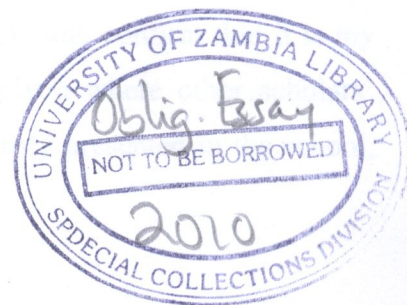


**FINANCIAL AND CORPORATE REGULATION: A COMPARATIVE STUDY OF THE
21ST CENTURY GLOBAL FINANCIAL CRISIS.**

BY

MABLE TEMBO (26112957)



A dissertation submitted to the University of Zambia Law Faculty in partial fulfilment
of the requirement for the award of the Degree of Bachelor of Laws (L.L.B.)

UNZA

APRIL 2010

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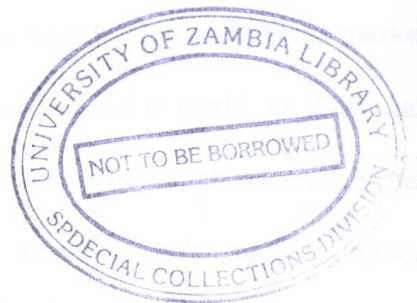
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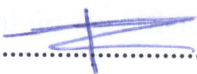
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accepted for examination. I have checked it carefully and I am satisfied that it fulfils the
uirements relating to the format as laid down in the regulations governing directed research.

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DR. P. MATIBINI, S.C

SUPERVISOR

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12th APRIL 2010

DATE

standards. This paper examines the regulatory regime in Zambia and proposes reforms tailored for Zambia based on the lessons from the US, and UK.

DEDICATION

To my mother Mrs. M. P. Tembo, the pillar of my strength.

My brothers and sisters, Boyd, Paul, Victor, Emmanuel, Jonathan, Philippa, Cuthbert and Florence.

ACKNOWLEDGEMENTS

I thank God Almighty for giving me strength to come this far and beginning this good work in me, which He will bring to completion.

The preparation of this work owes much to a number of people without whose support and encouragement would not have made this work possible.

Special gratitude goes to my supervisor Dr P. Matibini for critically analysing every chapter of my work, and for the excellent guidance. Thank you Sir.

David my love, thank you very much for all the sacrifices you have made for me, most of all for your love, care and support.

Special thanks go to my friends Claudia, Janet and Mofya, for always reminding me to work hard, and for the support you gave me throughout this work. I love you. Marjory, thanks for always being there for me, especially during my illness.

My brother Cuthbert, I would not have made it this far if not for your faith in me. Your personal motivation and sacrifices have kept me going you have been a great source of inspiration.

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My thanks go out to Mr. Hara and Mr. Illunga for according me the necessary information needed for my research.

TABLE OF LEGISLATION

The Bank of Zambia Act Chapter 360 of the laws of Zambia.

The Banking and Financial Services Act Chapter 387 of the Laws of Zambia

The Securities Act Chapter 354 of the Laws of Zambia.

TABLE OF CASES

1. The People of the State of New York v. First American Corporation and First American eAppraiseIT (Supreme Court of the State of New York).

LIST OF ABBREVIATIONS

Abbreviation	Full-Title
AIG.....	American Insurance Group
ARMs TED	Adjustable Rate Mortgages
BHC.....	Bank Holding Companies
BOZ.....	Bank of Zambia
CDOs	Collateralized Debt Obligations
CDS.....	Credit Default Swap
CRA.....	Community Reinvestment Act
CRB.....	Credit Reference Bureau
CSPR.....	Civil Society for Poverty Reduction
FHS.....	Financial Holding Companies
FSA.....	Financial Services Authority
FSMA.....	Financial Services and Markets Act
FHLB.....	Federal Home Loan Banks
GAO	General Accountability Office
GDP.....	Gross Domestic Product
GLB.....	Gramm Leach Bliley Act
GSEs	Government Sponsored Enterprises
HERA.....	Housing and Economic Recovery Act
HUD.....	Housing and Urban Development
IOSCO.....	International Organization of Securities Commissions
MBS.....	Mortgage Backed Securities

OFHEO.....Office of Federal Housing Enterprise Oversight

OTC.....Over the Counter

PCAOB.....Public Company Accounting Oversight Board

RMBS.....Rated Mortgage Backed Securities

SECSecurities Exchange Commission

SPVs.....Special Purpose Vehicles

UK..... United Kingdom

US..... United States of America

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CHAPTER ONE

1. GENERAL INTRODUCTION

The main object of this research is to conduct a comparative study of the 21st Century Global Financial Crisis in the USA and UK, with particular reference to financial and corporate regulation, and what lessons this poses for Zambia. In the year 2007, the global economy was hit by a crisis which began in the United States of America (USA), before spreading to the United Kingdom (UK), and finally to the rest of the globe. The financial crisis was as a result of the subprime mortgages in the US, where by people who had poor credit histories were given loans, without taking their credit histories into consideration. There was also evidence of deregulation in the financial markets, and this led to the collapse of the economy. With the spread of the crisis, and as a consequence of greater integration, Zambia has experienced very similar challenges to those in the USA, and the UK, which is adding to the current downturn in the global economy. These stresses have included rising price index, interest rate, unemployment, decreasing international trade, and sharply rising exchange rates. These economic shocks have also been accompanied by highly volatile securities markets. As the crisis worsened, governments in the USA and UK embarked on measures to bring about stability in the global economy. Specifically, they enhanced regulatory measures in the financial sector. They have proposed new laws that will strengthen their regulatory regimes.

There has been no evidence of subprime lending in Zambia, but this in itself does not entail efficiency in the regulatory regime. The Zambian financial sector has continued to face threats of financial instability due to the failure of some financial institutions. The cost to Government has been high and public confidence in the financial institutions has

remained uncertain.¹ With the rise of the 21st century global financial crisis that has inevitably impacted on Zambia, the United States of America (USA), which is the alleged source of the global financial crisis, as well as the United Kingdom (UK), have instituted reforms in the financial regulatory and corporate governance regimes in order to prevent a further crisis and also to stabilize the global economy. Therefore, it is the aim of this research to propose reforms for Zambia's regulatory regime, based on the US and UK.

To achieve its main objective, the study is divided into five chapters. Chapter one, gives a general overview of the study. Chapter two will discuss the causes of the 21st century global financial crisis. There have been a number of myths and arguments advanced about the causes of the crisis. It is therefore important that essay investigates the actual or real causes of the crisis. However, the causes all dwell on the subprime mortgages that led to a housing boom. The Subprime mortgages will be discussed in chapter two.

It is believed that one of the causes of the crisis is deregulation or lack proper regulation of financial systems. Once this is established, the study will delve into the regulatory regime in the UK and US as it was before the crisis and what has been done after the crisis. This will be discussed in chapter three. The chapter will also look at the legal challenges faced by the regulatory regime in the two nations, and how they have responded to them.

¹ L. Kamanga, 'Measures Taken By Bank of Zambia To Curb The Effects Of The Global Credit Crunch And What Lessons Have Been Learnt From The Crisis' Bank of Zambia (April 2009).

In chapter four, the study will discuss the regulatory regime in Zambia and compare the case in Zambia with that of the USA and UK. In Zambia, financial services are regulated under the Banking and Financial Services Act and corporate regulation is under the Securities and Act. This chapter will examine the regulatory regime under the two Acts and examine their efficiency in light of the financial crisis.

Finally, in chapter five, the study will propose reforms for Zambia's financial and corporate regulation by giving conclusions and recommendations.

1.1 STATEMENT OF THE PROBLEM

Considerable literature has been written on both the financial regulatory system and corporate governance in Zambia. Notwithstanding this, there has been no literature written so far on financial and corporate regulation in Zambia, in light of the global financial crisis, with a view to analyze what lessons Zambia can learn from the USA and the UK in reforming its regulatory regime. The Zambian legal system is founded on the English common law and principles of equity applied by the English courts. Whereas a number of legislative changes have taken place under the English Acts, the Zambian laws have tended to lag behind and are therefore usually not responsive to the changes in the socio-economic environment. The 21st century global financial crisis that began in the United States of America (USA) has had a great impact on the global economy, and ultimately, what happens on the global front also affects Zambia. This is so because Zambia's economy is primarily driven by mineral exports to countries of the west. It is these countries that stand as pillars to the global financial system. Inevitably, when they suffer, Zambia suffers. In response to the crisis, the USA and UK have developed a reformatory approach to their regulatory regime so as to regulate the financial sector and

improve on their corporate governance. The question is whether this poses any lessons for Zambia in terms of the need to revisit the laws that regulate financial institutions and corporate governance in Zambia. This research paper will attempt to answer this question.

1.2 OBJECTIVE OF THE RESEARCH

The overall objective of this research is to propose reforms in financial regulation and corporate governance tailored for Zambia which are modeled on the regulatory regime in the USA and UK. The specific objectives of the study will be to:

- Investigate the causes of the 21st century Global Financial Crisis, using USA and UK as case studies.
- Examine the regulatory regime as it was before and what was done after.
- Examine the legal challenges and response in the countries above.
- Examine the regulatory regime in Zambia and compare the case in Zambia with that of the USA and UK.
- Propose reforms to Regulations governing players in the Financial system

1.3 SIGNIFICANCE OF THE RESEARCH

This study is pertinent and relevant in view of the existing Global Financial crisis which has affected the global economy, without leaving out Zambia. It is therefore necessary to examine what is being done in the leading economies of the world in terms of regulation of financial services and corporate governance and based on this, to propose reforms in the regulatory regime in Zambia.

1.4 SPECIFIC RESEARCH QUESTIONS

- i. How has the developed world reacted to the global financial crisis in relation to financial regulation and corporate governance?
- ii. Is the regulatory regime in Zambia adequate to prevent a financial crisis and to handle the present financial crisis?
- iii. Are there any lessons that Zambia can learn from the developed world in *particular, the USA and the UK in the reformation of its regulatory system?*

1.5 RESEARCH METHODOLOGY

This study will rely on both primary and secondary information. The primary information will include interviews with financial service providers and securities regulators at the Bank of Zambia and the Securities and Exchange Commission for purposes of investigating whether the regulatory regime of financial institutions and corporate governance is efficient in Zambia.

The purpose of the primary information will be to show that there is need for reform in the regulatory system in Zambia. For secondary information relevant published and where necessary unpublished work will be consulted. Also, relevant pieces of legislation, reports and student obligatory essays will be used. Sources from the internet will also be used.

CHAPTER TWO

2.0. CAUSES OF THE GLOBAL FINANCIAL CRISIS

2.0. INTRODUCTION

The credit crisis is the foremost economic issue facing the United States today. The global financial crisis of 2008 – 2009, began in July, 2007, when a loss of confidence by investors in the value of securitized mortgages in the United States resulted in a liquidity crisis that prompted a substantial injection of capital into financial markets by the United States Federal Reserve, Bank of England and the European Central Bank. The TED spread, an indicator of perceived credit risk in the general economy, spiked up in July, 2007, remained volatile for a year, then spiked even higher in September 2008, reaching a record 4.65% on October 10, 2008. In September 2008, the crisis deepened, as stock markets worldwide crashed and entered a period of high volatility and a considerable number of banks, mortgage lenders, and insurance companies failed in the following weeks.² This chapter will seek to discuss the causes of the Global financial crisis and how it has impacted the global economy, with focus on mortgage lending, using the USA and UK as case studies.

2.2. BOOM IN THE US HOUSING MARKET.

2.2.1 Growth of the Housing Bubble

The subprime crisis is the name for what is a historical turning point in the US economy, and culture. It is, at its core, the result of a speculative bubble in the housing market that began to burst in the United States in 2006, and has now caused ruptures across many other countries in the form of financial failures, and a global credit crunch. It is evident to the world that the problems in the subprime mortgage market, which began to show up in

² J. E. Bethel et al, 'Legal And Economic Issues In Litigation Arising From The 2007-2008 Credit Crisis' Harvard Law School 17 (November 2008).

the United States in 2007 and then spread to other countries. Home prices and home ownership has been booming since the late 1990s, and investing in a house had seemed a sure route to financial security, and wealth. According to the U.S census, the homeownership rate increased from 65.7% to 68.9% (which represents an 11.5% increase in the number of owner-occupied homes) over that period.³

2.2.2 Subprime Lending

There is evidence that both government and competitive pressures contributed to an increase in the amount of subprime lending during the years preceding the crisis. Major U.S. investment banks and government sponsored enterprises like Fannie Mae, played an important role in the expansion of higher-risk lending. From 1997, to the middle of 2006, nominal U.S. housing prices rose by an average of 7.5percent a year, whereas real U.S. housing prices increased by an average of 5.0 percent a year.⁴ The annual rate at which housing prices increased accelerated between 2001 through 2005. Rising housing prices, and the availability of adjustable rate mortgages (ARMs) persuaded many potential homeowners with marginal incomes, limited net worth, and poor credit histories to buy or refinance homes. In some instances, homeowners, knowing that they could not service loans from their income, still bought homes, anticipating that they could quickly flip them for a profit or refinance with accumulated equity. The demand for home financing by borrowers with weak credit histories, and the specter of additional fees for mortgage originators from an expanded pool of borrowers resulted in some mortgage originators lowering their underwriting standards.

³ R. J. Shiller, *The Subprime Solution: How today's Global Financial Crisis Happened and what To Do About It*. (Princeton: Princeton University Press, 2008).

⁴ R. J. Shiller, *Irrational Exuberance*, 2nd Edition. (Princeton: Princeton University Press, 2008).

2.2.3 Predatory Lending

Evidence is now mounting that at least some mortgage bankers and brokers may have submitted false appraisals and financial information to qualify otherwise unqualified households for subprime mortgage loans. Others purportedly did not document or verify subprime mortgagors' incomes, net worths, and credit histories. According to an analysis by Fitch of a small sample of early defaults from its 2006 Fitch-rated subprime RMBS, as much as one quarter of the underperformance of the 2006 vintage of subprime RMBS, may have resulted from inadequate underwriting and fraud. Fitch concludes in its report that there was "apparent fraud in the form of occupancy misrepresentation; poor or a lack of underwriting relating to suspicious items on credit reports; incorrect calculation of debt-to-income ratios; poor underwriting of 'stated' income loans for reasonability; and substantial numbers of first-time homebuyers with questionable credit/income." ⁵

Base Point Analytics LLC, a fraud analytics and consulting firm, found results consistent with Fitch's findings. Base Point analyzed over 3 million loans originated between 1997 and 2006, (the majority being 2005–2006 vintages), including 16,000 non-performing loans that had evidence of fraudulent misrepresentation in the original applications. Base Point's research found that as much as 70 percent of early payment default loans contained fraudulent misrepresentations on applications.⁶ The New York Attorney General's office is investigating loan originators' appraisals, and has filed suit against real estate appraiser First American Corporation and its subsidiary, eAppraiseIT for

⁵ 'The Impact of Poor Underwriting Practices and Fraud in Subprime RMBS Performance' Fitch Ratings Ltd (November 2007).

Available at: www.americansecuritization.com/uploadFiles/Fitchoriginators. Accessed on 19/08/09.

⁶ Report on Broker Facilitated Fraud 'The Impact on Mortgage Lenders' Base Point Analytics, (2006).

allegedly colluding with Washington Mutual, a loan originator, to inflate appraisal values.⁷

2.2.4 Easy Credit Conditions

The gatekeepers to detect loan-origination frauds and lax underwriting standards are the due-diligence firms that review and verify loan information and loan-origination policies and procedures. Several of these firms are currently under investigation by the New York and Connecticut Attorney Generals' offices and the SEC. Linked to these investigations are allegations that some mortgage backed securities (MBS) sponsors may have ignored or withheld information about the credit risks of mortgage pools, and may have even pressured due-diligence firms to overlook credit issues on loans. Government officials are investigating whether MBS and collateralized debt obligations (CDOs) sponsors failed to disclose information to credit-rating agencies and investors about high-risk loans, known as "exceptions," that failed to meet credit standards. Deutsche Bank, for instance, underwrote \$1.5 billion of New Century mortgages in 2006, that included a number of exception loans. According to the *New York Times*, these loans suffered unusually high levels of defaults and delinquencies.⁸ The number of loans reviewed by due-diligence firms fell from about 30 percent in 2000, to five percent in 2005. Even for those loans reviewed, due-diligence firms encountered obvious challenges, given that many loans lacked standard documentation or, indeed, any documentation. In assessing these practices, one must bear in mind that MBS originators almost certainly purchased exception loans at discounts to face value and, in turn, sold them at discounted prices to SPVs.

⁷ The People of the State of New York v. First American Corporation and First American EAppraisal (Supreme Court of the State of New York)

⁸ New York Times, 12 January, 2008.

By mid-2006, housing prices began to decline nationally, dropping by about 1.5 percent between 2006 and 2007. Although this decline seems small, some markets were hit harder than others. Home sales fell as well, interest rates increased, and more than two million homeowners faced interest-rate resets on their mortgages by February of 2008. Mortgage payments increased by as much as 30 percent from earlier payments, and many homeowners could not afford them. In the past when housing prices rose, ARM borrowers sold or refinanced their homes to pay off loans before they reset to unaffordable rates. But given flat or declining housing prices, homeowners' options dwindled, and many became delinquent in their payments or defaulted. Using data from the Mortgage Banker's Association, the General Accountability Office (GAO) found that ARMs experienced relatively steeper increases in default, and foreclosure rates compared to fixed-rate mortgages and accounted for a disproportionate share of the increase in the number of loans in default and foreclosure.⁹

Whereas many of the problem subprime loans are ARMs, there are non-ARM subprime borrowers who also are at high risk of default. Using data on both ARM and non-ARM, subprime mortgages originated between 1998 and the first three quarters of 2006, Schloemer, Li, Ernst, and Keest (2006) estimate cumulative foreclosures of 2.2 million, with losses to homeowners of \$164 billion.¹⁰ This estimate is probably low, given that housing prices have declined more than the study's authors may have originally anticipated. Using data from the Mortgage Banker's Association and Moody's, the GAO

⁹ J. E. Bethel et al, 'Legal and Economic Issues in Litigation Arising From The 2007-2008 Credit Crisis' Harvard Law School 17 (November 2008).

¹⁰ E. Schloemer, & K. Keest, 'Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners' Center for Responsible Lending (December 2006).

estimates defaults and forecloses to be rising overall, with the largest share being subprime: Subprime loans comprise less than 15 percent of loans serviced, but about two-thirds of the overall increase in the number of mortgages in default, and foreclosure from the second quarter of 2005 through the second quarter of 2007.

2.3 WEAK REGULATION AND SUPERVISION OF BANKS

Another factor that led to the global economic crisis, is the failure of regulators to rein in aggressive lending. Ever since the Depository Institutions Deregulatory and Monetary Control Act of 1980, effectively ended state usury laws, and made it possible for originators to make a profit with subprime lending by charging interest rates to offset the costs of the inevitable defaults and foreclosures, there had been a need for expanding the scope of regulation. Yet the expanded regulation never came, and over time during the 1990s and into the 2000s a “shadow banking system” of non bank mortgage originators was allowed to develop without anything like the regulation to which banks were subject.¹¹ But the lack of urgency among regulators in doing their job must ultimately have originated in their inability to believe that there could ever be a housing crisis of the proportion we are seeing today.

After the 1980s home- price boom, the U.S. government passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (GSE Act). This was during the housing market debacle. The Act, in turn, created the Office of Federal Housing Enterprise Oversight (OFHEO), to oversee the risks to government-sponsored enterprises Fannie Mae and Freddie Mac. One of the OFHEO’S objectives specified in the Act was to prevent even the possibility of financial freeze-up. OFHEO today is still watching out for possible systemic risks. The GSE Act required that OFHEO develop a stress test that

¹¹ R. J. Shiller, *The Subprime Solution: How the Global Financial Crisis Started and what to do About it.* (Princeton: Princeton University Press, 2008).

stimulates possible adverse interest rate and credit risk scenarios, and OFHEO has done so.¹²

However, in its annual reports to Congress through 2007, OFHEO never showed any recognition of the housing boom that has been the main cause of the risks, let alone, any understanding of its psychological origins. These regulators did not see the risk, and they allowed Freddie and Fannie to go on supporting the housing boom. The regulatory framework did not keep pace with financial innovation, such as the increasing importance of the shadow banking system, derivatives and off-balance sheet financing. In other cases, laws were changed or enforcement weakened in parts of the financial system. Key examples include:

- In October 1982, President Ronald Reagan signed into law the Garn-St. Germain Depository Institutions Act, which began the process of Banking deregulation that helped contribute to the savings and loan crises of the late 80's/early 90's, and the financial crises of 2007-2010. President Reagan stated at the signing, "all in all, I think we hit the jackpot".¹³
- In November, 1999, President Bill Clinton signed into law the Gramm-Leach-Bliley Act, which repealed part of the Glass-Steagall Act of 1933. This repeal has been criticized for reducing the separation between commercial banks (which traditionally had a conservative culture), and investment banks (which had a more risk-taking culture).¹⁴

¹² Ibid.

¹³ Paul, Krugman, 'The Return of Depression Economics and the Crisis of 2008. W.W. Norton Company Limited, Reuters Business Wire News database. (29th February, 2009).

¹⁴ Ibid

- In 2004, the Securities and Exchange Commission relaxed the net capital rule, which enabled investment banks to substantially increase the level of debt they were taking on, fueling the growth in mortgage-backed securities supporting subprime mortgages. The SEC has conceded that self-regulation of investment banks contributed to the crisis¹⁵
- Financial institutions in the shadow banking system are not subject to the same regulation as depository banks, allowing them to assume additional debt obligations relative to their financial cushion or capital base. This was the case despite the Long-Term Capital Management debacle in 1998, where a highly-leveraged shadow institution failed with systemic implications.¹⁶
- Regulators and accounting standard-setters allowed depository banks such as Citigroup to move significant amounts of assets and liabilities off-balance sheet into complex legal entities called structured investment vehicles, masking the weakness of the capital base of the firm or degree of leverage or risk taken. One news agency estimated that the top four U.S. banks will have to return between \$500 billion and \$1 trillion to their balance sheets during 2009. This increased uncertainty during the crisis regarding the financial position of the major banks. Off-balance sheet entities were also used by Enron as part of the scandal that brought down that company in 2001.¹⁷
- As early as 1997, Fed Chairman Alan Greenspan fought to keep the derivatives market unregulated. With the advice of the President's Working Group on

¹⁵ R. J. Shiller, *The Subprime Solution: How the Global Financial Crisis Started and what to do About it*. (Princeton: Princeton University Press, 2008).

¹⁶ P. Krugman, 'The Return of Depression Economics and the Crisis of 2008'. W.W. Norton Company Limited. Reuters Business Wire News database. (29th February, 2009)

¹⁷ J. E. Bethel et al, 'Legal and Economic Issues In Litigation Arising From The 2007-2008 Credit Crisis' Harvard Law School 17 (November 2008).

Financial Markets, the U.S. Congress and President allowed the self-regulation of the over-the-counter derivatives market when they enacted the Commodity Futures Modernization Act of 2000. Derivatives such as credit default swaps (CDS) can be used to hedge or speculate against particular credit risks. The volume of CDS outstanding increased 100-fold from 1998 to 2008, with estimates of the debt covered by CDS contracts, as of November 2008, ranging from US\$33 to \$47 trillion. Total over-the-counter (OTC) derivative notional value rose to \$683 trillion by June, 2008. Warren Buffett famously referred to derivatives as "financial weapons of mass destruction" in early 2003¹⁸

2.4 FINANCIAL INNOVATION AND COMPLEXITY

The term financial innovation refers to the ongoing development of financial products designed to achieve particular client objectives, such as offsetting a particular risk exposure (such as the default of a borrower), or to assist with obtaining financing. Examples pertinent to this crisis included: the adjustable-rate mortgage; the bundling of subprime mortgages into mortgage-backed securities (MBS); or collateralized debt obligations (CDO) for sale to investors, a type of securitization; and a form of credit insurance called credit default swaps (CDS). The usage of these products expanded dramatically in the years leading up to the crisis. These products vary in complexity and the ease with which they can be valued on the books of financial institutions.¹⁹

Certain financial innovation may also have the effect of circumventing regulations, such as off-balance sheet financing that affects the leverage or capital cushion reported by major banks. For example, Martin Wolf wrote in June, 2009: "...an enormous part of

¹⁸ibid

¹⁹ B. Steverman and D. Bogoslaw , 'The Financial Crisis Blame Game - Business Week' Businessweek.com (October 18, 2008).

what banks did in the early part of this decade – the off-balance sheet vehicles, the derivatives and the 'shadow banking system' itself – was to find a way round regulation."

20

2.5 THE ROLE OF FANNIE MAE, FREDDIE MAC AND THE FHLB IN THE CRISIS

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSE) that purchase mortgages, buy and sell MBS, and guarantee nearly half of the mortgages in the U.S. A variety of political and competitive pressures resulted in the GSE taking on additional risk, beginning in the mid-1990s and continuing throughout the crisis and their government takeover in September, 2008.

HUD loosened mortgage restrictions in the mid-1990s. So first-time buyers could qualify for loans that they could never get before. In 1995, the GSE began receiving affordable housing credit for purchasing mortgage backed securities, which included loans to low income borrowers. This resulted in the agencies purchasing subprime securities. In 1996, HUD directed Freddie and Fannie to provide at least 42% of their mortgage financing to borrowers with income below the median in their area. This target was increased to 50% in 2000, and 52% in 2005. In addition, HUD required Freddie and Fannie to provide 12% of their portfolio to "special affordable" loans. Those are loans to borrowers with less than 60% of their area's median income. These targets increased over the years, with a 2008 target of 28%.²¹ In 2004, HUD ignored warnings from HUD researchers about foreclosures, and increased the affordable housing goal from 50% to 56%.

²⁰ F. T. Martin Wolf, 'Reform of Regulation and Incentives' [paulw's Blog](#) (March 2, 2009)

²¹ S. A. Holmes, 'Fannie Mae Eases Credit To Aid Mortgage Lending' [The New York Times](#)

In addition to political pressure to expand purchases of higher-risk mortgage types, the GSE were also under significant competitive pressure from large investment banks and mortgage lenders. For example, Fannie's market share of subprime mortgage-backed securities issued dropped from a peak of 44% in 2003 to 22% in 2005, before rising to 33% in 2007. In the early 2000s, Fannie Mae aggressively bought Alt-A securities, where these loans may require little or no documentation of a borrower's finances. In the early 1990s, Fannie Mae had abandoned Alt-A products because of their high risk of default. As of November, 2007, Fannie Mae held a total of \$55.9 billion of subprime securities and \$324.7 billion of Alt-A securities in their portfolio. As of the 2008Q2 Freddie Mac had \$190 billion in Alt-A mortgages. Together they have over \$500 billion in Alt-A mortgages.²²

2.6 GLOBAL EFFECTS

A number of commentators have suggested that if the liquidity crisis continues, there could be an extended recession or worse. The continuing development of the crisis has prompted in some quarters fears of a global economic collapse although there are now many cautiously optimistic forecasters in addition to some prominent sources who remain negative. The financial crisis is likely to yield the biggest banking shakeout since the savings-and-loan meltdown.²³ Investment bank UBS stated on October 6 that 2008, would see a clear global recession, with recovery unlikely for at least two years. Three days later UBS economists announced that the "beginning of the end" of the crisis had begun, with the world starting to make the necessary actions to fix the crisis: capital

(September 30, 1999).

²² Ibid.

²³ P. Krugman, 'The Return of Depression Economics and the Crisis of 2008'. W.W. Norton Company Limited. Reuters Business Wire News database. (29th February, 2009)

injection by governments; injection made systematically; interest rate cuts to help borrowers. The United Kingdom had started systemic injection, and the world's central banks were now cutting interest rates. UBS emphasized the United States needed to implement systemic injection. UBS further emphasized that this fixes only the financial crisis, but that in economic terms "the worst is still to come". UBS quantified their expected recession durations on October 16: the Eurozone's would last two quarters, the United States' would last three quarters, and the United Kingdom's would last four quarters.²⁴ The economic crisis in Iceland involved all three of the country's major banks. Relative to the size of its economy, Iceland's banking collapse is the largest suffered by any country in economic history.²⁵ At the end of October, UBS revised its outlook downwards: the forthcoming recession would be the worst since the Reagan recession of 1981 and 1982, with negative 2009 growth for the U.S., Euro zone, UK; very limited recovery in 2010; but not as bad as the Great Depression.²⁶

The Brookings Institution reported in June, 2009, that U.S. consumption accounted for more than a third of the growth in global consumption between 2000 and 2007. "The US economy has been spending too much and borrowing too much for years and the rest of the world depended on the U.S. consumer as a source of global demand." With a recession in the U.S. and the increased savings rate of U.S. consumers, declines in growth elsewhere have been dramatic. For the first quarter of 2009, the annualized rate of decline

²⁴ Ibid.

²⁵ U, Louis 'Pain Spreads as Credit Vise Grows Tighter' The New York Times:

Available at: <http://www.nytimes.com/2008/09/19/business/economy/19econ.html>. Accessed on 03/08/09.

²⁶ The Economist 'Cracks in the Crust'.

Available at: http://www.economist.com/world/europe/displaystory.cfm?story_id=12762027. Accessed on 11/11/09

in GDP was 14.4% in Germany, 15.2% in Japan, 7.4% in the UK, 18% in Latvia, 9.8% in the Euro area and 21.5% for Mexico.²⁷

2.7 CONCLUSION

This chapter set out to look at the causes of the 21st century global financial crisis as well as its global impact, using USA and UK as case studies. The chapter has shown that the major cause of the global financial crisis is the subprime mortgage lending, which is, at its core, the result of a speculative bubble in the housing market that began to burst in the United States in 2006. Loans were given out to people or companies that had poor credit histories; others obtained loans fraudulently; while in most situations, the credit conditions were so easy, anyone could obtain a housing loan. This was further aggravated by poor financial regulation, whereby the major banks and other financial institutions were not properly regulated in terms of their lending levels and conditions. Further, there was a development in the financial products designed to achieve particular client objectives, such as offsetting a particular risk exposure (such as the default of a borrower) or to assist with obtaining financing. It has also been mentioned that the GSEs like Fannie Mae and Freddie Mac, contributed greatly to the financial crisis, as a result of borrowing huge loans and not repaying them. They purchase mortgages, buy and sell mortgaged-backed securities (MBS), and guarantee nearly half of the mortgages in the U.S. In terms of global effects, the subprime crisis has caused ruptures across many other countries in the form of financial failures. Most of the big nations like Germany, China and others, have had their GDPs drop to low levels. The next chapter will discuss the US and UK regulatory responses to the crisis.

²⁷ *ibid.*

CHAPTER THREE

3. U.S AND U.K REGULATORY RESPONSES TO THE CRISIS

3.1 INTRODUCTION

The current financial crisis is often viewed as a reason to sound retreat, to return to yesterday's simpler methods of financial dealing. This would be a mistake. On the contrary, the current situation is really an opportunity to redouble our efforts to rethink and improve our risk management institutions, the framework that undergirds our increasingly sophisticated financial sector. Every crisis contains the seeds of change. Now is the time to restructure the institutional firmament of financial activity in positive ways that will stabilize the economy, rekindle the wealth of nations, reinforce the best of financial innovation, and leave society much better off than if there had not been such a crisis.²⁸ This chapter is an effort to discuss the regulatory regime as it was before and what has been done after, while also examining the legal challenges facing the regulatory regimes and responses in the United States (U.S) and United Kingdom (U.K).

3.2 THE REGULATORY REGIME AS IT WAS BEFORE THE CRISIS

A widely held myth about the current crisis is that it has occurred in regulatory vacuum. It is true that deregulatory initiatives and regulatory restraint have played a role in the crisis. But these have taken place within an overall framework of complex rules and regulation by multiple agencies whose responsibilities have not always been clear or adapted to a changing world. That is to say, in as much as there is regulation of financial and corporate industry, the regulation has not measured up to the needs of these industries. It must then be mentioned that the financial and corporate regulatory regime in the US is the Federal State statutes and regulations, (this also includes the Securities and

²⁸ Shiller, R. J. (2008), *The Subprime Solution: How Today's Global Financial Crisis Happened and What to do About it*. Princeton: Princeton University Press

Exchange Commission) and Financial Services Authority (FSA) in the UK. These bodies operate using various statutory instruments or laws.²⁹

3.2.1 Corporate Governance and US Banking Regulation:

The United States has traditionally had a federal-state structure for financial regulation. Federal and state regulators shared responsibility for ensuring the prudential soundness of US banks and financial institutions. In the late 1970s and 1980s, Congress responded by enacting legislation that delegated broad authority to federal bank regulators to supervise and control the activities of all banks operating in the US - whether they were US or foreign or seeking federal or state licenses. U.S banks and bank/financial holding companies are governed by a comprehensive system of statutory regulation that generally provides regulators with broad discretion to take measures to promote safety and soundness in the banking system, protect the deposit insurance fund, and promote competition in the banking sector, as well as enhance corporate governance. The Federal Reserve administers these statutory provisions for all depository institutions and has the power to provide exemptions from these provisions.³⁰

3.2.2 The Securities and Exchange Commission (SEC)

To begin with, the SEC has conceded that self-regulation of investment banks contributed to the crisis. The role of the SEC is that of securities regulation, it works to practices of bank-levered speculation and other abuses on the securities markets. The SEC relaxed rules in 2004 that enabled investment banks to substantially increase the level of debt they were taking on, fueling the growth in mortgage-backed securities supporting subprime mortgages.³¹

²⁹ K. Alexander, 'Financial and Corporate Regulation in the UK and US' Cambridge Endowment for Research in Finance (June 2004).

³⁰ Ibid.

³¹ 'Financial Crisis 2007-2010'

Available at: http://www.wikinfo.org/index.php?title=Financial_crisis_of_2007-2010. Accessed on 11/11/09.

The top five US investment banks each significantly increased their financial leverage during the 2004–2007 time periods, which increased their vulnerability to the MBS losses. Three of the five either went bankrupt (Lehman Brothers) or were sold at fire-sale prices to other banks (Bear Stearns and Merrill Lynch) during 2008, creating instability in the global financial system. The remaining two converted to commercial bank models in order to qualify for Troubled Asset Relief Program funds (Goldman Sachs and Morgan Stanley).

The SEC is also responsible for establishing financial disclosure rules. Critics have argued that disclosure throughout the crisis was ineffective, particularly regarding the health of financial institutions, and the valuation of mortgage-backed securities.³²

3.2.3 Gramm Leach Bliley Act (GLB)

In the United States the Gramm-Leach-Bliley Act of 1999 repealed the Banking Act of 1933 (Glass-Steagall) which prohibited Federal Reserve member banks from conducting investment bank activities (securities underwriting and dealing, etc.) and insurance. The 1999 Act allowed subsidiaries of banks to conduct most financial activities, and hence to compete with securities firms and insurance companies. Thrifts too were permitted to engage in banking and securities businesses. It also streamlined supervision of bank holding companies by clarifying the regulatory role of the Federal Reserve as the consolidated supervisor. Otherwise it reaffirmed the role of functional regulation (similar activities should be regulated by the same regulator) of the various affiliates by state and other federal financial regulators, while allowing a number of possible arrangements for supervision at the group level. As early as 2005, the General Accounting Office (GAO) expressed concern about this arrangement, noting: “Multiple specialized regulators.” Ultimately, it can be said that the Gramm-Leach-Bliley Act removed the remaining legal

³² Ibid.

restrictions on combined banking and financial services, and ushered in the current hyper-deregulated era.³³

3.2.4 Community Reinvestment Act (CRA)

The CRA was originally enacted under President Carter in 1977. The Act was set in place to encourage banks to halt the practice of lending discrimination. There is debate among economists regarding the effect of the Community Reinvestment Act, with detractors claiming it encourages lending to uncreditworthy consumers, and defenders claiming a thirty year history of lending without increased risk.³⁴

3.2.5 Sarbanes- Oxley Act

It is notable that in the United States supervisory resources failed to keep pace with the rapid growth of the industry being supervised. There was a significant increase in staffing at the Securities and Exchange Commission following the passage of the Sarbanes-Oxley Act of 2002. The Sarbanes–Oxley Act is a United States federal law enacted as a reaction to a number of major corporate and accounting including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom. These scandals, which cost investors billions of dollars when the share prices of affected companies collapsed, shook public confidence in the nation's securities markets.

The legislation set new or enhanced standards for all U.S. public company boards, management and public accounting firms. It does not apply to privately held companies. The Act contains 11 titles, or sections, ranging from additional corporate board responsibilities to criminal penalties, and requires the Securities and Exchange Commission (SEC), to implement rulings on requirements to comply with the new law. It

³³ P. Krugman, 'The Return of Depression Economics and the Crisis of 2008. W.W.

Norton Company Limited, Reuters Business Wire News database. (29th February, 2009).

³⁴ Tragger & Hinkely, 'CRA A Welcome Anomaly in the Foreclosure Crisis' US news and world report (July 2008)

created a new, quasi-public agency, the Public Company Accounting Oversight Board, or PCAOB, charged with overseeing, regulating, inspecting and disciplining accounting firms in their roles as auditors of public companies. The Act also covers issues such as auditor independence and corporate governance.³⁵

3.3 UK Financial and Corporate Regulation

3.3.1 The Financial Services and Markets Act:

The Financial Services and Markets Act 2000 (FSMA), and its accompanying regulations create a regime founded on a risk-based approach to the regulation of all financial business. FSMA's stated statutory objectives are to maintain confidence in the financial system, to promote public awareness, to provide "appropriate" consumer protection, and to reduce financial crime. FSMA incorporates and simplifies the various regulatory approaches utilized under the Financial Services Act of 1986, in which self-regulatory organizations were delegated authority to regulate and to supervise the financial services industry. FSMA created the Financial Services Authority (FSA) as a single regulator of the financial services industry with responsibility, inter alia, for banking supervision and regulation of the investment services and insurance industries. To achieve these objectives, the FSA has been delegated legislative authority to adopt rules, and standards to ensure that the statutory objectives are implemented and enforced.³⁶

The financial regulatory framework under the UK Financial Services and Markets Act 2000 (FSMA), requires banks and other authorized financial firms to establish internal systems of control, compliance, and reporting for senior management and other key personnel. Under FSMA, the Financial Services Authority (FSA), has the power to review and sanction banks and financial firms regarding the types of internal control and

³⁵ Investors Business Daily 17th September, 2008.

³⁶ K. Alexander, 'Financial and Corporate Regulation in the UK and US' Cambridge Endowment for Research in Finance (June 2004).

compliance systems they adopt. These systems must be based on recognized principles and standards of good governance in the financial sector. These regulatory standards place responsibility on the senior management of firms to establish and to maintain proper systems and controls, to oversee effectively the different aspects of the business, and to show that they have done so. The FSA will take disciplinary action if an approved person - director, senior manager, or key personnel deliberately violates regulatory standards or her behavior falls below a standard that the FSA could reasonably expect to be observed.

Although UK corporate governance regulation has traditionally not focused on the special role of banks and financial institutions, the Financial Services and Markets Act 2000, has sought to fill this gap by authorizing the FSA, to devise rules and regulations to enhance corporate governance for financial firms.³⁷

3.4 WHAT HAS BEEN AND IS BEING DONE AFTER THE CRISIS

From the above outlined regulatory regime, it can be said that despite the new laws such as the Sarbanes-Oxley Act of 2002, various firewall rules for example the Glass-Steagall Act were removed in the late 1990s, allowing the mixing of banking, securities underwriting and dealing, and insurance, helping to set the scene for the subprime crisis from 2007. Governments in both the UK and US, have been keen on responding to the crisis in relation to their regulatory regimes.

3.4.1 US Regulation.

United States President Barak Obama and key advisers introduced a series of regulatory proposals in June, 2009. The proposals address consumer protection, executive pay, bank financial cushions or capital requirements, expanded regulation of the shadow banking

³⁷ Ibid.

system and derivatives, and enhanced authority for the Federal Reserve to safely wind-down systemically important institutions, among others.³⁸

The biggest overhaul of US regulation since the Great Depression was outlined by the White House in a politically delicate effort to stop reckless risk-taking, predatory lending and dangerous debt. In a wide-ranging package intended to prevent a future financial crisis, President Barack Obama set out a list of measures including tougher powers for the Federal Reserve to oversee "too big to fail" banks, registration of hitherto unchecked hedge funds, and the creation of a consumer agency to protect the public from incomprehensible small print on loans or mortgages. He said the changes were intended to promote innovation, and unleash creativity while discouraging recklessness or abuse, adding: "We did not choose how this crisis began, but we do have a choice in the legacy this crisis leaves behind."³⁹

New authority for the Federal Reserve forms the centerpiece of the plan. The central bank will get responsibility for watching over "systemically significant" institutions where failure would jeopardize the broader financial system.

Other reforms include the introduction of regulation for exotic derivatives such as credit default swaps, blamed for the near-collapse of America's biggest insurer, AIG. New rules will force mortgage companies to hang on to at least 5% of their loans rather than passing on all risk by bundling up products and securitizing them on the secondary credit markets.⁴⁰

³⁸ "Remarks of the President on Regulatory Reform | The White House". Available at: http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/Whitehouse.gov. Accessed on 11/11/09.

³⁹ Ibid.

⁴⁰ "Remarks of the President on Regulatory Reform | The White House".

Yet the shake-up stopped short of a more radical clear-out of the cluttered regulatory universe, once envisaged by the White House. There had been calls for the creation of a single financial body akin to Britain's Financial Services Authority, to replace Washington's "alphabet soup" of regulators. But the only organization to disappear in the plan will be the Office of Thrift Supervision, which oversaw troubled firms including AIG, Washington Mutual and Countrywide Financial. Hedge funds, which have avoided US control by basing themselves in offshore regimes, will have to start reporting to the Securities and Exchange Commission.⁴¹

3.4.2 UK Regulation

Further, UK regulators announced a temporary ban on short-selling of financial stocks on September 18, 2008. Short-selling is a method of profiting when a stock declines in value. When large, speculative short-sale bets accumulate against a stock or other financial asset, the price can be driven down. Short sales were among the causes blamed for rapid price declines in Lehman Brother's stock price prior to its bankruptcy. On September 19, the U.S. Securities and Exchange Commission (SEC) followed by placing a temporary ban of short-selling stocks of financial institutions. In addition, the SEC made it easier for institutions to buy back shares of their institutions. The halt of short-selling in the US was set to expire on October 2, but was extended until it expired at 11:59PM EDT on October, 8. The action was based on the view that short selling in a crisis market undermines confidence in financial institutions, and erodes their stability.

Available at: http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/ Whitehouse.gov. Accessed on 11/11/09.

⁴¹ *ibid.*

In the wake of a subprime mortgage crisis and questions about Countrywide's VIP program, ethics experts and key senators recommend that members of congress should be required to disclose information about their mortgages.⁴²

3.6 LEGAL CHALLENGES AND RESPONSES

The credit crisis is not solely an economic phenomenon, but a legal one as well. There are a number of challenges that regulators have experienced during the crisis. To begin with the federal government's responses to the impending bankruptcy of Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of non-bank financial firms, including affiliates of banks or other insured depository institutions. In the absence of such a framework, the government's only avenue to avoid the disorderly failures of Bear Stearns and AIG was the use of the Federal Reserve's lending authority. And this mechanism was insufficient to prevent the bankruptcy of Lehman Brothers, an event which served to demonstrate how disruptive the disorderly failure of a non-bank financial firm can be to the financial system, and the economy. Such firms as AIG, owned insured depositories, but escaped the strictures of serious holding company regulation because the depositories that they owned were technically not "banks" under relevant law. However, in response to challenges like these, a sweeping proposal was presented on 31st March, 2008, regarding the regulatory powers of the U.S. Federal Reserve, expanding its jurisdiction over other types of financial institutions and authority to intervene in market crises.⁴³

It has been observed that bank holding companies and financial conglomerates pose a special type of agency problem for regulators because these financial companies often own

⁴² J de Larosiere, et al 'Report of the High-Level Group on Financial Supervision in the EU' Brussels (February 2009).

⁴³ 'Financial Regulatory Reform: A New Foundation'.(2009).

separate subsidiaries and divisions that perform various financial functions, often in multiple jurisdictions. In response to this, the Bank Holding Act of 1956, and the Financial Services Modernization Act of 1999, attempts to address the principal-agent problem within the group structure of banks and financial firms. To do so, the Board of Governors of the Federal Reserve System (Federal Reserve), has been granted broad authority to adopt regulations to govern the management of banking and financial holding companies.⁴⁴

Further, the GLB Act impedes the Federal Reserve's ability, as a consolidated supervisor, to obtain information from or impose prudential restrictions on subsidiaries of a Bank Holding Companies (BHC) that already have a primary supervisor, including banks and other insured depository institutions; SEC-registered broker-dealers, investment advisers and investment companies; entities regulated by the CFTC; and insurance companies subject to supervision by state insurance supervisors. By relying solely on other supervisors for information and for ensuring that the activities of the regulated subsidiary do not cause excessive risk to the financial system, these restrictions also make it difficult to take a truly firm-wide perspective on a BHC and to execute its responsibility to protect the system as a whole.⁴⁵

This still poses a challenge to the regulatory authorities. To promote accountability in supervision and regulation, the US government is working towards giving the Federal Reserve authority to require reports from and conduct examinations of a Financial Holding Company (FHC), and all its subsidiaries, including those that have a primary supervisor. To the extent possible, information should be gathered from reports required or exams conducted by other supervisors. The Federal Reserve should also have the authority to

⁴⁴ K. Alexander, 'financial regulation and corporate governance in the UK and US' Cambridge Endowment for Research in Finance (2004).

⁴⁵ Ibid.

impose and enforce more stringent prudential requirements on the regulated subsidiary of a FHC to address systemic risk concerns, but only after consulting with that subsidiary's primary federal or state supervisor and Treasury.⁴⁶

3.7 CONCLUSION

The chapter has looked at the financial and corporate regime in the US and UK before the financial crisis. In the US, the regulatory authority is on the federal or state statutes. The Federal Reserve administers these statutory provisions for all depository institutions, and has the power to provide exemptions from these provisions. In this vein, the Securities Exchange Commission was, and is still responsible for regulation of security markets, and also for establishing financial disclosure rules. The Gramm Leach Bliley Act of 1999, which repealed the Glass-Steagall Act allowed subsidiaries of banks to conduct most financial activities, and hence to compete with securities firms and insurance companies. Thrifts too were permitted to engage in banking and securities businesses. It also streamlined supervision of bank holding companies by clarifying the regulatory role of the Federal Reserve as the consolidated supervisor. Further, the Community Re-investment Act was set in place to encourage banks to halt the practice of lending discrimination. And finally, the Sarbanes–Oxley Act, enacted as a reaction to a number of major corporate and accounting scandals. These scandals, which cost investors billions of dollars, when the share prices of affected companies collapsed, shook public confidence in the nation's securities markets. The legislation set new or enhanced standards for all U.S. public company boards, management and public accounting firms. It does not apply to privately held companies. In the UK, the Financial Services Commission was and still is the main regulator of financial and corporate markets. It has however, been observed that the

⁴⁶ 'Framework for Regulatory Reform' US Treasury (March 2009)

existing regulatory regime at the time was not adequate to prevent and handle the financial crisis of the 21st century. Therefore, the governments in the two nations introduced measures to enhance the regulatory regime. In the U.S. President Barak Obama and key advisers introduced a series of regulatory proposals in June 2009. The proposals address consumer protection, executive pay, bank financial cushions or capital requirements, expanded regulation of the shadow banking system and derivatives, and enhanced authority for the Federal Reserve to safely wind-down systemically important institutions. And also in response to a concern that lending was not properly regulated, the House and Senate are both considering bills to regulate lending practices. In the UK, the State introduced measures to ensure that banks and other financial institutions face tougher regulation under the Financial Services Authority. There have also been a number of proposals made some of which have been implemented, for example, the establishment of a new regulator for GSEs. The chapter has also examined some of the legal challenges that have been faced by the US and UK regulatory regimes in the crisis and how they have responded to these.

CHAPTER FOUR

4. ZAMBIA'S REGULATORY RESPONSES TO THE CRISIS

4.1 INTRODUCTION

The Zambian financial sector did not immediately or directly become adversely affected by the global economic crisis as was reflected in the continued stability of the banking sector, with most banks being adequately capitalized and the inter-bank market operating normally. This was mainly due to the sector's limited integration into the international financial markets. Further, the Country's financial sector had no exposure to toxic assets, which led to the credit crunch in most developed markets. However, one can say that the ensuing global financial crisis, with the global economic recession that followed, adversely affected Zambia, like most global economies, mainly through: reduced revenue earnings from mineral resources; job losses, particularly in the extractive industry; lower foreign capital inflow (both foreign portfolio investment (FPI), and foreign direct investment (FDI)); loss of foreign exchange reserves; rising domestic inflation driven by pass-through effects of the depreciation in the exchange rate of the Kwacha against major currencies; and declining number of foreign tourists. This deterioration calls for more vigilance for the regulation of the financial sector. This chapter will therefore, examine the regulatory regime in Zambia. The chapter will also investigate the responses of regulators to the crisis and analyze the efficiency of these responses, while giving proposals for reform.

4.2 THE CURRENT REGULATORY REGIME IN ZAMBIA.

4.2.1 The Bank of Zambia.

The Bank of Zambia (BOZ), (hereinafter referred to as ‘the Bank’), as the central bank in Zambia, is established under the Bank of Zambia Act⁴⁷. Its role is to licence, supervise and regulate the activities of banks and financial institutions. This is done to promote safe, sound and efficient operations of the financial system. The Bank carries out its role under the provisions of the Banking and Financial Services Act.⁴⁸

4.2.2 Banking and Financial Services Act 2000

The main objective of the Act to provide for the regulation of the conduct of banking and financial services and to provide safeguards for investors in and customers of banks and financial institutions, as well as other matters related to the foregoing. Among the salient features of regulation under the Act, are:

Licencing

BOZ regulates who is to be given a licence to operate a financial institution or a bank.⁴⁹ The reason for this is to ensure well capitalized banks with skilled managers are allowed to operate. Under section 7, the Bank has the power to investigate applicants of licences, so as to ensure they match up to the requirements. And further, under section 16, the Bank can revoke a license if it is in breach of any of the requirements of the Act, for example, if there was fraud.

Record- Keeping

Under sections 51 to 55, the Act provides for record keeping, but particularly, under section 52, financial service providers are required to create and maintain credit documentation and any information concerning its business relations with its customers or any person that the Bank may prescribe. This ensures transparency, as well as

⁴⁷ Chapter 360 of the Laws of Zambia.

⁴⁸ Chapter 387 of the Laws of Zambia.

⁴⁹ Section 4 – 22.

accountability of financial services providers. The information needed here includes: reasonably current financial statements of the indebtedness of the borrower, and any guarantor of the borrower to the bank or institution; a description of any collateral over which the financial service provider has any mortgage or charge as security for the due payment of the indebtedness to it; a statement of the terms of the credit, including the principal amount, rate of interest, schedule of repayments, and the borrower's objective or purpose for borrowing; and the signature of each person who authorized the credit on behalf of the financial service provider.

Financial Accountability

Under sections 56 and 60, the Act provides for financial accountability. This is to ensure transparency, protect depositor's interests, and it also gives bank supervisors knowledge as to adequate capital.

Supervision and Prudential Regulation

This is provided for under sections 69- 84. Banks are to maintain a reserve account that is to be prescribed by the Bank.⁵⁰ The provision ensures that banks do not pay out profits to their shareholders until sufficient capital remains in the bank to provide protection for depositors, and creditors of banks.

Section 72 prohibits a bank from pledging its assets for borrowing except in the ordinary course of business to the Bank of Zambia for short term liquidity advances. This provision protects banks' assets for the benefit of depositors.

Section 77 empowers the Bank to take action to correct unsafe or unsound practices for financial institutions. This provision could be used to take over management of banks in distress.

⁵⁰ Section 65.

Further, section 78 allows BOZ to examine each bank and subsidiaries to determine whether the bank was in a sound financial condition. This is done by on-site visits to make sure banks complied with the provisions of the Act, and that they are not involved in unsafe activities.

Finally, under section 81, BOZ could take action if an examination showed that a bank was conducting its affairs or engaging in unsound conduct for any reason.

4.2.3 Basle Core Principles.

The Basle Committee established a report on the core principles for effective banking supervision. The report presents a comprehensive set of twenty five core principles. The principles are designed to be applied by all countries in the supervision of banks in their jurisdiction. Globally these are the main guidelines for central bank supervision of commercial banks. They relate to: Preconditions for effective banking supervision, under principle one; Licencing and Structure, under Principles Two to Five; Prudential Regulations and Requirements, under Principles six to fifteen; Methods of Ongoing Banking Supervision under Principles sixteen to twenty; Information Requirements in Principle twenty-One; Principle twenty-two provides for Formal Powers of Supervisors, and; Cross Border Banking is under Principles twenty-three to twenty-five. The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the Central Bank Governors of the group of ten countries in 1975. It consists of senior representatives of banking supervisory authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. Following the episodes of bank failures in 1995, Zambia established measures to improve the quality of bank regulation and supervision. In 2002, the financial sector assessment program carried out by the

World Bank found that Zambia satisfactorily complies with the Basel Core Principles on Bank supervision.⁵¹

4.2.4 Securities Exchange Commission (SEC)

The Securities Exchange Commission (SEC) is established under the Securities Act 1993⁵². It is the body corporate that supervises and regulates securities in Zambia. It performs its role under the provisions of the Securities Act.

Under section 6, the Commission has power to make rules to regulate securities exchanges. This is done under statutory instruments. In relation to this, the Act prohibits the establishment of unlawful markets and holds any person who contravenes this, criminally liable. The import of this is to allow only exchanges that have complied with the provisions of the Act and are within the rules set out by the Commission, to operate. Further, the Commission also regulates the granting of licenses, where the Commission is satisfied that is in the interest of the public to grant such a licence.⁵³

Under section 30, the Act proscribes fraudulent applications for licences, and any person who is found to be in contravention of this is criminally liable.

Under sections 32 to 38, Securities Exchanges are required to be registered, as non-registered exchanges cannot operate. Further, the Commission also regulates the operation of securities businesses. Particularly, under section 47, short selling is prohibited; this is because certain types of short selling or the use of short selling with certain abusive strategies may contribute to disorderly markets.

Finally, under the Act, the Commission regulates against fraudulent trading, especially in relation to manipulation of market prices.

⁵¹ FSDP plan for 2004-2010. Section 55

⁵² Chapter 354 of the Laws of Zambia.

⁵³ Section 8 (3) and sections 18- 21.

4.3 REGULATORY RESPONSES TO THE CRISIS

As has been alluded to in the beginning, the effects of the global financial crisis have impacted greatly on Zambia, although it did not participate in causing the crisis. It has therefore, been imperative that Zambian regulators respond to this crisis, as has been done by most countries globally, especially those from which the crisis emanated, like the U.S and the U.K. In this regard, there have been a number of regulatory measures that have been announced. These include:

Improving information flows: The Bank of Zambia has enhanced its vigilance and interaction with the domestic financial system to ensure adherence to its supervisory guidelines, and to enhance information flows. BOZ is continuously interacting with banks to ensure that detailed information regarding foreign exchange transactions is provided and has also engaged major business entities to understand their expected foreign exchange requirements. This is necessary to ensure market constraints are addressed expeditiously.

Issuance of directives: On March 2, 2009, the Bank of Zambia issued directives to commercial banks prohibiting the extension of loans and/or credits and providing other sources of Kwacha funding to non-residents for any maturity period of less than one year. The Government is in the process of issuing a statutory instrument, which will clarify this position, in order to protect the integrity of the financial market.

Collaboration with regulators: Engaged other regulatory authorities regarding measures to stem the growing trend of dollarization, including some consideration to legislate and provide stringent regulations against this practice, which erodes the effectiveness of domestic monetary policy. In this regard, the Government is in the process of issuing a Statutory Instrument to ban quoting, invoicing and settling in foreign currency of domestic transactions for goods and services in Zambia. Accordingly, the Bank also

introduced measures to ensure that financial market players under its supervision provide detailed information on their foreign exchange transactions. Further, the Bank has continued to reinforce the regulation and supervision of the financial sector. Effective surveillance of the financial market has entailed adoption of appropriate risk management policies, and procedures meant to ensure that financial institutions do not undertake excessive risks that may increase the vulnerability of the country to external shocks.

Further, there is an ongoing effort to address Zambia's low level of financial inclusion. Financial institutions' usage of the Credit Reference Bureau (CRB), has now been mandated, through a BOZ directive under the Banking and Financial Services Act, in an effort to improve the credit information framework and reduce credit risk, and thereby reduce bank costs. In addition, the effectiveness of Statutory Instrument No. 183 of 1995, which regulates bank charges, is under review, with a view to requiring financial institutions to report their bank fees and charges, and any modifications thereof, to BOZ. Building on the successful pilot programs launched by a handful of financial institutions within Zambia, and the experiences of other developing countries, consideration is being given to the broad introduction of "basic accounts", with no (or low) minimum balance, no fees, and limited transactions.

The Securities Exchange Commission on the other hand has not introduced any specific regulatory measures, but has maintained the Securities Act. Mr. Hara⁵⁴ reported that the only measure the Commission has undertaken so far is to propose repeal of the Act to pave way for a new one that will be up to international standards. These are the regulatory responses that have been undertaken so far in the nation.

⁵⁴ Interview: with Mr. Constantine Hara , Legal Counsel, Securities Exchange Commission Lusaka. 4/03/10.

4.4 COMPARATIVE ANALYSIS OF ZAMBIA'S REGULATORY RESPONSES TO THE CRISIS IN LIGHT OF THE EXISTING REGULATORY REGIME

As has been discussed, there are a number of regulatory measures that have been announced by Zambian regulators. Namely, the Bank of Zambia and Securities Exchange Commission. On the on-set, the current regulatory regime in Zambia appears to be efficient, in that it has been able to support a satisfactory financial sector. However, on examining the regime, one discovers that there is still need for more to be done in order for the regime to attain international standards. In as much as there are reforms that have been announced, however, with the current regulatory regime, there is possible inefficiency in these responses.

To begin with, the Central Bank regulates Banks and Non-bank financial institutions alike, under the Banking and Financial Services Act. What the regulators overlook is that banks and non- bank financial institutions need different approaches to corporate governance that are proportional to the size, complexity, structure and risk profile of the bank. This should be taken into consideration in evaluating bank and non-bank corporate governance. The task should be for both securities regulators, as well as financial regulators, because there is interconnectedness in these sectors.

Secondly, Under the Securities Act, it seems that only companies can be licensed as securities exchanges in Zambia. If this is so, then there is a problem as regards the self-regulation of securities exchanges. In the U.S, the Securities Exchange Commission (SEC) conceded that self-regulation of investment banks contributed to the global financial crisis. It is likely that the same could occur here. As Mr. Hara⁵⁵ observed, the Commission does regulate the separate rules that the exchange markets make, however,

⁵⁵ Interview: with Mr. Constantine Hara, Legal Counsel, Securities Exchange Commission. 4/03/10.

in practice, these rules, once implemented, are not checked as to whether or not they are being complied with. This contributes to poor corporate governance.

The greatest problem faced, as Mr. Hara and Mr. Illunga⁵⁶, observed, is that there are two aspects to regulation, namely; supervision and enforcement. Supervision has to do with the provisions of the enabling legislation, whereas enforcement involves the actual implementation of the provisions. However, in as much as there is supervision of financial and corporate sectors, there is lack of enforcement, as the rules are just on paper, but not practical. In the U.S. Investors scandal of Bernard Madoff, the Securities and Exchange Commission enforced charges against Madoff, which included securities fraud, investment advisor fraud, mail fraud, wire fraud, money laundering, false statements, perjury, making false filings with the SEC, and theft from an employee benefit plan. The accused was sentenced to hundred and fifty years imprisonment.⁵⁷ Such enforcement should be the concern of Zambian regulators. Regulation should not just be on paper. There should be serious enforcement in order to curb financial crimes such as those of Madoff.

The same lies with the new reforms that have been announced as responses to the crisis. These are just on paper but enforcement has not been activated. There is evidence to this effect as regards the Securities Exchange Commission. The question is whether it effectively performs its functions. It has however, been observed that there have not been any major complaints. The reason could be that the Commission is not doing its job of effective regulation. However, other factors include shortage of staff, and also lack of independence from the State due to the fact that the Commission is funded by the State;

⁵⁶ Interview: with Mr. Marvin Illunga, Head -Public Relations, Bank of Zambia. on 9/03/10.

⁵⁷ Available at:<http://www.bernardmadoff.wikipedia.mht/>. Accessed on 30/03/10.

therefore, there is political influence in the allocation of securities. The danger here is that government officials may acquire licences for securities exchanges without meeting the requirements and this may lead to irregularities. This in turn reduces investor confidence in the country, and may make the country vulnerable to external shocks. It must be mentioned that corporate governance or indeed financial regulation cannot be effective on paper. Proper, sound, and effective criteria are those that incorporate a punitive and reward system.

In addition, as at November 2009, Civil Society for Poverty Reduction (CSPR), observed that Zambia is experiencing a total collapse of corporate governance coupled with a failed political system to resolve issues on corporate governance. They observed that persons appointed to manage Parastatals were no longer interested in making decisions, which would help save companies from collapsing as they worked on directives from those in authority. It was observed that National Savings and Credit Bank, Indeni Petroleum Refinery, Development Bank of Zambia and Public Pensions Funds were, entities that needed total attention in the manner they were managed.⁵⁸ Indeed there is need for these entities to be given proper regulation. As most of the shares are government owned, there is likelihood that poor management will characterize them. Not only this, but also assessment of huge bonuses at the expense of the nation in these entities and other companies needs to be regulated. This is a risk to the nation's economy.

It must be observed that the global financial crisis in the U'S did not occur abruptly, but rather was cumulative. It is such inconsistencies that cumulatively lead into such crises. In addition to this, Mr. Illunga, reported that Zambia among the countries least affected

⁵⁸ The Post Newspaper November 15, 2009.

by the crisis, as such, there was no need to change legislation, and also the time frame within which to change legislation was too short. He also observed, as have many others, that the financial and corporate system has been doing well lately, despite the fall in share prices, and also banks and financial institutions have been complying with legislation, therefore, it is unlikely that we could get to the point of having a crisis. He, however, overlooked the low levels of liquidity in the market during the turbulent times, and what caused the market to suffer low liquidity leading to reduced lending. Certainly, in view of this, one cannot argue that there is sufficient regulation going on. It is this comfort zone that is dangerous to the nation. The U'S regulators had the same attitude two years before the crisis. They never foresaw a crisis after the great depression, but it did occur. It is such an attitude that could lead to relaxation in regulatory measures, thereby exposing the economy to risk.

During the past few years, banks and non-financial institutions have increased their lending to small and medium-sized enterprises (SMEs) and the household sector. With the economic crisis especially on the copper belt, many of these SMEs, workers and households will be unable to service their loans. This is likely to lead to increased defaults and the consequent increased risk and cost of lending to these sectors. Already there is evidence that banks have become more circumspect in lending to such sectors.

Also, the Bank of Zambia, has not addressed the issue of deposit protection, especially for SMEs. It is important that deposits are protected, especially in this crucial period, just in case banks or financial institutions fail, people should not lose their money.

From these observations, it can be argued that the government has not taken any austerity measures to reform the current regulatory regime. It seems that the most efficient

measure taken is that of issuing directives to commercial banks, preventing them from extending loans less than a year to non-Zambians. A lot still needs to be done in bank supervision and corporate governance, to meet international standards of banks supervision and prudential regulation and corporate governance. Zambia should realize that if the nation does not have a sufficiently regulated system, the risks will always be there.

4.5 PROPOSALS FOR REFORM

In view of the flaws highlighted above, regard must be had as to the possible solutions of reforming the regulatory regime. These are based on some of the reforms undertaken in the UK, and US. To begin with, there is need for effective enforcement of standards by regulators, which may require increased independence for enforcement agencies. That is to say, regulators, in enforcing prudential standards, must be free of political interference to get on with job. When regulators have the confidence to get on with their jobs, free of political interference, this builds a culture of activist, yet measured regulation.

Secondly, the scope of regulation should be increased to embrace all systematically important financial institutions, markets and products. In this regard, particularly, the Securities Exchange Commission should increase its regulation of securities markets to reduce the need for self- regulation which is uncertain, thereby risky. There is need for mechanisms for continual updating of regulatory frameworks, to keep pace with innovation and evolving broad trends in the financial sector, and to accommodate changes to global best practice.

Zambian regulators must realize that transition to a new regime takes time, political will, legislative development and policy co-ordination. In this vein, it is proposed that

supporting industries including accounting, auditing and legal services need to review their processes in preparation for implementation. Regulatory authorities should either be newly established or encounter substantially revised responsibilities, and will need to re-define the full extent of their authority and relationship with stakeholders.

Further, as has been observed, the regulators have no explanation for the low liquidity that led to reduced lending. Government had to come in and finance the banks. In this vein, regulators must ensure that liquidity regulation and supervision should be recognized as of equal importance to capital regulation. It is important that the Bank of Zambia embarks on more intense and dedicated supervision of individual banks' liquidity positions.

Furthermore, in view of the collapse in corporate governance, as has been observed, regulators must ensure that bonuses should reflect the actual performance, and not be guaranteed in advance. Like the U.K Financial Services Authority (FSA), it is important that regulators oversee the suitability of financial institutions' bonus assessment policies, and require changes where such policies encourage excessive risk taking, and where necessary, impose additional capital requirements under Pillar II of Basel Principles, in case no adequate remedial action is being taken.

Ultimately, good regulation is about accommodating diversity, not suppressing it, by claiming that the country has not been adversely affected.

4.6 CONCLUSION

The chapter has examined the regulatory regime in Zambia, as it is currently, highlighting the salient provisions of the enabling Acts. It has also investigated the regulatory

responses taken by the regime in light of the global economic crisis. Having analyzed the responses, it was observed that there was need for reform in the regulatory regime. The chapter, therefore, gave the relevant proposals for reform. The next chapter will make final conclusions and recommendations.

CHAPTER FIVE

5. CONCLUSIONS AND RECOMMENDATIONS

5.1 CONCLUSIONS

The overall objective of this research was to propose reforms in financial regulation and corporate governance tailored for Zambia, which are modeled on the regulatory regime in the USA and UK. To this effect, It has been observed that the regulators of the financial market in Zambia have been very reluctant to enhance financial and corporate regulation under the guise that Zambian banks and financial institutions have not been performing irregularly as was the case in the U.S and U.K., and also that Zambia was among the countries least affected by the crisis. This in itself poses a risk to the nation, as this may cumulatively lead to deregulation. Thus, as the Zambian financial system develops and becomes more complex, so too must its regulatory framework. Strong supervision and investor protection, and effective enforcement are key building blocks. Traditional dichotomies that have become outdated must be addressed; legacy paradigms must be revised and new regulatory frameworks must conform to International principles. More specifically, Zambia's financial regulators and supervisors must protect consumers and investors, support market disciplines, avoid adverse impacts on other jurisdictions, reduce the scope for regulatory arbitrage, support competition and dynamism, and keep pace with innovation in the market place.

Chapter one gave the general introduction of the research, outlining its objectives, and structure of the paper. In chapter two, the research investigated the causes of the global financial crisis, which was focused on subprime mortgage lending. It was observed that regulators had become relaxed in their obligations, and as such, a lot of irregularities were going on in the financial sector. Also, a number of government sponsored enterprises like Fannie Mae and Freddie Mac purchased loans and never paid them back. The research also observed that in terms of global effects, the subprime crisis has caused

ruptures across many other countries in the form of financial failures. Most of the big nations like Germany, China and others, have had their GDPs drop to low levels.

Chapter three discussed the regulatory responses of the U.S, and U.K, to the financial crisis. Due to the impact of the global financial crisis in the two nations, regulators saw the need to improve their regime. That is, improving prudential regulation and supervision. They introduced new and tougher prudential rules, for example, the Financial Services Authority in the U.K. was given wider regulatory powers, and similarly, in the U.S, there was a new approach to the regulation of banks and their non-bank affiliates was undertaken, including the Federal Reserve assuming regulatory responsibility for all systematically important institutions. The Federal Reserve also assumed responsibility for supervising all firms that could pose a threat to financial stability, whether or not they are banks, including parent companies and their subsidiaries, on the basis that threats to financial stability can emerge from any business line, and any subsidiary and empowering the Federal Reserve to require reports and conduct examinations directly as regards any of the above. The regulation of the Securities Exchange Commission was also enhanced. It was also observed that the regulators in the two nations face some legal challenges, to which the regulators have responded favourably.

In chapter four, the paper undertook a comparative analysis of the regulatory responses in Zambia. The research examined the regulatory regime as it is in Zambia, mainly under the Banking and Financial Services Act and the Securities Act. The responses of the regulators to the global financial crisis were examined and analyzed, and an analysis showed that there was still need for more work to be done. In this vein, the paper makes a number of proposals tailored on the regulatory regime in the U.S and U.K.

5.2 RECOMMENDATIONS

Often, it is said that there is an opportunity in every crisis. In this instance, the crisis affords regulators an opportunity to revisit the design, structure and approach to regulating and developing financial systems. In this fashion, Zambia should adopt a willingness to examine existing policies and practices and consider a wide range of alternatives. As the country's financial sector develops and becomes complex, with new banks and financial institutions coming into operation, so must regulators enhance their respective regulatory frameworks, as did the U.S and U.K. In this vein, the following recommendations are made as regards the regulatory regime in Zambia, to enhance financial regulation and corporate governance:

5.2.1 Strengthening Financial and Corporate Regulation and Compliance with International Standards.

The crisis has raised the urgency for Zambia to enhance its regulatory frameworks in line with internationally agreed best standards that a global financial system requires. The boundaries of regulatory frameworks in the nation should be reviewed periodically, in light of financial innovation and broader trends in the financial system, based on agreed methodologies and tools. For example, they could enhance their corporate governance in line with the standards laid out in the 'King Report on Corporate Governance', which sets out the best corporate standards globally. The Securities Exchange Commission should review their legal and regulatory framework in line with the best practice standards highlighted by the International Organization of Securities Commissions (IOSCO) principles.

5.2.2. Promoting Market Integrity

It is believed that Zambia experienced relatively low if any instances of market manipulation, insider trading, and frauds during the financial crisis. Or simply put, there was no subprime lending. However, there is need to strengthen the regulatory oversight

and supervision over market participants including speculative investors and intermediaries, in anticipation of a rise in misconduct and abuse given deteriorating global financial conditions. This will need to be complemented by strong and effective enforcement regimes, supported by adequate regulatory resources. Thus, Zambia must look into strengthening investor protection given that the fragile market could be easily vulnerable to attack from manipulators as a result of the uncertainties over global capital market developments.

5.2.3 Increase Profile and Representation of Financial Market

The impact of the global financial crisis that Zambia has experienced clearly establishes the extent to which Zambia has become more integrated with the global financial system. In this regard, Zambia must participate actively with developed countries like the U.S and U.K, in international financial co-ordination and have a greater voice in decision making process, especially in issue of regulation.

5.2.4 Implement Financial Crimes Laws

Cases like the Bernard Madoff case reveal that there are possible financial crimes in financial systems. It is important that Zambian regulators consider enacting laws to curb financial crimes. Not all crimes can be punished under the Penal Code, and the Banking and Financial Services Act and the Securities Act, do not provide extensively for financial crimes. It is therefore, important that a Financial Crimes Act be enacted.

5.2.5 Implement Laws on Depositors' Protection

It is important that depositor's funds be protected in case a bank fails, however, this cannot be done in a vacuum. Zambia needs laws like the Public Deposits Protection Act of the U.S. which protects all deposits made to the bank, in case a bank becomes insolvent.

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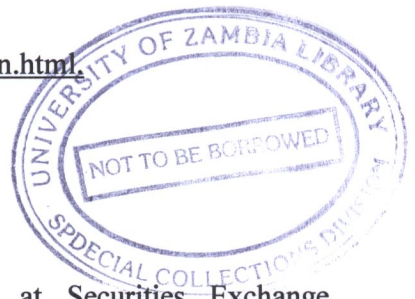
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