

# PRUDENTIAL REGULATIONS AND THE PERFORMANCE OF PRIVATE BANKS: A CRITICAL REVIEW OF THE SOUTH AFRICAN ENVIRONMENT SINCE 1970

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## Summary of the paper

- 1. Review international and theoretical context of prudential regulations**
  - ❖ We present the evolution of capital adequacy banking regulations in SA since 1970 from a perspective informed by the changing international economic order of the second half of the 20th century
- 2. Review the changes in the prudential regulations of SA's banking system**
  - ❖ We review key changes in the relevant SA legislation, concentrating on the trade-off between the benefits of prudential regulations (enhanced stability of the banking sector) and the costs of reduced competition struck by successive rounds of bank regulation.
- 3. Empirical analysis of performance of banks in SA since 1970**
  - ❖ We investigate possible links between changes in regulations and aspects of bank performance

## What did we find?

- It is very useful to understand the system of prudential regulations in South Africa as an attempt to balance stability with competition (and innovation)
- SA's prudential regulations changed significantly with the introduction of the Banks Act (Act 94 of 1990)
- The relationship between stability and performance is a complicated one:
  - ❖ The SA banking sector has enjoyed notable stability since 1970
  - ❖ The change in the regulatory regime has:
    - Improved the ability of banks to compete
    - Led to improvements in the performance of the banking sector in certain dimensions
  - ❖ But there is evidence that this has been accompanied by diminution of competitive pressures over this period

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## 1. International and theoretical context

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## Globalisation, banking and regulation (1)

- Rationale for prudential regulation
  - ❖ Systemic risk argument
  - ❖ Representation hypothesis argument
- Important changes in global banking sector → liberalisation of financial markets, increasing integration of international capital markets and changes to monetary policy had following effects:
  - ❖ Increasing international competition, both internationally from other banks and locally from other financial institutions
  - ❖ Securitisation an especially important change in the business model of banks - originate-to-distribute (OTD) model
  - ❖ Financial innovation – in the form of derivatives and their trading markets, securitised loans and firms' securities – changed the risk profile of banks profoundly

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## Globalisation, banking and regulation (2)

- Traditional criteria for regulating the solvency of banks inadequate
- Market evolution required change from regulators and theory of regulation evolved to emphasise an institutional perspective of changing functional needs
- Policy instruments shifted away from ...
  - ❖ direct controls (deposit control, credit ceilings) to indirect (market related) measures
  - ❖ attempts at controlling the money supply to fixing the repo rate (interest rates)
- International convergence of bank capital regulation (Basle I & II)

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## Globalisation, banking and regulation (3)

- Three types of bank regulation, applied variously between and within countries over time, resulting in different regulatory regimes
  - ❖ *Softening of competition* (e.g. restrictions on the entry of new banks or limitations to the free deployment of competitive tools by banks)
  - ❖ *Restricting banking activities* in space and scope, i.e. constraining banks' potential to diversify and exploit economies of scale
  - ❖ *Capital adequacy regulation* to reduce insolvency risk of a systemic nature, thus altering the competitive position of banks vis-à-vis other non-bank institutions
- Jurisdiction of regulatory authorities confined to national territories; internationally integrated financial markets have no borders
  - ❖ Because of international spill-over effects, exposed regulatory authorities cannot address problem at source; need international coordination of banking regulation

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## International changes in banking regulations

- Basle I (Basle Accord, 1988)
  - ❖ Focus on (credit) risk adjusted assets (RAA) (loans) as basis for determining capital adequacy requirements
    - Risk 'buckets' approach adopted (relatively crude)
    - On and off-balance assets included in RAA
  - ❖ Capital Adequacy Requirement (CAR) = 8% of RAA must be held, with 50% Tier 1 capital (equity and unimpaired reserves)
- Basle II (initially published 2004)
  - ❖ Market risk now included (on top of credit risk) in CAR calculation
  - ❖ More sophisticated approach to risk adjustment of assets allowed:
    - Can use internal risk models to estimate market and credit risk exposure
  - ❖ "Endogenous risk" (Goodhart) not yet adequately addressed

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## 2. Changes in SA regulation

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## Changes in SA's prudential banking regulatory environment (1970-2008) (1)

- 1965 Banks Act (notably interventionist)
  - ❖ Prudential requirements set i.t.o. liabilities
  - ❖ Regulation type 2 (restricting bank activities)
  - ❖ SARB: price (interest rate) and quantity (loans) controls on banks directly
- 1990 Banks Act (more market-related; aligned to international financial trends and Basle)
  - ❖ Result of recommendations in (amongst others) De Kock Commission (1984), Basle I (1988)
  - ❖ Functional, not institutional, approach adopted
    - Complicated institutional definitions removed – all banks treated similarly
  - ❖ Principle, not rule, based

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## Changes in SA's prudential banking regulatory environment (1970-2008) (2)

- ❖ Risk based reporting requirements a key innovation
  - Assets, not liabilities, basis for capital adequacy
  - Different credit risks taken into account (risk buckets)
  - More regular (monthly) reports
- ❖ Creation of the Office of the Registrar of Banks (housed in the SARB)
- ❖ More modern approach to supervision, focusing explicitly on risk management, was implemented.
- 2008 Regulations issued in terms of 1990 Banks Act (next slide)
  - SA implementation of Basle II
  - Companies can use their own risk models
  - Registrar of banks reserves right to reject adequacy of models

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## Empirical analysis of performance of banks in SA

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## Did regulatory changes have any impact on the performance of the SA banking sector?

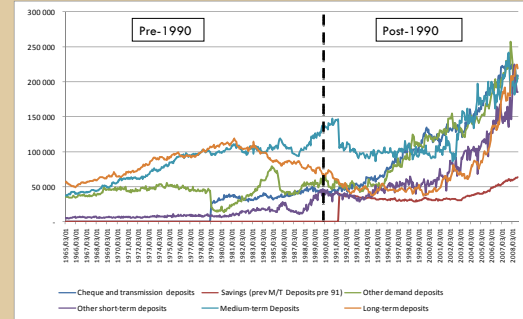
Measures of banking system performance examined:

- Growth in liabilities (deposits)
- Growth in assets (credit extended)
- Innovations in the payments system
- Stability and competition (number and type of banks)
- Interest rate spreads

**Did the regulatory changes in 1990 lead to significant changes in any of these dimensions?**

Source: Gilbert Calitz DuPlessis Banking Regulation EHSSA PE 07-09-2009

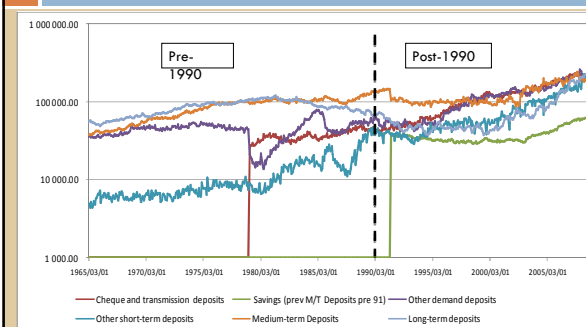
## Deposits (liabilities) of the SA banking sector: 1965 – 2008 (in real terms)



Source: SARB Quarterly Bulletin and Monthly Statistics

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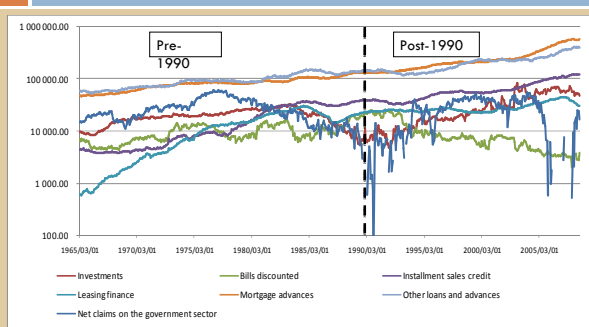
## Log of real deposits (liabilities): 1965-2008



Source: SARB Quarterly Bulletin and Monthly Statistics

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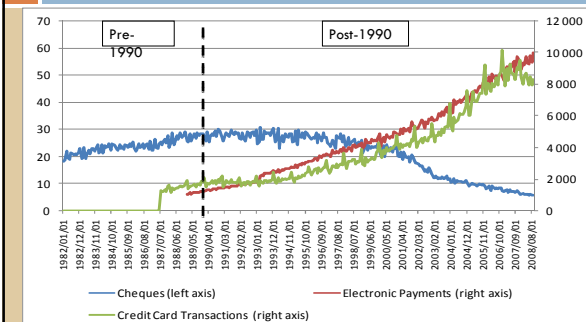
## Log of real credit extended (assets), 1965-2008



Source: SARB Quarterly Bulletin and Monthly Statistics

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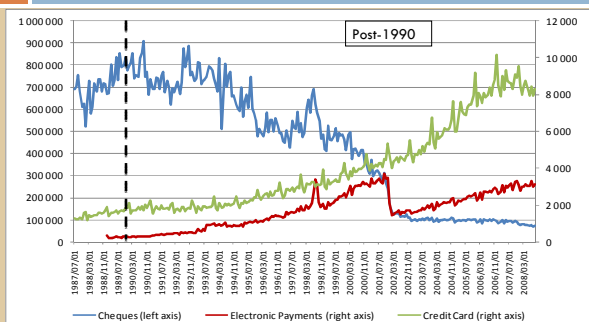
## Number of payments by channel, 1982-2008



Source: SARB Quarterly Bulletin and Monthly Statistics

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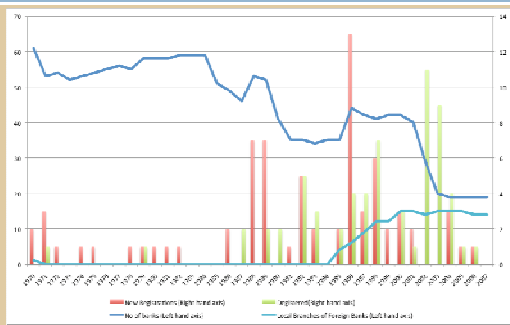
## Value of payments by channel, 1987-2008



Source: SARB Quarterly Bulletin and Monthly Statistics

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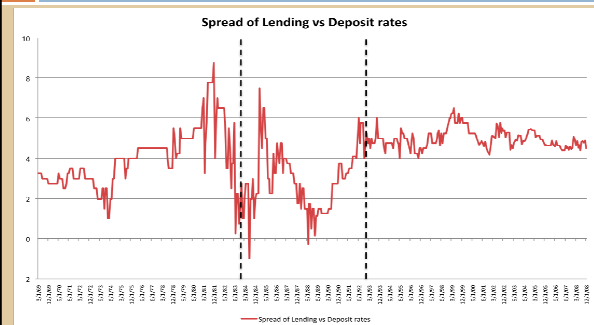
## Entry and exit of banks in the SA banking sector (1970 – 2007)



Source: Office of the Registrar of Banks

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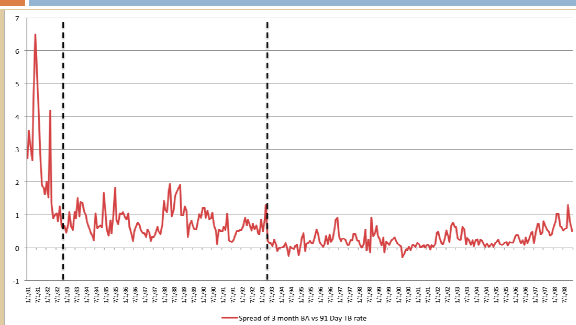
## Spread between lending and deposit rates, with change points, 1969-2008



Source: SARB Quarterly Bulletin and Monthly Statistics

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## Spread between 3 month BA and T-bill rates, with change points, 1981-2008



Source: SARB Quarterly Bulletin and Monthly Statistics

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## Conclusions (1)

- Adoption of the 1990 Banks Act reflects a major shift in spirit of regulation from prescriptivist towards more market-orientated focus
- No fundamental changes in the rate of growth of the banking operations of the banks in SA post the 1990 Banks Act
- Evidence of innovation in the payments system
- No effects on the stability of the banking sector in South Africa
  - ✦ Number of bank failures not significantly different in the two periods
- There has been significant consolidation in the number of banks in the sector especially since 2002

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## Conclusions (2)

- Comparison of the yield spreads in the retail and commercial sectors suggests significant changes in the level of competition in the banking sector
  - ✦ Retail spreads stabilised at higher level than before the regulatory change, while commercial spreads have stabilised at a lower level.
- In summary: a mixed picture. The relatively more competition friendly 1990 Banks Act has:
  - ✦ Allowed the Bank Registrar to maintain the stability of the banking sector
  - ✦ But expected gains from higher levels of competition have not materialised fully
  - ✦ De facto protection of incumbents in desire to maintain stability has limited extent of competitive pressures

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THE END

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