeted international codes and principles.[169]

The key standards address issues as diverse as accounting, auditing, anti-money laundering, countering the financing of terrorism, banking supervision, corporate governance, data dissemination, fiscal transparency, insolvency and creditor rights, insurance supervision, monetary and financial policy transparency, payments systems, and securities regulation. In preparing the ROSCs, experts from the World Bank and IMF not only familiarize themselves with the relevant country's laws and regulations, but also participate in several on-site inspections and interview stakeholders such as law firms, government officials, and financial institutions.[170]

These surveillance functions with particular emphasis on the implementation of the international financial standards have been officialised by the G20 and now appear as one of the major missions of the IMF in connection to the global financial system. However, it seems that the ROSCs and the FSAPs are based on the (voluntary) technical assistance provided to the Fund by its members, and not (or only marginally) on Article IV surveillance activities. Could this be a problem for the efficient implementation of the standards in the future? All G20 and FSB members committed themselves to undertake FSAPs and to support the transparent assessment of their national and regulatory systems. Furthermore, the IMF as the overarching institution for macro-financial supervision with universal membership and

[168] Brummer n 166 above 281; M Giovanoli n 166 above 18; DB Bradlow , The reform of the governance of the international financial institutions, a critical assessment in DB Bradlow et al n 167 above 38 and 39
[169] Brummer n 168 above 281; M Giovanoli n 168 above 18.
[170] Brummer n 169 above 281; M Giovanoli n 169 above 18.

macro-economic expertise was invited to take a leading role in drawing lessons from the current crisis, consistent with its mandate and to conduct early warning exercises consistent with the FSB.[171]

It is important to hasten that the IMF, unlike the G20 is not a club of a number of influential countries, but a fully-fledged international organisation within a solid international underpinning and universal membership. For this reason, it is much more representative than any of the 'Gs', although the system of quotas which determines the participation and contribution of member countries on the basis of economic criteria and, even more so, the allocation of quotas have given more rise to some discontent. At the April 2009 London summit, the leaders reached a broad agreement to enhance the representation of emerging-market economies through a revision of quotas.[172] The IMF has increased its member states' basic votes in order to enhance the representation of its smallest and poorest member states in its total votes. It also increased and redistributed the quotas of some of its member states to ensure that formerly underrepresented states are now more appropriately represented in the total votes of the organisation. As a result, a number of the emerging markets now have some of the biggest quotas in the IMF. In addition, the IMF membership agreed to reassess the formula used in assigning quotas (and therefore votes) to its member states so that the counts more accurately reflect the role of its member states in the global financial and economic system.[173]

The membership of the IMF has also agreed to reform the structure of its board of executive directors. In particular it has agreed to appoint a second alternative executive director to support the executive directors who represent large members of states. There will also be a reduction in the European representation on the board and a concomitant increase in the developing country representatives on the board. Finally, the membership has also agreed to move to an all-elected board, thereby eliminating the privileged position that its five largest shareholders held on the board.[174]

[171] M Giovanoli n 170 above 18.
[172] n 171 above18.
[173] D Bradlow n 168 above 41.
[174] n 173 above 41.

The implementation of the standards is further encouraged by a number of market incentives and official incentives the latter of which may take the form of peer pressure, peers assessment, or even black-listing of non-cooperative countries.[175]

4.5 Recent Developments within the Basel Committee and Shortfalls

The Basel Committee has made clear progress in enhancing its legitimacy by expanding its membership in March 2009 to 20 members, with the edition of representatives from Australia, Brazil, China, India, Korea, Mexico, and Russia and in June 2009 to 27 members, with addition of representatives from Argentina, Hong Kong SAR, Indonesia, Saudi Arabia, Singapore, South Africa, and Turkey.[176] It remains to be seen whether the Basel Committee continues to function as efficiently as hitherto in its new larger and less homogenous form.

The Basel Committee is in a similar situation to the FSB as regards its undefined status and its lack of legal personality. Despite its renewed status and adoption of a formal Charter, endorsed at the Pittsburgh summit in September 2009, the FSB as an institution does not have a legal personality under international law (in the absence of a treaty) or under private law (owing to the law of corporate will or of any incorporation or registration) . Until this matter of legal personality is settled and the FSB receives a clear institutional basis, it appears that the FSB cannot act legally in its own name in relation with third parties. It cannot open a bank account, enter into contracts (including employment contracts), sue or be sued for liability. It is unclear how the FSB can ensure its external representation, a difficulty faced by the Basel Committee. Thus the BIS had to represent the Basel Committee for the creation of the Public Interest Oversight Board a foundation established jointly with the IOSCO and the IAIS in charge of overseeing the standard-setting activities of IFAC (which is a private sector body).[177]

Additionally uncertainty results from provisions of Article 16 of the FSB Charter stating *ad verbatim* that ‘This Charter is not intended to create any legal rights and obligations.’ This does not, of course, prevent the FSB from working efficiently and publishing its recommendations and the product of its activities as the consensus of its participants.

[175] M Giovanoli n 172 above 5.
[176] n 175 above 25; Press Release of 13 March 2009 available at http://www.bis.org/press/p090313 and Press Release of 10 June 2009 available at http://www.bis.org/press/p090610 (accessed on 10 April 2012); National Treasury Report n 150 above 11.
[177] M Giovanoli n 176 above 19 & 25.

However, in the long run this is certainly an odd situation and may become a practical handicap for the FSB.[178]

Unlike the FSB, the Basel Committee has not published to date detailed documents on its internal structure and functioning. However the two press releases relating to the broadening of tis membership specify that the 'Basel Committee's governing body will likewise be expanded to include central bank governors and heads of supervision from these new member organisations. Presumably, this enlarged governing body within the expanded Basel Committee will eventually decide on the final adoption of its standards. There is a need for more transparency with regard to the Committee's procedures. More generally, following the expansion of the Basel Committee, there may well be a need for more precise organisational rules and an enhanced infrastructure.[179]

4.6 Conclusion Remarks

The Basel Committee does not have the right to impose its own Accord on others, and has never, at least explicitly, sought to do so. The Accords in their nature are predominantly soft and implementation, it can be argued, is mostly by choice of members and non-members states. Nevertheless, more than 100 countries have implemented the Basel Accord in some form. There are several possible explanations: it is cheaper to pick one off the shelf than to start from scratch; financial markets reward governments and banks in developing countries where a Basel regime is implemented; the international official community (including the Basel Committee and the international financial institutions) encourages them to do so; and financial institutions from countries not complying with Basel standards find it difficult to enter important financial centres such as London and New York. Developing country regulators may feel that they have little choice. If so, the Accord has the status, if not the form, of customary international law, and those designing it bear the responsibilities of international law-makers.[180]

[178] n 177 above 20.
[179] n 178 above 25 & 26.
[180] J Ward The new Basel Accords and developing countries, problems and alternatives (2002), ESRC Centre for Business Research Cambridge University.

Chapter 5

The Adoption, Domestication and Implementation of Basel II and III in South Africa and Botswana-Hurdles and Challenges.

5.1 Introduction

The issue of implementation of the Basel Accords particularly Basel II is a challenge to both developed and developing countries. To complicate matters further, even the US, a country where the 2008/9 global recession originated, has not fully implemented the Accord and has also deviated from the provisions of Basel III. The chapter will discuss how the Basel Accords are implemented in South Africa and Botswana and the challenges met by these countries. South Africa is a member of the Basel Committee having joined in 10 June 2009 and Botswana is not.

5.2 South Africa

5.2.1 Introduction

The financial services sector is at the heart of the South African economy and touches the life of each and every citizen. Financial services allow people to make daily economic transactions, save and preserve wealth to meet future aspirations and retirement needs, and insure against personal disaster and banks in my view play a leading role.

The financial sector in South Africa comprises over R6 trillion in assets, contributing 10.5 per cent of the gross domestic products of the economy annually, employing 3.9 per cent of the employed and contributing at least 15 per cent of corporate income tax. This sector has survived the crisis relatively unscathed, and continued its strong performance of the last decade [181]

5.2.2 Bank Regulation in South Africa

As stated in Chapter 1 above the South African Reserve Bank is responsible for bank regulation and supervision in South Africa. The Reserve Bank achieves this mandate by virtue of the powers conferred on it by the Constitution of the Republic of South Africa[182],

[181] National Treasury Report n 176 above 3.
[182] Act 108 of 1996

the Banks Act, the Mutual Banks Act and any other related Act. Section 225 of the Constitution provides as follows;

> The Powers and functions of the Reserve Bank are those customarily exercised and performed by central banks, which powers and functions must be determined by an Act of Parliament and must be exercised or performed subject to the conditions prescribed in terms of that Act.

Section 10 of the South African Reserve Bank Act gives the Reserves Bank its powers and duties. Of relevance to this study is section 10(1)v which provides as follows;

> The Bank may, subject the provisions of section 13, perform the functions assigned to it by the Banks Act and the Mutual Banks Act.

The focus of this Chapter shall be on the Banks Act particularly on provisions relating to prudential supervision, corporate governance and compliance. Banks in South Africa are public companies incorporated under the Companies Act[183] and Registered under the Banks Act.[184].

The definition of a bank depends on the context in which it is used and different statutes in South Africa define the concept differently.

(i) In terms of section 1 of the Banks Act, a bank means a public company registered as a company in terms of the Act.

(ii) Section 27 of the Civil Proceedings Evidence Act[185] provides that for purposes of Part V of the, ‘bank’ means a banking institution as defined in the Banks Act, 1996, and includes the Land and Agricultural Bank of South Africa.

(iii) In terms of section 1(1) of the Criminal Procedure Act[186], a bank means a bank as defined in the Banks Act and includes the Land and Agricultural Bank of South Africa referred to in section 3 of the Land Bank Act 13 of 1944.

(iv) In the Bills of Exchange Act[187] bank means any “body of persons, whether incorporated or not, that carries on the business of banking, and the definition

[183] Act 71 of 2008 superseded the Companies Act 61 of 1973 on 1 May 2011
[184] Act 94 of 1990; FR Malan, *et al*, South African banking legislation (2009) Juta; Moorcroft & Raath n 13 above 2-1.
[185] Act 25 of 1965.
[186] Act 51 of 1977.
[187] Sec 1 of Act 34 of 1964

includes banks, mutual banks, the Reserve Bank and the Post Office Savings Bank.

Whatever the correct definition may be, it must be noted that section 2 of the Banks Act provides that subject to the provisions of this Act, except where expressly stated otherwise, and in so far as they impose requirements with which any institution may comply with before it may carry on the business of a bank; or in the lawful carrying on of the business of a bank, shall not apply to the Reserve Bank, the Land Bank, the Development bank of Southern Africa, the Corporation for Public Deposits, the Public Investment Commissioners, any mutual bank, a co-operative bank or any other institution or body designated by the Minister of Finance by notice in the Government Gazette.[188]

The business of a bank is defined by in section 1 of the Banks Act with reference to the acceptance or soliciting of deposits from the public and to the utilisation of the money deposited.

5.2.3 The Role Players and Decision Makers

The Minister of Finance assumes overall political control and responsibility of the banking sector. He exercises the powers conferred upon him by the Constitution. He must make decisions but is entitled to rely on the advice of the Registrar of Banks, and it is the Registrar who carries out the administrative functions that precede the implementation of a decision taken by the Minister.[189]

Linking the banks and the Government is an important role player known as the Banking Association of South Africa which is an executive driven body[190] comprising of chief executive officers of local and international banks which is mandated to represent its membership in liaison with the government and other stakeholders, guiding transformation and in research and development of the banking sector.[191] It sees its broad role as being to 'to establish and maintain the best possible platform on which banks can do responsible, competitive and profitable banking.[192]

[188] Malan *et al* n 184 above 1-17; Moorcroft & Raath n 184 above 2-1.
[189] Sec 91 and 92 of the Constitution of South Africa, Act 108 of 1996 read with section 4 of the Banks Act; Moorcroft & Raath n 188 above 2-8.
[190] www.banking.org.za/default.aspx. (accessed on the 18 April 2012)
[191] Moorcroft & Raath n 189 above 13-1.
[192] www.banking.org.za/about_us/overview.aspx. (accessed on the 18 April 2012); Moorcroft & Raath n 191 above 13-1.

5.2.4 Prudential Supervision of Banks in Relation to Basel II and III

The Bank Supervision Department (BSD) of the South African Reserve Bank is the body responsible for prudential supervision of banks. Section 4 of the Banks Act provides these powers to the BSD.

Section 4(4) of the Banks Act states that the Registrar shall implement a supervisory review process. Section 4(6) states in permissive terms that the Registrar may implement such international regulatory or supervisory standards and practices as he or she may deem appropriate after consultation with the banks.

The mission of the BSD is to ensure safety and promote the soundness of the South African banking system through the effective and efficient application of international regulatory and supervisory standards and to contribute to financial stability. In its intermediate endeavour to continuously improve on its supervisory programme and practices the BSD steadfastly models its regulatory and supervisory framework on the Core Principles and the Basel II, Basel 2.5 and Basel III frameworks.[193]

5.2.5 The Implementation of Basel II and Proposed Developments for Implementing Basel III

The BSD through the legal frameworks stated above adopted and implemented Basel II in January 2008 which yielded improved management practices and stronger crisis management within the banking sector.[194] It is important to remark that at the time South Africa was not a member of the Basel Committee having only joined the Basel Committee in June 2009.[195]

A joint report issued by the International Monetary Fund and the World Bank revealed that local banks and insurance firms had remained profitable during the crisis, while their capital adequacy ratios had remained above the regulatory minimum.[196] The report states: 1. banking supervision in South Africa has been effective and has contributed to reducing the impact on the financial sector of the global financial crisis. Throughout the crisis, the banks have remained profitable and capital adequacy ratios have been maintained well above the regulatory minimum. The Registrar of Banks' direct access to the board and the audit

[193] Available at http://www.resbank.co.za/AboutUs/Departments/Pages/BankSupervision.aspx (accessed on the 18 April 2012); National Treasury Report (2011) n 181 above 8.
[194] National Treasury Report (2011) n 193 above 14.
[195] M Giovanoli n 179 above 25; Press Releases n 176 above; National Treasury Report (2011) n 194 above 11.
[196] National Treasury Report (2011) n 195 above 3.

committee, combined with the sound governance requirements for banks, have been effective in raising board awareness of regulatory and supervisory matters and ensuring strong risk management in South African banks.[197] 2. The BSD is to be commended for its early adoption and full implementation of the Basel II framework in an emerging market environment on 1 January 2008, and its continuous efforts to remain in line with subsequent international developments.[198] The systemic risk-add on and the implementation of idiosyncratic capital buffers have contributed to the strength and stability of the South African banking system. The overall implementation of the Basel II advanced approaches has been rigorous and comprehensive.[199]

An Accord Implementation Forum (AIF) consisting of a Steering Committee, on which various stakeholders, including National Treasury, banks, Bank Supervision Department of the South African Reserve Bank and the South African Institute of Chartered Accountants, were represented, and a number of subcommittees, were created to spearhead the Basel II implementation initiative in South Africa.[200]

The following are the main sub-committees:

• **Disclosure Sub-committee**; This sub-committee focused on the disclosure requirements contained in Pillar 3 of Basel II. In addition, the subcommittee developed education programmes.

• **Economic Impact Sub-committee**. This sub-committee addressed the economic impact of Basel II on South Africa.

• **Regulatory Framework Sub-committee**. This sub-committee was responsible for developing a new regulatory framework which incorporates Basel II.

• **Risk Sub-committee**. This sub-committee focused primarily on Pillar 1 of Basel II, but also addressed some of the issues arising from Pillar 2 of Basel II.[201]

The result of the AIF's work was a set of proposed amendments to the Banks Act and the Regulations thereto. These were presented to the Standing Committee on the Revision of the Banks Act. Upon having satisfied itself, the said committee forwarded the proposed

[197] n 196 above 3.
[198] n 197 above 3.
[199] n 198 above 3.
[200] Kruger n 48 above 5.
[201] n 200 above 5.

amendments to the Banks Act to the Minister of Finance, who tabled them in Parliament and were approved.[202]These regulatory reforms have been praised for protecting the sector from the 2008/9 recession that claimed iconic institutions.[203]

However, as with most financial sectors across the world, South Africa has become more globally connected and concentrated potentially exposing the country to significant risks. While South Africa was spared the direct effects of the global financial crisis, the resultant effect has resulted in substantial job losses[204]

South Africa is strongly placed to implement Basel III. Domestic banks are already capitalised above the new levels. Even though South African bank supervision does not call for capital conservation buffers, domestic banks are capitalised in excess of the buffer requirements. The current leverage ratio is far more conservative than the proposed change. Consequently, there is no requirement for South African banks to either raise capital or deleverage.[205]

Domestic banks, however, do not presently meet the new global liquidity standards. Moreover, compliance with the standards will require structural changes to the financial system that allow banks to increase the maturity of their funding and investment managers to increase the horizon of their investments.[206]

In consultation with regulators, National Treasury is examining ways to reduce regulatory asymmetries that hinder banks from meeting these requirements. The first step has been to change aspects of Regulation 28 of the Pension Funds Act to allow banks access to more long-term financing: pension funds will now be allowed to buy long-dated bank debt. In addition, there have been changes to the definition of "cash", which will reduce the incentives for pension funds to hold large amounts of short-term operational funds outside the banking system.[207]

Further steps will be taken, such as ensuring that non-bank products are appropriately regulated given their risk profile, Moreover, as outlined in the Budget Review, work to reform the savings environment to reduce tax distortions is on-going. In addition, banks have

[202] n 201 above 5.
[203] National Treasury Report (2011) n 199 above 14.
[204] n 203 above 4.
[205] n 204 above 17.
[206] n 205 above 18.
[207] n 206 above 18-19.

already begun to take proactive steps to raise the proportion of their funding from retail deposits, a step that will also benefit savers.[208]

To facilitate implementation in South Africa, the Reserve Bank has made proposals to amend the existing regulations to the Banks Act. Three drafts of the proposed amendments to the Regulations were released for comment during 2010.

5.2.6 The South African Banking Legal Framework- A Discussion

The South African banking regulatory framework has been hailed for being resilient to the 2008/9 global meltdown and by successfully adopting and implementing Basel II as discussed above. The following feature of the Banks Act and the Regulations warrant discussion in order to highlight the strong features thereof. However it is submitted that the full implementation of the Basel II alone is not to get all the praise. It will be argued hereunder that complimentary legislative measure we also instrumental in protecting the financial sector.

5.2.6.1 Prudential Requirements for Banks

Section 70 subsections (2), (2A) and (2B) of the Banks Act respectively distinguishes between banks that do not trade in financial instruments, those that do so exclusively and those whose business trade includes trade in financial instruments.[209] These banks are required by these provisions to manage their affairs in such a way that the sum of their primary and secondary capital, their primary and secondary unimpaired reserve funds and their tertiary capital in the Republic were fixed at ten (10) per cent with effect from 1 October 2001.[210]

Banks are also required to hold minimum liquid assets in the Republic and the manner of calculating and determining the amounts of such assets are prescribed in section 72. These liquid assets are not to be encumbered unless the Registrar grants the bank concerned a specific exemption in terms of section 72(3).[211]

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[208] n 207 above 19.
[209] Malan *et al* n 188 above 1-79; Moorcroft & Raath n 192 above 2-19
[210] Moorcroft & Raath n 210 above 2-19; Regulation 38 of the Rules Relating to Banks as promulgated in GN R 3 (GG 30629) of January 2008 which provides for calculation of Capital Adequacy-Directives and Interpretations for completion of monthly return concerning Capital Adequacy
[211] Moorcroft n 211 above 2-19.

It is undesirable for a bank to be exposed to an aggregate amount exceeding ten (10) per cent of such amounts of its capital and reserves as may be prescribed. The permission of the board or of a specially appointed committee to approve large exposures is required for such exposure in terms of section 73(1)(a) of the Banks Act. Additional capital and reserve requirements may be imposed when such exposure in aggregate exceeds 800% of a prescribed amount in terms of section 73(1)(b) of the Act.[212]

In terms of section 73(2) of the Act a bank may not without the prior written approval of the Registrar commit itself to exposure of more than 25% of a prescribed amount to a private sector non-bank person. The Registrar in terms of section 73(2)(c) in granting such approval prescribe additional capital requirements. Exposures of more than 25% to a person other a private-sector non-bank person must be reported to the Registrar in terms of section 73(2)(b).[213]

Failure to comply with sections 70 or 72 above must be reported to the Registrar by the concerned bank, together with the reasons for such failure. The Registrar may immediately take action against the bank concerned or condone its failure and afford it an opportunity to comply.[214] The Registrar may impose a fine, irrespective of whether criminal proceedings are pending or contemplated.[215] Should the bank not pay the fine, the Registrar may by way of civil action recover the amount he considers justified.[216]

A bank is required to furnish the Registrar with returns in order to enable him to determine whether it is complying with the provisions of sections 70 and 72 of the Banks Act and section 10 of the South African Reserve Bank Act and to determine the nature and amounts of the bank's assets, liabilities and contingent liabilities.[217] The bank is also required to submit to the Registrar returns relating to the extent and management of risk exposure in the conduct of its business. [218]

5.2.6.2 Corporate Governance of Banks

The board of directors and executive officers of a bank are required to establish and maintain an adequate and effective process of corporate governance with the objective of achieving a

[212] n 212 above 2-20.
[213] n 213 above2-20.
[214] Section 74(2); Malan *et al* n 210 above 1-85.
[215] Section 91(3); Malan *et al* n 215 above 1-100.
[216] Section 74(3); Malan *et al* n 216 above1-85.
[217] Section 75(1); Malan *et al* n 217 above 1-86.
[218] Section 75(3); Malan *et al* n 218 above 1-86.

bank's strategy and business objectives efficiently, effectively, ethically and equitably within the acceptable risk parameters,[219] and ensuring compliance with all applicable laws and the realisation of listed goals.[220]

The banking regulations[221] recognise that the conduct of a business of a bank entails the management of risks. The bank must put in place comprehensive risk management processes and board approved policies and procedures to address these risks.[222]

The corporate governance process must be consistent with the nature, complexity and risk inherent in the bank's on-balance sheet and off-balance sheet activities and able to respond to changes in the bank's environment and conditions.[223]

The bank's management must ensure that the risks are managed appropriately and this requires them to set capital targets commensurate with the bank's risk profile and control environment, implement robust and effective risk management and internal control process, and develop an appropriate strategy that ensures that the bank maintains adequate capital and an internal capital assessment process that responds to changes in the business cycle.[224]

Management must also conduct "stress tests" to identify events or changes in market conditions that may have an adverse impact on the bank.[225]

5.2.6.3 Compliance Policy of Banks

The establishment of the compliance policy function within the financial institution originated in the promulgation of the Regulations Relating to Banks[226] under section 90 of the Banks Act, particularly in that of regulation 47.[227] The compliance policy deals with all risk compliance, which are procedures implemented by an entity to ensure compliance with relevant statutory, regulatory and supervisory requirements. It consists of two elements namely a regulatory and reputational element.[228]

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219 Sec 60B(1) and (2) of the Banks Act read with section 60B(3); Moorcroft & Raath n 212 above 7-1.
220 Sec 60B(1)(a)-(i); Moorcroft & Raath n 220 above 7-1.
221 Regulations relating to bank, published under GN R3 in GG 30629 of 1 January 2008; Directive D3/09 (5 February 2009) read with Circular C1/11 (7 March 2011).
222 Regulation 39(3), (4) and (5) n 222 above.
223 Regulation 39(2) n 223 above.
224 Regulation 39(6)(a)-(d) of GN R3 in GG 30629 of 1 January 2008 n 224 above.
225 Regulation 39(6)(e) n 225 above; Registrar's Guidance Note G9/08 (24 October 2008) read with Guidance Note G1/11 "Status of previously issued guidance notes" (7 March 2011).
226 Regulation of GN R3 in GG 30629 n 226 above.
227 Moorcroft & Raath n 221 above 10-1.
228 n 228 above 10-1.

A compliance policy should typically cover all institutions in a group and includes joint ventures in which the bank has an interest of 50% or more. Banks should encourage entities in which they own less than 50% of the shares to apply the same of similar requirements.

5.2.6.4 Foreign Institutions

In terms of section 18A(1) of the Banks Act, an institution which has been established in a country other than the Republic and which conducts in such other country a business similar to the business of a bank may, notwithstanding the provisions of section 11(1)[229], with the prior written authorisation of the Registrar and subject to the prescribed conditions and to such further conditions, if any, as the Registrar may determine, conduct in a business of a bank by means of a branch. The prescribed application must be lodged with the Registrar and accompanied by written statement containing prescribed information and the prescribed fee.[230] The Registrar may require the foreign bank to furnish him with additional information or documents or with further information regarding;

(b)…the nature and extent of supervision exercised or to be exercised by the responsible supervisory authority of the foreign institution's country of domicile in respect of-

(i) the proposed branch in the South Africa.

(ii) the foreign institution itself

(iii) any group of institution of which the foreign institution may be part of…[231]

The Registrar must be satisfied that proper supervision will be exercised by the responsible supervisory authority of the foreign institution's country of domicile.[232] He must be satisfied that the institution "conducts business similar to the business of a bank" in a foreign country and that the supervisor in that country has approved the establishment of a branch in South Africa.[233]

The foreign institution and its local branch must ensure as far as reasonably possible that its supervisors adhere to the relevant:

[229] Sec 11(1) of the Banks Act provides that subject to the provisions of sec 18A, no person shall conduct the business of a bank unless such person is a public company and is registered as bank in terms of the Act.
[230] Sec 18A(2) of the Banks Act read with regulation 1(8) of the GN R1 in GG 30627 n 227 above; Moorcroft & Raath n 229 above 6-1.
[231] See section 18A(3)(a) and (b) of the Banks Act read with regulation 1(6) of the GN R1 in GG 30627 n 231 above ; Moorcroft & Raath n 231 above 6-2
[232] Section 18A(5) of the Banks Act; Moorcroft & Raath 232 above 6-2.
[233] Regulation 1(6) of GN R1 in GG 30627 n 232 above.

(i) Core principles to effective banking supervision;

(ii) The minimum standards in respect of consolidated supervision of banking groups and their cross-border establishment;

(iii) Recommendations relating to the cross-border banking, and

(iv) Proposal, guidelines and pronouncement …issued by the Basel Committee[234]

The provisions of the Banks Act applicable to local banks apply also to branches of foreign banks in so as those provisions can *mutantis mutantis* be applied and are not inconsistent "with the context' or clearly inappropriate.[235]

The requirement set forth under this sub-topic applies likewise to representatives of offices of foreign banks subject to slight differences which are not significant for this study.[236]

5.6.7 What Really Protected the South Africa Financial Sector from the Recession-Basel alone or Basel Complemented?

It has been generally submitted under Chapter 4 above that the Accords are themselves are not a panacea. The pre-dominance of the standards in financial law does not imply that it is not flawed and that they provide a complete solution to the current and future financial crisis. South Africa is a classic example. While the full implementation of Basel II is hailed for protecting the banking sector, it cannot get all the credit.

In addition to the full implementation of Basel II in 2008, some of the following policy components protected the country from a financial and subsequent sovereign crisis. The following initiatives equally deserve credit;

5.6.7.1 A sound framework for financial regulation and well-regulated institutions ensured that potential risks were anticipated and appropriate action was taken to mitigate them. South African regulators have generally not followed a light-touch approach. Sustainable credit extension has been possible through effective legislation, such as the National Credit Act 34 of 2005, strong regulatory action, and good risk management systems

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[234] Regulation1(6)(c) of GN R1 in GG30627 n 234 above.
[235] n 235 above.
[236] Sec 34 of the Banks Act.

at banks. The National Credit Act prohibits certain unfair credit and credit-marketing practices and promotes responsible credit granting and use.[237]

5.6.7.2 Limited exposure to foreign assets. The prudential regulation of foreign exposure as applied in the last decade, including limits on the extent of exposure to foreign assets by institutional investors and banks, has helped to limit overall foreign risk.[238]

5.6.7.3 Subsidiary structure and listing requirements. Registered banks have to be subsidiaries of the domestic or foreign parent company, so their assets and liabilities are ring-fenced even when the parent company is in distress. The listing requirement also ensures transparency, rigorous disclosure standards and high standards of corporate governance, forcing banks to satisfy shareholders and stakeholders at all times.[239]

Further it is important to realise that the South African financial system was protected by a much broader set of prudent economic, fiscal and financial sector policies that insulated the economy from the worst of the global shocks. These include:

5.6.7.4 A robust monetary policy framework that is capable of absorbing relatively large external shocks with minimum impact on the domestic economy. The flexible inflation-targeting framework provides a much-needed anchor for monetary policy during times of excessive volatility. Moreover, the flexible exchange rate can lessen the impact of disruptive capital flows. In contrast, Eurozone countries, for example, are locked into a fixed exchange rate with their neighbours. This reduces their ability to manage shocks.[240]

5.6.7.5 Countercyclical monetary policy. Leading into the crisis, rapid growth in credit extension posed a risk to the inflation target. In response, the Reserve Bank gradually raised the repo rate, from 7 per cent in 2005 to 12 per cent by mid-2008. This acted to stem excess credit growth and mitigate the risks of the global surge in financial activity. Then, as the financial crisis unfolded, the Reserve Bank reduced rates rapidly, which cushioned the domestic economy from adverse global conditions.[241]

5.6.7.6 Countercyclical fiscal policy. The crisis led to a substantial fall in domestic tax revenue and the need for increased spending to deal with the worst of the crisis. South

[237] National Treasury Report (2011) n 203 above 13; Wille n 18 above 16; Moorcroft & Raath n 233 above 23-1.
[238] National Treasury Report (2011) n 238 above 14.
[239] n 239 above 14.
[240] n 240 above 14.
[241] n 241 above 14.

Africa‘s strong fiscal position meant the country could respond appropriately. Countries that overspent during the boom years before the crisis have found it extremely difficult to survive the crisis, and face an austere fiscal consolidation process.[242]

5.6.7.7 A proactive approach to dealing with bank credit risks. As credit extension boomed, the Registrar of Banks took proactive steps to reduce potential risks – including the raising of capital adequacy requirements and setting conservative leverage ratios. This placed sensible limits on credit extension.[243]

These measures were taken within the existing legal framework and while some of them may embody Basel II or Basel III principles, e.g. Counter-cyclical measure, the measures also deserve the credit accorded to Basel II implementation and serves as an indication that South Africa is well ahead.

5.3 Botswana

5.3.1 Introduction

Botswana has maintained one of the world's highest economic growth rates since independence in 1966. Diamond mining has fuelled much of the expansion and currently accounts for more than one-third of GDP, 70-80% of export earnings, and about half of the government earnings. However economic growth was negative in 2009, with industrial sector shrinking by 30%, after the global crisis reduced Botswana's demand for diamonds. It was regarded as one of the three SADC countries affected negatively by the 2008/8 recession alongside Seychelles and Zimbabwe. Botswana's heavy reliance on a single luxury export was therefore the critical factor in the sharp economic contraction of 2009.[244] The economy is since recovering with GDP growth in 2010 at 7.2% and an estimated GDP growth of 6.2% in 2011. [245]Botswana maintains a healthy and stable financial sector. Botswana is not a member of the Basel Committee but the majority of Banks (10 commercial banks and one investment bank) if not all, operating in Botswana originate from member jurisdictions.[246] The banking regulatory framework is discussed below;

5.3.2 Banking Regulatory Framework

[242] n 242 above 14.
[243] n 241 above 14.
[244] CIA World Factbook 2011: Botswana n 20 above.
[245] n 245 above.
[246] Directory of Financial Institutions Operating in Botswana prepared by the Bank Supervision Department of Bank of Botswana available on www.bob.co.bw (accessed on 18 May 2012).

Banks in Botswana are regulated by the Bank of Botswana (BoB). The principal objective of the Bank is to promote and maintain monetary stability, an efficient payments mechanism and the liquidity, solvency and proper functioning of a soundly based monetary credit and financial system in Botswana. Pursuant thereto, the Bank's mission is to promote and maintain a safe, stable, sound, efficient and competitive banking system.[247]

Section 4(2) of the Bank of Botswana Act provides that in the attainment of the objectives set out in section 4(1), BoB shall have and may exercise all the powers generally conferred upon a central bank.

Like in South Africa, BoB regulates banks through the Banking Act.[248] Section 3(1) of the Banking Act provides that no person shall transact banking business in Botswana without a valid licence issued by the central Bank.

Bank means a company, incorporated in accordance with the provisions of the Companies Act, which is licensed under the Banking Act to conduct banking business.[249]

Banking business also means the employment of deposits in the making or giving of loans, advances, overdrafts or other similar facilities, and in the making of investments or engagement in other operations authorised by law or under customary banking practice, for the account of, and at the risk of the person or persons accepting such deposits, and includes the discounting of commercial paper, securities and other negotiable instruments, for the purpose of extending loans or other credit facilities.[250]

No applicant shall be granted a licence unless it is incorporated under the Companies Act and limited by share capital, and BoB is satisfied that it is a fit and proper recipient of a banking licence, and complies with such requirements as may be prescribed.[251] Regulation 4[252] states that for the purposes of section 8(1) of the Banking Act, in processing an application, BoB shall require to be satisfied with regard to:

> (*a*) the technical knowledge, integrity, experience, financial condition and history of the applicant;

[247] Section 4(1) of the Bank of Botswana Act 19 of 1996.
[248] Act 13 n 248 above.
[249] Section 2 of the Banking Act.
[250] n 250 above.
[251] Section 8(1) n 251 above.
[252] Banking Regulations of 20th October 1995.

(*b*) the adequacy of its capital;

(*c*) the character of its business, and the experience and qualifications of its management;

(*d*) the convenience and needs of the community and market to be served;

(*e*) the ability and willingness of the applicant to comply with any conditions the Central Bank may impose pursuant to the Act.

5.3.3 Capital Structures and Financial Requirements for Banks in Botswana

Every bank shall maintain paid up unimpaired capital at least equal to such percentage of such bank's total assets as may be prescribed for the purpose.[253]

Capital, in relation to a bank, means the bank owner's equity, and includes-issued and paid-up ordinary shares of the bank; issued and paid-up non-redeemable, non-cumulative preference shares of the bank; such other issued and paid-up preference shares of the bank, or debentures which BoB may approve in accordance with specified conditions; undivided profits, retained income and other reserves which are disclosed in the bank's annual accounts and which are freely available for the purpose of meeting losses; undivided profits, retained income and other reserves which are freely available for meeting losses but which are not disclosed in the bank's financial statements; such percentage of reserves of the bank resulting from the revaluation of certain fixed assets as may be prescribed; and general provisions held against unidentified and unforeseen losses which may arise from the bank's assets.[254]

“Unimpaired" in relation to the capital of a bank means the absence of any legal or technical covenant, term, restriction or encumbrance which would otherwise render such capital not to be freely available for distribution to depositors or other creditors in the event of the liquidation or dissolution of the bank, and the absence of any condition or arrangement which would, in the opinion of the BoB, diminish the value of the whole or any portion of the capital of the bank.[255]

[253] Section 13(1) n 252 above.
[254] Sec 13(3) n 254 above.
[255] Sec 13(4) n 255 above.

BoB shall, from time to time, determine which of the funds identified under subsection (3) shall constitute core capital, and which shall constitute supplementary capital.[256]

The core capital of any bank shall constitute a minimum of fifty percent of the total capital of such bank as determined by BoB. The unimpaired capital and liabilities of any bank shall be of such kinds, and computed in such manner, as may be determined by the BoB.[257] The current percentage is 8%.[258]

The minimum capital required in respect of any bank shall be the greater of such amount as may be prescribed, or such percentage of its assets, or groups of assets, and other risk exposures as may, from time to time, be determined by the Central Bank.[259] Currently, for Commercial and Investment banks - the greater of P5, 000,000 or 8 per cent of the risk weighted assets and other risk weighted exposures of the bank as prescribed in sub-regulation 1.[260]

5.3.4 Liquidity Requirements for Banks in Botswana

Every bank shall maintain in Botswana, on a daily basis, liquid assets in accordance with the requirements of subsection (2), and shall report to BoB in such manner and as often as may be prescribed.[261] Subsection (2) provides that the amount of liquid assets to be maintained by every bank shall, in relation to each such bank, be expressed as such percentage of the bank's deposits and other similar liabilities, as BoB may determine, computed on a basis to be fixed, from time to time, by BoB.

In terms of the Act liquid assets mean freely transferable assets, unencumbered by any charge or lien whatsoever, including Treasury bills and other securities issued by the Government or the BoB itself and maturing within 370 days, negotiable instruments of such types as the Central Bank may approve and payable within a period of 184 days, and generally such other assets as BoB may, from time to time, approve.[262]

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256 Sec 13(5) n 256 above.
257 Sec 13(6) and(7) n 257 above.
258 Regulation 7(1) of the Banking Regulations (1995)
259 Sec 13(9) n 258 above
260 Regulation 7(3)(a)&(c) n 259 above.
261 Sec 16(1) n 260 above read with regulation 8 n 261 above.
262 Sec 16(5) n 262 above.

5.3.5 Implementation of Basel II and Proposed Basel III in Botswana, A Cautious Approach

As indicated above Botswana is not a member of the Basel Committee. However all commercial banks operating in Botswana are foreign, with the majority, if not all originating from the Basel Committee members.[263] Botswana has not implemented Basel II or any parts thereof and this is the case with most African countries. Drawing on a 2008 Financial Stability Institute Survey[264] this study discerns that most Low Income Countries (LICs) in Africa, like Botswana are adopting a very cautious approach towards Basel II. Their intentions are first to understand better how Basel II works and to have a better grasp of their possible implications, in order to be able to adopt an informed decision on the issue. It is a 'better wait' approach. Furthermore, several LIC countries feel that they have previous tasks to complete within Basel I or more generally within banking regulations before they tackle Basel II.[265]

Botswana adopted Basel I in 1994 and this later saw the adoption of the Banking Act and Regulations in 1995 which contain some features of Basel I.[266] According to Mr Motsomi, Director of Banking Supervision at BoB, the Bank intends to implement Basel II and III in the next two years.[267] Without detailing why Botswana has not implemented Basel II since its introduction in 2004, Motsomi describes the Accords as *de facto* minimum international standards for regulation of capital to which Botswana subscribes. He states that the adoption of these standards by a non-member is a matter of discretion. He however notes that the IMF and the World Bank, to which Botswana is a member expects member countries to comply with the best international regulatory standards.[268]The IMF and Basel Committee say they share the caution by LICs and do not intend to push them to adopt Basel II. However, there seems to be pressure from international consulting firms, rating agencies and others for countries to adopt Basel II.[269]

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[263] Directory of Financial Institutions n 247 above; R Gottschalk Basel II implementation in developing countries and effects on SME development,(2007) Institute of Development Studies, University of Sussex 4.
[264]2008 FSI Survey on the Implementation of the new capital adequacy framework in non-Basel Committee member countries, 10, available www.bis.org (accessed on 18 April 2012)
[265] Gottschalk n 264 above 3; Ward n 180 above 5.
[266] Bank of Botswana correspondence by Mr Andrew M. Motsomi, Director of Banking Supervision, dated 15 May 2012, referenced BSD 1/1/94 II (SK) addressed to Professor Danny B. Bradlow.
[267] BoB correspondence n 267 above.
[268] BoB correspondence n 268 above.
[269] Gottschalk n 266 above 3.

In an attempt to implement Basel II and possibly Basel III, BoB has been in consultation with the banking industry since 2007, which resulted in the circulation of a consultative paper in 2011 on the proposed implementation.[270] According to Mr Motsomi, the paper is confidential, and we are yet to see the results thereof.

Mr Motsomi states that the Botswana banking sector comprises of foreign banks and domestic statutory banks. He submits that the subsidiaries of foreign banks tend to use Group policies which embody Basel Accords principles, in the domestic market. He further submits that BoB position in relation to these policies are that they must be customised or adapted to the local environment and that for purposes of implementation of Basel II, all banks will adopt local regulatory reporting approaches that have been approved by BoB and not what is imposed at Group level.[271]

5.4 Concluding Remarks

South Africa has fully implemented Basel II and is better placed to implement Basel III. However an argument has been made in this Chapter that while the implementation of Basel II has assisted in protecting South Africa's financial sector from the negative effects of the 2008/9 recession, the Accords are not a panacea and should not be given all the credit. South Africa in addition to implementing Basel II has taken other initiatives which equally deserve some credit. These includes maintaining a sound framework for financial regulation and well regulated banks with limited exposure to foreign assets, a robust monetary policy, countercyclical fiscal policy, and a proactive approach to dealing with bank credit risks.

On the other hand, Botswana only implemented Basel I and still pondering on implementing Basel II and possibly Basel III. The country just like other LICs' cautious attitude reflects their awareness about the complexities that Basel II involves, and their lack of human and financial resources to deal with these complexities. Whilst banks in Botswana are capitalised at the current Basel II 8% ratio the country was hard hit by the recession and the financial regulatory framework still faces major challenges. The challenges comprise the need to build long and reliable data bases to run sophisticated risk assessment models, and to build supervisors' capacity to assess, validate and monitor the use of such models.[272]

[270] BoB correspondence n 269 above.
[271] BoB correspondence n 269 above.
[272] Gottschalk n 270 above 3; Ward n 266 above 5.

Chapter 6

Concluding Thoughts

6.1 Summary of findings

A historical development of the Basel Accords has been unpacked above. It has been submitted that these Accords provide a framework for determining the minimum capital financial institutions must hold as a cushion against losses and insolvency. Without financial institutions holding this minimum amount of capital, banking regulators would not permit banking organisations to conduct normal banking business.

The Accords evolved from Basel I to Basel II since 1979 with a view to arrive at significantly more risk-sensitive capital requirements that are conceptually sound. Whilst Basel II retained the key elements of Basel I, it reviewed the definition of eligible capital in the longer term.[273] Further changes also provided for a regulatory approach based on banks' internal risk modes, based on reliability, validation and competitive equality[274].

The success or failure of Basel II was severely tested during the 2008/9 recession. It has been submitted that while the Basel II has assisted in maintaining stability in the banking sector, it has failed to weather the effects of the 2008/9 recession. This resulted in the adoption of the Basel III Accord which provides for more resilient measures. Basel III which will be implemented extensively beginning 2013 proposes that the minimum requirements for core Tier 1 be raised, and that elements of capital that are not available to bear loss be deducted from Tier 1 Capital. This will strengthen the quality of capital and raise its amount. Both will lower the probability that intervention will be required.[275] This framework also proposes that banks be required to maintain a buffer of capital above the minimum requirements that will enable the bank to absorb losses without requiring intervention. The buffer will be set as a proportion of the minimum capital requirement and may be scaled up if there is a need to constrain credit growth in the economy.[276]

Basel III is also proposing to set a global standard for liquidity as there is none currently. Together, the liquidity coverage ratio and net funding ratio would limit for the first time the

[273] para 17 Introduction, Basel II n 264 above.
[274] Para 18 n 274 above.
[275]Huertas & Lastra n 127 above 268; Eubanks n 126 above 4.
[276] Huertas & Lastra n above 268; Eubanks n 276 above 5.

liquidity risk that banks could assume.[277]Such capital and liquidity regulation is intended for all banks. Consideration is also being given requiring that systemic banks hold extra capital and extra liquidity so as to reduce more substantially the probability that such systemic banks would require intervention.[278]

It has further been submitted that the Basel Accords in their nature are predominantly soft and implementation, it can be argued, is mostly by choice of members and non-members states. The Basel Committee does not have the right to impose its own Accord on others, and has never, at least explicitly, sought to do so. Nevertheless, many countries have implemented the Basel Accord in some form. Several possible explanations have been given: it is cheaper to pick one off the shelf than to start from scratch; financial markets reward governments and banks in developing countries where a Basel regime is implemented; the international official community encourages them to do so; and financial institutions from countries not complying with Basel standards find it difficult to enter important financial centres. Developing country regulators may feel that they have little choice. If so, the Accord has the status, if not the form, of customary international law, and those designing it bear the responsibilities of international law-makers.[279]

South Africa has fully implemented Basel II by January 2008 and is better placed to implement Basel III. South Africa joined the Basel Committee in June 2009 and participates therein through the BSD. However an argument has been made that while the implementation of Basel II has assisted in protecting South Africa's financial sector from the negative effects of the 2008/9 recession, the Accords are not a panacea and should not be given all the credit. South Africa in addition to implementing Basel II has taken other initiatives which equally deserve some credit.

On the other hand, Botswana only implemented Basel I and still pondering on implementing Basel II and possibly Basel III. Botswana is not a member of the Basel Committee. The country just like other LICs' cautious attitude reflects their awareness about the complexities that Basel II involves, and their lack of human and financial resources to deal with these complexities. The challenges comprise the need to build long and reliable data bases to run

[277] Huertas & Lastra n 277 above 269; Eubanks n 277 above 6.
[278]Huertas & Lastra n 278 above 269.
[279] Ward n 273 above 5.

sophisticated risk assessment models, and to build supervisors' capacity to assess, validate and monitor the use of such models.[280]

6.2 Conclusion and Recommendations

It is therefore advisable that Botwana proceed cautiously in implementing Basel II and possibly III. With political support capacity should be built first and BoB should not rush to implement the more complex approaches, which are favoured by the international banks.

BoB also need to carefully assess the broader implications of Basel II, not just for banking stability, but also for credit policy (which have implications for macro stability and growth), and to fully assess implications of unregulated access to credit which may be achieved by adopting robust legislative measure in order to ease credit burden.[281] Furthermore, issues of impact of bank regulation on competitiveness of national versus international banks and their effects on the economy, as well as financial stability need to be carefully assessed.

In order to appreciate the complexities of the Basel Accords and to fully implement same, Botswana needed a high level of technical assistance. Admittedly there is little assistance by the standard setters and the non-membership of Botswana to the Committee gives the country less interactions with adequate information on the standards to assist in implementation thereof. Botswana should therefore collaborate with South Africa to learn from the already advanced financial sector. South Africa remains the only member of the Basel Committee in Africa and possesses first-hand information and the requisite technical knowledge with respect to the standards.

This could keep BoB informed and decide on the right pace and modality of implementing Basel II and III in ways most appropriate for Botswana's development objectives.

[280] Gottschalk n 273 above 3; Ward n 280 above 5.
[281] Just like South Africa adopted the National Credit Act n 239 above.

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