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HOW EURO SHRINKS DEMOCRACY: INSIGHTS FROM THE GREEK CRISIS

Alberto Lanzavecchia*, Eugenio Pavarani**, Giulio Tagliavini**

Abstract

The adoption of a single currency in Europe is a pure political project. What we have learned from Greek crisis is that being in the Eurozone means that creditors can destroy a national economy and seize public assets if the government steps out of line. To keep the European project alive, we here call for a fundamental reform on sovereign debt: switching from a goal to which policy is constrained, back to a tool to serve policy aims. In a distressed country, lenders has the power to forces the borrower to accept and to adopt restrictive spending policies that defend their interest at the expense of citizen's ones. Eventually, this leads inevitably to the loss of autonomy in borrower's decisions on fiscal policy, spending policy, public properties. If the cause for this degenerative process is the privilege on sovereign debt, then we need to find a new framework that reclassifies the public debt as functional to human development rather than individual profits. A country shall not be allowed to repay a debt that goes beyond its repayment capacity. The maximum payback capacity shall be settled before the credit is granted as a fraction of its primary balance. As such, the amount of primary balance not pledged to the repayment of the debt shall be always available to the government to undertake investments, social or security expenses and to face unexpected events. If this rule were implemented, the capital market would be automatically regulated: the debt that exceeds that threshold would be automatically written-off.***

JEL code: F02, H63, K33

Keywords: Eurozone Crisis, National Debt, Democracy, Euro Zone, Greece

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1. Eurozone's 2008/14 Crisis: Quick Guide For Non-Europeans

More than 170 publications written during the period 1989-2002 by US eminent academic economists addressed a simple question: "*Is the Economic and Monetary Union (EMU) a good or a bad thing?*" Based on an optimum currency area approach, their common conclusions were startling: potential EMU Member States were further away from a well-functioning monetary union (Jonung and Drea, 2009, pp. 33-34).

The exchange-rate fluctuation is the most effective and the promptest instrument for the adjustment of the external imbalances. By introducing a single currency within member States, alternative mechanisms would have then adjusted imbalances, to make the local production more competitive. Any differential in competitiveness would then have been transferred from the exchange rate market to the labor one.

Adopting a single currency implies giving away much more than a more or less useful mechanism for rebalancing the external accounts: the surrender of a national currency creates huge political economy problems (Bagnai and Ospina, 2014, p. 3).

A sovereign state can borrow money, which is committed to honor. Nevertheless, it can only honor it according to the sustainability of its accounts. A sovereign counterpart is not like all other private ones. It may run into financial crises that push it in dire straits, but, by definition, it has the last word. It can, for example, raise taxation, reduce or "consolidate" the debt, or print money: the mint is a vital organ of the State, such as the army or the courts.

Hence, the adoption in Europe of a single currency is a pure political project. Such a project considers crisis (predicted and unavoidable) a price to pay in order to reach more quickly the final target: the realization of a European Federal State.

The functionalist view of the European Integration Project, advanced by Jean Monnet[1], assumes that moving some policy functions to the supranational level will create pressure for more integration through both positive feedback loops (as voters realize the benefits of integrating some functions and will want to integrate more) and negative ones (as partial integration leads to inconsistences that force further integration) (Guiso et al., 2014, p. 3). In the words of Mario Monti (2004), former European Commissioner from 1995 to 2004, who espoused this theory: «*We shouldn't be surprised by Europe's need of crisis, grave crisis, to take steps ahead. Europe's steps ahead are nothing else but transfers of national sovereignty to supranational level. It is obvious that the political power and the social identification with a national community can be prepared for these cessions only when the political and psychological cost of not doing them exceeds the cost of doing them, because there is a visible, claimed crisis underway*»[2].

Well, such integration is the result of a democratic process driven by an enlightened elite's effort.

However, *«democracy, national sovereignty and global economic integration are mutually incompatible: we can combine any two of the three, but never have all three simultaneously and in full»* (Rodrik, 2011). If we want more globalization, we must either give-up some democracy or some national sovereignty. In a European perspective, each Member State shall give-up national sovereignty to a full global economic integration and a full democracy shall be exercise within an innovative Federal European State.

Yet, the European Union is even shrinking both democracy *and* national sovereignty towards a global economic integration, without any political integration within a forthcoming European Federal State! The former, by establishing institutions unlinked to polls and governments, the latter by conferring competencies and activities from Member States to supranational entities (namely: Eurogroup, European Central Bank, European Banking Authority, European Commission, etc.). In fact, according to the Treaty on the Functioning of the European Union (TFEU), when treaties confer to the Union exclusive competence in a specific area, it implies that only the Union may legislate and adopt legally binding acts.

International treaties do not automatically qualify for democratic legitimacy, even if the counterparties are democratic sovereigns. Democracy shall not be fully delegated: a well-functioning democratic polity would place severe limits on the transfer of rule-making and enforcement authority to transnational bodies. This is crucial whenever elite or its technocratic agents negotiate in secret complex agreements – such as the Transatlantic Trade and Investment Partnership (TTIP) or the Trade in Services Agreement (TiSA), currently being negotiated at supranational level without any public draft texts. Howes (2013) argues that the public and indeed even most elected representatives, in these cases face such enormous agency costs and information asymmetries which make problematic the democratic legitimacy of international economic law.

Whereas a single market within Europe might be fully achieved by regulations on free movement of capital, people and services, any further conferring of competences from Member States on EU Institutions is not functional to a free market – it is functional to a new order of sovereignty.

Following the Maastricht Treaty (formally, the Treaty on European Union or TEU), money shall no longer fit the economy of a State, but any public decision of a Member State shall fit the value of the common currency.

Essentially, within the Eurozone, Member States are experiencing a tricky inversion of aims by tools: from economic policies targeted to social goals and public finance as a tool to raise resources to pursue those goals, to European policies that set economic goals (in terms of deficit, debt, inflation) and government engaged in finding ways to achieve them.

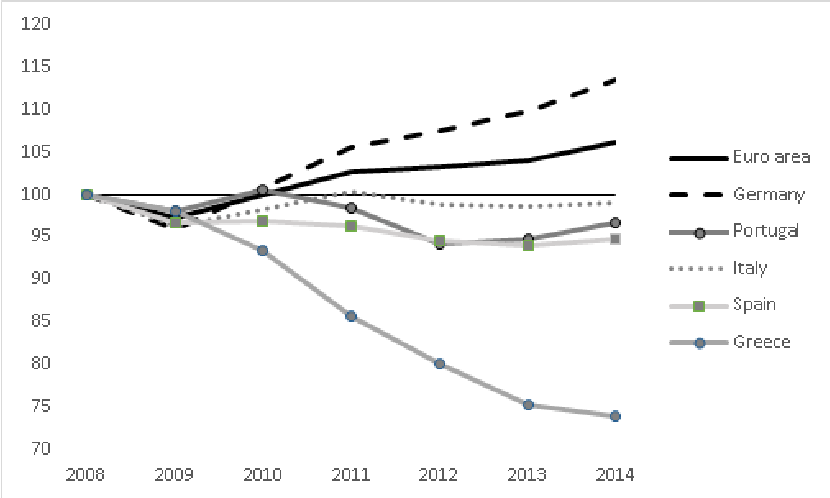
While any Member State may decide its withdrawal from the Union in accordance with its own constitutional requirements (art. 50, TEU), the question of whether a country can unilaterally leave the Eurozone without leaving the EU is controversial (Dammann, 2013). Nor a country shall be forced to leave the Eurozone.

Within this framework, in 2008 happened what was unavoidable and predicted by economists: the breakdown of unsustainable equilibria. Today the Eurozone records the lowest percentage of growth in the world; it is an island of stagnation, deflation and high unemployment rate. In fact, six years after the beginning of the crisis, most of the European countries have not yet recovered the value of GDP recorded in 2008 (figure 1).

[1] «L'Europe se fera dans les crises et elle sera la somme des solutions apportées à ces crises» [Europe will be forged in crises, and will be the sum of the solutions adopted for those crises] (Monnet, 1976).

[2] Interview in Italian available at: http://tinyurl.com/ojstk9d

Figure 1. Real GDP across selected EU Member States (2008=100)



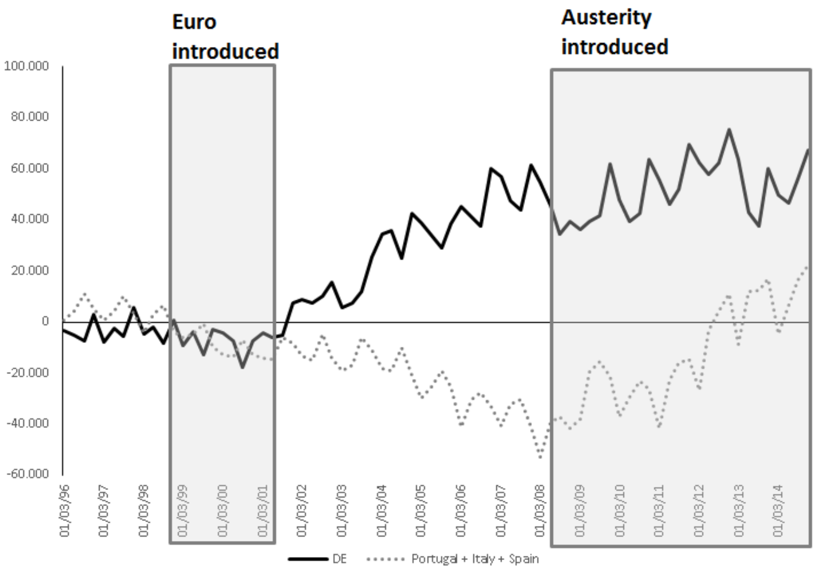
At the heart of the problem, there is a huge market failure driven by the introduction of the Euro, and its related economic policies that favored the creation of imbalances in the balance of payments.

The Brugel's final report to European Commission on the analysis of developments in EU capital flows in the global context clearly asserts: *"Persistent and excessive current account deficits, which are financed by financial account surpluses, expose countries to the risk of sudden stops and reversals in capital flows, which can lead to significant financial instability, and may lead to painful and prolonged macroeconomic adjustments"* (Darvas et al., 2013, p. 8).

In fact, the 2007/08 crisis is related to a continuous and ascending trend of accumulated deficit of the balance of payments in several economies (such as Greece, Spain, Portugal and Italy) and the correspondent accumulated surpluses in other countries (basically in Germany). These imbalances are the result of the divergences between the competitive positions of tradable products among EU Member States. The balance of the current accounts is offset by the balance of the capital account: countries facing a deficit in their current account accumulated huge debts towards countries facing a surplus, whereas the latter had financed the former, supporting their imports (vendor financing).

Figure 2 shows the quarterly current account of balance of payments in selected countries within the Eurozone. Before the introduction of the Euro data shows certain equilibrium. After that, a wide decoupling was generated by Germany, fully counterbalanced by deficits in southern countries (Portugal, Italy, and Spain). With the burst of the 2008 financial crisis, the trend is inverted, thanks to austerity policies enacted in debt countries to reduce deficit in balance of the current account and to face the capital outflow.

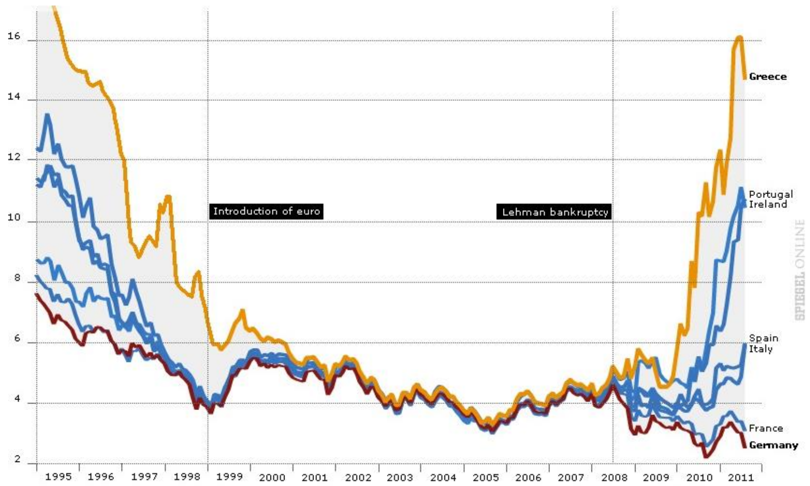
Figure 2. Current account, selected set of Countries (EUR, mln)



Yet, well before the crisis burst, such a growth paradigm was unsustainable, since it allowed several countries to grow well above their actual possibilities – e.g. not driven by productivity or return on investments. Those imbalances were fed and hidden by affordable credit, pumped by capital flows directed to deficit countries.

Like Odysseus saved the lives of his men blinding Polyphemus and then escaping hidden under the fleece of a sheep, so capital markets, fleeced with the euro, did not see the credit risk implicit in major differences in the fundamentals of European countries. In fact, after the convergence period, which ended with the introduction of the euro, differences in 10-year government bond yields among euro area countries were never more than 50 basis points until August 2008 (figure 3), but the institutional foundations of national economies continued to diverge. All national governments were considered by the bond market virtually the same, without taking into account each specificity, such as their level of debt, cash burning and therefore credit risk: at least until 2008 we have witnessed the greatest market failure in our history!

Figure 3. Interest rates on 10-year government bonds, selected set of Countries (in percent)

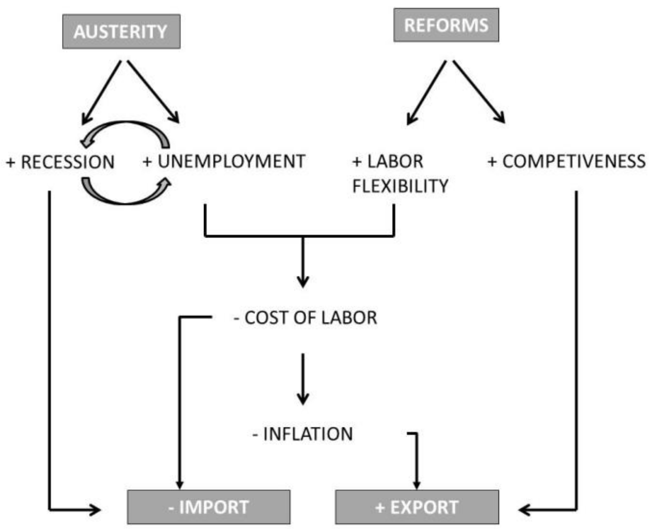


Source: Thomson Reuters Datastream

Following the Lehman Brothers bankruptcy, market's risk assessment awoke and risk appetite vanished. When German banks discontinued their revolving interbank credit to peripheral country banks, a huge liquidity shortage rose and the entire European economic system became very soon rickety.

Within the institutional and legal framework of the Eurozone, there are only two solutions to adjust the current account balance (figure 4): austerity (more taxes, less public expense, less available income, less aggregated demand, less imports) or structural reforms aimed to increase the export.

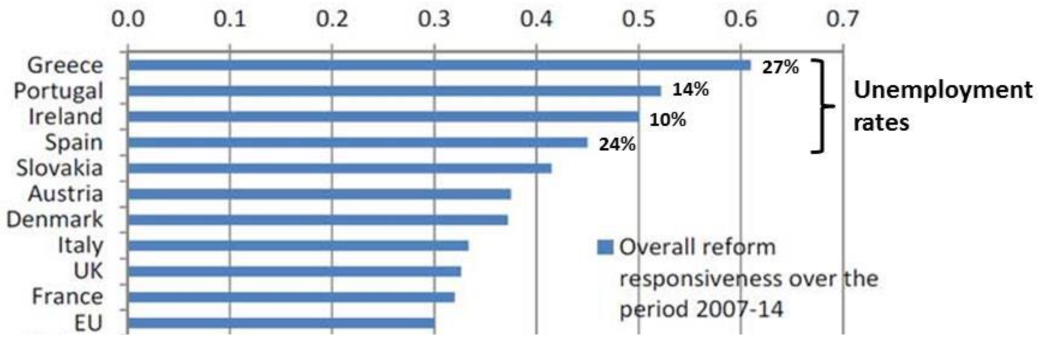
Figure 4. Policy actions and effects during the 2008/14 recession



This adjustment process has been borne by debtor nations only. "*In the absence of the option to devalue, the latter countries have been forced to reduce wages and prices relative to the creditor countries (an 'internal devaluation') without compensating wage and price increases in the creditor countries ('internal revaluations'). This has been achieved by intense austerity programmes in the south without compensating northern stimulus*" (De Grauwe, 2015).

Actually, the expected results of the structural reforms were particularly modest. Paradoxically, the countries that registered a more vigorous implementation of the reforms (namely Greece, Portugal, Ireland, and Spain) were actually the ones that relied mostly on austerity generating abnormal unemployment rates (figure 5).

Figure 5. OECD Going for Growth reform responsiveness score, selected set of Countries (average 2007-2014)



Source: OECD, Eurostat

In the above-mentioned scenario of asymmetrical adjustments, the majority of the Eurozone countries were caught in a trap which implied recession, job losses, decrease of the wage percentage in the national income, reduction of the welfare State; stuck in a misleading equilibrium of low growth and high unemployment rates. According to an Oxfam research (Cavero, 2015), in Europe, poverty and inequality have reached a shocking level (between 2009 and 2013, the number of Europeans living without enough money to heat their homes or cope with unforeseen expenses, rose by 7.5 million to 50 million), driven by austerity alongside unfair and regressive tax systems.

Moreover, in those countries such a condition fostered a vicious circle: the debt/GDP ratio or the public deficit/GDP ratio jumped out of the line due to the dramatic fall in GDP, lower tax revenues and higher financial cash burning.

Actually, now the pertinent question in the Eurozone should be: what institutions must we have (or disestablish) to take back democracy (Bagnai, 2014, p. 374)?

2. Insights from the Greek Crisis

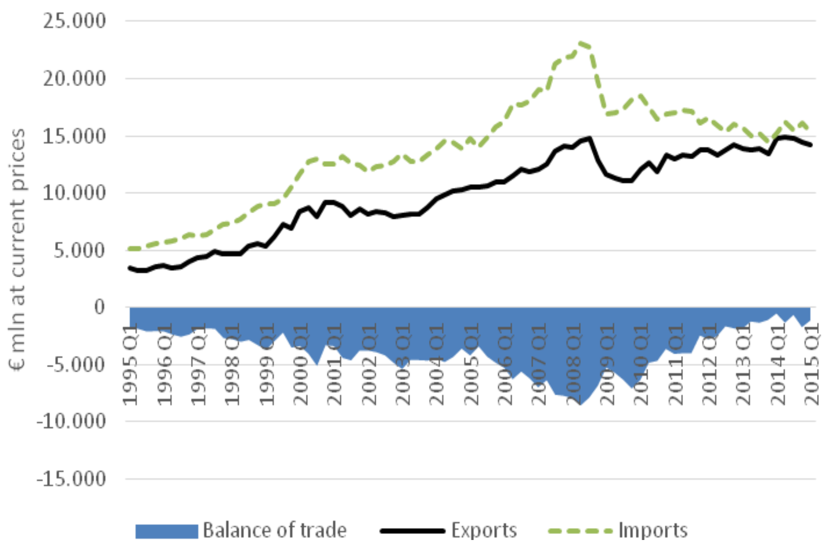
The case study offered by the Hellenic Republic in the management of the default of its public debt is not so much paradigmatic of the causes of the crisis, just described above, as of the solutions adopted, which does not recognize the causes and proposes solutions even aggravating.

Lesson 1: Fixed exchange rate or not Greece has a structural dependence on capital inflows to finance its external deficits in the balance of trade

At least since 1995 (e.g. six years before its adoption of euro) Greece reports regular trade deficits due to higher volume of imports of goods and services (figure 6, lower shadow area).[3] With the beginning of the 2008 crisis, the balance of trade has reversed its negative trend (actually unsustainable), but this has happened mainly through the destruction of domestic demand for imports (figure 6, dotted line). Greece cannot rely on exports as long as its trade goods are not demanded at any competitive level.

[3] Main imports are mineral fuels (34 percent of the total imports); machinery and transport equipment (14 percent) and chemicals (13 percent).

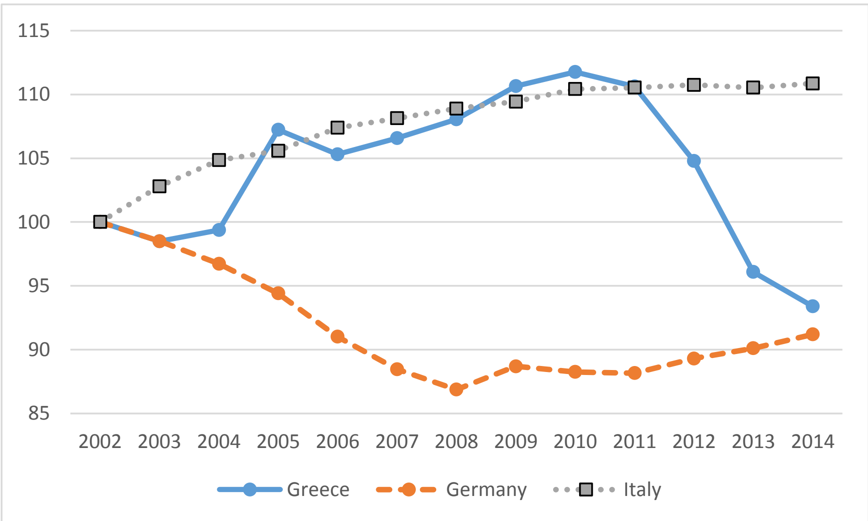
Figure 6. Greek balance of goods and services (quarterly seasonally adjusted figures)



Source: Hellenic Statistic Authority

The relative unit labour cost (ULC) series measures the trading position of an individual country relative to its partners in the euro area and as such offers an indication about changes in its competitive position. ULC takes into account variations in relative price levels based on the unit labour cost and therefore can be used as indicators of competitiveness. A decrease in the relative ULC index is regarded as an improvement of a country's competitive position relative to their trading partners in the euro area.

Figure 7. The relative unit labour cost, selected set of Countries (2002=100)



Source: Eurostat

Well, in Greece, despite the internal devaluation of labour (figure 7), the decrease of the cost of oil and the depreciation of the euro, exports were reported to the pre-crisis level in 2015 only (figure 6, solid line). This suggests that in the current situation, the Greek economy does not seem to be characterized by the elasticity of foreign trade.

If Greece quits the Eurozone, then it would cope anyway with an external constraint, due to its inability to finance its external deficit. In fact, today it can at least rely on the TARGET2 system. Out of the eurosystem Greece should instead earn every single dracma or dollar on exports in order to buy its imports from abroad. In case of insolvency in front of either the International Monetary Fund (IMF), the

European Central Bank (ECB) or the European Stability Mechanism (ESM) there would not be any possible financial support from lenders of last resource.

Once again, money serves the sovereign, not vice versa. In an effective (federal) state, the mint would print (devalued) currency, or *whatever it takes*, to serve the obligations of the sovereign. Here, we grudgingly face not a sovereign to serve, just a single private insolvent debtor. A failed debtor who need to stay within the Eurosystem safety network.

Lesson 2: the country needs debt relief

The IMF (2015), the United States' government, many other governments around the globe, and most independent economists believe (along with us) that the Hellenic republic needs debt relief. This conclusion derives first and foremost by morale (Pogge, 2002) - well before simple algebra.

Public debt should be seen from a perspective where it is functional for human development. The general principle of credit protection shall be reconciled with the higher principle of dignity protection of a person, his liberty, and the outlook of overcoming its economic problems.

Moreover, the legal relations with sovereign states should not be governed by private law, or even up to the bankruptcy law. In private law the parties are set by *synallagma* on the same level of rights and obligations. In bankruptcy law the insolvent loses rights on his assets in favor of the creditors. But the sovereignty of a country can be neither at the level of a single private creditor nor lost, but by the surrender and submission to another's foreign authority. Of course, a sovereign state shall be bound to repay its debts, as much as it can, but not at all costs. Here comes the key factor to unveil before discussing debt sustainability: the primary balance of a nation.

Primary balance is defined by ECB as government net borrowing or net lending, excluding interest payments on consolidated government liabilities. In plain English, it is the cash in hand to payback debt, interest and capital. After interests payments the budget might be in deficit or surplus. Table 1 shows time series data on primary budget across selected European countries.

Debt sustainability assessment is based on primary balance and its realistic projections. In fact, a state might maintain a fixed value of the outstanding debt (by issuing new debt when the former falls due and pay interests on the outstanding debt) or deleveraging to reduce future cash burden for interest payments (by paying back debt). The primary balance is the source of cash either for the former strategy (to pay interest on outstanding debt) and for the latter (to pay interests and the principal).

Here comes basic algebra. As of 31 December 2014, the nominal value of the outstanding debt issued by Hellenic Republic worth 317.094 million euros, that is 169 times its primary balance recorded in that year. Or, to say, other things been equal, it is needed a period of 85 years to payback the 50% of the outstanding debt on an interests-free basis. Please note that the primary balance in Greece was negative until 2012.

Table 1. Primary balance, selected set of Countries

	Germany		Greece		Italy		EMU 18	
Year	€ mln	% GDP	€ mln	% GDP	€ mln	% GDP	€ mln	% GDP
2014	69.512	2,394	1.872*	0,590	26.126	1.617	n.a.	n.a.
2013	60.499	2,153	667*	0,209	30.487	1,894	-9.854	-0,099
2012	65.769	2,392	-7.128	-3,670	35.776	2,215	-61.489	-0,626
2011	43.870	1,625	-6.154	-2,962	19.262	1,175	-111.893	-1,145
2010	-41.509	-1,611	-11.883	-5,253	715	0,045	-322.379	-3,389
2009	-9.680	-0,394	-24.383	-10,270	-13.424	-0,853	-314.180	-3,394
2008	67.963	2,657	-12.051	-4,978	36.525	2,237	79.591	0,576
2007	74.942	2,986	-5.021	-2,156	52.089	3,235	211.242	2,254
2006	28.155	1,178	-3.553	-1,631	13.320	0,597	121.394	1,367
2005	-11.335	-0,493			5.003	0,233	32.147	0,265
2004	-19.492	-0,860			15.061	1,039	9.720	0,083
2003	-25.434	-1,147			21.671	1,558	7.445	0,095
2002	-20.670	-0,937			32.062	2,381	56.418	0,516
2001	-1.019	-0,047			34.971	2,691	123.695	1,684
2000	87.132	4,123			59.560	4,804	250.658	3,571
1999	31.043	1,506			53.809	4,590	166.160	2,494
1998	17.788	0,613			55.057	4,847	134.411	2,099
1997	10.000	0,354			67.055	6,150	114.430	1,869
1996	529	0,027			46.201	4,428	65.093	1,107
1995	-111.927	-5,897			38.337	3,891	-109.379	-1,926

Source: ECB Statistical Data Warehouse. *: Hellenic Republic, Ministry of Finance

Of course, the primary balance might grow by means of higher revenues (taxes) or lower expenditures (public services), or both. In theory, the former might grow constantly every year, but cost cutting has a minimum threshold below which a state ceases to function.

Well, Eurozone is an island of stagnation and deflation (figure 1). Among European Union member states, over the period 2010/2014, Lithuania recorded the highest compounded average growth rate in GDP: +4,29%. However Greece cannot exploit exports to push its GDP (and indirectly its primary balance via taxation) nor to cut further its services provided to citizens. Optimistically, Greece might stands halfway, between Lithuania and the average stagnation. Eventually, it might sell all assets it holds: public, tradable and commons. The government of Greece has officially promised to raise euro 50 billion (about 16% of total debt) through sales of public assets. Privatization can overcome liquidity problems. If the problem is solvency, such as the one experienced in Greece, privatization will only make difficulties worse, especially if assets are sold at distressed prices (Manasse, 2011; Gros, 2011). Would it be still a sovereign state the one who holds nothing to manage for its citizens? Individual creditors shall not seize public goods and commons.

Consiglio and Zenios (2014) proposed a scenario analysis for debt sustainability and integrate it with scenario optimization for risk management in restructuring sovereign debt. An application to the case of Greece confirms that its debt is highly unsustainable, but sustainability can be restored either with an upfront nominal value haircut of 50%, or interest rate concessions of 70%, or maturity extension by about 10 years (Consiglio and Zenios, 2015). Their findings are in line with the IMF (2015) conclusions, and provide additional robustness since they hold true with high probability. Based on a slightly more complex algebra, their conclusion is clear-cut and consistent with ours: "*No matter how misguided the negotiating tactics of the Greek government might have been, debt was unsustainable before they came to power*".

What we have learned from Greece debt negotiations is that being a member of the Eurozone means that creditors can destroy a national economy and seize public assets if the government steps out of line: "*it is as true as ever that imposing harsh austerity without debt relief is a doomed policy no matter how willing the country is to accept suffering*" (Krugman, 2015).

Lesson 3: #ThisIsACoup

Let's go back to the Dani Rodrik's political trilemma of the world economy. Given three policy targets, namely "international economic integration", the "nation-state", and "mass politics", we can pick any two out of three: "*If we want true international economic integration, we have to go either with the nation-state, in which case the domain of national politics will have to be significantly restricted, or else with mass politics, in which case we will have to give up the nation-state in favor of global federalism. If we want highly participatory political regimes, we have to choose between the nation-state and international economic integration. If we want to keep the nation-state, we have to choose between mass politics and international economic integration*" (Rodrik, 2000, p. 180).

Greece, as a member state of the European Union, is headed in the direction of aligning jurisdictions within the internal market and of removing "border" effects. In the Rodrik's trilemma framework, EU would be in the "global federalism" case, by giving up single nation-states. In this case, national governments would not necessarily disappear, but their power would be severely constrained by supranational legislative, executive, and judicial authorities. A global government would take care of the fully integrated market. By contrast, in a pure global federalism case, politics need not, and would not, shrink: it would relocate to the global level, where political institutions are responsive to mobilized groups of electors. However, EU is far away from a federal system at present, as long as its fundamental authorities are excluded from the electoral scrutiny.

Eventually, European Union is even giving up a second node of the Rodrik's trilemma: mass politics – democracy. The case of the couple "nation-state" & "international economic integration" in the trilemma is what Thomas Friedman (1999) labeled as the "Golden Straitjacket":

As your country puts on the Golden Straitjacket, two things tend to happen: your economy grows and your politics shrinks.... [The] Golden Straitjacket narrows the political and economic policy choices of those in power to relatively tight parameters. That is why it is increasingly difficult these days to find any real differences between ruling and opposition parties in those countries that have put on the Golden Straitjacket. Once your country puts on the Golden Straitjacket, its political choices get reduced to Pepsi or Coke - to slight nuances of tastes, slight nuances of policy, slight alterations in design to account for local traditions, some loosening here or there, but never any major deviation from the core golden rules" (Friedman, 1999, p. 87).

According to Rodrik (2000), in a world where national markets are fully integrated, the shrinkage of "mass politics" would get reflected in the insulation of economic policy-making bodies from political participation and debate, the disappearance (or privatization) of the welfare state, and the replacement of development and social goals with the prerequisite to maintain market confidence. Once the requirements for a sound and fully integrated global economy are set, the ability of parties or popular groups to access and influence national economic policy-making has to be restricted.

Now, in light of this framework, fully outlined ten years before the Greek crisis (curiously right in the year when Greece adopted the euro), we can step ahead in our analysis.

In fact, the one here discussed is a unique shocking case study on how democracy shall be shrunk to serve a stodgy "Golden Straitjacket & (still in progress) Global Federalism" double sandwich.

On 26 January 2015 Alexis Tsipras, leader of the Syriza anti-austerity party, was sworn in as prime minister of Greece at the presidential palace in Athens. During the ceremony, he said he would have given his all "to protect the interests of the Greek people" and "an era of national humiliation is over". Together, Syriza and Independent Greeks jointly control 162 seats in Greece's 300-seat legislature. Syriza staked its election campaign on repudiating the steep budget cuts and tax increases that Greece agreed to in exchange for a financial rescue. He has promised, first, to deliver a spending package aimed at Greece's struggling poor, and then to use money earmarked for debt payments on social programs in Greece (Bouras and Granitsas, 2015).

At the end of June 2015 the negotiations with creditors stalled. Consequently Alexis Tsipras called a snap referendum to ask the Greek people whether or not the government is willing to surrender to measures demanded by the Juncker Commission, the IMF and the ECB (jointly, the so called "Troika") during the Eurogroup (an entity not disciplined by any Treaties) meeting on 25 June, which are conflicting with the electoral program.

The question of how to vote in Greece's referendum has split Nobel economists. Paul Krugman and Joseph Stiglitz came out on the No-side, while Christopher Pissarides on the opposite one, even if they jointly called for debt relief earlier.

As a result of the 5 July referendum, the bailout conditions were rejected by a majority of over 61% to 39% approving, with the "No" vote winning in all of Greece's regions.

Just a week later, Greece surrendered to Troika and its democracy vanished.

On 12 July 2015, the Euro Summit[4] (2015) welcomed the commitments of the Greek authorities to legislate without delay a first set of measures which include, among others: higher taxes, a comprehensive pension reform programme, quasi-automatic spending cuts in case of deviations from ambitious primary surplus targets, a significantly scaled up privatisation programme with improved governance[5].

Of course, in a parliamentary government such measures ought to be discussed and voted freely by Members of Parliament. In this dramatic case study, all of them were decided and written *before* a discussion within the deliberative body. The Greek Parliaments had only to ratify norms decided elsewhere by external authorities – unlinked to polls nor mandates.

Such a result is fully suitable to the Rodrik and Friedman's Golden Straitjacket: *once your country puts on the Golden Straitjacket, its political choices get reduced to Pepsi or Coke* – no referendum for Ubutu cola or else!

Here comes the bitter lesson learned: any resurgence of democracy or popular "bottom-up" choices shall be sedated. The election results from *referendum* or elected government who attempt to remove the straitjacket shall be quickly dismissed.

Neoliberalism running integrated economies does not govern with the tanks and the colonels. It requires that nation-states approve in full its diktats about economics orthodoxy. It requires that nation-states internalize and disseminate the role of play among the people and next-door countries. It entails that debtors feel guilty if they fail to repay a debt and kneel to expiate such sins.

Lesson 4: Greek banks: illiquidity or insolvency?

While at government level the matter is one of solvency (e.g. value of outstanding debt higher than the value of assets), at bank level is it the case of insolvency or liquidity? Can banks survive the bankrupt of the State?

As a result of the credit multiplier, no bank in the world could face the willingness of all creditors to withdraw their deposit. Indeed a modern banking system is based on trust: trust that money deposited in a bank exits - even if it is not so. If all creditors run to a bank to withdraw, a bank fails.

Given the end of trust among depositors, without the ECB liquidity provision Greek banks are unable to convert their assets into the cash that their depositors are willing to withdraw. However, the Emergency Liquidity Assistance (ELA), supplied by the European Central Bank, can only be provided against sufficient collateral. Hence, the financial situation of the Hellenic Republic has an impact on Greek banks since the collateral they use in ELA relies to a significant extent on government-linked assets.

If ELA were to be terminated (in case of no deal on debt restructuring) the banks would effectively run

[4] The Euro Summit is composed by the heads of state or government of the euro area countries, the Euro Summit President and the President of the European Commission. It provides policy guidance to ensure the smooth functioning of the Economic and Monetary Union. This helps to coordinate all the relevant policy areas between the euro area member states.

[5] Valuable Greek assets will be transferred to an independent fund that will monetize the assets through privatisations and other means. The monetization of the assets will be one source to make the scheduled repayment of loans for a targeted total of euro 50 billion.

out of cash and collapse. A significant part of their assets currently pledged as collateral for the ELA would be seized, as the banks would have no cash left to repay the ELA funds. At that point, the banks would need to be heavily recapitalized. A default of the Greek government would negatively affect banks not only via liquidity shortage (ELA termination), but sooner via insolvency too.

In fact, as of May 2015, the four larger Greek banks hold government bonds for 3% to 5% of their total assets (Merler, 2015). A sovereign default would further negatively affect the Greek economy, which recorded arrears by the Greek finance ministry during the first six months of 2015, and this would in turn affect banks non-performing loans figures.

According to Merler (2015) the ESM tool for direct recapitalization would require a very significant bail-in of 8% of total liabilities, that is, given the structure of Greek banks' liabilities, it would require a 100% haircut on junior and senior (non-government-guarantee) bonds plus very high haircut on uninsured deposits (ranging between 12% and 39%).

The lesson learned here is that it is crucial to separate banks' troubles from those of the sovereign and ensure that the banks can be kept alive even if the sovereign is dead.

The ESM, even if it is never used as of today, seems to be a step backward of one's desired. Harshly limiting banks holding in government bonds on a going concern is what seems to solve the problem at its root.

3. From lessons learned to policy actions

In a previous article, we questioned whom among Euro or Democracy will surrender first (Lanzavecchia and Pavarani, 2015). After Greek capitulation, the only possible democratic outcome in Europe is now the collapse of the political project, and its fundamentals institutions, designed to serve capital against people: like it or not, all else is slow-burning tyranny. Many observers are now sharing the conclusion that "*Neoliberalism is inherently incompatible with democracy. Something has to give, and it must be the people. This is the true road to serfdom: disinvesting democracy on behalf of the elite*" (Monbiot, 2015).

Electors feel frustrated when they realize the impossibility to change the Eurozone's self-destructive economic policy through elections or referendum - that is the most basic rules and instruments of democracy. In spring 2017, the European Commission will make specific proposals on how to pool sovereignty further. We fear that by that date there would be no more sovereignty to pool.

To keep the European project alive, we here call for a fundamental reform on sovereign debt: switching from a goal to which policy is constrained, back to a tool to serve policy aims.

Let's start our arguments from the "international resource and borrowing privileges" (Pogge, 2002), which allow a third entity effective power in a country to sell its assets and resources or to borrow in its name.

Under existing international rules, a government may authorize a person or a group holding to sell the country's resources and to dispose of the proceeds of such sales; to borrow from investors and thereby to impose debt service obligations upon it; to sign treaties on people's behalf and thus to bind its present and future population.

According to Pogge (2002), international resource and borrowing privileges cause there main dysfunctional results.

First, this mechanism finances and sustains countries where governments are either not democratically elected or even unpopular by electors.

Second, international resource and borrowing privileges allow privatizing the wealth of a country, because the new borrowing equals the discounted cash value of future wealth otherwise not yet transferable.

Third, any future democratically elected government would face the burden of the enormous debt piled up by predecessors that shrinks its capacity to implement social policy.

In all of these scenarios, people are overwhelmed by capital (and its tyranny).

The refinancing process of a distressed country pushes the creditor to lend more funds in order to facilitate the repayment of past debt. The net capital employed in the refinancing process is ultimately low.

In a distressed country, lenders has the power to forces the borrower to accept and to adopt restrictive spending policies that defend their interest at the expense of citizen's ones. Eventually, this leads inevitably to the loss of autonomy in borrower's decisions on fiscal policy, spending policy, public properties. The result is a national sovereignty loss.

"We have been indebted for fifty, sixty years and even more. That means we have been led to compromise our people for fifty years and more. Under its current form, that is imperialism controlled, debt is a cleverly managed reconquest of Africa, aiming at subjugating its growth and development through foreign rules. Thus, each one of us becomes the financial slave, which is to say a true slave, of those who had been treacherous enough to put money in our countries with obligations for us to repay. (...) Debt cannot be repaid, first because if we don't repay, lenders will not die. That is fore sure. But if we repay, we are going to die". (Thomas Sankara, former president of Burkina Faso, on 29 July 1987 at the OUA in Addis Ababa).

If the cause for this degenerative process is the privilege on sovereign debt, then we need to find a new framework that reclassifies the public debt as functional to human development rather than individual profits. The private law on bond provisions shall be limited by human rights: capital shall be limited by human dignity and the right to liberty and life without slavery or servitude.

Hence, we urge to break up this mechanism.

To break this loop, a country shall not be allowed to repay a debt that goes beyond its repayment capacity. The maximum payback capacity shall be settled before the credit is granted, in the loan's prospectus, as a fraction of its primary balance. As such, the amount of primary balance not pledged to the repayment of the debt shall be always available to the government to undertake investments, social or security expenses and to face unexpected events – e.g. the exercise of its sovereignty.

The primary balance pledged to the repayment of public debt shall not include capital disposals of strategic assets (architectural heritage, infrastructures and commons) or commons.

Under this rule, the maximum cash flow to international creditors would be flexible, varying every year depending on the primary budget.

If this rule were implemented, the capital market would be automatically regulated: the debt that exceeds that threshold (e.g. a debt unsustainable without hurting present and future generations) would be automatically written-off.

It is important to prevent a government to payback more than what it is coherent to the needs of the same country for an internal balanced equilibrium. Likewise, international financial institutions have to evaluate the cash flow a country need to repay its current debts and what is the sustainable amount, under the penalty of automatic write-off. If the loans granted are higher that the repayment capacity, an automatic haircut mechanism would balance out the distortion and put it back to a stability condition.

A limit to the repayment of the external debt could provoke a weakening of the borrowing capacity and this might be considered by someone as a harmful effect to the economic freedom of a country. But the rule aforementioned is finalized to realize an exchange between (less) freedom ex-ante and (more) freedom in case the repayment capacity would turn for the worst. Furthermore, the solution here described would be coherent with the need to curb the incentive to take on excessive debt for some countries and to restore market monitoring, nowadays hidden behind misleading automatisms.

If this rule were applied to the public debt of Greece (or Italy's), today the nominal value of the issued debt would not be reimbursable under conditions of equilibrium and full sovereignty (not even privatising all public goods). Today international lenders would not grant any more credit, borrowers would benefit automatic write-off on the outstanding debt, but the country would continue its normal activity having its residual primary surplus intact and it would not be forced to dispose assets owned by the people, present and future, to satisfy private creditors.

Until a mechanism able to discourage further lending to an entity that is not in the condition the repay it in the future is in place, we will always face a "loan shark" that takes advantage of the state of need of the borrowers. This usurer would first take all its proprieties, and the ones of the related parties, and eventually the life of people.

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EVALUATION OF THE AUDIT COMMITTEES OF GOVERNMENT MINISTRIES IN NAMIBIA: THEIR COMPOSITIONS, FUNCTIONS AND REGULATIONS

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Abstract

The aim of the underlying study to this paper is to evaluate the audit committees in the government ministries in Namibia; by assessing their composition, the function and regulations that govern committees. The study used a qualitative approach of inquiry. A purposive sampling method was used as the researcher selected ministries with audit committees. Thematic and content analysis was used in this study. Both primary and secondary and data were used. On primary data, interviews were conducted and recorded with a voice recorder. Secondary data was during the review of existing literature on the subject. The study found that from the 4 government ministries with audit committees, only one ministry consisted of independent members as well as an independent chairperson, while 3 ministries are chaired by members within their organisations. There was clear evidence of lack of accounting / financial /auditing competence among the committee members. This trend is contrary to the best practice which requires that the chairperson of the audit committees be independent of the ministry as well as the members of the audit committee. The finding indicates possibility of lack of capacity to carry out the functions of audit committees; weak internal control systems; chances of conflict of interest and complacency due to the lack of independence. There is avenue for further research as more ministries in Namibia are now establishing their audit committees, especially as the Namibian Code of Corporate Governance (the NamCode) gains more popularity among the public sector.

Keywords: Audit Committee, Internal Control, Non-Executive Director, Ministry, Permanent Secretary

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Introduction

According to Enofe, Aaronmwana and Abadua (2013) the development of audit committee in corporate environment can be divided into two periods, voluntarily establishment and mandatory establishment period. Saurez, Garcia, Mendez and Guitierrez (2012) argues that voluntarily setting up of an audit committee does not necessarily imply that there was a genuine intention on the part of the company to create an effective control mechanism to prevent the manipulation of accounting information. Moreover Davies (2009) argued that in Spain, researchers found that voluntarily audit committee did not lead to the improvement on the reliability of accounting information. However, such committees are merely the product of marketing campaign to improve the firm’s public image. Audit committees have become topical in modern corporate governance world following the major scandals such as Enron in 2001 (BBC, 2002). The scandal even saw the fall of 'Big Five' Accounting Firm Arthur Anderson Firm in United States (Nguyen, 2009). These scandals that lead to the collapse of the firms brought up an awaken call out to audit committees to improve the performance of their functions (Enofe,et al.,, 2013) Due to these scandals authorities were forced to device a lot of legislative instruments such as the King III report (Ferreira, 2008). Furthermore, there was an increase on both regulation and guidance in order to improve corporate governance mechanisms and to reinstate assurance on investors in financial reporting (Morgan, 2010); hence the mandatory establishment period. Sarbenes-Oxley Act (SOX) stipulates that audit committees responsibility is to assist in transparency on internal controls in reporting of financial matters in private and public sector (Chien, Mayer & Sannettie, 2010). Relating more to Africa, KPMG (2009) recommends that audit committee should consist of independent and suitably qualified audit committee should be appointed by the shareholders. The South African Companies Act 71 of 2008 state that an audit committee is a governance control designed to oversee financial reporting, internal controls to assess risk and audit activities (Lin, Hutchinson & Percy, 2013). The main aim is to improve the organisational governance, whether in private or public sector, and to provide assurance on financial and compliance issues through thorough examinations, accountability and efficient use of resources. Audit committees also serve as an advisory function aimed to improve the performance of an organization (Magrane & Malthus, 2010).

For the effectiveness of the audit committee, KPMG (2009) indicate that when appointing an audit committee there should carefully scrutinize on the composition to have members who are knowledgeable in financial accounting, auditing and corporate law. Furthermore, Barua, Rama and Sharma (2010) reiterates the same concept of the need for suitably qualified and experienced audit committee members with specific accounting expertise and auditing experience who are positively associated with internal control effectiveness and the quality of financial reporting. Contrary to this, as Ferreira (2008) points out, a number of studies have shown that most of the audit committees are composed of individuals who do not have the necessary skills, knowledge and experience to function as audit committee members. Ferreira (2008) further contends that the lack of skills, knowledge and appropriate experience hinders the members to perform their duties with due diligence. Further to the above, Ferreira (2008) also states that non-availability of experienced non-executive directors is another challenge faced by audit committees. Migrane and Malthus (2010) contend that in the later studies of their examination of the audit committees it was found that audit committees with less financial expertise are likely to be identified with internal control weaknesses. Similar trends have been reported in some African countries as well as the public sector.

There has been an emphasis that government ministries in Namibia should establish audit committees. The Public Accounts Committee (PAC) of Namibia in its recommended that the ministries and offices must establish audit committees. (Ihuhua, 2012). Currently in Namibia, the only document that governs audit committees in the private sectors and State-owned Entities (SOEs) is the Corporate Governance Code for Namibia (NamCode). So far there is no documentation that regulates government ministries audit committees, but only the PAC recommendations (Ihuhua, 2012). Following the 1994 King Report on Corporate Governance for South Africa and its successors, King II and King III, Namibia established the NamCode based on King III report that provides guidance to all Namibian corporate entities with a list of best practice principles to assist and guide directors to make the right choice for their entities for good corporate governance (Deloitte, 2013). According to Deloitte (2013), the NamCode provides guidance to all Namibian corporate entities, as well as public entities, on various governance related aspects; including audit committees.

Notwithstanding the provision of these codes, suitably qualified committee members with some levels of independence are essential to an efficient audit committee. Otherwise, there will be no assurance of effective internal controls, processes and system in place. Kauaria (2005) observes that there is an absence of an effective internal audit function in the government ministries in Namibia. Furthermore, Masawi (2012) states that most Namibian companies do not have enough representation of qualified board members and audit committee members while public institutions are dominated by political appointees; a situation that compromises the efficiency within SOEs and government ministries, being the most affected institutions. It is against this background and problem that this paper presents the following objectives.

Objectives of this paper

This paper aims to: 1.) assess the compositions of the audit committees in selected government ministries in Namibia; 2.) evaluate the functions of the audit committees in the government ministries in Namibia; and 3.) understand how audit committees in government ministries are regulated.

The remaining part of this paper is divided into sections on literature review, research methodology, presentation of result and discussion thereof, conclusion, recommendations and suggestions for further studies.

Literature Review

Scarcity of Skills

The issue of skills has been a problem in the audit committees. Ferreira (2008) maintained that South Africa's most audit committee members in some instance lack necessary skills, knowledge and experience that qualify them to be effective members of the committee. Wixley and Everingham (cited in Ferreira 2008) state that there is lack of availability of non-executive directors who are willing to serve on audit committees. Ferreira (2008) further stresses that a professional director at Ernest and Young stated that is not easy to find people with the appropriate skills, experience and who can work effectively in an audit committee. Morgan (2010) states that the requirement which the audit committee have to meet such as the independence and financial literacy makes candidates to hesitate in acceptance of these positions.

Al-Saeed and Al-Mahamid (2011) declare that an audit committee cannot be effective if it does not have the necessary and properly qualified people as members. According to Beasley (cited in Al-Saeed & Al-Mahamid 2011) pointed out that companies with fewer rate of outside independent directors are more vulnerable to financial fraud compare to companies with majority members who have executive directors. Al-Saeed and Al-Mahamid (2011) state that, based on a research that was done in the US, large number of audit committee members lacked knowledge in accounting and auditing. Thus, many companies did not depend on these audit committees. Similarly, Davies (2009) adds that in Welsh, there was a problem in recruitment of audit committee members, particularly on small councils, it was difficult to identify members with suitable talents and know-how and especially when such members are serving on multiple committees as they tend not to be committed.

Munro and Buckby (2008) in their study found out that in Australia the compliance on independence of audit committee members is not in accordance with the stipulated practices and guideline, it was far much lower than commended. This arose as a fact of lack of transparency in disclosing what independence is all about and not appointing independent audit committee members. Munro and Buckby (2008) further state that prior studies by Buck in 1994, reported that in Australia 46% of audit committee chairpersons and 14.1 % of other audit committee members had accounting and auditing experience the rest did not have accounting knowledge. The results indicated that audit committee members were relatively lacking financial expertise during the first period of regulation.

The collapses of Barings, Enron, HIH insurance and many others around the world were the catastrophes of the monitoring systems. However this was due to certain limitation of lot of information, not knowing what to do and lack of availability of information that limited their capability to turn out to be effective monitors (Lama 2011).

Huang and Thiruvadi (2014) argued that the percentage of independent member and the average tenure of audit committee members has a significant negative impact related to the incident of misappropriation of assets in public held companies. Moreover firms that operate in poor corporate environment with fewer outside directors and who are overcommitted seems to fall into fraud. Bhasin (2012) argues that most of the roles of the audit committees has been limited due to the lack of expertise and time. Morgan (2010) argued that the high experienced audit committee members do sit on too numerous audit committees and this affects their time to be committed.

Szezepanskowski (2012) on his study found that 40% of audit committee members gave reasons for slow audit practice, which is caused by lack of financial accounting or audit experts on supervisory boards and audit committees, independency of committee members, shortfall of laws or other regulations and lack of proper cooperation from management. Morgan (2010) states that audit committee members need to be educated on a continuous basis to stay abreast of the new changes as they might not have current knowledge on International Financial Reporting Standards.

It seems that most authors have acknowledged that there is lack of financial expertise in audit committees and that other tasks besides being audit committee members hinders them to perform their duties diligently. This may be evident in the case of Namibian ministries.

The nature and composition of audit committees

According to Ng (2013), the efficiency of audit committee is influenced by their structures and members and the governance characteristics such as the independence, financial knowledge, knowledge about the industry the company operate on, holding of meetings on regularly basis, size of the committee, and the presence of an audit committee charter.

Al-Saeed and Al-Mahamid (2011) argued that one of the vital features of establishing an audit committee is the composition of an audit committee. The independence of audit committee members is considered as the most important feature that need to be looked at. Moreover the composition of equal numbers who are non-executive directors enable the audit committee to effectively check the powers of the executive directors (Enofe et al 2012). The most critical success factors in the audit committee composition are to have non- executive directors who are considerate, diligent, good morals and judgmental (Morgan 2010).

Lexicon (2012) states that the UK Corporate Governance Code of 2010 necessitates that the "board should formulate an audit committee that consists of at three members, and at least two in smaller companies. The audit committee members should be independent from management. The need for three members is also supported by the Public Finance Management Act (PFMA) of South Africa which requires that audit committee consists of three members of whom one should not be a member of the public service. The majority of audit committee members should not be employees of the department. Departure of having majority members can only be approved by the treasury. (Ferreira, 2008).

Islam, Islam, Bhattacharjee and Islam (2010) believes that independent directors should meet certain features that will assist them in achieving their monitoring role. One of the characteristics that they bring in to the committee is the expertise and another one is independence. The expertise and independence is vital in order to retain or enhance their reputations in the external labour market. Munro and Buckby (2008) maintain that independence of audit committee members should be perceived as a crucial characteristic in ensuring that they accomplish their fiduciary duties on making good decisions that are in the best interest of a company's shareholders. Audit committees that consist of independent members are more effective and meet corporate governance requirements. Furthermore, there is an increase in financial expertise when the majority of audit committee members are independent.

Chairpersons of audit committees

(Ng 2013) stresses that the independence of the chairperson is deemed to play a crucial role in enabling audit committee effectiveness. Ferreira (2008) accent that in South Africa the Corporate Laws Amendment Bill of 2006, stipulates that the chairperson may not be an employee of the department, this is included in the National Treasury of 1999 of South Africa. Ferreira (2008) also maintained that the chairperson of audit committee should be an non- executive member and should not be chairperson of the board of directors. There should be a distinct between the chairperson of the audit committee and the board of directors. Furthermore Al-Saeed and Al-Mahamdi (2011) pointed out that the success or failure of the operation of an audit committee depends on the chairman of the audit committee. Therefore the chairman of the audit committee should be chosen with great care. In addition Hegazy, Hegazy and Hegazy (2010) argued that combining the role of the chairman and Chief Executive Officer (CEO) reduces effectiveness of audit committees. However (Hegazy et al., 2010 & Ng, 2013) believe that there should be a difference of the CEO and chairman in terms of their positions. The chairperson of the audit committee should not be the CEO or Chief Financial Officer (CFO) of the company neither a board member. Ng (2013) also accords that the chairperson of the audit committee plays a crucial role in ensuring the effectiveness of the audit committee's operation in a company. The chairperson of the audit committee should have financial background and should have knowledge on the operations of the company.

Size of audit committees

The audit committee should comprise of at least three members of whom the majority should be independent members and an independent chairman. Munro and Buckby (2008) reiterate that audit committee should have three members who are financially literate. Prior studies have shown that financial knowledge is critical for audit committee members to have the ability to read and understand financial statements. NG (2014) is also in agreement with other authors that audit committees should consist of three members who will be responsible tin performing the committees 'roles. Ferreira (2008) further states that the number of the audit committee members might depend on the size of the company.

In Namibia, the composition of the audit committee is prescribed in the NamCode which states that the audit committee should be appointed by the shareholders and comprises of at least three independent non-executive directors (Deloitte, 2014).

Independence and experience of audit committee members

Stewart (2012) argues whether the experience of audit committee members affects decisions to side with auditors or management. Bhasin (2012) state that audit committee that consists of qualified independent directors contributes better toward the auditor's independence. Independent audit committees and independent auditors have a significant advantage on enhancing the quality of disclosures, in reducing unrestricted earnings of management and generally enhance the value of the firm. Al-Saeed and Al-Mahamdi (2011) maintained that the audit committee should have independent and competent members with necessary skills to be able to monitor external communications, the external auditor and internal controls, in order to accomplish monitoring task. Moreover the performance of audit committee is confidently influenced by a larger rate of outside directors. Bhasin (2012) further pointed out that independent directors are a necessary component of an audit committee, and the formation results is significantly benefit to the company.

In order for an audit committee to be effective, certain attributes should be considered such as the qualification, independence, skill sets, personal attributes and available time of individual committee members. Ferreira (2008) suggested that audit committee should be collectively consists of qualified and capable persons.

The efficiency of an audit committee depends on the experience of members who are both financial and non-financial literate (Al-Saeed and Al-Mahamid 2011). Islam, Islam, Bhattacharjee and Islam (2010) also argue that the audit committee must have a financial expert who possess either professional qualifications or experience in preparing, analysing and evaluating of financial statements. The audit committee has a financial control function and the inclusion of at least one financial expert as required by the US Sarbanes-Oxley Act of 2002, it helps to explain the financial function of the audit committee (Lexicon, 2012). Yasin and Nelson (2012) also argued that audit committee members with financial expertise are a necessity as they provide support on the reliability of financial statement and great quality of reporting on earnings.

In Namibia the Namcode (2010) specifies that there should be a basic level of qualification and experience for audit committee membership. The audit committee members should have knowledge on integrated reporting, internal financial controls, external audit process, internal audit process, risk management and the governance processes within the company.

It can be noted that the prescribed composition of the audit committees puts emphasis on expertise of the members, especially financial expertise in order for them to be able to perform their duties effectively.

The functions of the audit committee

The functions of the audit committee play an important role in execution of their duties with diligence. This can be achieved through the meetings held in order to discharge these functions. Mohamed and Hussain (cited in Lama 2011) stress that the function of audit committees has been rapidly changing in the current periods due to new challenges in the corporate world and lot of scandals that have been occurring from time to time. The functions of the audit committee continue to intensify and broaden on daily basic. Risk assessment and management have been one of this areas. Some companies have instituted risk committees while others are utilising audit committees to give guarantee to the board of directors and management that the risk polices are trustworthy and operative

According to Ng (2013), the major responsibility of an audit committee in terms of financial reporting is to assist the board of directors of a company to undertake their responsibility on studying of financial information and to ensure that the organisation's accounting records are in accordance with the statutory requirements. The audit committee also ensures the facilitating of the quality of external auditors and ensuring their independence. An audit committee is also responsible for reviewing the internal audit function on its effectiveness and independence from management.

Aida and Tony (2009) state that audit committees should maintain direct oversight on internal audit function in order to ensure management on issues of control and risk management. According to Braiotta, Gazzaway, Colson and Ramamoorti (2010), the function of the audit committee is to provide guidance to management, external auditors and investors and to make sure that financial information is complete and accurate The audit committee submits its opinions, results of assessments and analysis to the supervisory board, especially on irregularities which were found including the difference of opinions between the management board, internal auditors and external auditors (Szezepanskowski 2012).

Lama (2011) points out that the function of the audit committee is no longer limited only to ensuring independence of the external auditors from management, nonetheless has as well expanded to improve businesses on reporting issues, governance and reinstating public assurance. Audit committee's functions is to ensure that risks and governance matters are addressed which have a spillover disadvantages on the company's risk management and operational performance and also to ensure that there are controls over risks that will enable to enhance their operating results. It is not only acceptable but vital to investigate whether the existence of audit committee enable the firms to better manage risk and to enhance their operating results. Huang and Thiruvadi (2014) point out that for an audit committee to handle risk it need to discuss the challenges faced in accounting with the management, internal and external auditors on timely basis.

Marx (2009) states that the role of the audit committee was traditionally centred on assisting the directors in meeting their financial reporting, control and audit related responsibilities. This was evident based on the King 1 report as (cited in Marx 2009), that the responsibilities of the audit committee fall into five main areas, namely:

- Review the functioning of the internal control structure and the accounting system and reporting.
- Review the work of the work of the internal auditors
- Make sure that there is inter communication with external auditors
- Ensure that there is adherence with applicable laws and regultions.
- Ensure that there is adherence with the organisation's code of conduct.

In Namibia, the NamCode (2010) proposes a number of functions for the audit committees which are to: oversee the integrated reporting; review and provide remarks on financial statements; oversee the internal audit function; establish and implement risk management; oversee the external audit process

It should be noted that the function of the audit committee plays an important to guide the audit committee on their responsibilities and should be clearly stipulated and well defined. For audit committee members to function properly they should have the right skills and should be properly regulated.

Regulation of audit committees and benchmarks to other countries

Islam et al. (2010) state that in some countries audit committees are mandated by law (e.g. Canada, Singapore, Thailand and South Africa). According to Lama (2011) the government and regulatory bodies across the world come-up with solutions to resolve conflict of interest among management and shareholders of a company. This was achieved through establishment of various governance codes and regulations. The codes and regulations required companies to adhere to certain structures, processes and procedures which would assist in controlling of entities to comply with best practices. The best practices will assist organisations to minimize the agency cost and to improve the value of the organisation. Islam et al. further state that in numerous countries' audit committees are not mandatory by law but can be introduced on voluntary basis. According to Marx (2009) various legislation and regulations have been promulgated over the years assigning audit committee with specific responsibilities, focusing mainly on strengthening the external auditor's independence and overseeing external audit and financial reporting process.

The functions and responsibilities of audit committees can be guided and regulated by law or principles of corporate governance. In New Zealand's public sector, there are no laws or regulations governing audit committees but only pieces in the legislation of the Public Finance Act of 1989, the Crown Entities Act of 2004 and the Local Government Act of 2002 (Magrane & Malthus, 2010). In Netherlands, there were guidelines with regard to the scope, responsibilities and tasks of the audit committee; this applies to organisations that choose to have one. In 2012, the Ministry of Finance reviewed and added a new regulation of ministerial public sector audit (Hepworth & De Koning, 2012).

According to O'Riordan (2013) in Irish government the secretary general approves the charter or terms of reference of the audit committees and any change he or she also provides input into the content of the internal audit units' work plans, and maintain a high level of interest in the work of the audit committee. The secretary general meets with the chairman of the committee at least once a year and reviews the preceding year plan. The audit committee meet with the secretaries if there are any arising issues during the year. The secretary general appoints senior internal official members who together with the heads of internal audit will keep updating and briefing them on activities discussed during the meetings and also by receiving minutes and reports.

In India the Companies Bill of 2009, stipulates the role and the power of the audit committee. The responsibilities of the audit committee are to ensure an oversight on financial reporting and accuracy of financial statement certain stipulations as stated by Securities and Exchange Bureau of India (SEBI). The audit committee should evaluate the annual financial statements of the company with the help of management before it is handed over to the board of directors. The audit committee should analyse the accounting policies that the organisation uses, and should check for disclaimer, any adjustments on financial statements and other transactions and the qualification of audit reports. A mandate of power is also stated, where audit committees can investigate any suspicious issues that may come to their attention. The audit committee has the right to interrogate any staff member. (Sarkar & Sarkar 2010). The audit committee has the right to get external legal and professional advice that it considers necessary to carry out its investigations (Sarkar & Sarkar 2010). Sarkar and Sakar (2010) stress that there was an amendment in the regulation of India which previously required that all the audit committee members must be non-executive directors. However, in the new amendment it is required that two third of the audit committee must be independent directors making provision allowing inside directors also to be part of the audit committee members. The regulation made it mandatory for the management to be part of the audit committee. Sarkar and Sakar (2010) agrue that management should not be made mandatory by law, but the audit committee should invite them voluntarily when it deems necessary to do so.

According to Van-der-Nest (2008) in South Africa the public service legislation requires each government department or public entity to have an audit committee. The establishment of audit committees has been widely recognized as a best practice and is added in the public service financial management legislation. Audit committees form part of the accountability structure that is created in the public sector to assist employees or organisations in establishing accountability required from them in performing duties put upon them by the Public Finance Management Act.

Van-der-Nest (2008) states that in the South African's legislation, the audit committee are required to report the accounting officer and to Parliament through the annual report of a department. In South Africa, one of the requirements is that the internal audit activity are required to present a three year strategic plan based on risk background of the departments of the organisation according to the South Africa of 2005 and National Treasury. The audit committee then requires that the Head of the internal audit should give a quarterly feedback on the implementation of the approved plan and to give reasons why the internal audit division failed to achieve the set objectives.

According to Davies (2009) in Welsh there was awareness on the advantage of formulating audit committees in 1996. An audit commission then published a so called *Account the role of audit committees in local government.* It then identified the qualities of the supervising body. Moreover, there was a necessity for understanding internal controls, work performed by auditors, reports produced by internal and external auditors.

According to Enofe et al (2013), Nigeria is governed by the Company and Allied Matter Act (CAMA) that requires public companies to establish audit committees for strengthening the independence of external auditors and quality of financial statements.

In Namibia, there is no legislation regulating on companies to comply with the NamCode but the main purpose of the NamCode is voluntary compliance with recommended practices (Delloitte, 2014). However, as according to Delloitte (2014), the NamCode provide a valuable tool guide to directors and other office bearers to ensure compliance with corporate law. Citing from other authors, it can be seen that there are no strict statutory laws for regulating audit committee members, but there are guidelines that have to be followed. It is important for audit committees to be regulated by law. However, the Namcode is not an obligation for companies to adhere to but they may deviate and explain the deviations.

Research Methodology

The method which was used was qualitative and used the following techniques thematic and content to analyse the set objectives which are: to assess the compositions of the audit committees in selected government ministries in Namibia, to evaluate the functions of the audit committees in the government ministries in Namibia and to determine how audit committees in government ministries are regulated.

The sampling method which was employed for this research is purposive sampling as the researcher focused on 4 ministries with audit committees. These ministries are;- Ministry of Health and Social Services, the Ministry of Justice, the Ministry of Information and Communication Technology and the Ministry of Youth, Sport and Culture.

Data collection

Interviews were conducted for this research paper for the four ministries. Appointments were made telephonically and the interviewees were interviewed at their place of work. The interviews were recorded, and the transcripts were decoded into data. Open questions were used in order to obtain more detailed information on the audit committee in government ministries.

Data analysis

Data analysis usually involves reducing accumulated data to a manageable size, developing summaries, looking for patterns, and applying statistical techniques (Cooper and Schindler 2011). Thematic analysis was used to understand similarities and differences (themes) among respondents' experiences, views and perceptions. The themes which were analysed were on the functions of the audit committees in the government ministries in Namibia. These were the functions that applied frequently to all the three audit committees and were then clustered into themes. Four themes emanated from these functions of the audit committees. Content analysis was applied to government documents as they were reviewed and anlaysed in order to determine how audit committees in government ministries are regulated.

Ethical issues

Appropriate ethical consideration was followed, where participants were informed of the objectives and benefits of the study before they were interviewed. The participants were informed of their rights and that data will be handled by the researcher herself and information obtained through recording will be kept confidential. During the interviews participants were informed that the outcome of the research will be made available to them if willingly to know the end result. The researcher ensured privacy to the participants by giving the assurance on the confidentiality of information shared and not mentioning the names of the persons to ensure anonymous.

Findings and Discussion

The findings are analyzed based on the outcome of the interviews and information obtained. The findings and the discussions are based on the three objectives of this paper as earlier stated

Finding based on objective 1: which is to assess the compositions of the audit committees in selected government ministries in Namibia.

For this objective 7 questions emanated to address the composition of the audit committees in the government ministries. The following questions were asked;

1. Who is the Chairperson of the audit committee?
2. What are the qualifications of the audit committee members?
3. How many years of experience do the members have in auditing and finance?
4. Where have the members worked before and what were their previous positions?
5. Describe the relationship that the audit committee members have with the Ministry?
6. How many members do the audit committee consists of?
7. To whom does the audit committee report?

Ministry of Youth, Sports and Culture and ministry of Justice's respondents, responded that the chairperson of the audit committee was the Permanent Secretaries for those particular ministries. Ministry of Health and Social Services responded that the Chairperson of the audit committee was a medical doctor within the ministry. Ministry of Information and Communication Technology's interviewees respondent that the chairperson was a Deputy Director Internal Audits from Ministry of Health and Social Services.

Interviewees from ministry of Justice responded that; the audit committee consisted of 5 members who have degrees in law and one in accounting and auditing. Interviewees from ministry of Health and Social Services responded that the audit committee consisted of one member who has a qualification in law and two in medicine. Ministry of Youth, Sports and culture consisted of directors who have qualifications in Public Administration. Ministry of information consisted of 3 members with degrees in accounting.

In the ministry of Justice out of the six members only 1 have experience in auditing and finance. The rest of the members do not have any knowledge of auditing and accounting. In ministry of Health and Social Services there are three audit committee members and all the members do not have financial background as the 2 have experience in medicine and 1 in law, this also applies to the ministry of Youth, Sport and Culture out of the 6 audit committee members none have financial background but experience in administration. Ministry of Information and communication technology have 3 members of which all the 3 members have been in the accounting and auditing field.

In ministry of Justice 5 out of 6 of the audit committee members have worked in the same ministry and their previous position before were lawyers and only 1 out of the 6 was an accountant. In ministry of health the 2 out of 3 were medical doctors and 1 of policemen. In the ministry of Youth, Sports and Culture the all 6 audit committee members worked before as administrators and lastly, ministry of information and communication technology 1 out of 3 members was an accountant at ministry of finance and the other 2 were auditors, 1worked at ministry of finance and the other member at the Khomas Regional council.

The fourth question which was asked based on objective 1 was the relationship that the audit committee members have with the Ministry. This question was posed to determine the independence of the audit committee members. The researcher found that in all the three ministries the audit committee members were employees of that particular ministry and except for ministry of Information that consisted of 3 members who were outsiders or non-executive directors. The research revealed that the other three ministries consisted of executive directors.

Another question that emanated from objective 1 was the number of members which the audit committee consisted of. This question was to determine the number of members that are serving in the audit committee as it is also part of the audit committee composition. Ministry of Youth, Sport and Culture and ministry of Justice‘s respondents responded that the audit committees consisted of 6 members while ministry of Health and Social and Ministry of information consisted of three members.

The last question that derived from objective 1 was: to whom do the audit committees report to? This question was asked to determine the independence of the audit committee from management. The research revealed that the audit committees in the ministry of Justice, Ministry of Health and Social Services and ministry of Information does not have a higher authority were they report to. While ministry of Youth, Sports and culuture ‘s audit committee report to the Permanent Secretary who is the chairperson of the audit committee.

Finding based on objective 2, which is to evaluate the functions of the audit committees in the government ministries in Namibia.

Two questions emanated from this objective 2, which are question 8 and 9 and consisted of the following questions.

1. How frequently does the audit committee meet?
2. What are the functions of the audit committee?

Ministry of Justice‘s audit committee met in 2013 and since then never met again. Ministry of Health and Social Service’s audit committee never meet since its establishment in 2011. Ministry of Youth, Sports and Culture never met since its establishment in 2012, while Ministry of Information, Communication and Technology met twice last year.

When the interviewees were asked question about their functions they referred the researchers to the audit committee charter. The audit committee charter clearly articulated the functions of the audit committees. The functions of the ministries were taken from these charters as it was a referred document. Three ministries provided their charter, which are the Ministry of Justice, Youth and Sports and Ministry of Information for the functions of the audit committees. Ministry of Health did not provide their charter as it was not compiled by the audit committee for they never met since its establishment.

Through studying of the audit committee charters there were some shortfalls that were discovered from the other ministries. The analyses of the charters revealed that Ministry of Justice’s audit committee provide the risk management and internal control policies while Ministry of Youth, Sport and Culture’s audit committee‘s role is to review the risk management policy. Ministry of Information, Communication and Technology does not have risk management on their charter. The analysis revealed that ministries’ audit committee functions lack uniformity. There is no framework for audit committee functions.

Finding based on objective 3, which is to understand how audit committees in government ministries are regulated.

One question emanated from this objective which is as follows:

1. Is there any policy in place that regulates the audit committee?

In Namibia the State Finance Act of 1991 does not make provision of internal auditors in the government ministries neither does it make provision for audit committees. It was found that currently the audit committees are not regulated by any law or by any document except the Namcode that applies to private sector and SOE. The Namcode is also not enforced on private sector or state owned entities. The companies can state the reason for not complying with the Namcode. Therefore, the Namcode is not a mandatory for the private sector either.

All the interviewee responded that there is no policy regulating audit committees in the government ministries.

Discussions

The researcher used content and thematic analysis. The discussion is based on content and thematic analysis of the transcription of the responses during the interviews. For content analysis the responses were analysed for similarities and differences. Themes were formed based on content analysis. From the content analysis the following themes emanated. The themes were then categorized under each objective.

Objective 1

For objective 1 the following themes came up:

1. Unsuitable qualified individuals
2. Lack of accounting background and experience
3. Lack of independence
4. Appropriateness of the audit committee size
5. Lack of reporting structure
6. Lack of audit committee meetings

Unsuitable qualified individuals

The research revealed that 2 out of 4 of the audit committees were chaired by the Permanent Secretaries, while 1 out of 4 is chaired by an inside director and 1 was chaired by an outsider (non-executive director). If the chairperson of the audit committee is the Permanent Secretary of that particular ministry who oversees the financial matters of the ministry, a question of fair judgments arises. There might be no fairness when it comes to making decisions that affects financial matters of the ministry. Ng (2013) stresses that the Chief Executive Officer (CEO) or the Chief Financial Officer (CFO) cannot be a member of the audit committee as this might lead to unfair judgments.

The audit committee should be chaired by a non-executive director, which is not in this case from the three ministries. Ferriera (2008) believes that the chairperson may not be an employee of the department and should be a non-executive director. The results revealed that chairperson of the audit committees do not have accounting knowledge, a question of effectiveness arises on how effective might that audit committees be? O'Riordan (2013) stresses that the position of the chairman is viewed as a critical key for the success of an audit committee and such candidate should have qualification in accounting and should be independent. Ng (2013) states that the chairperson of the audit committee should be a financial expert and should have knowledge of the company. The research revealed that the Permanent Secretary is the chairperson of the audit committee as well as the accounting officer of the ministry. Hegazy et al. contend that there should be a separation between the CEO and chairman of the audit committee, for better management and effective control over the business operations.

It is evidently clearly that 3 out of 4 of the ministries audit committees are being chaired by people within the organisation.

Lack of accounting background and experience

Out of the 18 audit committee members, only 4 have qualifications in accounting and the majority of the members have qualifications in law, medicine and public administration. The majority of the audit committee members in the ministries lacked financial expertise and such knowledge is needed on analysing the auditor's reports and financial matters. Without financial expertise it might be difficult for the audit committee members to assess internal controls pertaining to financial matters. Financial background plays an important role when it comes to the composition of the audit committee as such expertise will be required from audit committee member to carry out their functions. Yasin and Nelson believe that financial expertise plays an important role when composing an audit committee and suggest that at least a postgraduate qualification to be a suitable qualification. Financial expertise is considered important as the major role of audit committee is on the oversight of financial reporting. Bhasin (2012) also states that audit committee members with accounting experts appear to demand more extensive auditing when the risk is higher. Okpala (2012) concurs that at least one member should have financial expertise and professional qualification from a recognized professional accounting body in order to prevent corporate failure.

Inappropriate experience in accounting might have a negative impact on analysing of financial and auditing matters for the other three ministries as the members have lack of financial expertise. Audit committee should consist of the majority of independent members who have the necessary skills and experience to be able to face up management (Ferriera, 2008). According to Enofe et al. (2012) audit committee members should have knowledge in accounting policies to be a better and effective monitoring tool for the company. Audit committee members with accounting and audit experience are able to assist management by providing advices that can improve the effectiveness of internal controls. Barua, Rama and Sharma (2010) found that audit committee members with specific accounting expertise and auditing experience are positively associated with internal control effectiveness and quality of financial reporting.

It is evidently clear that it is only ministry of Information who has an effective audit committee with members who are financial literate. The rest of the ministry lack financial expertise.The majority of the members do not have previous accounting skills and might be difficult to understand financial matters pertaining financial statements as well as audit findings and recommendations made. Okpala (2012) believes that in order for an audit committee to discharge their duties diligently, all members should be financial literate.

The government stakeholders, which are taxpayers will be interested to know whether public funds are properly utilised and safeguarded. This can only be achieved if the government applies good corporate governance, by making sure that there are strong monitoring tools such as effective audit committees in government ministries. This can be achieved if audit committees have proper skilled members with qualification and relevant experience in auditing and finance. A committee without proper experience in auditing and accounting cannot be relied on to perform their duties diligently. Moreover, for audit committees to be effective it should have members with relevant experience in accounting and auditing. This is not the case with the other three audit committees. The composition of these audit committees need to be revised. Ng (2013) argued that audit committee members with financial knowledge are more likely to understand the extent of internal controls and work performed by the internal audit function and provide support to external audits on disagreement with management. Yasin & Nelson also argued that having audit committee members with financial experts decreases the probability of stealing of assets in public held companies.

Lack of independence

The research revealed that most of the audit committee members were executive directors only one ministry consisted of non-executive directors. These executive directors were from different departments of the ministries. This might bring conflict of interest as it is their departmental audit reports that need to be discussed by the audit committee. Audit committees that consist only of executive directors is not in support of good governance practices of the King 111 report as well as the Namcode that stipulate that the majority of the audit committee members must be non-executive directors. Independent audit committee members are able to face management when confronted with tough issues, which were deliberately done by management. If management are part of the audit committee, they might override some of the decisions. Audit committee members who are executive directors might not be good monitoring tools as there might have conflict of interest and might not be able to face management as they are part of management. A question of management override on internal control may also arise. Poudel and Hovey (2013) argue that independent audit committees from management are likely to prevent manipulation of financial results. In addition, independent audit committee members are a good monitoring tool for managers as they do not have any economical or personal connection or relationship with management. Salloum, Azzi and Gebrayel (2014) believe that executive members can impair the effectiveness of audit committees by influencing decision-making process of the board. The higher the percentage of executive directors the higher the limitation of information held by the board members. Neal, Palmrose and Scholz (2008) also believe that inside directors can lead to manipulation of decisions and dilution of power, by compromising their decisions. Li et al. (2011) argue that audit committee independence is important as independent directors are more likely to be effective monitors of management's actions. Audit committees that are independent are more likely to be free from management influence and will ensure the quality and credibility of the reporting process.

Appropriateness of the audit committee size

International recommendation says that the audit committees should consist of at least three to six members. In 2 of the ministries the audit committee consisted of 6 members while 2 consisted of 3 members. With these numbers, it is clearly that work can be executed effectively. In Namibia and South Africa the audit committee should have at least three members. This is supported by the Namcode and the PFMA of South Africa. Salloum et al. (2014) believe that larger committees losses concentration and becomes less participative than small audit committees and therefore, smaller boards are better monitors than bigger boards.

Lack of reporting structure

The researcher found that there is no proper reporting structure to which the audit committees report to. In case of ministry of Youth, Sports and culture the Permanent Secretary report to himself. The same person who makes the final decisions should not be the same person whom the audit committee should report to.

In the other three ministries the audit committees do not report to anybody or any organ. There is no standard or legal framework on issues of reporting. This is in contrarily to the Irish government departments were the audit committee reports to the secretary general (O'Riordan 2013). In South Africa the legislation, stipulates that audit committees should report to the accounting officers as well as to

Parliament through a report in the annual report of the department (Van-der-Nest 2008).

Lack of audit committee meetings

Some audit committees never met since their establishment. A question also rests on whether the functions are being executed by the audit committees if they do not meet to execute these functions as it revealed that the audit committees do not meet. Some of the 3 ministries' audit committees never met at all to discuss financial matters of the ministries. The performance of the audit committee is therefore questionable as to its effectiveness. Audit committees that meet frequently contribute to audit committee effectiveness and are more likely associated with higher quality audits (Yasin & Nelson, 2012; Munro & Buck 2008). In the case where some audit committees have never met, the questions arises as to how are the audit committees going to be informed of the auditing issues of the company, if the audit committees do not meet? Audit committees that meet frequently are more likely to be informed of current audit issues and are more obliged in fulfil their duties (Ng 2013, Yasin & Nelson 2012). If the audit committee never met how are their functions executed? Thiruvadi (2014) states that audit committees that meet at least twice a year are likely to be sanctioned on fraudulent or misleading reports. In addition, Swidi and Fadzil (2014) coincide that frequent meeting of audit committees determines the activeness of the committee in examining accounting, internal control systems and providing information to top management on actions taken. At least audit committees need to meet quarterly in order for them to be effective in executing their duties.

Objective 2 - Lack of uniformity on guidelines of audit committee functions.

The ministry of Information, Communication and Technology‘s audit committee does not have the function of risk management. This is an important function and should be incorporated in the audit committee charter. . Mohamed and Hussain (cited in Lama 2011) pointed out that the roles of the audit committee have been changing over the years to meet rapid changes in the corporate world. One of the major responsibilities of the audit committee that has expanded dramatically is risk assessment and risk management.

There is a clear indication that each ministry‘s audit committee has their own function as they deem necessary. At least Ministry of Finance or Office of the Auditor General should come up with a generic audit committee charter including the functions of the audit committees in all the ministries on what is expected of them. Some of the functions are really not necessary as they are not the major functions of the audit committees. The audit committees should have benchmarked with the Namcode and King 111 report.

Objective 3 - Lack of regulations.

There are no regulations guiding audit committees in the government ministries of Namibia. At least the State Finance Act should make it a mandatory that ministries should have audit committees, the authority, composition and functions of the audit committees should be clearly stipulated. A comparison can be made to New Zealand and South Africa. In New Zealand there are pieces guiding audit committees in the public sector legislation, such as the Public Finance Act, Crown Entities Act and the Local government Act (Magrane & Mathus, 2010). South Africa is also another country were audit committees are included in the public service legislation such as the Public Finance Management Act and National Treasury (Van-der-Nest, 2008).

Recommendations

The recommendations derived in this thesis are based on the conclusion that were found and are stipulated below:

- The Chairperson of the audit committees should be independent from management and should be non-executive directors.
- The audit committee members should be outsiders in order for them to discharge their duties with more diligence and to avoid conflict of interest.
- The audit committee members should consists of the majority of the members who are financial literate and some with auditing skills to be able to analyse and give advice on matters of finances and auditing.
- The audit committee should meet on a regular basis at least four times in a year in order for them to discharge their functions.
- The functions of the audit committees should be clearly stated in the State Finance Act.
- At least the State Finance Act should be amended to include the government internal auditors as well as the audit committee on the authority, composition, meetings and functions. This will assist audit committees to know the composition of the audit committee and what are the required to do. By coming up with legislation this will assist in uniformity across the board in order to abide to the corporate governance which is the best practice.

Suggestions for Further Research

Due to the time constraints and limited data, further work in this same area should also be considered in evaluating the performance of audit committee in government ministries and to come up with the best results. Future research may assist in providing the government ministries with best practices on audit committee. People who want to do further studies should include the new ministries.

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INFLUENCE FACTORS AND LEVELS TO CREATE A CULTURE OF DEMOCRACY: CRITICAL STUDY

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Abstract

Includes a general concept for the various philosophical implications for the conduct based on participation in the exercise of power through the institutions of formal and informal value of finality associated outputs any effect of each of these other actors and processes on daily life from the simplest affairs to the most complex groping ordinary citizen impact of these outputs through its relationship with actors and represented locally and nationally this perception itself constitute the base of the logical behaviour of the political mechanisms of nutritious local and other actors thus - as we have seen in the former - this is a performance of official institutions and non-formal primary factor effecting the nature and size of the feedback. We are trying to address through the topic of the impact of the level of human development and the content of those measures various dimensions of political, economic, social and cultural rights on the culture of the citizen. Lifting of the levels of human development in general requires efforts and cooperative from all sectors of society groups also requires equal participation of key parties and requires the mobilization of all the energies and finally the existence of the ability of these key parties to cooperate and participate in the responsibility for achieving development and motivating factor to all of this is to be a human being effective role through participation and production would not be available without a good rehabilitation and the acquisition of knowledge and skills with a reduction of the necessary rights of citizenship. On this basis, we examine how it affects the performance of institutions to create the motivation of individuals to be active citizens through three axes: ideology, the actors and the psychological impact of building individual capacity.

Key Words: Culture of Democracy, Human Development, Performance of Institutons, Motivation

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Introduction

The right to information Is tied to the role of the media's right of access to information shall not be deemed to information needed for people, but also a prerequisite for the Government of arable information allows people to carefully scrutinize the work of the government and is essential to have a discussion that is suitable for business.

Was confirmed by Arab Reform Conference, which was held in 2004 on the liberalization of the press and media in the Arab world.

Because this editing a strong pillar of the pillars of the democratic system and a clear representation of the freedom of expression and the mainstay strong transparency, it is developing the media and the laws regulating the publication of newspapers and the establishment of radio stations and TV channels in order to rely on independent ownership and management, transparency and funding and achieving the ability of media to organize and protect their profession without interference from the power.[1]

The consecration press and free media in the Arab countries, leading to devote two rights: the right to investigate any informed journalist on official information management and this does not crystallize only within the political culture of the view that the national interest requires that citizens should be aware of the second right is the right to receive any receipt Citizens of information media faithfully to the fact that the nature of media and device information associated level of readability of the citizens of the newspapers and their desire to exercise their right to receive add-on linked semi-commercial and political interests.[2]

The level of enjoyment of the rights and the nature of the political culture of an active role in the exercise of freedom of expression exercised by the press and the right to receive exercised by the citizen and the fuse freedom and the right in this case .The transformation of the leaks and the information published by the media to file a lawsuit in collaboration with civil society organizations form investigative journalism and an effective way to achieve civil society of the government's decisions and activities Through the investigation into important and dissemination journalists can expose waste, mismanagement and corruption so the government and sector organizations, government accountability as well as the role of access practiced by the media, the media as well as a key role in the construction of the general culture of the citizen as a culture of rights and the duties and values of equality, tolerance and acceptance of others and the difference.

The transparency and the fight against corruption issue of the management of government is primarily a question of the failure of institutions in the performance of its mission institutions are weak unable to provide the community with a broad framework of information for operations and policies carried out while strong institutions are trying to engage the community through informed of what is happening and thus pave the way for effective participation The private sector as well as civil society played an important role in access to information and delivered to citizens in general and dedicated system of good governance cooperation between the parties to reach a high degree of transparency and to facilitate the conduct of public affairs.

1. The Factors of Creating democracy

The conditions of democracy fall into severa! great groups or classes. Although these groupings are for the most part natural, any such classification must inevitably impose sorne measure of arbitrary ordering upon its materials. The severa! classes are not without cross-relations, to which I shall point from time to time, nor do the separate treatments of them and their sub-categories imply sharp !ines of division. I distinguish five major kinds into which the conditions of democracy can be sorted.

1. The Material Conditions of Democracy. These include such matters as geographical environment and the brute machinery of participation. They also include the material circumstances of the citizens and the economie arrangements of the community as a whole. Although they appear easy to specify and agree upon, it is with regard to these material conditions that sorne of the most bitter ideological disagreements arise. Ironically, these are !east appreciated as conditions of democracy where they are best realized.

2. The Constitutional Conditions of Democracy. These concern the principles, embodied in the organism or constitution of a community, which protect the rights of the citizens to act as they must be able to act if they are to participate fully and genuinely in the governing process. The right to speak freely, to criticize leadership, to assemble freely, to publish without censorship-these are leading examples of the constitutional conditions of democracy. Of all the conditions of democracy these present the most difficult theoretical problems. Although honored in name, they are seldom fully met.

3. The lntellectual Conditions of Democracy. These concern the capacities of the citizens to perform the tasks that democracy imposes, and the provision of the information and training essential for the proper employment of those capacities. More than any others the intellectual conditions of democracy are unstable, the levels of attainment required increasing with the advancing state of human knowledge and powers of control. They too receive universal Hp-service, but pose enormous practical problems still.

4. The Psychological Conditions of Democracy. These consist of a complex of dispositions and attitudes that must be manifested by the individual members of the community if democracy is to function. Fallibilism, a willingness to compromise, a capacity for self-restraint when holding power, are only sorne examples of the persona! Traits democracy requires in generous measure. About conditions in this category we know the least, and over them we appear to have the least control. They are difficult to cultivate, difficult to maintain; yet their effect upon democracy is profound.

5. The Protective Conditions of Democracy. These concern the capacities of the democratie community to defend itself against external onslaught, and against internai deterioration. Defenses needed against attackers of different kinds sometimes conflict with one another; vigorous discipline to protect against attack from without may erode other conditions of democracy within. Agonizing practical difficulties are sometimes created, therefore, by these protective conditions. Unlike the others, however, they tend to be almost exclusively the concern of national democracies (or democracies otherwise sovereign); and of all the conditions these are the most extrinsically related to democracy itself.[3]

2. The Levels of Creating democracy

2.1 Effective system of calculation and post

Equality before the law among the most important pillars of the state of right and law, citizens before the law, regardless of colour, sex or creed, belief or affiliation intellectual and political represents an essential support for the exercise of freedoms and the preservation of rights, and falls within the responsibility of the ruling before the law.

The rule of law means that there is no individual, president or citizen is above the law, as the government itself is subject to restrictions of law, as it works all state officials elected in the framework of the Constitution and the law on the basis of the powers conferred upon them and legally defined. In all cases must reflect these laws the will of the people through the boards.

By this logic, the principle of equality as a basis for individual freedom and the exercise of the rights and mastery of them, whether political, economic, social or cultural.

Raises the concept of the rule and the law through the principle of equality before the law is the responsibility of governing the front row, which is the principle of non-cached on the whole in the Arab countries, as it is not unheard of in the press about the appearance of senior political level before the court because of a lawsuit filed by a citizen against him for some reason linked performing its functions. That the principle of political immunity enjoyed by the Arab heads of state and governments, ministers and high-level officials of the States, prevents held accountable before the courts by citizens. Moreover weakness parliament Arabic, did not make it a functional regulatory effectively, allowing it to accountability minute to governments for their actions.

It also raises the concept within the principle of the separation of powers principle of parliamentary immunity, which means a lack of accountability or follow-up member of parliament because of his parliamentary duties, and enjoy the results of parliamentary immunity not to continue or stop the members of parliament, in general, can not raise them civil suit or criminal or shed any pressure on them because of their views expressed in the discussion or what its words or because of their votes, but the principle of parliamentary immunity was used in Arab countries, in addition to the text of the law in matters of personal as an ordinary citizen nationals others. [4]

Declaration stressed the continent about the independence of the judiciary, which was drafted during the second conference of Arab justice held in February 2003 that "the independent judicial system is a mainstay of support for civil liberties, human rights, and development processes, overall, the reforms and trade regulations, investment and regional economic cooperation and international building institutions of "democracy. [5]

Coming principle of contrast authoritarian within the concept of quality of political, eliminates this principle, independence of the judiciary and the rule of power of the right and the law of any "subject all state bodies and members of the general rule and abstract and binding placed in advance respected by both the ruling and the ruled alike, and includes the scope of application of all the ruling authorities in the state." [6]

Not enough and there are strict laws require severe penalties on acts of corruption or establish organs and regulatory bodies have the power to control accountability in the community, but must be eliminated honest independence and strength adequate to cope with the pressures of actors practice of corruption that may affect the performance of judges. the judicial authority constitutes an essential element of democratic governance, and increase their contribution to the consolidation of justice and respect for the rights and freedoms of citizens whenever they are strong and enjoy sufficient independence to other authorities, note that the system lacks an independent judiciary system is warped violate where justice does not possess In any citizen to guarantee respect for rights and freedoms.

I have turned the principle of independence of the judiciary is an international standard, after he was an internal matter, as the text of the Universal Declaration of Human Rights in 1948 in the tenth article of it that: "Everyone is entitled in full equality to a fair and public hearing by an independent and impartial tribunal when deciding the rights and duties of any criminal charge brought against him "Under the European Convention on Human Rights in 1950 in Article VI that" every human being when deciding civil rights and obligations or any criminal charge brought against him, the right to a public trial within a reasonable time before an independent and impartial tribunal established in accordance with the law. [7]

In fact, none of the Arab states of the applied standards of judicial independence supreme, if sometimes be restricted in its terms of reference texts of legislative and executive actions, such as the state of emergency., And noted that most of the judicial authorities in the area are complaining that they do not receive sufficient resources, and do not have complete control these resources, and holds the executive power represented by the Ministries of Justice issue a report expenses instead of legislative power directly.

At the majority of Arab countries followed the law system semen Latin, and specifically in the French version, usually the executive power a very big role in judicial affairs, through the Minister of Justice, which is at the head of the Ministry of Justice and is a member of the Council Ministerial, and the Minister of Justice, one of the members of the final authority in the gradation of the judicial system. Also this executive authority represented by the President of the Republic or the King is the owner of the power-Semitism in the country as a "first judge" or "judge the judges "coupled with the powers of the judiciary in the field. [8]

Clear the extent of public confidence in the integrity and independence of the judiciary and its subsidiary organs through turnout in every problem encountered. If there is a lack of trust between the citizen and the body that is supposed to ensure that the rule of law and protect the right and his money and protects them from arbitrary administration, the resort to eliminate the alternative which mean a return to relations clan in the community, so lies the importance of the independence of the judiciary for the development of humanity, in that the protection of human rights and promoted based on the existence of strong judiciary and a fair and independent, able to put all the political players and the social position of accounting. Adding that this principle is supportive of stability and political justice, will be resolved all the conflicts and dilemmas of political and social peacefully by resorting to spend is a solution for the control of pressure and power of the ruling or the ruling party or the Parliament and others.

That the existence of an independent judiciary gives the impression to the ordinary citizen the possibility to exercise their economic, political, social and cultural rights, supported by the law, which is equal in front of everyone. Also gives the confidence of effective investigations and commissions of inquiry the problem of the simplest issues to the largest of which may affect even senior international civil servant and figures As the political and law everyone is equal in front of him there is no room for discrimination between women and men, especially in the case of inheritance, divorce and personal status to the limits of the laws legitimized itself, which is supposed to reflect the cultural and civilization belonging to the citizen.

Finally, is the independence of the judiciary a critical element in the development of strong economies, as it enhances the independence of the judiciary rule of law in order to avoid inefficiency in the performance and, especially in the area of the bank, so expressed institutions and international development, including the World Bank, the development of the judiciary waged with the advent of intellectual property issues in all fields, "Health, Internet," and requires the development of the Arab judicial systems tailored to the new global variables, and it remains their role on traditional issues, especially in light of globalization and the control of the private sector.

2.2 Participating organizations outside the framework of moderation

Called on the United Nations Development Programme through the Arab Human Development Report 2003 to apply the local government instead of the local administration and considered corner fundamental to the rule of Al Rashid (good governance) and fasten it to participate actively in the fight against poverty "and to push for the activation of public services such as basic education and health care, and directed towards the poor ".[9]

The human development through decentralization impose inherently challenges and responsibilities of the huge local administrations, and requires them to prepare appropriate in terms of organization and the ability to management and autonomy in material and stay away from excessive reliance on central funding, and the development of components and capabilities of local and provide the necessary infrastructure to promote investment in the human element, and that the slowdown in the confrontations of these challenges lead to a gradual loss of human capital, and the decline in physical resources, and therefore the loss development factors. Local government can achieve local citizens: [10]

The local administrations more responsive than central departments, tailored to the needs and preferences of infrastructure, technical, public services, so it looks at the distribution of the central budget to local plans are not central guarantor of the component quality in the provision of services. As allowing women to participate at the local level, making it possible to adopt a political approach more sensitive to gender issues, and become health programs and facilities more compatible, especially that estimates from the World Health Organization indicate 80 percent of the diseases that afflict the world's population due to lack of water, sanitation , This includes the consequences of drinking contaminated water or water-carrying germs and helping to grow and multiply, and diseases resulting from lack of dirt and washing.

2.3 Accountability and transparency more - less

A recent study of five fifty seemed to cancel the central government spending is linked closely by low corruption among bureaucrats. Decentralization allows up and mechanisms of transparency and accountability, and the placement of programs and services for cost calculations and yield. Supports So the nature of the local elected as the people of the region, what makes the relationship between them and the community events and economic relationship, "the ego and the other" and not "ego and this thing," in addition to the programs and projects evaluation in the field is not documented, as is the case in those Central by elected and citizens together. Diminutive and local budgets compared to national budgets, facilitates the process of accountability with the appropriations spent and what return it.

The local administrations more responsive to the needs of citizens because they are closer to citizens, allowing the flow of enough information about the nature of the region, the nature of the dominant culture, the size of the problems, the resources required ... what gives better analytical ability, and from there be able to formulate plans and strategies appropriate. Applies it to the civil society and the private sector, as it facilitates the process of obtaining information about the local administration and projects to be applied and the nature of the problems faced by the local community to organize these needs and thus help the local administration in the resolution and management of development.

2.4 Widening the opportunities for political representation

The right of political participation reflects the political representation of local councils, and allows the decentralization of the political side b:

– Achieving democracy through fair representation of members of the community in the political institutions in the presence of popular works councils to participate in the positive development of those communities.

– allow political participation of local citizens to pay in contributing to the performance of their political role.

– leads to solve social and economic problems and alleviate the social and economic disparities in the region to a sense of belonging.

Raises the concept of democracy participative principle governs the responsibility of the citizen, and this is what is to be achieved in a more serious and deeper in the councils arm due to the small size and clarity of the economic and social conditions, as it will allow local election or re-election, ousting the elected.

2.5 Corporate culture

Is the effectiveness of the assessment and evaluation of public policies, the possibility of the removal of governments responsible for public policy, and the possibility of trading power, and lead assemblies, which are supposed to reflect public opinion trends play an important role through mechanisms conferred by the Constitution in the withdrawal of confidence, or even through periodic elections fair. Freedom as that of public opinion and of expression and freedom of assembly as well as to allow citizens to express uncle positions of public policy, and thus the arrival of the message directly to the policy makers and implementers.

Launched in the center of the race "for International Private Enterprise" from the question of whether there is a role for public policy to accelerate progress? To reach that governments are able to encourage reform are those that originated from stable environments as the public policies that originated from the practice of democracy and presented to the representatives of the people to be tested and our be more acceptable to citizens and more just when implemented.

And introduced the International Foundation for Democracy and elections, "the general principles of evaluation method Democrat" and considered that these values are comprehensive and effective in the context of the government's representative gives people the right to others to report policy on their behalf and considered that the correlation between values and institutions are what give the evaluation process credibility. [11]

The emergence of the concept of good governance to the emergence of schools of thought starts from the premise that the management of public affairs effectively requires the application of methods and approaches of the private sector in public administration. Turned which is a public administration to "manage the work of the government," and appeared several entrances to major in the field of public administration focused all in the concept of quality management, means "management style interview depends on customer satisfaction and achieve benefits for all personnel and the community, and the participation of each individual institution in the continuous improvement of processes, products and services using practical tools in order to succeed in the long term. Than during the previous definition concludes that the impact of the concept of quality Management in Public Administration: [12]

The incomes of new governmental administration entrance re-engineering., Which aims to achieve the product best for the client, where the solution concept of the client replace the concept of the citizen, so that the client is the giver of legitimacy, and providing poor services lead to a loss of legitimacy. Requires re-engineering Public Administration in the Arab world for radical change in all areas of intellectual and organizational and structural tailored to local conditions of each country.

Based on the full interaction to involve everyone in the system of governance of citizens and decision-makers in the direction of hurt to instil confidence and cooperation for the development of public policies that are geared to the public interest. Requires the democratization of government administration, including helping customers discover the sites the defect to be repaired, based on the freedom to participate in decision-making, transparency, ease of access to information, rapid response, also includes a fully interact well that everyone in the administration is responsible for what he says its work or services, and provide the best, all members of the administration are interested in working.

2.6 Recognition and measurement

Depends appreciation and measurement operations sounding views, embodied in the election as expressing citizens about their satisfaction on the results obtained, and their point of view in the executive process of public administration, and allows the measurement and recognition to know the stages that were accessible compared to the desired results.

Methods developed to improve public administration and government performance in general what is known as the electronic government any introduction of information technology in public administration. Stems the concept of e-government development of electronic technology in the administration, as is the concept of electronic management is an important input according concepts are synonymous to the " electronic government " refers to the use of the media to modern techniques and the development of performance management, the adequacy some see the use of electronic administration.

Require electronic government provide an appropriate level of technical infrastructure to get to the information and delivery as well as the appropriate level of education for its citizens, providing secrecy and security of information personal , and the availability of these conditions are allowed to enable citizens by providing to information and easier handling and improved interaction with government services and increase efficiency public administration , and the main benefits resulting in easier handling and improve the efficiency of the economic system and increase transparency and reduce corruption, all of which human capacity building and editing .

It has launched three Arab countries, Jordan and Egypt and the UAE construction projects Governments electronic, and embarked on the governments of Qatar and Saudi Arabia implementation of similar projects, although the UAE has reached an advanced stage in that the rest of the world is still in its early stages, and the Pan Arab states, the features required by e-government in addition to the cost of the material that makes achieving a long-term, at least in the medium term.

Allows the principle of adversity and variation of the right opposition to form political pluralism enjoy the conditions the minimum difference, representing the political parties, all political forces and social, allowing the process to represent the citizens truly represented them to choose their representatives in power, and the expression of their will and aspirations. Also mobilize masses and creating political awareness , enabling them to know their rights and how to defend as a necessary condition for the formation of an informed public opinion helps to create a partnership with the government , and controls on their actions , and gives citizens an important role in the decision-making process and draw political orientations .

Linked to political pluralism, elections and the right to vote and then the rotation of power, "The freedom to vote as they mean the right of the citizen in elections or run for election, and secretion results in a fair - form the core of every democratic institutional based on the authorities of the three separate: the executive, legislative and judiciary with the need for a spend independently. described the elections as free and fair , inter the right of universal suffrage , and open registration procedures , and polls unlocked for trading , and the right of access to voting sites for all and independent oversight bodies, and the fundamental freedoms of opinion and expression and association . [13]

The presence of an effective political and genuine pluralism is an important element in the management of emerging conflicts, and building democracy effective, especially in the communities of overlapping ethnic and religious deep. Depends political impact of interference on the way in which the expression of harmony and taking the demands of national rather than ethnic sectarianism. They can also parties to play a role to give the concept of citizenship after practice this role is critical in Yemen and Jordan, for example, which considers the tribal structure and clan is an essential component in public life, political parties in this case, create a stable and comprehensive providing links between the citizen and the government and management of the conflict by peaceful means. [14]

If to look at the environment, human rights is of paramount importance, as a framework necessary supportive of the establishment of a civil society, it is because democracy, which is a condition to secure the chances of a strong civil society recognized by researchers, perverted practice social, but under the laws and regulations allowing individual citizens to express themselves and organize themselves according to their choices and interests. has reached some empirical research on the evolution of democracy in a number of third World countries that some of the countries that I knew the experience of the most successful in the democratic development such as India, are available with a wide network of voluntary organizations of this kind in other countries, even at levels less, led to the downfall of some authoritarian regimes, as happened in the Philippines during the Marcos regime. [15]

We have led the development of the concepts to transform the role of civil society institutions, if become a pressing socio - economic, especially with the growing gap between the ability to provide services and the increasing needs. This witnessed the Arab countries, as the increasing rates of poverty, unemployment, marginalization and decline in the effectiveness of government institutions, led to the emergence of a new role for civil society to provide services and humanitarian aid, and down to the pressure and influence public policy and due acknowledgment in partnership between civil society organizations and the government. [16]

The active role played by civil society organizations in influencing escalated change social and political, and there is the impact on relations between individuals and groups and to escalate the level of awareness and instill a sense of teamwork and supply of skills of communication and political skills and work on developing negotiating capacity in the field of public right and the collective benefit in addition to the social role which has long had a civil society organizations in Arab countries.

The institutions of civil society vital role in the activation of political reform and development in general, as proven by field studies comparison in a number of communities that the multiplicity of membership in civil society organizations linked directly proportional increase of the ability to control the voting behavior and the high level of political participation and opportunities social mobility and to the highest level of productivity and is often linked to the membership of those organizations that give the individual a sense that he is able to influence even modestly in his social environment in addition to that he earns some organizational skills and political virtue of what it entails relative freedom to organize meetings and dialogues and competition in the selection of leaders. [17]

The expansion of civil society and independence affect the growing capacity of civil society to act independently of the state and its organs in time shrink the role of the state to the concept of traditional state, democracy and political participation is not only a vote in the election formality, but all that would secure the continued participation in the mechanisms decision-making and implementation in the field.

Results

These five factors are the classes of conditions that must be met if democracy is to emerge, and to maintain itself. Sorne of the important things to be noted about these conditions are rather obscure; sorne are obvious. No harm is done by recapitulating clearly what is commonly but vaguely understood; and there is rouch advantage to be derived from a horough review of Ali of Democracy's Conditions, putting into arder a mass of argument and evidence rarely thought through. Specifying the conditions of democracy consists largely of Iaying out the common sense of the matter; but organizing the content of that common sense is essential if it is to be effectively brought to bear on practical problems.

The culture of the citizen. Lifting of the levels of human development in general requires efforts and cooperative from all sectors of society groups also requires equal participation of key parties and requires the mobilization of all the energies and finally the existence of the ability of these key parties to cooperate and participate in the responsibility for achieving development and motivating.

The level of enjoyment of the rights and the nature of the political culture of an active role in the exercise of freedom of expression exercised by the press and the right to receive exercised by the citizen and the fuse freedom and the right in this case.

Equality before the law among the most important pillars of the state of right and law, citizens before the law, regardless of colour, sex or creed, belief or affiliation intellectual and political represents an essential support for the exercise of freedoms and the preservation of rights, and falls within the responsibility of the ruling before the law.

To promote transparency and accountability in a society, must be based primarily on the work of Awareness doing the press and civil society and supported by political will brilliantly in getting rid of forms of corruption.

The existence of an independent judiciary gives the impression to the ordinary citizen the possibility to exercise their economic, political, social and cultural rights, supported by the law, which is equal in front of everyone

The human development through decentralization impose inherently challenges and responsibilities of the huge local administrations, and requires them to prepare appropriate in terms of organization and the ability to management and autonomy in material and stay away from excessive reliance on central funding.

The expansion of civil society and independence affect the growing capacity of civil society to act independently of the state and its organs in time shrink the role of the state.

The state is responsible to its citizens and the provision of data and reports reliable for its business and civil society, responsible to the state and in front of bodies of reference comprehensive system of accountability must be applied by the parties, which is one of the most important elements of good governance and democratic accountability.

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LEGISLATION AND EMPLOYMENT RELATIONS IN SOUTH AFRICA: A NARRATIVE OVERVIEW OF WORKPLACE DISPUTE

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Abstract

This paper provides an overview of legislative measures applied in handling grievances and disciplinary matters in the workplace from the South African perspective. South Africa is one of the unionised countries in the world and the involvement of trade unions in resolving disputes including grievances and disciplinary matters is crucial. Trade unions, employers' organisations and the state play an integral role in employment relations. Unions represent their members during dispute proceedings at various institutions where they (trade unions) are recognised. The country's statutory measures must always be adhered-to in the handling of grievances and disciplinary procedures. The author relates the manner in which grievances and disciplinary proceedings are handled in a unionised workplace environment.

Key Words: Trade Union, Employment Relations, Legislation, Code Of Good Practice, Grievances And Disciplinary Procedures

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1. Introduction

Based on statistics presented by Adcorp Employment Index in 2013, only one in four workers (i.e., 25.5% of the workforce) in South Africa are unionised. This very statistics indicates that 43% of the people who join the workforce for the first time join trade unions and this leads to the increasing number of union membership in the public sector (ADCORP, 2013). Trade unions represent their members in a number of disputes including issues of grievances and disciplinary proceedings in institutions where trade unions are recognised.

Trade unions are voluntary associations formed to protect the common interests of members and promote their interests in relation to employers. Their primary function is to see to it that employees are protected against unfair labour practices. Unions use their collective power to negotiate with employers on various issues that relates to their members. These issues may include employees' payments, job security, working hours, leave days and other equally important matters (Trade Union Readcast, 2009). Trade unions may even engage in political activities where legislation affects their members (Johnson, 2000).

To contextualise the practice of employment relations with direct reference to handling grievances and disciplinary procedures, a clear grasp of the context of labour legislation is required. Von Holdt and Webster (2005) argue that the approach to grievances and disciplinary actions taken in the workplace is constituted through compliance to the legislation. The processes set out by the labour legislation must be followed by the employers and employees. African countries like Ghana, Nigeria, Kenya, Zambia and Mauritius, saw enactment of new legislation. The new legislation is destined to regulate employment relations as contained by democratic principles (Horowitz, 2007). The main attribute of new legislation is to emphasise and encourage dispute resolution through peaceful negotiations. Furthermore, new legislation simplifies statutory requirements for the establishment of new collective representation in a democratic manner as advocated by Koçer and Hayter (2011).

South Africa as one of the African countries with a young democracy since 1994 is not an isolate from countries such as the ones stated above (Wood, 1998). South Africa, regards the Constitution (Act 108 of 1996) as the supreme law of the country. The new labour legislation which regulates employment relations in South Africa is ratified on the constitution since 1996 (Mhango, 2014). This article aims to provide an overview of employment relations and the application of legislative measures in South Africa. Attention is given to the handling of grievances and disciplinary matters in a unionised workplace environment. The paper is arranged as follows: Conceptualisation of employment relations is presented in Section two then followed by the legislative framework regulating employment relations in Section three. Section four and five present the lodging of grievances and disciplinary issues and the code of good practiced in the workplace respectively. A brief discussion of the participants on employment relations is presented in Section six before concluding remarks are summarised in Section seven.

2. Conceptualising Employment Relations and Elucidation of Grievances and Disciplinary Procedure

Nel and Holtzhausen (2008) state that the early attempt to define the field of industrial relations was made by Dunlop based on the work of various sociologists from the systems perspective. Nel and Holtzhausen (2008), regards the industrial relation system as follows:

"It is comprised of certain actors (managers, workers, and specialised government agencies), certain contexts (technological characteristics, the market and the distribution of power in the society), ideology which bind the industrial relations system together, and a body of rules created to govern the actors at the workplace and work community" (Nel & Holtzhausen, 2008:4).

According to Nel and Holtzhausen (2008), since the early primarily sociological perspectives, the focus has much been on rule-making and work-control processes in an employment context. Gradually, different perspectives developed as Nel and Holtzhausen (2008) further argue that, since the 1980s the definition and scope of industrial relations have attracted renewed interest and debate. Furthermore, in the early 1990s the debate was taken a step further when industrial relations or labour relations were termed employment relations (Nel *et al.*, 2012:1).

Gough *et al.* (2006) elucidate that any analysis of employment relations needs to be understood in a context of broader theories about society and organisation. Complex societies and organisations require human to understand employment relations with an open mind. The pluralists principle imply that employment relationships, as subsystems of the society, are the platforms in which the diverse and conflicting interests of employees and employers are harnessed towards compromise and consensus (Finnemore and Van der Merwe, 1996). Furthermore, Finnemore and Van der Merwe (1996) argue that the basic principles of pluralism in employment relations are considered as the backdrop to structuring grievances and disciplinary procedures in the workplace.

A grievance procedure, in the absence of union representation, may exhibit some weaknesses, allowing management to be both judge and plaintiff as Nurse and Devonish (2007) point out. Without union representation, the employee with a grievance is unlikely to find satisfaction. Fair management should recognise the existence of a union and its representatives, as they (union representatives) represent and accompany members who are involved in a grievance or disciplinary matter (Nurse & Devonish, 2007).

According to Jordaan and Stander (2004), employee dismissal in the workplace is a major concern of both unionised and non-unionised members. There are various matters that may lead to dismissals of employees from the workplace. Jordaan and Stander (2004) further emphasise that grievances and disciplinary procedures are processes that can be followed before an employee is dismissed and that the trade union's role is to represent its members who are involved in grievances and disciplinary actions against the management in the workplace.

Nurse and Devonish (2007) argue that a grievance procedure should be one of the prerequisites for a collective agreement. According to Nurse and Devonish (2007), in any conflict arising in the workplace between the employer and an employee, the grievance procedure should be regarded as an institutional device, as well as a better practice for handling and resolving conflict. Reinforcing their argument, Nurse and Devonish (2007) maintain that handling of a grievance matters has become institutionalised by management and employees in general, acknowledging the differences which derive from unavoidable conflict between employees and employers. Grievance procedures are thus specifically designed to resolve conflict and secure peace in the workplace. In defining grievance, Britton clarifies it as:

"Any dispute that arises between an employer and the employee which relates to the implied or explicit terms of the employment agreement or contract" (Britton, 1982:12)

A grievance is a formal complaint, which may be defined through a specific institution's policy on conflict resolution, as outlined by the formal process to address day-to-day complaints or problems (Hunter and Kleiner, 2004). Hunter and Kleiner (2004) also suggest that the rationale for making a grievance depend on whether or not there is just cause or reason for such a complaint.

In many countries, including South Africa, the collective agreement settled between labour organisations and the employers consists of terms and conditions governing the various stages in handling a grievance (Nurse & Devonish, 2007). This practice is applicable in both the public and the private sectors, though the distinct stages are more likely to be established in the unionised sectors and as more formalised systems.

A grievance may be filed by any employee who is a member of a labour organisation or association against or on behalf of such an organisation. The most commonly reported grievances from employees are complaints about a malfunctioning employment agreement between the two parties (employer and employee), unfair treatment by the employer, and defamation. For a grievance to be resolved effectively, the employer is obliged to follow certain guidelines (HRA, 2011; Hunter and Kleiner, 2004). As stated by HRA (2011), the grievance procedure comprises a number of steps at various levels which need to be followed before the matter can be resolved. The first step is mainly informal, offering an opportunity for the worker and the line-manager to sort out the dispute with the assistance of a union shopsteward. The next step is a formal written grievance, in which the worker or the union appeals to the higher management of the organisation. If the matter remains unresolved after the second step, an appeal is made to a neutral arbitrator.

Hunter and Kleiner (2004), emphasise that, in most instances, grievances are resolved at the very first two steps of the procedure if all parties are willing to reach arbitration. This contention was confirmed by findings of a study conducted by Lewin and Peterson (1988) on grievance procedure at a specific company in New York, where the majority of cases reached arbitration. In particular, Lewin and Peterson (1988) found that expedited grievances reached settlements more rapidly.

Albrecht and Thompson (2006) define the disciplinary procedures as a structured approach which an employer uses to deal with ill-discipline at the workplace. The objective of the disciplinary procedure is to warn individuals whose conduct gives cause for dissatisfaction in the workplace, and this practice is applied in order to improve their behavior or their performance (Farnham, 2000).

Many institutions use criteria guided by policy and labour laws to determine how an organisation has to discipline an employee (BNA Editorial Staff, 1959-1987). According to Hunter and Kleiner’s (2004) analysis, complaints by employers which most commonly lead to a disciplinary action against employees are absenteeism, misconduct, insubordination, and substance abuse, for example where employees are found drinking alcohol during working hours. Other complaints include unsatisfactory performance, as well as safety and health violations in the workplace. Warnings, temporary suspension from work, and permanent release from occupation are typical penalties imposed by management to discipline employees.

Folger and Cropanzano (1998) argue that implementation of the disciplinary code and procedures in an organisation entail the application of justice in the workplace. The implementation of the disciplinary code and procedures imply fairness concerning the methods, procedures, and processes that are used to determine fair outcomes on disciplinary issues. Concurring to this argument, Beugre (1998) indicates that organisational justice involves a consideration of what or which issues are perceived to be fair towards bringing changes in the workplace. These changes could be social or economic and may involve the employee’s relations with the supervisors, co-workers and any other workers generally in an organisation as a social system.

3. The Scope of Legislative Framework Regulating Employment Relations in South Africa

The Constitution of the Republic of South Africa (Constitution) (Act 108 of 1996), the Labour Relations Act (LRA) (Act 66 of 1995), and the Basic Conditions of Employment Act (BCEA) (Act 75 of 1997) provide the context of the grievances and disciplinary procedures. Alongside their subsequent amendments, these three pieces of legislation constitute a guide to the application of the labour laws in South Africa. Employers are obliged to include details of any workplace grievances and disciplinary procedures in terms of employment of their employees. The Disciplinary Code and Procedure in the LRA set to promote respect as well as uphold the common law and statutory rights of both the employer and the employee in the workplace or the institution (Saundry *et al.*, 2008; Antcliff & Saundry, 2009).

Section 4(1) of the Code of Good Practice (Schedule 8) of the Labour Relations Act 66 of 1995 makes provision that investigations must be conducted by the employer so as to find out if there are justifiable reasons which prompt to the dismissal. The involved employee should be informed by the employer regarding accusations conducted against him or her in a form of language which is clearly understood by the employee. The involved employee should be given a chance to make his or her own statement pertaining allegations posed to him or her. Such employee is fully entitled to be given sufficient time to prepare a response towards the case and have a choice to get union representative or fellow employee’s assistance. Once the enquiry has taken place and the decision has been taken, the employer must communicate the outcomes to the employee and the employee’s representative. Most preferably, a written notification of the decision taken is expected in this regard (ULR, 2006a).

Employee participation in decision-making as well as obligations pertaining labour relations’ issues are contained in the LRA. Employee participation is the influence which employees have on decision making, ranging from task centred to power centred forms as noted by Anstey (1997) and Salamon (1992). Employee participation promotes industrial peace while achieving social justice and employee protection. The LRA guided by the Constitution has a priority over other labour laws. The BCEA specifies the basic conditions of employment in order to protect the employees from malpractice possibly implied by the employers (Bendix, 1996).

The above mentioned legislation established the right to fair labour practice as well as the right to participate in the activities and programmes of a trade union. Trade unions in South Africa have gained the recognition by the State and other institutions for their members. As such, trade unions are essential links between employer and employee in their relationship and in the regulation of labour relations. In this regard, trade unions play a pivotal role in the preservation of industrial peace and social progress (Frauenstein, 1993).

Through provisions of the LRA, bargaining councils are formed primarily to deal with collective agreements between employers and employees. Bargaining councils are formed by registered unions and employers' organisations. Amongst other responsibilities of the bargaining, is to handle disputes and make proposals on labour laws and policies regulating labour processes. Sectors which are excluded from the bargaining councils are the South African National Defence Force (SANDF), the National Intelligence Agency (NIA) and the South African Secret Service (SASS) (Moore, 2006).

Sections 85 and 86 of the LRA make provision for consultation between employer and employee and matters requiring joint decision-making within a workplace forum. Trade unions and employee organisations play an important role in the labour relations of large organisations. Much of the emphasis of labour relations in the current legislative climate in South Africa is on the facilitation of communication between employees and employers (Olivier, 1996; Nel, 2002).

The LRA also confers registered unions with the power to negotiate collective agreements. It accommodates both the employer and employees' right to negotiate employment relations, enabling unions to negotiate on behalf of their members. It is a legal requirements applied to engage on any matters in collective bargaining (Barry & May, 2004).

3.1 Conditions of Work

The BCEA stipulates the minimum conditions of employment in order to protect employees against exploitation. It specifies the time an employee could work, overtime, time-off duty or leave days of an employee per annum. Thus, it covers the main conditions of employment and as such, when the organisation develops conditions of service, the management considers the BCEA. The BCEA confers power on labour inspectors to enforce basic conditions and compliance (Wille *et al*., 2007). The BCEA of 1997 and subsequent amendments, forms the pivot of labour legislation in post-apartheid South Africa.

3.2 Legislation and the Role of Trade Unions

Employers are obliged to include details of any workplace grievances and disciplinary procedures based on the legal requirements stipulated on the LRA. In this regard, formal grievances and disciplinary procedures are common in most, if not all workplaces or institutions. Saundry *et al.* (2008) are of the view that the introduction of legal handling of the grievance procedures and applying dismissal in the workplace have permanently tighten and secured regulatory practice all over the industry. The unions' representatives are legally allowed to assist their members in many organisations and this principle is observed to be appropriate in dealing with grievances and discipline in the workplace.

In support of the assertion made above, Salamon (1998) argues that recognition of the trade union is possibly the most significant stage in the development of an organisation's employment relations system. He further states that acknowledgement of the unions bestow their (unions) recognition to exercise their rights and ensure their capacity in their role. Thus, the right to represent and protect union members' interest is acknowledged by the employers whilst they (employers) become involved in the control and practice of employment relations in the workplace.

When a union is recognised by the employer in the workplace, it is permissible to visit its members in various constituencies and gain access at ease to the premises. The recognition allows the union to discuss a variety of labour issues with their members without any difficulty in meeting their members. Feedback on resolutions taken between union and management are easily communicated amongst members and their mandate reach the union structures quite simple (Barry & May, 2004). Since the LRA makes provision to the statutory recognition procedure, an increase of trade unions' recognition agreement occurs as influenced by the LRA. It appears that the statutory model has encouraged capacity and unions' strengths to increase regarding engaging on discussions with employers (Wood, 2008; Moore, 2006).

When an employee is lodging a grievance matter, he or she has a right to consult fellow worker for assistance. Employees have the right to be accompanied to attend a disciplinary hearing. Any employee can choose to be accompanied by a co-worker or a union official. Often, the union official will be a workplace representative who is also a co-worker (BIS Acas, 2010). According to Barry and May (2004) the objectives of the Employment Relations Act (ERA) applied in New Zealand are similar to that of the LRA applied in South Africa.

An indication made by Von Holdt and Webster (2005) is that, the main focus of union is to look after its members and ensure that the members' mandate is carried as required. Von Holdt and Webster (2005) conclude that while unions appear not to have entirely satisfied their membership, unions have made their mark through championing in the labour policy planning, its control and the approach to engage employers. Thus, unions need to expand their communication channels and raise concerns pertaining existing imbalances and inequalities in an attempt to eradicate dissatisfaction of their members and secure the rights of marginalised communities.

4. Dispute Resolution and Lodging of Grievances and Disciplinary Issues

The center piece of the dispute resolution system in South Africa is the Commission for Conciliation, Mediation and Arbitration (CCMA) as introduced through the LRA. The dispute resolution system provides a means whereby councils may become accredited to resolve various types of disputes in the public sector and various or any other types of workplace dispute by means of conciliation and arbitration. In this regard, the statutory council is established on application by either the representative trade union or the employers' organisation. Thus, should a member of union have a dispute against employer, the union representative is allowed to accompany their member to declare their dispute to the CCMA with an aim to get the matter resolved externally (Godfrey *et al*., 2010).

If issues of grievances and disciplinary procedures are handled effectively by the employer and employee or employee representatives, that can help to minimise the number of cases referred to the CCMA (Bendeman, 2001). Effective handling of grievances and disciplinary matters can also improve relationships in the workplace. A relationship between trade unions and management, though they may differ in their views is very important in the work environment. Management and trade unions are the key role players concerning labour matters and to resolve labour related conflicts and misunderstandings.

According to Antcliff and Saundry (2009), it is a statutory right and is important that an employee be accompanied within grievances and disciplinary hearings. Antcliff and Saundry (2009) are of the opinion that by providing access to workplace representatives, employees would be treated more fairly within grievances and disciplinary processes. A grievance can either be initiated by the employee or the supervisor. A supervisor should intervene when employees are unable to settle differences on their own and in such cases morale could be uplifted amongst the subordinates (ULR, 2006b). Table 1 below presents a standard form that must be completed by the complainant (aggrieved party). The other involved role-players must also complete the form before the grievance proceedings could unfold or take place.

Table 1. A typical template which is completed in reporting a grievance

<table>
<tr><td colspan="2">NAME:</td><td colspan="2">EMPLOYEE NUMBER:</td></tr>
<tr><td colspan="2">NATURE OF GRIEVANCE:</td><td colspan="2">SOLUTION REQUIRED:</td></tr>
<tr><td colspan="2">Date on which grievance was reported:

____________ 2014 (date) ____
SIGNATURE OF AGGRIEVED EMPLOYEE:</td><td colspan="2">To Supervisor (name):

Date of receipt by Supervisor:
____________ 2014 (date) ____

SIGNATURE OF SUPERVISOR:</td></tr>
<tr><td colspan="4">FOR USE BY SUPERVISOR HANDLING OF GRIEVANCE</td></tr>
<tr><td>DATE:</td><td colspan="2">STEPS TAKEN:</td><td>SIGNATURE:</td></tr>
<tr><td colspan="4">FOR USE BY LABOUR RELATIONS</td></tr>
<tr><td>Stage completed:</td><td colspan="2">Code:</td><td>Duration:</td></tr>
<tr><td colspan="3">REMARKS</td><td>Step 1:
Step 2:
Step 3:</td></tr>
</table>

Source: ULR (2006b) 1-4 Annexure 1 B-iv

Handling grievances successfully requires commitment. A situation where the conflict affects the productivity or service and morale of other employees is an indication of an escalation of the situation. A superior must then intervene where employees are not making an earnest effort to get the issue resolved, and are deadlocked. When employees are unable to resolve disputes and grievances on their own, it is the supervisor's responsibility to take charge and implement the appropriate action.

A grievance could be filed by any member of staff who is permanently employed within an institution. Any other employees who are still on probation terms being newly appointed employees in the institution are subjected to complete their employee evaluation period first before the employees could qualify to file a grievance. In this regard, such employees do not yet have access to the grievance procedure for instance on problems corrective action or layoff as well as termination.

Filing a grievance is viewed as a practice whereby employees exercise their rights in their employment relationship without fear of retaliation, harassment or negative impact in the organisation (HRA, 2011).

When filing a grievance, there are time restrictions which are stipulated at each stage of the grievance proceedings which guides the complainant regarding the process. Any extensions to the time limits could only be done if both parties concur to the extension on time required. Importantly on time restrictions, the complainant must ensure to file the grievance in less than ten working days from when the incident he or she is complaining about happened. It can take three to seven days to seat for a grievance matter to be resolved and it could take more days depending on the availability of the person who is supposed to oversee the process. Grievances must be presented in writing, and a grievance form is used. Any employee can get the grievance form from the Human Resources Office of his or her employer. After completion of the appropriate sections on the grievance form, it could be presented to the immediate supervisor or the line manager of that particular department (HRA, 2011).

Steps in grievance procedures are followed internally and if the matter happens not to be resolved internally, it could be referred to the external bodies. Table 2 below exemplifies steps followed during grievance proceedings.

Table 2. Diagrammatic representation of steps on grievance proceedings

		NOTES
STEP 1 (Informal)	**SUPERVISOR**	The Supervisor investigates. Action must be taken within 3 working days of the grievance being reported. If the grievance remains unresolved, proceed to Step 2.
	↓	
STEP 2 (Formal)	**SUPERVISOR'S LINE MANAGER**	The Supervisor's Line Manager investigates. Action must be taken within 3 working days of the referral of the grievance. If the grievance cannot be resolved by the person to whom it has been referred, proceed to Step 3.
	↓	
STEP 3	**LINE MANAGER'S IMMEDIATE SUPERIOR**	The Line Manager's immediate superior investigates. Action must be taken within 3 working days of the referral of the grievance. If the grievance cannot be resolved by the person to whom it has been referred, proceed to Step 4.
	↓	
STEP 4	**EXECUTIVE MEMBER; PERSONNEL MATTERS OR HIS/HER PROXY**	The Executive member responsible for Personnel matters or his or her proxy investigates. Action must be taken within 3 working days of the referral of the grievance. If the grievance cannot be resolved by the person to whom it has been referred, proceed to Step 5.
	↓	
STEP 5	**CCMA***	
	CONCILIATION	
	↓	*Commission for Conciliation, Mediation and Arbitration
↘	**ARBITRATION**	
		LABOUR COURT

Source: ULR (2006b) 1-4 Annexure 1 B-i

Antcliff and Saundry (2009) argue that the crucial and significant representation of employees in the workplace primarily involves effective representation. Effective employee representation reduces conflict and meanwhile making it feasible to resolve individual disputes successfully in the workplace. The steps in disciplinary procedures are progressive as portrayed in table 3 shown below.

Table 3. Delegation of authority in respect of the imposition of disciplinary procedure

Disciplinary measure	Deputy Director & or Divisional Head of Department	Director	Chief Executive Officer, Executive Director
Verbal warning or reprimand	#	#	#
Written warning	#	#	#
Final written warning	Recommend	#	#
Suspension without pay	Recommend	Recommend	#
Demotion	Recommend	Recommend	#
Dismissal (including summary dismissal)	Recommend	Recommend	#

Source: LRC (2000)

First is a verbal or oral warning, followed by a written warning, then a final written warning, and lastly a dismissal or suspension without pay or demotion depending on the merits of the case. The hashtag (#) sign or symbol on the table shows the stages which the manager affected has the authority to execute or enforce the sanction concerned. In some instance it will depend on the type of an offence committed which could lead to dismissal, for example theft. Based on procedure, it is permissible that an employee could be entitled to get full payment while on suspension due to a pending matter still investigated against such employee. Disciplinary instances vary as each case has its own merits, thus there are more serious actions where dismissal could be declared at an earlier stage (LRC, 2000).

Effective employee representation could prolong further than narrow margins of accompanying workers to formal disciplinary hearings. An argument made is that, in resolving workplace disputes, effective management could assist. However, previous research, using data from Workplace Employment Relations Survey, found little association between management practices and unions regarding disciplinary outcome issues (Edwards, 1995; Knight & Latreille, 2000). Nonetheless, good work relations between employers and trade unions are underpinned by presence of fair management as Edwards (2000) suggests. He further argues that it is important to shape both formal notions of disciplinary procedures and the development of self-discipline.

Table 4. Disciplinary hearing proceedings (South African Labour Guide)

Confidentiality: Discipline is a confidential matter, therefore

- Hearings are held in camera, and
- Only those persons permitted in terms of the disciplinary procedure may be present

Laying the charge: During the 3 hearing steps, the employee is confronted with the relevant facts by

- Laying the charge(s)
- Calling of witnesses and
- Submission of any relevant documents

The employee and his representative is given the opportunity to study any documents and cross-examine witnesses

Presenting the defence: The employee and his representative must be given the opportunity to

- Submit evidence
- Submit relevant documentation, and
- Call witnesses

Returning a verdict of guilty

If the employee is found guilty as charged, the chairperson of the hearing must advance reasons for finding the employee guilty as charged;

- Give the employee or representative opportunity to present mitigating circumstances;
- Decide on applicable disciplinary action to be taken against the employee;
- Furnish reasons for deciding on the disciplinary action; and
- Give the employer or representative opportunity to address him on the applicable disciplinary action

Source: South African Labour Guide (2010)

The steps or stages in table 4 are the established and acceptable procedures in South Africa (SALG, 2010). All employees appointed by the institution must have access the policy and procedure document which contains clear guidelines regarding grievances and disciplinary procedures. The employer must ensure if the employees or the union are aware of the policy and procedures' document and that union representatives understand the content thereof.

It is stipulated in the disciplinary code and procedure document (ULR, 2006a) that every manager is responsible for the discipline of the staff members (subordinate – employees) who report to him or her. The responsibility of the manager includes the duty to act as chairperson in disciplinary inquiries concerning the employees reporting to such particular manager or superior at managerial position. Furthermore, where at all possible, disciplinary action should be initiated at the lowest level subject to delegation of management authority as set out in specific paragraph relevant to disciplinary in the document itself.

5. Code of Good Practice in the Workplace

A Code of Good Practice is applied in many organisations as a prerequisite of Schedule 8 of the LRA. The provision of Code of Good Practice is to guide employer, employees as well their representatives about the ethics which are applied and expected in an organisation. The general principles or ethics are predestined and functional in the use of grievances and disciplinary procedures. Clear guidelines on the application of grievance and disciplinary procedures, the best practice and effect of such procedures are outlined (LRC, 2000).

According to the SALG (2010), it is stipulated in Schedule 8 of the LRA under section 3 that "all employers should adopt disciplinary rules that establish the standard of conduct required of their employees." The Disciplinary Code and Procedure of an organisation must be made accessible and conveyed to all employees within an organisation. It must be made available in a form of writing as well as contain content of language that is clearly understood by employees. This is to avoid instances whereby employees are subjected to be disciplined for breaking a rule which they (employees) are absolutely not aware of, hence the employer have to make the organisational policies clear and accessible to all.

An emphasis is made that the management of an organisation must have clear policies on how to address and implement disciplinary measures where offences occur. Some of the commonly occurring offences in the workplace which employees commit or find themselves tempted to include but not limit to insubordination, absenteeism, fraud, consumption of alcohol on the organisational premises, consistent late coming at work, taking of legal forbidden substance having a narcotic or and other offences (SALG, 2010).

For the purposes of fair use of the Code of Good Practice for both employees and the employers, clear definitions and descriptive aspects are outlined. The descriptions includes for instance, indications of what entails 'employee representative' which could either be a union representative or fellow colleague requested by an employee based on his or her choice. It includes indications like, which employees' organisation is eligible to represent a member, for example a registered trade union but not any other person or body unconnected with the organisation. The Code of Good Practice entails a number of stages that must be followed in handling a grievance and disciplinary matter. The processes or stage includes who can the employee report the matter to, for instance to his or her line manager in the first instance. And then escalate it further if the matter does not receive attention it deserves. Thus, depending on a particular reported matter, a number of steps involving more senior management structure of an organisation could be reached until the matter is resolved. This would be internal process of handling the matter. Failure to resolve the matter appropriately and or internally could result to the matter being referred to the third party or externally in accordance with the agreed arrangements (LRC, 2000).

For employees or employers to comply with the processes of the Code of Good Practice, the employer-employee relationship plays a role. In South Africa, the legislation makes clear provisions in this regard. There are countries whereby the relationship between the rule of law and the practice in employment relations has been debatable for a long time like in Great Britain. According to the British traditional "voluntarists" perspective, the law had no position in industrial operations. The voluntarists perceive the 'absence of law in industrial operations' to be what union and employers preferred (Howell, 2004). According to Moore (2006) citing Brown's (2004) analysis, collective bargaining was the most possible system than any other means of having minimal legal intervention in employment relations.

The disciplinary Code and Procedure of any institution should not set down rigid rules which could be applied unquestioned. It should make consideration of the working conditions as well as circumstances associated particularly with the organisation's commonly divergent activities (ULR, 2006a). Saundry *et al.* (2008) portend that the Code of Good Practice sets out principles of handling grievance proceedings and disciplinary hearings in a much straightforward approach to make it uncomplicated for the involved parties. Employees and employers should find it helpful to use the Code of Good Practice based on its clear guidelines and all general terms on how to handle various grievance or disciplinary matter. All members of the management of the institution on various levels as well as employees, particularly union representatives are highly expected to familiarise themselves with the disciplinary code of their respective organisation. Everyone in the organisation or institution is obliged to adhere to the disciplinary code (LRC, 2000).

6. Discussion

In South Africa, trade unions play an integral role in labour markets leading since the dawn of democracy in 1994 (Hirsch, 2004). The role of trade unions in the mediating processes has increased and unions continue to exercise substantial political influence in various platforms which involves the government (state) and employers (Wood, 1998). The trade unions, employers' association and the state, are the prominent participants in employment relations. Koçer & Hayter (2011) as well as Nel *et al.* (2012) concur and provide the interpretation of employment relations' role-players as follows:

The state

Koçer & Hayter (2011) elucidate that the state plays a major role in the regulation of labour market through laws and enforcement mechanisms. Koçer & Hayter (2011) are of the view that the most crucial role of the state in employment relations is the establishment of institutions for coordination and consultation processes to ensure that economic growth and sustainability are maintained countrywide.

Trade Unions

According to Pitcher (2007) and Stirling (2011) in Africa during the entire post war period trade unions have been crucial actors whose effect surpassed the domain of employment relations and their demands surprised the ruling elite. In the case of South Africa, it is argued that should it never have been for the trade unions' support towards the liberation of country, chances could have been slim to obtain South African democracy (Baskin, 1991; Innes, 1992). As a result of its role and for improving employment relations, the trade unions are even recognised in the Constitution of South Africa of 1996 as stipulated in section 23.

Employers' Organisations

Michael (1992) indicates that the employers' organisations have been established since the first half of the 20th century signaling the existence of vibrant private sector activities. Koçer & Hayter (2011) argue that in case of African situation, the African employers' organisation emerged lately than the 20th century and the African employers' organisations were established in response to the growing strength of trade unions. Employers' organisations has a crucial role to play in employment relations in South Africa and as such, like the other two indicated employment actors above, these institutions form part of the role players in the National Economic Development and Labour Council (NEDLAC). NEDLAC is an institution established in the context of democratic transition in South Africa with an aim of promoting participation instead of unilateral decision-making (Friedman, 2002). NEDLAC played a major role through involvement of all stakeholders or rather most parts of the society in formulating policies to benefit the majority (Wood and Glaister, 2008).

Based on the pluralists' perspective, differences of interest and conflict do exist in many organisations and this situation is resolved through negotiations (Haralambos and Holborn, 2000). The existence of grievances and disciplinary procedures and the practice thereof indicates realism that differences occur in a workplace and such incident is unavoidable. In this regard, the role played by all three participants in employment relations is not just significant but it is a key factor in bringing about peace through negotiating in good terms. Koçer and Hayter (2011) argue that trade unions, given the emphasis put on dispute resolution, must seek ways to settle their issues without resorting to overt conflict.

7. Conclusion

In concluding this discussion, the remarks expressed by Saundry *et al.* (2008) that the rationale of accompanying employees during grievances and disciplinary hearings is to promote equity and efficiency is worth noting. Saundry *et al.* (2008) also emphasise that employees receive the needed support and advice at a difficult time in the workplace. Those involved in making decision in the workplace, particularly employers should not be deterred in making excessive decisions if it's compliant to the legislation and is viewed to be beneficial to the organisation and its employees. Thus, involvement of union official or representative plays a major role in building a support towards representing members during grievances and disciplinary proceedings. The legislation in South Africa makes provision and allows such practice in the workplace.

Concurring to Koçer and Hayter (2011) it is appropriate to end this paper by recalling that employment relations' actors, especially trade unions, play a crucial roles in all transitions in contemporary history of South Africa. In this regard, it could be argued that it is accepted to expect trade unions to remain important in the future and represent their members on dispute matters including grievances and disciplinary matters provided that union representatives understand the legislation and strive to negotiate in good terms.

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THE INFLUENCE OF OIL PRICE SHOCKS ON CHINA'S MACRO-ECONOMY: A PERSPECTIVE OF INTERNATIONAL TRADE

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Abstract

This paper is aimed at investigating and understanding the relationship between China's macro-economy and oil price from a new perspective--the international trade perspective. We find strong evidence to suggest that the increase of China's price level, resulting from oil price shocks, is statistically less than that of its main trade partners'. This helps us to understand the confused empirical results estimated within the SVAR framework. More specifically, SVAR results suggest that China's output level is positively correlated with the oil price. Positive correlation between China's output and oil price shocks presumably results from the drop in China's relative price induced by oil price shocks, which is inclined to stimulate China's goods and service exports.

JEL Classification: F41; Q43; Q48

Key Words: Oil Price Shocks; International Trade; China's Macro-Economy

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1. Introduction

China has enjoyed impressive economic growth and undergone spectacular economic transformations since introduction of profound economic reforms in 1978. At the same time, it is also increasingly dependent on oil resources. The International Energy Agency (IEA) documented in a research report that the oil demand of China would keep increasing in a foreseeable future, associated with its fast speed industrialization and urbanization. China first became an oil-import country in around 1992, which happens to be the time of Deng Xiaoping's Southern Tour and China's shift towards a fully-fledged market economy. According to Figure 1, since 1992, China's oil imports have steadily increased, and were even immune to the financial crisis of 2008. Moreover, Figure 1 shows that increasing oil imports to China have been accompanied by sharply rising oil price. Specifically, the oil price has gradually climbed since 1992, with a small drop during 1997-1999 possibly resulting from Asian financial crisis. It upsurges dramatically after 2002. Interestingly, this timing quite closely follows that of China's entry into the WTO. Although with a sharp decline during the financial crisis between 2008 and 2009, the price gained momentum and instantaneously rebounded back after that, more importantly, seemingly with a higher volatility. Unambiguously, the interactions between the world oil price and China's macro-economy should have been more significant than ever.

Apart from many distinguished characteristics (for instance, the pricing of oil being not completely decontrolled) from other economic entities, a salient feature of China's economy is that it relies heavily on international trade. To study and better understand the effects of oil price shocks on China's macro-economy, it is essential and helpful to put sufficient attention on the fact that China is a typical export-oriented country. Concretely, it ranks first in terms of the proportion of total trade to GDP, which peaked to 65.3% in 2006. According to the data from China's National Bureau of Statistics (NBS), the average proportion of total trade to GDP is as high as 46.5% during 1992-2013.

Figure 1. Net Oil Imports of China and World Oil Price

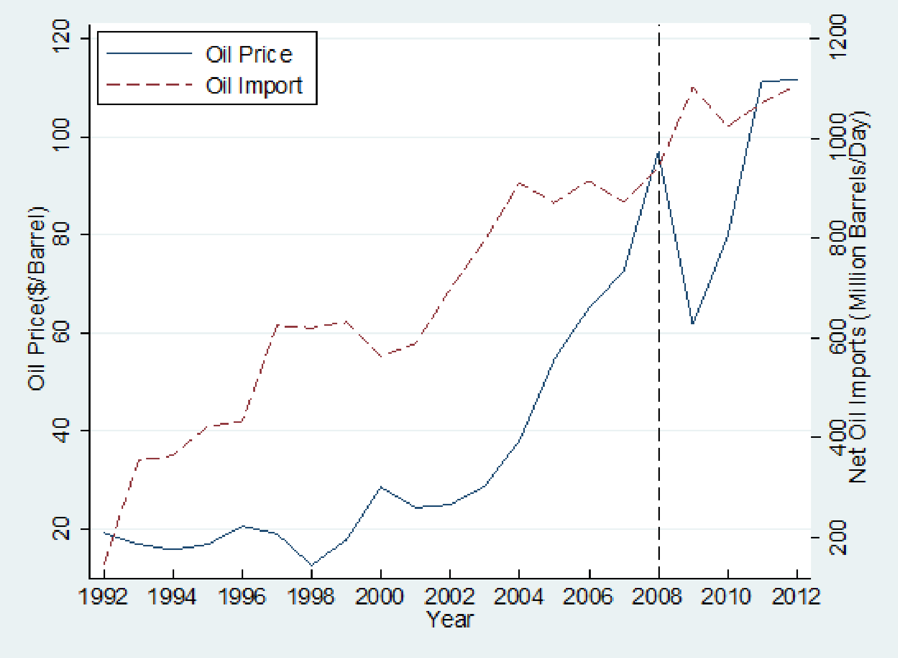
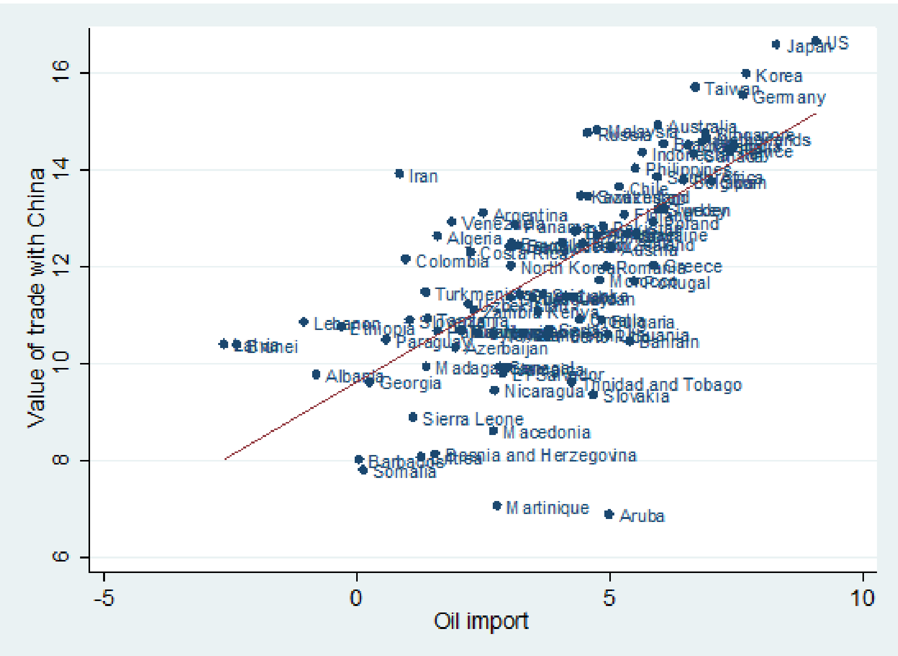


Figure 2 illustrates that the countries importing more oil are basically the ones that trade more with China, which implies that oil price shocks will influence China and its main trade partner simultaneously. The facts above show, on the one hand, that international trade is essential for China, on the other hand, that China's main trade partners are also major oil-dependent countries in the world. We have reason to believe that oil, as the most important bulk commodity in international trade today, will potentially change China and its partners' relative price level and further the goods and service exports of China or other relevant variables. This insight enlightens us to study and understand the effects of oil shocks on China estimated by econometric models from this new perspective, and accordingly distinguishes our paper from the existing literature.

Figure 2. Value of Trade with China and Oil Imports of Different Countries



Note: The oil import and value of trade with china is log scaled.

The remainder of the paper is organized as follows. In section 2, we review the literature related to our paper. The SVAR empirical results of oil price shocks are presented in section 3. In section 4, we give new interpretations for puzzling empirical results from SVAR estimation. Section 5 concludes.

2. Related Literature Review

The first oil crisis occurred in the 70s of the last century has spurred a large amount of literature which concentrates on the relationship between oil shocks and macro-economic activities. Nevertheless, considerable debates persist over the effects of oil price shocks in terms of both quantity and direction. Moreover, a variety of distinguished underlying transmission mechanisms have been proposed to rationalize the corresponding different empirical results.

Observing the fact that seven out of the eight postwar U.S. recessions have been preceded by a sharp increase in the price of crude petroleum, Hamilton (1983) concludes that oil shocks are a contributing factor in at least some of the US recessions prior to 1972. Hamilton (1996) proposes a measure of asymmetric oil price--net oil price increase, which is the maximum of zero and the differences between the level of the crude oil price in quarter t and the maximum value for the level achieved during the previous four quarters. The author draws a conclusion that supports his point in 1983 that real output of the US is negatively correlated with oil price shocks and the relationship is also statistically significant. A series of his following work (Hamilton, 2005; Hamilton, 2009 and Hamilton, 2010) reported similar results. Jimenez-Rodrigueza et al. (2005) confirm that the real GDP growth of oil importing economies suffers from increases in oil prices in both linear and non-linear models. Constructing large-scale macro-financial-econometric-model, Morana (2013) finds that oil market shocks have contributed to slow economic growth since the first Persian Gulf War episode. Lin and Mou (2008) explore the effects of oil price shocks on China within the framework of computational general equilibrium (CGE), and also present similar results. It is also the case for Zhang and Xu (2010). Le and Chang (2013) study the relationship between oil price shocks and trade imbalances, and find that for net oil importing economies, undesirable outcomes are associated with oil price shocks.

By contrast, other researchers have drawn different or even opposite conclusion. Bernanke et al. (1997) suggest that an important part of the effect of oil price shocks on the economy results is not from the change in oil price itself, but from the resulting tightening of monetary policy. Darrat et al. (1996) provide evidence to show that once the resulting interest rate increase is controlled, the effects of oil price shocks on the US economy will not be statistically significant any more. Barsky and Kilian (2004), argue that the effect is small and that oil shocks alone cannot explain the US stagflation of the 1970s. Blanchard and Gali (2007) present evidence showing that the dynamic effect of oil shocks has decreased considerably over time, owing to a combination of improvements in monetary policy, more flexible labor markets, and a smaller share of oil in production. Wong (2013) provides evidence to show that inflation pass-through from oil shocks in the 21st century relative to the 1970s has dampened. Establishing a five-variable VAR model Du et al. (2010) investigate the influences of oil price shocks on China's macro-economy. Their results show that China's output is positively correlated with oil price shocks, which is similar to our findings below. But our paper is different from Du et al. (2010) in both methodology and explanation.

Some researchers are committed to studying the underlying transmission mechanisms through which oil price shocks influence the macro-economy. Noticing that the empirical results are different, it is rather natural that the corresponding underlying transmission mechanisms used to interpret them are also dissimilar. In general, there are two different views on the relationship between oil price shocks and economic recession. One is they are statistically correlated to each other; the other is that this relationship is not significant or not clear.

According to Bernanke (1983), uncertainty will lead to a postponement of purchases for capital and durable goods, so the oil price shocks will influence the economy by increasing the uncertainty firms are confronted with. Rotemberg and Woodford (1996) suggest that the imperfect competition of the production market may better interpret the large negative effects of oil price shocks. Finn (2000) points out that in order to minimize depreciation expenses, when energy price changes, firms adjust capital utilization rates. Ramey and Vine (2010) argue that when the oil price rises, a shift in demand away from larger cars seems to have been a critical feature of the macroeconomic response to historical oil shocks. However, some other researchers argue that the relationship between oil price shocks and economic recession is not significant or not clear. Rogff (2006) elaborates that the effects of the oil shocks on the economy are generally weakened by technological advancements, improved energy efficiency, and the development of the financial market. As for the result that China's output is positively correlated with oil price shocks found by Du et al. (2010), the authors argue that this is presumably linked to that both China's growth and the world's oil price are affected by US and EU countries' economic activity in the same direction. Morana (2013) documents that as the negative impact on domestic demand may be mitigated by the increase of external demand (due to boosted imports of net oil export countries), the overall implications of the oil price drag mechanism are, however, not clear.

In summary, it can be stated that there is no consensus on empirical results about the effects of oil price shocks on the macro-economy and the transmission mechanisms through which the oil price shocks affect the macro-economy. Moreover, although a large amount literature has studied the transmission mechanisms, quite a few concentrate on the issue of China. Considering the reasons mentioned in section 1, we examine how international trade transmission mechanism works and investigate the effects of oil price shocks on China's macro-economy from this perspective. A related paper is Rasmussen and Roitman (2011). The authors argue that the negative impact of oil price shocks on oil-importing countries is partly offset by concurrent increases in exports and other income flows, and that these flows arise from high commodity prices being associated with good times for the world economy as well as from the recycling of petrodollars by oil-exporting. By contrast, we model these flows via a drop in China's relative price resulting from oil price shocks. Another related paper is Allegret et al. (2014), which investigate the effects of oil price shocks and their associated transmission channels on global imbalances. They find that along with oil price shocks, there is a transfer of wealth from oil-importing countries to oil-exporting ones. Our paper, however, proposes that this transfer can also happen (through the change of relative price induced by oil price shocks) among oil-import countries.

3. Empirical Results of SVAR

3.1 SVAR Model

In virtue of the work of Sims (1980), vector auto regression (VAR) has already become a widely used approach in macro-economy empirical analysis. Nevertheless, VAR is also constantly exposed to the criticism that it lacks economic interpretations. As Bernanke et al. (1997) indicates, it is not possible to infer the effects of changes in policy rules from a standard identified VAR system, since this approach typically provides little or no structural interpretation of coefficients that make up the lag structure of the model. By contrast, SVAR incorporates some structures or the economic theory into the analysis. Hence, we will investigate the effects of oil price shocks on China’s macro-economy within the framework of the SVAR in this paper. Formally, the SVAR system is formulated as:

$$A(I_K - A_1L - A_2L^2 - \cdots - A_pL^P)Y_t = Be_t \qquad (1)$$

Where A and B include the information that the economic theory implies and are $k \times 1$ matrices. L denotes lag operator, A_1, A_2 … A_p are $k \times k$ matrices, e_t is $k \times 1$ orthogonal disturbance term, that is, $e_t \sim N(0, I_K)$, and $\forall s \neq t$, $E(e_t e_s^{'}) = 0_K$. But what we can directly estimate is its reduced form:

$$Y_t = A_1Y_{t\text{-}1} + A_2Y_{t\text{-}2} + \cdots + A_pY_{t\text{-}p} + \mu_t \qquad (2)$$

In which μ_t is disturbance term and $\mu_t \sim N(0, \Sigma)$. Thus the relationship of the parameters in equation (1) and equation (2) can be written as:

$$\mu_t = A^{-1}Be_t \qquad \Sigma = A^{-1}B(A^{-1}B)^{'} \qquad (3)$$

By comparing the number of parameters between equation (1) and equation (2), we know that $(3k^2 - k)/2$ constraints are needed to identify equation (1), where k is the number of endogenous variables. In order to identify the model, we order the variables in the SVAR model as: oil price, real output, the price level, interest rate, money supply and exchange rate. That is, the oil price is prior to other macro-economy variables, signifying the oil price has a contemporary effects on other variables, but not the other way around; a reasonable assumption, since the oil price is primarily determined by the environment of the whole world but not a single country. Besides, we put all nominal variables after the real output. This is equivalent to assume that the real output has contemporary effects on them, but not the opposite; also, a weak assumption, since the commonly known time-lag influences of nominal and policy variables on real variables, which are indicated by the economic theory. Furthermore, we suppose the off-diagonal elements of the B matrix are all zero, meaning that the error terms of different times are not correlated. Considering that current variables are included in the system, this assumption is also not unreasonable. For now, combined with the normalization of the current variables' coefficients, the SVAR system above will be exactly identified.

3.2 Data

Monthly data spanning from 1994 to 2012 is conveyed to uncover the effects of oil price shocks on China's macro-economy. While we can easily explore the influences of oil price shocks on other macro-economic variables of relevance, we primarily focus on real output, general price level, money supply, interest rate and exchange rate on two grounds: First, they are most relevant to living standards and thus have received the closest attention from ordinary people. Second, in oil literature (Bernanke et al., 1997; Zhang and Xu, 2010; Du et al., 2010 and so on) these variables are also the most commonly studied, therefore, primarily focusing on these variables allows our results to be more comparable to the existing literature. In addition, what is worthy of attention is although we can, to some extent, control the effect of exchange rate by directly transforming the US dollar oil price to the RMB price (for example, Cong et al., 2008; Du et al., 2010), we explicitly incorporate the exchange rate into the variable system. This is quite natural and reasonable, especially recognizing the above-mentioned essential role of international trade in China.

For the reason that the National Bureau of Statistics of China (NBS) only publishes yearly and quarterly GDP data, following Zhang and Xu (2010), we use monthly industry output as the proxy of monthly output, and deflating them into real output. Consumer price index (CPI) is generally regarded as an appropriate proxy of the price level. CPI, compared to the same month in the previous year, available in NBS is used as the proxy of price level. It is widely known that the central bank frequently reacts to the fluctuations of the macro-economy. Therefore, variables that best capture the central bank's policy should be incorporated. Money supply is regularly regarded as the monetary policy instrument of the People's Bank of China. Taking the broadly recognized distinctions between M1 and M2 into account, instead of M2, we exploit M1 (obtained from the web-site of the People's Bank of China) to stand for monetary supply. In the view of the fact that the formation mechanism of interest rates is becoming increasingly market-oriented, interest rates are also incorporated into our system, which may, potentially, further capture the monetary policy. It is measured by the 6-month short-term loan interest rate derived from the arithmetic mean of the daily data, and, again, obtained from the web-site of the People's Bank of China. As for exchange rates and oil prices, we get them from the OECD and IEA databases, respectively. The statistics of the variables above are shown in Table 1.

Table 1. Definition and Statistics of Variables

Variables	Definition	Mean	S.D.error	Minimum	Maximum
OilP ($/Barrel)	*Oil Price*	43.86	30.94	9.82	132.70
ER(RMB/$)	*Exchange Rate*	7.90	0.66	6.30	8.71
M1(Billion RMB)	*Money Supply*	9504.5	7493.6	1543.5	28984.7
IR (%)	*Interest Rate*	7.06	2.17	5.31	12.06
Y(Billion RMB)	*Output*	2069.4	1999.3	299.2	7757.4
PL (%)	*Price Level*	4.31	6.34	-2.20	27.70

Note: We have normalized price level by subtracting 100.

3.3 Nonlinear Test

The SVAR model above is based on linear specifications. Therefore, they cannot capture asymmetric relationships between macroeconomic variables, which is noticed by Mork (1989), Lee et al. (1995), Balke et al. (2002), Hamilton (1996, 2003), Kilian and Vigfusson (2009), Carlton (2010), Ravazzolo and Rothman (2010) and Herrera et al. (2010) and so on. Before estimating the model, it is useful and necessary to carry out asymmetric tests of the oil price's effects on other variables. Define OP_t as the log difference of oil price. Following Mork (1989), we separate the oil price into positive and negative ones: $OP_t^+ = \max\{0, \mathrm{OP}_t\}$, $OP_t^- = \min\{0, \mathrm{OP}_t\}$. Along the lines of Hamilton (2003), we run OLS as follows:

$$V_t = c + \sum_{i=1}^{p} \alpha_i V_{t-i} + \sum_{i=1}^{p} \beta_i OP_{t-i} + \sum_{i=1}^{p} \gamma_i OP_{t-i}^{\#} + \varepsilon_t \qquad (4)$$

In which

$$V_t \in \{real\ output,\ price\ level,\ interest\ rate,\ money\ supply,\ exchange\ rate\}$$

and is in log difference form, $OP_{t-i}^{\#} \in \{OP_{t-i}^+, OP_{t-i}^-\}$. The null hypothesis is that the oil price has no asymmetry effects on other variables, meaning $\gamma_1 = \gamma_2 = \cdots = \gamma_p = 0$.

The asymmetry test results based on equation (4) are reported in Table 2. While we can report the lags chosen by certain criterion, we instead present all lags of interest. This is motivated by the combined observations that the lag lengths chosen based on different criteria are not consistent and the criterion values of different lags are quite close. It can be claimed from the results that the null hypothesis couldn’t be rejected in most cases, which in turn signifies that the linear symmetric model provides a good approximation in modeling the responses to oil price shocks (Kilian and Vigfusson, 2011), and increases the credibility of our model specification.

Table 2. Asymmetry Tests

	Output	*Price Level*	*Interest Rate*	*Money Supply*	*Exchange Rate*
1-Lag	0.4885	0.0418**	0.0129**	0.7656	0.7188
	(0.48)	(4.22)	(6.29)	(0.09)	(0.13)
2-Lags	0.6985	0.1287**	0.0235**	0.9229	0.5657
	(0.36)	(2.08)	(3.82)	(0.08)	(0.57)
3-Lags	0.3452	0.3643	0.0744*	0.8787	0.7055
	(1.11)	(1.07)	(2.34)	(0.23)	(0.47)
4-Lags	0.8074	0.3004	0.0916*	0.9759	0.4853
	(0.40)	(1.23)	(2.03)	(0.12)	(0.87)
5-Lags	0.9220	0.3065	0.1367	0.9381	0.4794
	(0.28)	(1.22)	(1.70)	(0.25)	(0.90)
6-Lags	0.9393	0.6717	0.2802	0.8076	0.6016
	(0.29)	(0.67)	(1.42)	(0.50)	(0.76)
7-Lags	0.9561	0.5333	0.2933	0.7773	0.7008
	(0.29)	(0.87)	(1.22)	(0.57)	(0.67)
8-Lags	0.7935	0.8620	0.4101	0.5028	0.7649
	(0.58)	(0.49)	(1.04)	(0.92)	(0.61)
9-Lags	0.8072	0.6534	0.5261	0.4356	0.8221
	(0.59)	(0.76)	(0.90)	(1.01)	(0.57)
10-Lags	0.8931	0.8605	0.5343	0.6990	0.8820
	(0.49)	(0.54)	(0.90)	(0.73)	(0.51)

Note: The numbers out and in parentheses are p-values and F statistics, respectively. Null hypothesis is that the world oil price has no asymmetry effects on the variables of interest. *** denotes significant at 1% level; ** denotes significant at 5% level; *denotes significant at 10% level.

3.4 SVAR Results

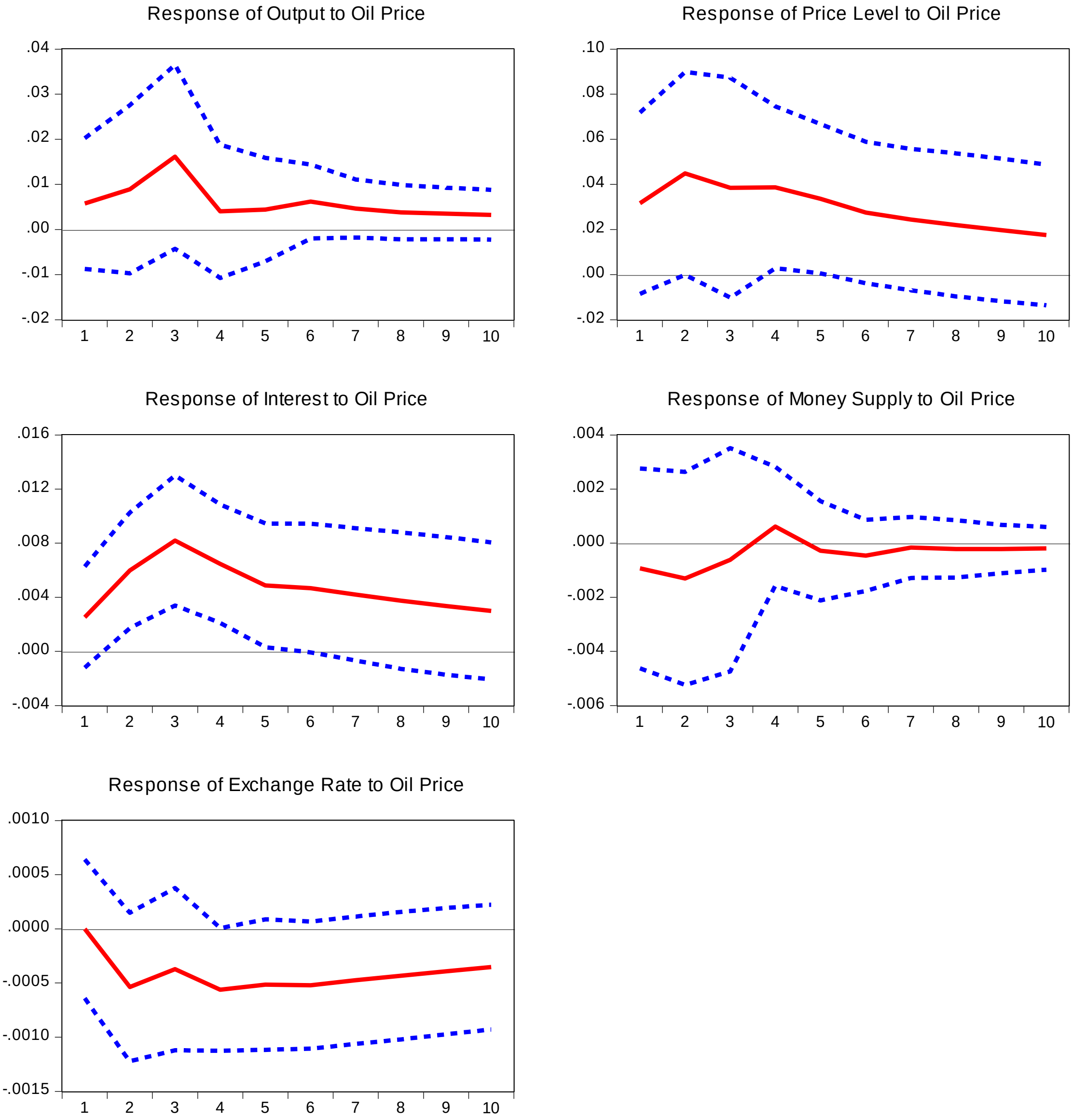
The lags of variables in SVAR model 2, as determined by AIC and FPE criteria. To satisfy stable conditions, the variables used in SVAR model are in log difference form. The response of main macro-economy variables to oil price shocks are presented in Figure (3). Figure 3 suggests that, except for the responses of output, our findings are quite intuitive and consistent with most of the existing literature. Specifically, the general price level of China rises in response to an increase in oil price. The rise in interest rates and decrease (although there is a small rise in period 4, it is not statistically significant) in money supply indicate the monetary policy tends to be tight in response to oil price shocks, showing the central bank's worry about inflation induced by oil price rising. Interestingly and notably, the response of interest rate is more persistent and quantitatively significant than that of money supply. This may reflect the swing in China's monetary policy instrument from giving priority to money quantity towards money price. Actually, Xia and Liao (2001) pointed out that money quantity is not appropriate to function as an intermediate target of monetary policy any more. Besides, it can be concluded from Figure 3 that oil price shocks slightly appreciate the RMB. A similar pattern is found by Huang & Guo (2007), which specializes in the study of the effects of oil price shocks on China's exchange rate, using a four variable VAR system.

For robustness reasons, the transformation of oil price is considered to allow for the measure of how unsettling an increase in the price of oil is likely to be for the spending decisions of consumers and firms, which is carefully studied by Hamilton (1996). Following literature, we exploit the transformation due to Hamilton (1996). The new "oil price" is titled as "Net Oil Price Increase" and is formally defined as:

$$NOPI_t^n = \max(0, \mathrm{OP}_t - \max(\mathrm{OP}_{t-1}, \mathrm{OP}_{t-2} \cdots \mathrm{OP}_{t-n})) \quad (5)$$

Where $NOPI$ denotes net oil price increase, OP stands for log difference oil price. Note that we have used log-difference of the variables in the SVAR analysis above, thus this transformation is used for log-difference oil price. The parameter n needs to be chosen, following Park and Ratti (2008) and Wang et al. (2013), n is set to be equal to 6.

Figure 3. Responses of Main Macro-economy Variables to Oil Price Shocks



Note: The dash line stands for 95% confidence interval.

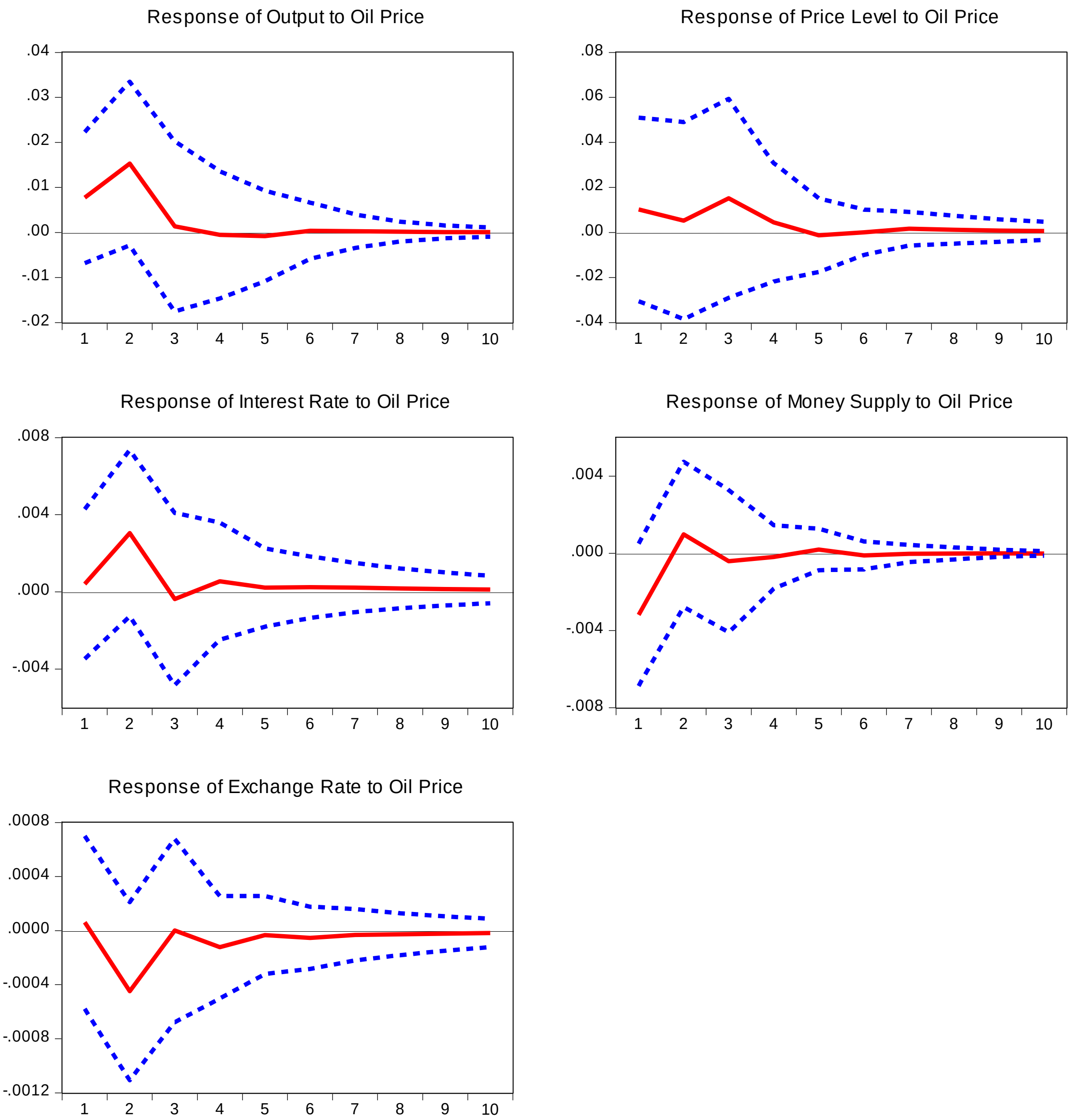
The SVAR model is re-estimated under the specification of Hamilton (1996), that is, the oil price is replaced by $NOPI$. The resulting impulse response functions are demonstrated in Figure (4). Though the results are quantitatively different from those illustrated in Figure 3, the response directions don't essentially change. Even if the differences between them in terms of quantity can also well be explained by recognizing that "Hamilton transformation" moderates the fluctuation of the oil price.

4. New Interpretations for SVAR Results

4.1 Basic Results

One puzzling result illustrated from Figure 3 and Figure 4 is that China's real output is positively correlated with oil price shocks. This finding is similar to that of Du et al. (2010) whose study period spans from 1995 to 2008. In their paper, by arguing that "…both China's growth and the world's oil price are affected by US and EU countries' economic activity in the same direction, and this in turn makes us observe … China's GDP and world's oil price is positively correlated from 1995 to 2008", the authors give a possible and preliminary interpretation for the real output of China is positively correlated with oil price shocks. But we want to go further and examine this puzzle not only from exogenous factors, but also from factors of China itself. Is there any mechanism that can interpret the puzzling results? According to section 1, while international trade is essential for China, China's main trade partners are also major oil-dependent countries in the world. Thus, there is no way to understand the puzzles above without paying attention to how oil price shocks influence China's trade condition. The most essential part of trade condition is relative price.

Figure 4. Responses of Main Macro-economy Variables to Oil Price Shocks (Hamilton Specifications)



Note: The dash line stands for 95% confidence interval.

If it is the case that there is a higher increase in the price level of China's main trade partners resulting from oil price shocks than that of China's, the abnormal phenomenon of the output's response to oil shocks will be well interpreted. This is because, relative to China, the higher increase of its main trade-partners' price levels resulting from oil price shocks will tend to stimulate China's exports and thus its output; To verify whether the increase of oil price lower China's relative price, we run the following regression for China and its main trade partners, respectively:

$$PL = \alpha_0 + \alpha_1 \mathrm{Oil}P + \boldsymbol{\alpha}_2 \mathbf{X} + \mu \qquad (6)$$

In which PL denotes the price levels, $\mathrm{Oil}P$ is the world oil price, and $\mathbf{X}$ is control variables including GDP growth rates, short-term interest rates, money supply growth rates and the exchange rates against the US dollar. The data used in equation (6) is from the OECD database, and the sample period spans from 1992:q1 to 2014:q2. As the GDP growth rate of China from 1992:q1 to 2010:q4 is missing in the OECD database, these missing values are calculated on the basis of the published data from NBS. World oil price data is from IEA. It should be noted that although, for China's data, we can use those from domestic databases, instead, instead we use the data from the OECD database, which enables our comparisons below more convincing, since due to different calculation methods or reference points, even the same variable from different databases will be diverse.

The regression results of equation (6) are presented in Table 3. For the record, since world oil price is same for all the countries, fix effect estimation cannot be implemented. The results in Table 3 provide substantial support to the point that the effects of oil price on China's price level and those of its major trade partners' are asymmetric, or more concretely, the oil price rise is intended to increase the price level of China's major trade partners more than that of China, China's relative price drops accordingly. These asymmetry effects are presumably correlated to the fact that oil pricing is not completely liberalized in China. Specifically, the oil price in China is to some extent regulated by the government, and thus oil price shocks will be inclined to have less influence on China's price level.

Table 3. Oil Price’s Effects on Price Level

	China	Main Trade Partner		
	OLS	POLS	RE	BE
Model (1)	0.342***	0.391***	0.391***	0.392***
	(0.023)	(0.018)	(0.020)	(0.020)
Model (2)	0.054	0.347***	0.347***	0.383***
	(0.054)	(0.015)	(0.015)	(0.016)
Model (3)	0.077**	0.048***	0.347***	0.375***
	(0.038)	(0.009)	(0.015)	(0.012)
Model (4)	0.048***	0.195***	0.201***	0.168***
	(0.009)	(0.008)	(0.008)	(0.011)
Model (5)	0.058***	0.184***	0.187***	0.148***
	(0.009)	(0.007)	(0.007)	(0.010)

Note: The number in brackets is standard error; ***, **, * stand for 1%, 5% and 10% significant level, respectively. Model (1) represents the case that no variables are controlled; In Model (2), the growth rate of money supply is controlled; In Model (3), the growth rate of money supply and exchange rate are controlled; In Model (4), the growth rate of money supply, exchange rate and interest rate are controlled; Apart from the previous control variables, output growth rate is also controlled in Model (5). P-OLS denotes pooled OLS; RE means random effect; BE stands for between estimators.

Increased oil price volatility probably affects the price level, since increased uncertainty presumably influences firms’ investment decisions (Bernanke, 1983; Pindyck, 1991), which in turn are closely linked to price level. The world oil price volatility itself is of relevance and emphasized by many authors (for example, Merton, 1980; Anderson et al., 2003; Park and Ratti (2008) and Pinno and Serletis, 2013). While oil price volatility may affect the price level, it is of course related with oil price. Omitting oil price volatility in equation (6) probably induces endogeneity problem. For robustness, oil price volatility needs to be included in the regression model. Before doing this, the oil price volatility needs to be calculated. In the paper of Merton (1980), Anderson et al. (2003) and Park and Ratti (2008), the measure of monthly oil price volatility is defined as the sum of squared first log differences in a daily spot oil price:

$$VOL_t = \sum_{i=1}^{n_t} \frac{(\log(p_t^{d+1}) - \log(p_t^d))^2}{n_t} \tag{7}$$

In which n_t denotes the number of trading days in month t. Since trading days in different months are not the same, it is not appropriate to simply replace n_t with 30. p_t^d is the spot oil price in day d of month t.

China is a transition country. According to the data from U.S. Energy Information Administration, its oil imports in 2012 are 15.8 times as many as those in 1993. Obviously, the oil price volatility in 1993 is different from that in 2012. In view of this distinguished characteristic of China, a new measure of oil price volatility is introduced in this paper, which is intended to capture the transition features of China. What we do is weight the measure of Merton (1980), Anderson et al. (2003) and Park and Ratti (2008) by the ratio of oil import to output. Formally, it can be formulated as:

$$WVOL_t = \frac{E_t}{Y_t} \sum_{i=1}^{n_t} \frac{(\log(p_t^{d+1}) - \log(p_t^d))^2}{n_t} \tag{8}$$

Where $WVOL$ is weighted oil price volatility, E denotes oil imports and Y is output, the remainder notations possess the same meanings as the ones in equation (7). The results that weighted oil price volatility is included in regression are reported in Table 4. Although oil price volatility is included, it is still the case that there is a higher increase in the price level of China's main trade partners resulting from oil price shocks than that of China.

Table 4. Oil Price’s Effects on Price Level (Oil Price Volatility is Included)

	China	Main Trade Partner		
	OLS	POLS	RE	BE
Model (1)	0.280***	0.401***	0.402***	0.402***
	(0.017)	(0.008)	(0.021)	(0.021)
Model (2)	0.069**	0.368***	0.370***	0.413***
	(0.035)	(0.008)	(0.021)	(0.027)
Model (3)	0.061*	0.370***	0.372***	0.357***
	(0.033)	(0.008)	(0.014)	(0.019)
Model (4)	0.052***	0.262***	0.271***	0.223***
	(0.009)	(0.005)	(0.001)	(0.017)
Model (5)	0.059***	0.250***	0.258***	0.212***
	(0.009)	(0.005)	(0.007)	(0.011)

Note: The number in brackets is standard error; ***, **, * stand for 1%, 5% and 10% significant level, respectively. Except for that additional independent variable oil price volatility is included, the independent variables of Model (1)-Model (5) are the same as those in Table 3.

4.2 Robustness Check

It is known that China has surpassed Japan and became the second largest oil-importer since 2008. Therefore, the economic conditions of China will more likely influence the world oil price. To alleviate endogeneity problem resulting from the interaction of world oil price and China’s economic conditions, instead of using current period oil price, one period lag oil price is included in equation (6). Since one period lag oil price is predetermined, the feedback effects from the dependent variable *CPI* is thus shut down. The results are reported in Table 5. These results also indicates that the increase of China's price level, resulting from oil price shocks, is statistically less than that of its main trade partners’, which means oil price increase is likely to lower China’s relative price.

Table 5. Oil Price’s Effects on Price Level (One Period Lag Oil Price)

	China	Main Trade Partner		
	OLS	POLS	RE	BE
Model (1)	0.345***	0.390***	0.390***	0.391***
	(0.023)	(0.018)	(0.020)	(0.020)
Model (2)	0.052	0.350***	0.350***	0.381***
	(0.053)	(0.016)	(0.016)	(0.017)
Model (3)	0.100**	0.351***	0.351***	0.371***
	(0.037)	(0.016)	(0.016)	(0.014)
Model (4)	0.049***	0.195***	0.197***	0.160***
	(0.010)	(0.007)	(0.008)	(0.009)
Model (5)	0.051***	0.183***	0.186***	0.146***
	(0.009)	(0.007)	(0.008)	(0.010)

Note: The number in brackets is standard error; ***, **, * stand for 1%, 5% and 10% significant level, respectively. The independent variables of Model (1)-Model (5) are the same as those in Table 3.

Another issue worthy being noticed is that the central government of China perhaps offsets the price level increase induced by oil price shocks through monetary policy operations. This means that the independent variables short-term interest rates and money supply growth rates in equation (6) will be affected by the dependent variable *CPI*. To resolve this problem, we use one period lag interest rates and one period lag money supply growth rates as the instrumental variables for interest rates and money supply growth rates, respectively. The IV estimation results in Table 6 still suggest that oil price increase is intended to lower China's relative price, which in turn signifies that the robustness of the results above.

Table 6. Oil Price's Effects on Price Level (IV)

	China	Main Trade Partner		
	OLS	POLS	RE	BE
Model (1)	0.342***	0.3910***	0.391***	0.392***
	(0.023)	(0.018)	(0.020)	(0.020)
Model (2)	0.053	0.326***	0.343***	0.378***
	(0.053)	(0.016)	(0.015)	(0.0160)
Model (3)	0.076**	0.326***	0.343***	0.372***
	(0.037)	(0.016)	(0.015)	(0.012)
Model (4)	0.047***	0.192***	0.202***	0.168***
	(0.009)	(0.008)	(0.008)	(0.011)
Model (5)	0.058***	0.183***	0.198***	0.148***
	(0.008)	(0.008)	(0.007)	(0.010)

Note: The number in brackets is standard error; ***, **, * stand for 1%, 5% and 10% significant level, respectively. The independent variables of Model (1)-Model (5) are the same as those in Table 3.

5. Conclusion

International trade has played a significant role in China over the last 20 years. In this paper we examined the influences of oil price shocks on China from this new perspective. We find that world oil price shocks have a positive relationship with both China's real output and price level. This paper interprets this puzzling result form a new perspective. We argue that the asymmetry effects (perhaps resulted from the fact that the oil pricing is to some extent regulated by the government in China) of oil price shocks on China and its major trade partners maybe an important factor in accounting for the "abnormal" response of output to oil price shocks. This is because the higher increase of its main trade-partners' price levels resulting from oil price shocks will tend to stimulate China's exports and thus its output.

Our paper also has significant policy implications. We have found that both the real output and price levels of China are positively correlated with oil price shocks. Imagine that, confronted with an oil price increase, the authority mistakenly considers the output is, just as many papers imply, negatively correlated with oil price shocks, and take steps to stimulate the economy. This may lead to a second round increase in both the real output and the price level, the economy will consequently be liable to get overheated. Now consider another case that the authority wants to offset the inflation induced by oil price increases. If it believes that the output negatively responds to oil price increases, worrying about further recession in output caused by tight policy, the authority will be inclined to compromise its original target and take modest measures to offset the inflation induced by the oil price increase. Our results, however, imply that a relatively severe measure may be a better choice in this case.

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INTERNET FINANCE: DIGITAL CURRENCIES AND ALTERNATIVE FINANCE LIBERATING THE CAPITAL MARKETS

Kim Wales *

Abstract

This article discusses how the sudden shift in policy reform and innovation has the potential to liberate the financial markets. The economic potential of internet finance is beginning to take hold across the capital markets as industries like Peer – to – Peer Lending, Equity and Debt based Crowdfunding and virtual currencies and cryptocurrencies which are types of digital currency are quickly transforming the way businesses are being financed. From borrowing and lending, buying and selling securities, to conducting wire transfers internationally, these innovations are creating a new class and generation of investors will source investments opportunities. Helping institutions and governments assess risks and manage performance in order to determine where to deploy capital; and showing signs of lessening the inequality gap. Following the neolithic agricultural revolution and the industrial revolution, this new revolution will enable more people to access financial services in less traditional ways, especially the unbanked world with its huge potential. These new financial opportunities, such as peer – to - peer (P2P) lending, will be discussed and examined, and we will stress how they can allow people to bypass current barriers in the global economy. We conclude by arguing that all these developments, energized by the efforts of innovators and entrepreneurs, have the potential to radically transform the world in which we live, while promoting the core values of industrialized societies including democracy, capital formation, sustainability, and equality without solely relying on tax increases.

Key Words: Internet Finance, Digital Currencies, Capital Markets, Alternative Finance

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Introduction

This article will first discuss the issues of traditional means of funding and the impact of that on small businesses and the "unbanked." This is followed by a discussion on the new legislation and how it affects banking and capital creation. Finally, I will discuss emergent technologies and alternative funding mechanisms, such as peer-to-peer lending and virtual and crypto currencies.

The way we do business is being revolutionized. There is decreasing trust of traditional banks, mainly due to the aftershocks of the 2008 financial crisis and the string of scandals that has affected banks reputation since then, including the LIBOR interest rate rigging scandal, money laundering, high risk lending and tax evasion. As access to traditional funding becomes more elusive and as more and more people join the ranks of the "unbanked," it is clear that new ways of creating business, job and capital, in a more equitable way must be found. And indeed, an economic revolution is underway, which is radically transforming the financial ecosystem, via emerging technologies, changing legislation, and alternative funding mechanisms.

Barriers in the Global Economy

Kendall and Voorhies (2014) note that in some countries, "the most important buffers against crippling financial setbacks are financial tools such as personal savings, insurance, credit, or cash transfers from family and friends. Yet these are rarely available because most of the world's poor lack access to even the most basic banking services." In addition, Webber (2014) notes that the World Bank calculates that about 75% "of the world's poor is unbanked," amounting to roughly 2.5 billion people who are unable to access any banking services. These unbanked people are often reliant on "a patchwork of informal and often precarious arrangements to manage their financial lives." [Kendall and Voorhies (2014)], and furthermore they have no access to "private sector financing," which could help to secure "higher economic growth and productivity" [Webber (2014)]. This is such an important issue that Christine Lagarde (2014), head of the International Monetary Fund recently stated that because of "… today's increasingly interconnected world, linked by ever growing financial flows, […it] is an economic and a moral imperative that we reach them and empower them" (see also Webber (2014)).

However, “technology and new business models [are beginning to shape] different types of business finance and funding” available across the globe [Vistage 2013], especially in developing countries. For instance, 75% of Kenyans now have mobile banking services, while in Brazil basic banking transactions are now available at local shops [Webber (2014)].

But while the ‘unbanked’ are increasingly being served in developing countries, Webber (2014) notes that inclusion in traditional banking services is becoming more problematic in the EU and US: The Alliance for Financial Inclusion, a global network of policymakers, reported that there are “58 million people in the EU without bank access and another 92 million are ‘underserved’ – having access, say, to just one bank [while in] the US, nearly 10 million households are believed to be outside of the formal banking system.”

Increasingly, the wealthy are being relied upon to redirect investment dollars toward emerging growth companies through different types of incentives and new funding models, however understanding the new range of financial services and means of access will be ‘challenging” but important for all involved [Vistage (2013)]. In particular, understanding the important differences between the huge range of finance and funding options available – from bank lending to crowd-sourced funding to microfinance to private equity and venture capital – is a challenge, but will be fundamental for business leaders, emerging growth companies and investors as they consider their place in the economic equation. At the same time, as I have written in an earlier paper, it is also important that average working class individuals are also given the chance to take advantage of these new investment and financing opportunities [Wales (2014)].

Maney (2013) says that the world is undergoing a third revolution (following on from the Neolithic Agricultural Revolution and the Industrial Revolution), and this is a very apt description. Humankind’s collective knowledge is being aggregated and disseminated and is increasingly allowing complete access to the surge of universal information and we all have the ability to connect with almost everyone on the planet [Maney (2013)]. Democratization of the capital markets with financial and investment products such as securities based crowdfunding, peer-to-peer lending (P2P), Bitcoin and more -- in parallel -- with technological advances on the Internet, social media, and the smartphone have all equally revolutionized the way that we do things. This new revolution, started in the developing world, will enable more people to access financial services in less traditional ways. These new financial opportunities, such as peer to peer (P2P) lending and bitcoin will now be discussed in turn.

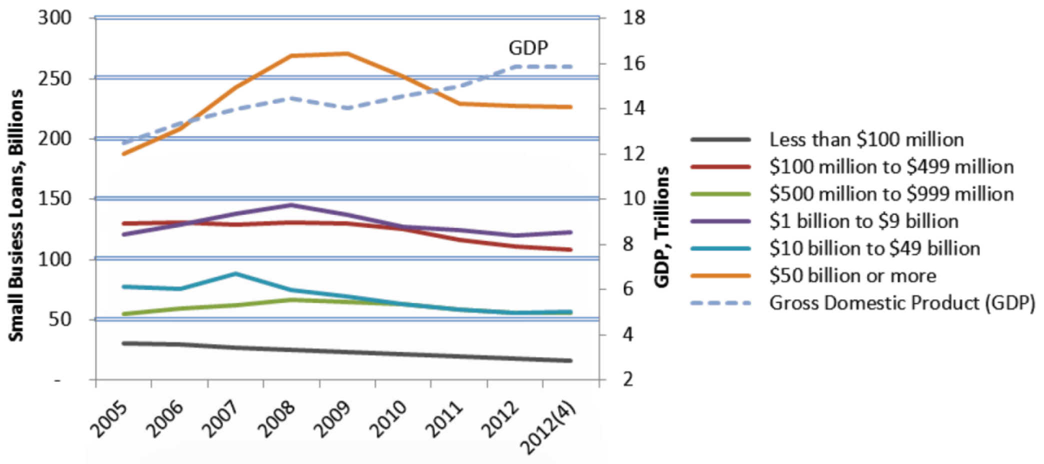
Dawn of a New Era: P2P and the Crowd

In recent years, peer-to-peer lending has attracted borrowers and lenders that had been displaced by the banks. The “new normal’ in this sea of change is leveraging networks of social capital, better known as “*the crowd*” to infuse the money needed into a company in order to start, grow or sustain its practice.

Traditional Lenders: the Banks

According to the Small Business Administration, recovering is continuing in both “borrowing and lending conditions”, although recovery is slower for smaller firms, as illustrated in Figure 2 [OASBA (2013)].

Figure 2. Total values of small business loans by depository institution size and gross domestic product, June 2005 – June 2012 [OASBA (2013)]



Source: U.S. Small Business Administration, Office of Advocacy, based on Call Reports from the Federal Deposit Insurance Corporation.

GDP and other indicators are trending upwards, however the "small firm loan markets remains stagnant, despite low interest rates," which have remained unchanged since January 2009 at 3.25% [OASBA (2013)]

Unfortunately, businesses have experienced a downturn in their financial position, which has made securing funds from banks very difficult during a time of increasing financial regulation [SBFI (2010)]. This is reflected in a number of studies into small business lending over the last few years. For instance, as was noted in NYFRB's (2012) Small business borrowers poll, "[m]ore than three years into the economic recovery, the number of small business loans stands at three-quarters of its 2008 peak. National data show that the number of small business loans – defined as $1 million or less – declined by 4.7 percent in 2011" While lenders report easing credit standards for large and medium-size firms, loan standards for small businesses have not changed in the past five consecutive years according to the Small Business Administration, Office of Advocacy [OASBA (2013)].

The New York Federal Reserve regularly surveys small business owners regarding "their needs and experiences," in order to gauge the credit environment, and in the. April/May 2012 survey, 544 small businesses participated [NYFRB (2012)]. The feedback from the survey indicates that "the recent drop in lending may be due in part to weaker firms self-selecting out of the credit market": about two-thirds of the participants did not apply for any financing, and half of these respondents did not do so because they feared their applications would be declined [NYFRB (2012)]. Participants also reported "higher denial rates" for microloans than for loans of higher amounts, suggesting that the demand for microloans is there [NYFRB (2012)].

Oxfam's (2014) report into global economic inequality stated that a mere 1% of the global population controls almost half of the global wealth. Furthermore, this 1% owns $110 trillion which is 65 times the combined wealth of the "poorest 3.5 billion people," the 85 richest people own the same as the combined total wealth of the bottom 50% of the global population, and 70% of the population reside in countries where "economic inequality has increased in the last 30 years" [Oxfam (2014)]. These statistics emphasize the fact that there is a disproportionate amount of capital not making its way into the hands of "the crowd" as well as the difficulty of gaining access to that capital.

"In the US, where the gap between rich and poor has grown at a faster rate than any other developed country, the top 1% percent captured 95% of post-recession growth (since 2009), while 90% of Americans became poorer." [Neuman (2014); Oxfam (2014)]

Professor Thomas Piketty (2014) points out that capitalism has a inherent tendency toward increasing inequality, because real estate, stocks, and other assets disproportionately held by a few wealthy individuals/families (i.e., capital) rise faster than the general economy (growth).

History illustrates that during periods of radical change, it took two world wars to shift the economy [Piketty (2014)]. Now inequality is rising back to pre-1915 war levels. According to Piketty (2014), this should be counteracted via global tax on wealth or similar measures.While here we agree on the inequality rise, I submit that wealth inequality could improve naturally through advances in technology and the democratization of capital under the umbrella of "internet finance" rather than through fiscal policy alone.

P2P: Marketplace Lenders

Globally, peer – to – peer platforms originated an estimated $70 billion in 2014. Yet, these loans only make up a small portion of the total number of small business loans [Eavis (2014)]. In the first quarter of 2014, banks lent a total of $291 billion to small businesses, according to FDIC figures, while in contrast, US P2P lending platform, Prosper Marketplace originated over $3 billion of loans on platform as of 1Q2015. As of the 2014, Peer – to Peer Lending (Debt) originated $11 billion in loans in the U.S., $56 billion in China and $5.6 billion in Europe in 2014, respectively. These numbers are projected to double by the end of 2015.

Market Making In a New Way

Capital market structure, as we know it for big businesses and sophisticated investors, is rapidly becoming a playing field on which individuals from all walks of life will have the ability to participate.

Access to capital – the lifeblood of business – is revitalizing the markets, which drives liquidity. Companies benefit from access to larger pools of investors because they can obtain finance for expansion at cheaper rates and due to that expansion, there are more job opportunities for workers, leading to a win-win situation. Investors benefit from transparency of choice, less sales pressure from investment advisors, and the freedom to invest towards the future.

The enactment of certain regulatory reforms such as the Jumpstart Our Business Startups Act (JOBS Act) framework ensures that no individual will be denied the right to partake in an economic society or to aspire to business ownership as opposed to just having a job.. Web 3.0 offers new ways to make financing available to more people, thereby addressing some of the most troubling financial statistics. A capital formation (i.e., savings, finance, and investment) using mechanism such as securities-based crowdfunding, peer-to-peer lending (P2P), and

Bitcoin illustrates true potential of a liberated marketplace.

Historically, market makers were firms "that [stood] ready to buy and sell securities on a regular and continuous basis at a publicly quoted price" [SEC (n.d.)]. However, in the new financial landscape, things have changed, with advances in:

1. Peer-to-Peer lending
2. Regulatory reform such as lifting the ban on general solicitation and advertising through Regulation D, Rule 506(c), (Title II) or Regulation Crowdfunding (Title III), and Regulation A+ transactions performed using these provisions could be considered "private public offerings" because they are private offerings that must look public through certain disclosures deemed by the Commission.
3. Bitcoin, a cyber-currency, allows for P2P sales and commissions, "meaning that the market itself decides directly what the spread should be" [Bots (n.d.)].

These exempt offerings differ from traditional offerings by targeting groups of individuals for smaller investments rather than seeking financing from one or two large investors. This new way of transacting in the marketplace might suggest that the "market maker" is rapidly becoming the "crowd," shifting the buy and sell features away from the institutions.

Benefits of Alternative Funding Sources

The following Table summarizes the problems and opportunities posed by alternative funding sources.

Table 1. Key Benefits for Investors and Issuers

Reduced Cost: New technology cuts out the layers of people that stymie the deal. This reduces the amount of time required to originate and underwrite a business or project, reducing overall cost to capital.	**Social Capital Network:** The adhesive that binds this new marketplace together. Understanding the value of your network allows issuers to tap into an investor pool that creates exposure for product development, brand awareness and ultimately, financing.
Access to Market Opportunities: Until securities laws changed with the JOBS Act and other global initiatives, there have been few sources available to raise capital. Securities based crowdfunding platforms, peer-to-peer (P2P) platforms and Bitcoin exchanges scale across the globe, matching buyers to sellers or investors to issuers, thus creating a blue ocean for capital formation.	**The problem in the market:** identifying the **'**best in breed and class', which often can only be discovered through due diligence, transparency and digestible information that the marketplace can share and leverage to make informed investing decisions. **Solution:** CrowdBureau, the Morningstar for the Alternative Crowd Finance Industry[6]. Solving this challenge by providing a centralized hub of ***rated information, investors, companies, and funds*** for the marketplace, enabling the first true gateway for cross border transparency and information.
Nimble and Efficient: Companies can access funding across the entire capital stack for a wide variety of industries. Creative terms often lead to an attractive alliance between the buyers and sellers, which is often lacking from traditional lenders or equity providers.	

Source: Wales Capital, a leading strategy, risk management, and regulatory compliance consulting firm.

[6] The author is the CEO of CrowdBureau

Technology Transforming Paradigms

Investors and companies attracted to this re-regulated marketplace can embrace capital formation with the emergence of Web 3.0; providing the opportunity of creating societies that can yield self-enrichment regardless of the region of the world in which they exist. We are now encroaching on the Internet of Smart Objects. The first phase of the Internet was about connecting machines and the second phase was about connecting people.

Web 3.0 is about bridging the gap between the two.

In other words, connecting the physical and virtual worlds by turning everyday devices into smart objects and linking behaviors to investment opportunities through crowd finance -- creating near frictionless capitalism.

Primary Market

In New Issue Market (NIM), or primary market, trading securities was typically conducted face-to-face, and the Nasdaq OTC market for stocks was one of the first markets where technology replaced this physical interaction [Hendershott (2003)]. Furthermore, “the functioning of the primary market is crucial for both the capital market and economy as it is the place where capital formation takes place” [FMW (2013)].

Volatility of the market will continue. But for buyers and sellers more comfortable with some risks, the gradual shift in adopting new mechanisms to access capital through a new ecosystem of regulatory reform, Web 3.0, and mobile are converging to create the next big economic frontier.

A new operating model for the financial markets is being made possible through:

- Connecting buyers and sellers of debt and equity securities via web enabled funding platforms, which are making computing and communications between global social networks possible for order routing;
- Broadening the reach of disseminating offerings, quote and trade information;
- Allowing transparency of choice with embedded due diligence, risk management and compliance protocols;
- Supplanting direct in-person contact with innovative financial, digital and social media technologies interlinked via Web 3.0.

In the case of Bitcoin, technology, such as the block-chain, is coupled with online networks reducing the friction to access the market, not only in trading but also in consumerism. This novel technology is further breaking down the barriers to capital while reducing costs to end users, lowering the obstacles to entry for new competitors, “enabling market data transmission to a much larger group of participants” [Hendershott (2003)], and making the Crowd more efficient and accessible.

The growth in online funding and “trade execution systems on an international basis has been explosive” [Hendershott (2003)], and new primary markets are becoming inclusive via the Web for the public private placements.

Table 2. Innovative Technology Solutions

Bitcoin Exchanges	Peer-to-peer (P2P)	Funding Platforms	Third Party Vendors
Australia’s Igot is positioned to expand operations across 40 countries including the Middle East, Africa and the European Union over the coming year.	Lending companies like Prosper Marketplace, Lending Club are serving as exchanges that match borrowers and lenders together online.	CrowdCube, Circleup, FundingCircle, WeFunder, FundRise, SeedInvest and Propellr for the public private placements across consumer products, real estate, equity and debt funding.	CrowdBureau, CrowdCheck, Folio, Crowdentials, Orchard, Wales Capital, are some firms serving as the infrastructure “refineries” for the ecology of the new capital market.

Source: Wales Capital, JOBS Act and Crowd Finance Advisory Management Consulting Firm

This seismic shift in buying and selling equity, debt and other consumer products is having a cascading effect across the global capital markets. The Igot exchange, for example, offers customers access to a full menu of exchange features such as: 1) remittances; 2) the ability to deposit and withdraw from their local banks; and 3) bill payment services.

Prosper Marketplace and Lending Club are paving the way for borrowers and investors (lenders) to avoid the overly burdensome requirements from banks to obtain funding or to earn some meaningful level of interest rate return for money that is sitting on the sidelines.

Secondary Market

Traditionally, the secondary market is defined as “that part of the capital market that deals with the securities that are already issued in the primary market” [FMW (2013)]. However, up until 2012, the sluggish investment into start-up and emerging growth companies and the decrease in companies listing on the secondary market, the JOBS Act has also paved the way for new secondary market mechanism to edge its way into the main stream.

As more and more companies are putting off going public for longer, requiring an "efficient means to access liquidity for employees and investors," Nasdaq OMX and Sharespost have forged a joint venture, which combines the Nasdaq old-style market and operating experience with Sharepost's cutting edge web-based platform [NASDAQ (2013)]. Other firms taking advantage of this trend is IssuWorks and OTC QBX. It is expected that more secondary exchanges fashioned in this new style of online buying and selling will proliferate once Titles II, III and IV are live, bringing the retail investor, "Mom and Pop," into the fold of the capital markets. What these types of solutions offer is a complete, end-to-end solution that will enable a private company to control the marketplace for its shares.

The traditional method of secondary market exchanges will be turned on its heels, because the value of a particular stock may vary from that of the face value and because fluctuating interest rates will impact the value of the resale of the securities [FMW (2013)]. However, this will not necessarily be the case with the new breed secondary market exchanges, such as the OTC and IssuWorks, who will be factoring in the voice of the retail investor, i.e., the "Crowd."

Mobile banking

Mobile banking is becoming increasingly popular and its applications have the "potential to encourage financial discipline in even more effective ways" [Kendall and Voorhies (2014)] Mobile banking has three advantages over traditional banking models, which can also be translated for primary and secondary markets [Kendall and Voorhies (2014)]:

- Mobile transactions are virtually free. Counter services at financial institutions make up most of the routine bank costs, however, with mobile banking, the same transactions can be made with little or no cost to the financial institutions or mobile service providers, and by extension those servicing transactions within the primary and secondary markets.
- These mobile transactions create huge amounts of data, "which banks and other providers can use to develop more profitable servers and even substitute for traditional credit scores (which can be hard for those without formal records or financial histories to obtain)". Over time, there will be an emergence of mobile ratings agencies that will assist entrepreneurs and investors to overcome this hurdle in the primary and secondary markets.
- Mobile platforms operate in real time, allowing instantaneous account information, messaging and new services sign up.

About 2.5 billion people live on less that $2 a day and 77% of the world's poor population do not have access to savings accounts and other basic financial services [Kendall and Voorhies (2014)]. This deficient marketplace is ripe for innovative technologies to provide access to financial services that could ultimately shift the financial tide.

A further important aspect related to technology transforming paradigms is given by digital currencies. We feel this is so important as to deserve a special analysis, to which we devote the remaining part of this article, before drawing general conclusions.

Digital Currency: the case of virtual and crypto currencies

Digital currency businesses are now proliferating with $350 million invested by venture capitalist in 2014 and $230 million invested the year prior. For a moment, let's explore how the crypto currency, Bitcoin could transform financial markets, by serving as a catalyst for capital formation, especially in underserved regions like Africa and Haiti, which are in dire need of banking facilities and access to capital and technology like blockchain is beginning to serve as the backbone infrastructure for the movement of currencies.

The marketplace learned about Bitcoin in 2008 when Satoshi Nakamoto sent out a paper [Nakamoto (2008)] on a cryptography mailing list, with "the first block of Bitcoin [being] mined in January 2009" [Vaishampayan (2014)].

Bitcoin is currency that can be traded internationally and anonymously, and because it is a decentralized digital currency, there are no fees, government regulation, and oversight by banks and government-backed securities [Pagliery (2014a)].

Five years after its introduction, Bitcoin is among the most studied and traded financial products. Bitcoin payments occur peer-to-peer with no administrator and this cryptocurrency is now a popular form of digital currency. A number of top investors support this digital currency (including, for example, Marc Andreessen and the Winklevoss twins). Merchants see Bitcoin with favor because of its lower fees when compared with credit cards, and the fact that fees are paid by the purchaser and not by the vendor. However, Bitcoin has also been quite volatile so far and has been subject to intense scrutiny by governments.

B Indeed, last year the bitcoin exchange, Mt. Gox, collapsed, which raised questions regarding "the security of investing in a virtual currency that isn't regulated by governments" [Vaishampayan (2014)]. However, other players, such as SecondMarket, created a new, and more secure, bitcoin exchange and launched a Bitcoin Investment Trust. .

There is an excellent and potentially revolutionary opportunity to incorporate cryptocurrencies like Bitcoin into products such as crowdfunding platforms and mobile-enabled platforms that could serve the unbanked, underserved, and the emerging middle class, who represent well over 2 billion people worldwide. $90 billion a year is spent by this population on alternative services such as check cashers and payday loans [Schutte (2014)] and they struggle to obtain the financing, beyond limited microfinance opportunities, to create businesses. Creating value for this segment of the population could be very exciting if social capital and technology are leveraged properly.

Bitcoin could be used for remittances, liquidity access to cash, and credit for frontier and emerging countries. A press release from the World Bank (2014) states:

"This year's remittance flows to developing countries will be an increase of 7.8% over the 2013 volume of $404 billion, rising to $516 billion in 2016. Global remittances, including those to high-income countries, are estimated at $581 billion this year, from $542 billion in 2013, rising to $681 billion in 2016."

However, even though some progress is being made, much more must be done. For instance, in sub-Saharan Africa, "remittance fees remain stubbornly high, hovering 12%" [World Bank (2014)]. Furthermore, developing countries such as Gambia, Ghana and Venezuela are in challenging positions due to the lack of local infrastructure to support reducing outward exchange controls [World Bank (2014)]. The so-called Diaspora, mainly consisting of migrant workers from emerging and frontier countries sending money back home make up a substantial portion of the remittances market. The diaspora spends upwards of $3.5 billion in remittance fees, which equates to 8.14% on average per transaction when sending money back home to friends and family [Schutte (2014)], and over the course of the last 12 months the average cost to send money decreased by .7%, given the year prior transaction fees were 9.1%.

On Bitcoin Regulations

Since 2009, a question that was not fully addressed is whether or not Bitcoin should (or could) be regulated. On April 6, 2015, the New York Department of Financial Services released a 44-page document, which amounts to a framework for "virtual currency" businesses to operate in the State of New York. Ironically, the very same Benjamin Lawsky, the former Director of the New York Department of Financial Services, who led the efforts to draft rules for "BitLicenses" over the summer of 2014 [Rizzo (2014)] announced plans to leave the [NYDFS] to create a consulting firm which will help companies deal within the regulations now in place for Bitcoin. To some degree, this is the first step in legitimizing Bitcoin as form of currency, and a "giant leap away from the, semi-anonymous, free-for-all that currently defines the independent digital currency" [Pagliery (2014b)].

Currently, central banks do not issue nor regulate Bitcoin, yet the public, which includes exchanges, trading platforms, e-wallet providers, and inventors and lay individuals, can transact with it as a means of payment [EBA (2014)].

Benefits of Bitcoin (and other virtual currencies) include "reduced transaction costs, faster transaction speed and financial inclusion" [EBA (2014)]. But, as discussed above, Bitcoin is not without risk: the currency's value has fluctuated wildly since inception, and $400 million suddenly disappeared overnight with the fall of Mt.Gox, a Bitcoin exchange based in Tokyo, Japan [Vigna (2014a)]. Mt. Gox was launched in July 2010, and by 2013 were "handling 70% of all Bitcoin transactions" [Vigna (2014a)] Mt. Gox, discontinued trading, shutdown their website and exchange service and filed for bankruptcy protection from creditors in February 2014 while seeking a buyer [McLannahan (2014)].

However, despite these problems, Bitcoin could have a positive economic impact as related to creating a free market, "frictionless capitalism."

Consumers and Vendors

Bitcoin remains a concern with regards to illegal activities. For instance, in October 2013, the FBI shut down the online black market, the Silk Road, seizing 144,000 Bitcoins worth $28.5 million from Ross Ulbricht, the convicted founder and operator of online black market Silk Road, who sentenced to life in prison in May 2015 after being found guilty of narcotics and computer hacking charges in February. [Greenberg (2013), BBC (2015)]. However, despite this, the US is generally favorable towards Bitcoin compared with other governments. In China for instance, there are restrictions in place for buying bitcoins with yuan and Bitcoin exchanges cannot hold bank accounts.

Others countries are even more vigilant. The European Banking Authority (EBA) had already warned consumers that would be unprotected if they traded with crypto-currencies, but now it has followed this up with a "don't-touch warning to banks," [Chrigwin and Sharwood (2014)]. EBA's announcement stated that it had found over 70 risks "that apply to users, banks, enforcement of money-laundering laws, and payments in fiat currencies" [Chirgwin and Sharwood (2014); EBA (2014)]. However, in a marked shift June 2014, the UK regulator, the Financial Conduct Authority, Chief Executive Martin Wheatley announced Project Innovate, a fast track initiative to help support finance industry innovation, setting the goal for "an FCA that creates room for the brightest and most innovative companies to enter the sector".

This prior outcry seemed to be of the spirit to block the creation of free capital markets and undermined the value created in developing a decentralized network that would spur Bitcoin's growth.

In Wheatley's address, he reflected on three questions: (1) How does the FCA encourage innovation in the financial service market? (2) Does it do enough to promote competition and create room for new entrants into the market, particularly those with novel business models? (3) Does FCA regulation more broadly serve the needs of innovative businesses? Quite rightly, he recognized several developments as having "transformed finance in improbable timescales" among them virtual currencies, crowd funding and peer-to-peer.

Today, the central banks manipulate and control the money supply in all countries. In part, this is what spurred the worst economic recession in our lifetime. Digital currencies such as Bitcoin move away from the centralized model and have the potential to empower individuals to manage and create wealth autonomously.

Crowdfunding Bitcoin

"New decentralized crowdfunding" platforms are emerging that will "support Bitcoin transactions and could lead to a reshaping of the peer-to-peer finance landscape" [Higgins (2014)]. One such platform is called Lighthouse. Raising capital on this innovative platform will function similarly to existing donation, rewards equity and debt-based crowdfunding platforms that bring buyers and sellers together in a secure manner. The technology behind Lighthouse will resemble the Android wallet app and is expected to provide the market with a lightweight, encrypted wallet [Higgins (2014)]. In addition to serving as a crowdfunding platform for projects and businesses, Lighthouse will try to capitalize on the platform by building advanced features and services for the public marketplace.

Some Operational Highlights: Features and Functions

Some Bitcoin models, such as Lighthouse, will use similar or existing standards and best practices for investor protections through the funding cycle by ensuring that no money [Bitcoin] transfers hands to the issuers until campaigns are fully funded that are leveraged under the JOBS Act for registered funding platforms for Title III. It will use the transaction database that links all computers (nodes) together via the block chain. Funds will remain in segregated accounts (akin to an escrow account) on the platform and the fundraisers will only collect the money when the campaign is fully funded [Higgins (2014)]. Once the campaign reaches its funding target goal, the Bitcoin network will verify (i.e., due diligence) and release the funds to the fundraiser. Transactions will be verified by participating Bitcoin crypto-currency protocol for each campaign.

Buyers will be able to rescind their pledges or purchases of securities up until the campaign close date [Higgins (2014)] -- this also follows the same rules being utilized by all other crowdfunding platforms. And finally, Lighthouse will "double spend the funds back to the user's account, freeing them up for other uses" [Higgins (2014)].

Distributed decentralized solution

Despite the legal issues with Mt. Gox and more recently the security breach at the European Bitcoin exchange, Bitstamp [Popper and Ember (2015)], Bitcoin, which was hailed as an alternative payments system, faster and cheaper with a more secure infrastructure, is regaining its reputation. As a decentralized virtual currency, Bitcoin is not controlled by a central bank as is the U.S. dollar or British pound.

Bitcoins are created through a process called "mining". A coin is produced when the mining computer solves a mathematical problem set by the Bitcoin software. Bitcoin blocks are awarded to the computer or groups of computers that win the cryptographic challenges [Vaishampayan (2014)]. Bitcoin transactions are recorded in the "blockchain', a public computerized ledger, which is maintained by the miners. Anybody can see the blockchain via websites such as blockchain.info, although the blockchain does not reveal who has carried out the transaction. It is this combination of semi-transparency and privacy that appeals so much to many of its users. Mark Williams, Finance professor at Boston University, describes Bitcoins as "virtual currency and payment system intertwined" [Vaishampayan (2014)].

Another factor which differentiates Bitcoin from traditional currencies is the current inability to evaluate its performance and compare it against an appropriate benchmark [Scott (2014)]. By creating economic anchors, buyers and sellers will be able to determine when they are over- or under-paying for Bitcoin [Scott (2014)]. For example, consider buying an espresso at a chain in the U.S. versus buying the same in the same chain in the U.K. Was the difference in price driven only by the fluctuation in the foreign exchange rate? Or were there other factors that made the espresso in the U.S. \$3 and in the U.K. £2.5? Equally you could compare the cost on a range of retail products either country to determine if you are paying fair market value.

Table 3. Guidelines for Investors and Companies

1 Who can use Bitcoins? Anyone can use Bitcoins to pay for goods and services online – there are plenty of outlets that will take them, both online and in the real world. Bitcoins are held in a 'digital wallet', either on your own machine or via an online provider, and transferred to the wallet of your payee. But proceed carefully, as with any investment, there are risks attached.	**4 Transactions (sending and receiving).** Personal computers, mobile devices or a web application is used to facilitate sending and receiving, using a Bitcoin wallet.
2 The first way to gain access to Bitcoin. Be a Bitcoin developer: compete to win Bitcoins via "mining," i.e., competing with other computers to solve algorithms. Winners of these challenges are rewarded payment in Bitcoin transaction fees or newly created Bitcoins.	**5 Small businesses like to accept payment in Bitcoins.** Why? They get paid straightaway, instead of having to wait for funds to clear via PayPal or other online payment methods.
3 The second way to gain access to Bitcoin. Set up a Bitcoin wallet and exchange fiat currency for products and services.	**6 Consumers (and businesses) like them too.** Why? Because there's no tax to pay on transactions and investors see Bitcoin as something of a safe haven, similar to gold. Generally, transaction fees are lower than the 2 - 3% fees imposed by credit card processors.

Source: Wales Capital, a leading strategy, risk management, and regulatory compliance consulting firm.

Market opportunity

Digital Assets

Blythe Masters a former JP Morgan banker has jumped into the fray as CEO of Digital Assets Holdings to tackle digital currency and claims to make trade settlement faster, cheaper and safer. Unlike other new entrants like the partnership formed Bloomberg and itBit, a Singapore-based firm, which "describes itself as a Bitcoin exchange for professionals" as well as the keeper of reliable deposit and withdrawals [Hajdarbegovic (2014)], Digital assets has no designs on being a trading business nor exchange.

Pantera Capital

Bitcoin-focused investment firm Pantera Capital has announced an index that enables investors to track Bitcoin over a medium-term timeframe [Cawrey (2014)]. Pantera Capital created the BitIndex, which has seven benchmark criteria [Cawrey (2014)]:

1. The GitHub development platform and interest of the developer community
2. Consumer and Merchant adoption rate
3. Bitcoin education, as measured by tracking the number of Wikipedia views.
4. Hashrate by "logarithmic scale corresponding to orders of magnitude"
5. Number of Bitcoin searches on Google
6. Number of wallets to quantify user adoption rate
7. Buyer and seller volume on the Bitcoin network

Pricing is not included in these criteria and unfortunately, ‚Pantera is not disclosing how it calculates the merchant adoption metric, however, different sources such as Google, Wikipedia and GitHub provide statistics for hashrate, user adoption by wallets, and transaction volume [Cawrey (2014)].

The future of Bitcoin

It is too early to know Bitcoin's fate because it is not clear whether a central bank or other regulatory entity will govern it, a decision which may ultimately lead to its success or demise. However, even with this uncertainty, venture capitalists are gambling on Bitcoin's future and the adoption rate of Bitcoin continues to increase: a number of well-known retailers, including Overstock, Expedia and Dell, have started accepting Bitcoin for domestic sales through their websites over the past few months.

Two possible Bitcoin scenarios:

1. Bitcoin can be viewed as an e-commerce infrastructure solution.

Technology advances in social media, Web 3.0, will allow for "processes to deliver quick and responsive service, including live chat, self-service tools, and quick turnaround on questions and orders," [Traxler (2012)] while providing the lowest prices to evolve. This approach will drive further disruption in the financial markets to companies like Visa and Mastercard; Bitcoin could displace these types of companies by becoming the gateway for money transfer services [Scott (2014)]. In addition, once the market matures, Bitcoin technology could serve as a value-add to crowdfunding platforms as way of reducing fees when transacting deals between buyers and sellers.

2. Bitcoin could become the anchor currency. It could take on a life of a "commodity reserve" monetary plan similar to what Thomas Edison proposed in 1922 [Sauser (2014); Hammes and Wills (2006)] and integrate with mobile banking and microfinance in regions such as Haiti or Africa. However, it does not need to be tied back specifically to agriculture, nor do 'interest free' loans have to be introduced. Rather, Bitcoin could be a freely traded security and currency across all commodities regardless of geographic location. Buyers and sellers could remain anonymous and smart technology could be developed to recognize pattern behaviors, which would alert the "crowd" and regulators to suspicious activities. It could provide tracking of transactions, management of documents, filings whether real estate, agriculture, oil and gas across the entire capital market.

Just imagine for a moment the implications to the market if Bitcoin's value were anchored to its use in a particular national economy that supplies a crucial global commodity.

Conclusion

The world is embarking upon a new economic revolution. Institutional market making may become a profession of the past as the democratization of capital is being driven more and more by retail investors. The catalyst for this phenomenon originated in the global economic recession. Unemployment, while going down, is till a problem, and interest rates remain at historic lows of almost zero percent while startup and emerging growth companies find it difficult to raise capital via traditional avenues.

Start-ups are major job creators (small firms created 65% of new jobs in the US between 1993 and 2009: OASBA (n.d.)), but they aren't getting the funding to remain operational. 2.5 billion people are unbanked [Chaia et al (2010)] while over 2 billion are living on less than $2 a day. With all of the global resources, it is hard to understand why the wealth disparity gap continues to increase in the 21st century with 1% of the population controlling over 50% of the world's wealth.

On April 5, 2012, President Barack Obama signed into legislation The Jumpstart Our Business Startups Act (JOBS Act), igniting a change to 80-year-old securities laws while spurring a changing of the guards globally and enabling the democratization of the capital markets. Technological advances such as Web 3.0, social capital, smartphones and mobile technology, and Bitcoin are fueling this economic revolution. This revolution is also known as "frictionless capitalism", a term coined by Bill Gates in 1994, in his book, The Road Ahead, which suggests a new generation of internet companies are innovating to find ways of reducing friction within the internet economy. I will take this thought one step further and propose that the internet is becoming the new industrial network where we can connect with one another directly allowing for advances in creating "frictionless labor markets."

Bitcoin is already driving the early stages of frictionless capitalism. A startup company, BitPesa, has launched a Bitcoin remittances company, which is different to M-Pesa, Kenya's mobile money system [Vigna (2014b)]. 15 Kenyans now living in London will pilot the scheme [Vigna (2014b)]; these individuals regularly send money back to their home countries via traditional remittance mechanisms. The participants will be using the Bitcoin platform to covert UK pounds into Bitcoins, which are then reconverted to Kenyan shillings at the other end [Vigna (2014b)]. The fees for BitPesa are 3%, much lower than the fees traditional remittance companies, such as Western Union, charge [Vigna (2014b)]. This could prove a win for all as there is a reduction in transaction fees, thereby placing more money in the pockets of local community people. This could spur business creation, job creation and ultimately decrease the wealth inequality gap.

Although remittance companies such as Western Union continue to dominate remittances globally, despite the high transactions fees, popular mobile money systems like M-Pesa, and start-ups like BitPesa, are positioned strategically to capitalize on the swift changes occurring across finance and technology.

As these examples show, a new economic revolution has the potential to disrupt social and capital norms. Every aspect of life will be transformed due to the interrelated nature of the ecosystem because increased activity in one part of the ecosystem spurs an increase in activity in others.

I conclude by arguing that all these developments, energized by the efforts of innovators and entrepreneurs, have the potential to radically transform the world in which we live, while promoting the core values of industrialized societies including democracy, capital formation, sustainability, and equality. A brave new world of business and finance, which is more equal and fairer, is just around the corner.

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THE USE OF TRADITIONAL VERSUS E-MARKETING IN SMES IN A DEVELOPING COUNTRY: A COMPARATIVE ANALYSIS

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Abstract

The revolution of the internet has changed the way many organisations conduct business in today's market environment, and has specifically changed in the way companies market products to consumers. E-marketing allows a marketer to not only reach a broader target market than traditional methods, but substantially reduces marketing costs as well, which can mean the difference between success or failure in small medium enterprises (SMEs). Multiple studies have investigated traditional and e-marketing practices, however, few studies have focused on SME marketing practices and their use of e-marketing in developing economies. This article provides an insight into current marketing tools employed by SMEs in South Africa and provides a comparative analysis between traditional and e-marketing tool usage. A self-administered questionnaire was distributed to SME owners, whereby data was analysed by means of frequency occurrence. The main results stemming from the research indicate that SME owners have no preference in using either traditional or e-marketing tools, with majority preferring to use both. However, the majority of marketing tools being used and receiving the most effective rating according to SME owners is directed towards e-marketing tools. From the results obtained recommendations are made to policy-makers, SME managers, development agencies and business owners so as to establish an appropriate strategy to improve SME marketability within South Africa. The findings can be universally applied as studies have shown that there is a lot of similarity in the challenges faced by SMEs irrespective of where they come from.

Key Words: Marketing, Traditional Marketing, E-Marketing, SMEs.

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1. Introduction

It is widely known in business spheres that the internet and e-commerce can enhance an organisation's exposure and performance in business, especially relating to small medium enterprises (SMEs) as the use of the internet allows SMEs to be more competitive on both a local and international platform (Cloete, Courtney & Fintz 2002:2). E-commerce provides all organisations, including SMEs, with cost effective tools to market themselves to their target audience, assist in the identification of potential opportunities, help to improve communications and to gather information (Cloete et al 2002:2). While a number of studies have investigated the comparison between traditional and e-marketing (Salehi, Mirzaei, Aghaei & Abyari 2012:385), few studies have, however, made a comparative analysis regarding the usage of traditional and e-marketing practices employed by SMEs in developing economies such as South Africa. This paper therefore aims to investigate South African SME businesses' usage of traditional and e-marketing practices. The following section outlines the aim and objective of the study and provides a brief background of traditional and e-marketing practices; whereafter SMEs and their importance are discussed. Finally the research methodology is discussed followed by the results, limitations, recommendations and conclusions of the research.

2. Literature Review

2.1 *Marketing: traditional marketing versus e-marketing*

Marketing plays a fundamental role in the success of any enterprise as it helps organisations to identify and satisfy customer needs, which in turn earns the organisation a profit. According to the American Marketing Association the term, marketing, can be defined as the "…set of institutions and processes for creating, communicating, delivering and exchanging offerings that have value for customers, clients, partners and society at large" (AMA 2014). Marketing can take on a variety of forms; however, the two main methods that are prominent in modern day society are that of traditional and e-marketing activities (Salehi et al 2012:385). Traditional marketing includes many forms of marketing activities; in essence they are the most common forms of advertising methods that one sees every day, and has four main categories, namely: telephone, broadcast, print and direct mail (Marketing-schools, 2012). In contrast e-marketing can be seen as the use of information technology to communicate, deliver value and build relationships with one's customers in such a way as to benefit investors and the organisation as a whole (Liew & Loh in: Rentchler & Hede 2007:38,40). Essentially e-marketing can be seen as the result of information technology (IT) applied to traditional offline marketing principles and techniques (Hasan 2011:201).

Amhed and Hussain (2014:189) conducted a comparison between traditional marketing and e-marketing and a number of differences between these methods were identified. Firstly, they indicate that there is a difference in cost in those traditional marketing methods such as newspapers, magazines, radio and television all carry a price tag relating to quality and target reach. E-marketing, on the other hand, can also carry a cost in that the business pays for the platform the organisation makes use of. However, the cost involved is relatively low which makes it a viable option for small businesses. In this respect it would imply that e-marketing is more affordable for small businesses as opposed to traditional methods, as small businesses' success relies largely on reducing costs while increasing the organisation's sales (Salehi et al 2012:386-387). Another difference is that of immediacy. Traditional marketing takes time to set up and requires various drafts to be formulated before the draft can go to print or be broadcasted. With e-marketing techniques, however, it can, if required, be instantaneous, and further provide an immediate impact by delivering meaning and information upon request (Amhed & Hussain 2014:189; Salehi et al 2012:386-387). E-marketing provides an easier means of feedback compared to traditional marketing. Organisations can track the amount of e-traffic received and can monitor the conversion rates of viewing to purchase (Amhed & Hussain 2014:189). E-marketing can be seen to have an advantage with regard to frequency as traditional marketing is much more expensive when it comes to cost per view. While traditional marketing tools are affective in reaching a broad target market, teenagers and millennials are a target segment that is using technology more frequently and they are apt to be exposed to e-marketing campaigns, which could tie in well with the target market of a small business (Amhed & Hussain 2014:189). Ahmed and Hussain (2014:189) also indicate a similarity between the two marketing forms as they are both able to attract a specific demographic segment and therefore could potentially miss out on a specific target market. Finally, small medium enterprises need to keep the factor of permanence in mind when considering which medium to select. To this end traditional marketing media, once printed, remains as is for a period of time, while e- marketing methods are less permanent and can change without huge associated costs (Amhed & Hussain 2014:189). From the comparison of traditional marketing and e-marketing it can be seen that e-marketing is an attractive method for SME businesses. While many SMEs still make use of traditional marketing methods, the internet has led to a more connected environment, and the growth of users making use of internet in business has resulted in a decline of the use and distribution of traditional marketing media. (Hasan 2011:201). It has therefore become important to evaluate the usage of traditional marketing versus e-marketing by SMEs in South Africa.

2.2 Small Medium Enterprises (SMEs) in South Africa

There is no general definition for what a small medium enterprise (SME) is. Definitions that exist come from business, economics and development literature, but vary in terms of size, turnover and number of employees (Mutula & Brakel 2006:402; Cloete et al 2002:1). However, the framework most broadly used to define SMEs in South Africa comes from the National Small Business Act 102 of 1996, which identifies five types of businesses based on annual enterprise turnover and size, number of employees, and an organisation's gross assets. The various types of enterprises are as follows (Abor & Quartley 2010:221):

- *A survivalist enterprise*: This type of company includes hawkers and vendors and is considered pre-entrepreneurial (part of micro-enterprise) as the income generated is less than the minimum standard income or the breadline.
- *A micro-enterprise*: These companies often are not registered; examples of such would be spaza shops and taxis. They usually employ not more than five people and turnover is often less than R150 000 per annum.
- *Very small enterprise*: This type of company has access to technology and operates in the formal market. It usually consists of 10 employees, but in industries like mining, manufacturing and construction for example, it could be 20 employees.
- *Small enterprise:* These companies usually exhibit more complex business structures and practices and consist of no more than 50 employees.
- *Medium enterprise:* This type of company is characterised by decentralised power with an extra management layer. The maximum number of employees is 100, however, in industries such as mining, manufacturing and construction the maximum number of employees is 200.

For the purpose of this research, however, SMEs are classified as businesses that have one chief executive officer (CEO) and not more than 50 employees (Cloete et al 2002:1).

Small medium enterprises (SMEs) play a vital role in economic development as they help to create jobs, they contribute to innovation, stimulate growth and furthermore are seen to help alleviate poverty in developing economies (Esselaar & Stork 2008:87; Abor & Quartey 2010:218; Elliot & Boshoff 2005:44; Jeppesen 2005:463). In today's business environment, SMEs make up about 91% of formal businesses, contribute between 52 and 57% to the country's gross domestic product (GDP), and approximately 60-61% to employment (Falkena, Abedian, Von Blottnitz, Coovadia, Davel, Madungandaba, Masilela & Rees n.d: 23; Abor & Quartey 2010:218). It is evident from these figures that SMEs play a vital role in the South African economy and therefore it becomes apparent why there is growing recognition of the important role they play in economies worldwide.

2.3 Importance of marketing to SMEs

Marketing is important for the growth of any business, as without it a business could offer the best products on the market but nobody would know of their existence (Hawes in: fin24 2013). Small firms in the beginning phases often face marketing challenges which can determine the success or failure of the business. The lack of a sophisticated marketing strategy can therefore be seen as problematic. While the importance of marketing applies to both large and small firms, small firms generally do not have the financial capacity or the resources to embark on an extensive marketing campaign, where traditional media would normally be employed (McCartan-Quinn & Carson 2003:204-206). E-marketing is therefore ideal for small businesses because of the fact that e-marketing can be implemented at a relatively low cost while still allowing small businesses to compete directly with larger organisations (Sundararaj 2013:193; McCartan-Quinn & Carson 2003:204-206). It creates significant opportunities for cost efficient, flexible messages that can reach the critical mass of customers that is needed for the company to be seen as successful. The marketing characteristics of small businesses is that they are faced with different competitive scenarios, do not always engage in marketing practices, and they have inherent production and pricing flexibility, but generally lack strong brand names and market power. The true competitive advantage that SMEs have is that they are more flexible than larger firms (McCartan-Quinn & Carson 2003:204-206).

A small firm with an implemented marketing plan will have the ability to establish direct contact with the customer or potential customers, thereby allowing for immediate communication among parties (Sundararaj 2013:193). Typically firms would also be able to rapidly change and respond to customers' changing needs (Mc Cartan-Quinn & Carson 2003:205). Globalisation and digitalisation have transformed the way business is conducted and how businesses compete in the marketplace. However, the problem is that many SMEs are employing traditional tools to stay competitive instead of taking on e-marketing tools to take on the competition (Modimogale & Kroeze 2009:504). Therefore it becomes important that research be conducted in order to investigate where South African SMEs stand in terms of traditional and e-marketing tool utilisation. The following section discusses the research methodology employed.

3. Aim And Methodology

The aim of this study is to investigate the extent to which small medium enterprises (SMEs) in South Africa utilise traditional and e-marketing tools.

Data collection was done by means of distributing self-administered questionnaires to a sample of SME owners who registered their businesses at an official state institution for SMEs. The questionnaire consisted of quantitative questions allowing small business owners to indicate the utilisation of various traditional and e-marketing tools. The sampling methodology utilised was that of non-probability, convenience sampling, which enabled the researcher to collect data quickly and easily. A sufficient number of questionnaires were distributed to achieve a confidence level of 95% and an error margin of 10% at 50% response distribution. A total of 71 useful responses were received which is an error margin of 11.38%. The number of responses will only give a general indication of how important traditional marketing and e-marketing tools are in South African SMEs.

The quantitative data was analysed using IBM SPSS Statistics V22. The data was checked, coded and corrected, and descriptive statistics (frequency counts) were used to describe the findings. Descriptive statistics are used to describe which marketing tools have been used previously, how often these marketing tools are used, and how effective the tools are perceived to be. The Independent samples Mann-Whitney U test was used to test for significant difference in the percentage of respondents who have been using traditional marketing tools and e-marketing tools in the past; are using traditional marketing tools and e-marketing tools "Often & Always"; who rated the effectiveness of traditional marketing tools and e-marketing tools as "Effective & Very Effective".

4. Findings

The findings are described taking into account the characteristics of the sample in terms of the number of employees, how frequently the marketing plan is updated, how much is spent on marketing actions per month and whether the respondents prefer to use traditional or modern e-marketing tools.

4.1 The sample characteristics

Of the 71 businesses/ respondents that were included in the survey, 67 provided information on the number of employees they have in their business. Fifty five (82.1%) of the businesses have less than 20 employees. The number of employees was non-normally distributed, with skewness of 3.42 (SE = 0.293) and kurtosis of 12.06 (SE = 0.578). The majority (50%) of the 66 businesses who provided information on the frequency of updating their marketing plan, update their marketing plans once a year while 27.3% of them update it once a month. The frequency of updating the marketing plan was normally distributed, with skewness of -0.261 (SE = 0.295) and kurtosis of -0.253 (SE = 0.582). The majority (51.5%) of the 68 businesses that provided information on their monthly expenses on marketing activities spend less than R1 000 per month, with 38.2% of them spending between R1001 and R5000 (table 1 below). The monthly expenses on marketing activities was non-normally distributed, with skewness of 1.202 (SE = 0.291) and kurtosis of -1.330 (SE = 0.574).

Table 1. The sample characteristics

Number of Employees	**Count(n)**	**%**	**Monthly Marketing Expenses**	**Count(n)**	**%**
Less than 20	55	82.1	Less than R1 000	35	51.5
21-40	7	10.4	R1 001-R5 000	26	38.2
41-60	1	1.5	R5 001-R10 000	5	7.4
61-80	2	3.0	More than R10 000	2	2.9
More than 100	2	3.0	**Total**	**68**	**100.0**
Total	**67**	**100.0**			
Frequency of Updating Marketing Plan	**Count(n)**	**%**			
Once a week	3	4.5			
Once a month	18	27.3			
Once a year	33	50.0			
Once every 5 years	12	18.2			
Total	**66**	**100.0**			

4.2 Descriptive analysis on the past use of marketing tools

On the use of different marketing tools respondents were asked to indicate which of the listed tools (traditional (9) and modern e-marketing tools (5)) they have used in the past to promote their businesses. The top five marketing tools which were used by more than 50% of the respondents were business cards (75.4%), e-mails (68.4%), pamphlets (61.4%), social media (59.6%) and websites (56.1%). Three of the top five marketing tools used are modern e-marketing tools. Furthermore, 43.9% of the respondents reported to have used SMS and newspapers for marketing. Traditional tools like magazines, posters and radio have been used by only 22.8, 21.1 and 19.3% of the respondents respectively. Similarly, blogs have been used by only 21.1%. The two least used marketing tools are traditional billboards and TV – used by only 8.8 and 5.3% of respondents respectively (figures 1 and 2). The Mann-Whitney U test indicated that the two groups did not differ significantly: U (11) = 28, p = 0.240.

Figure 1. Percentage of Respondents using Traditional Media in the past

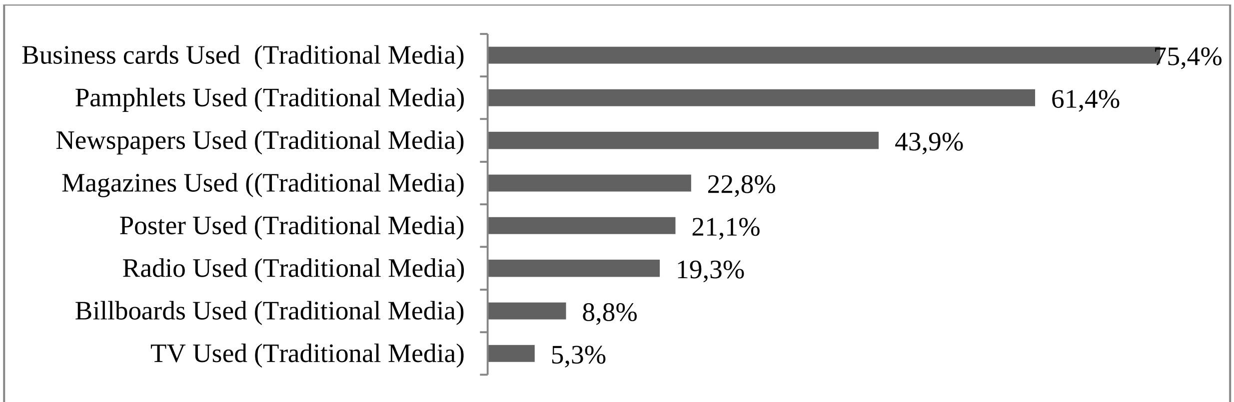
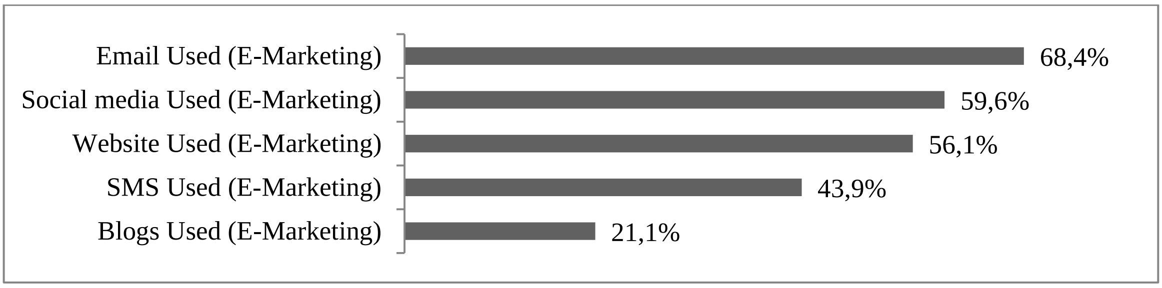
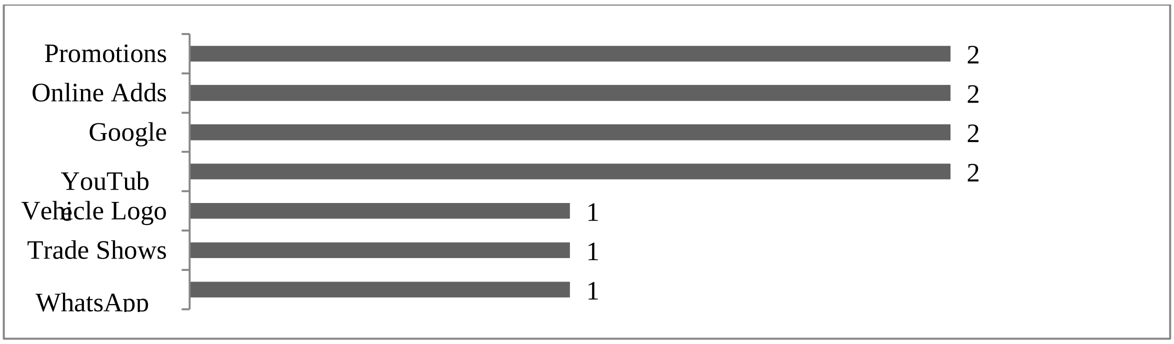


Figure 2. Percentage of Respondents using E-marketing tools in the past



Other marketing tools used in the past were mentioned by a few of the respondents. They were: promotions, online advertisements, Google, YouTube, vehicle logos, trade shows and WhatsApp (figure 3).

Figure 3. Number of respondents who used other marketing tools used in the past



4.3 Descriptive analysis on the frequency of using marketing tools

From the descriptive statistics for the questions on the frequency of use of the different marketing tools, it is clear that the frequencies are non-normally distributed (table 2).

Table 2. Descriptive statistics for the questions on the frequency of use of marketing tools

	N		Mean	Median	Mode	Std. Deviation	Skewness	Std. Error of Skewness	Kurtosis	Std. Error of Kurtosis
	Valid	Missing								
Traditional marketing tools										
Pamphlets	63	8	3.05	4.00	4	1.549	-.270	.302	-1.516	.595
Business cards	69	2	4.03	5.00	5	1.424	-1.310	.289	.323	.570
Radio	58	13	1.69	1.00	1	1.188	1.611	.314	1.492	.618
TV	55	16	1.22	1.00	1	.738	3.936	.322	16.102	.634
Billboards	57	14	1.44	1.00	1	1.053	2.358	.316	4.456	.623
Poster	58	13	2.16	1.00	1	1.374	.719	.314	-.902	.618
Magazines	59	12	1.78	1.00	1	1.260	1.342	.311	.450	.613
Newspapers	58	13	2.24	1.00	1	1.455	.625	.314	-1.165	.618
e-Marketing tools										
Social media	59	12	3.15	4.00	1	1.720	-.266	.311	-1.713	.613
SMS	55	16	3.00	3.00	1[a]	1.453	-.226	.322	-1.307	.634
Website	64	7	3.33	4.00	5	1.662	-.480	.299	-1.465	.590
Blogs	46	25	1.91	1.00	1	1.503	1.222	.350	-.267	.688
E-mail	65	6	4.00	5.00	5	1.447	-1.309	.297	.244	.586

a. Multiple modes exist. The smallest value is shown.

With the exploratory nature of this study, the data was analysed using descriptive statistics. Due to the sample size, the two lowest frequency scales and the two highest frequency scales were combined and the analysis was done on the three rating scales. Figure 4 below reports on the frequency of using traditional marketing tools. Of the 71 SMEs which were surveyed, more than 50% are using business cards and pamphlets, either often or always. TV, billboards, radio, magazines, newspapers and posters are never used by more than 50% of the respondents. The majority of the least frequently used tools are traditional marketing tools (figure 4).

For e-marketing tools, more than 50% of the respondents are using e-mails, websites and social media, either often or always. Blogs are never used by more than 50% of the respondents. The frequency of the use of SMSes is in between the most popular and least popular tools, with 32.7% using it rarely or not at all and 43.6% using it either always or often. The majority of the most often used tools are modern e-marketing tools (figure 5).

Figure 4. Frequency analysis of the frequency of using traditional marketing tools

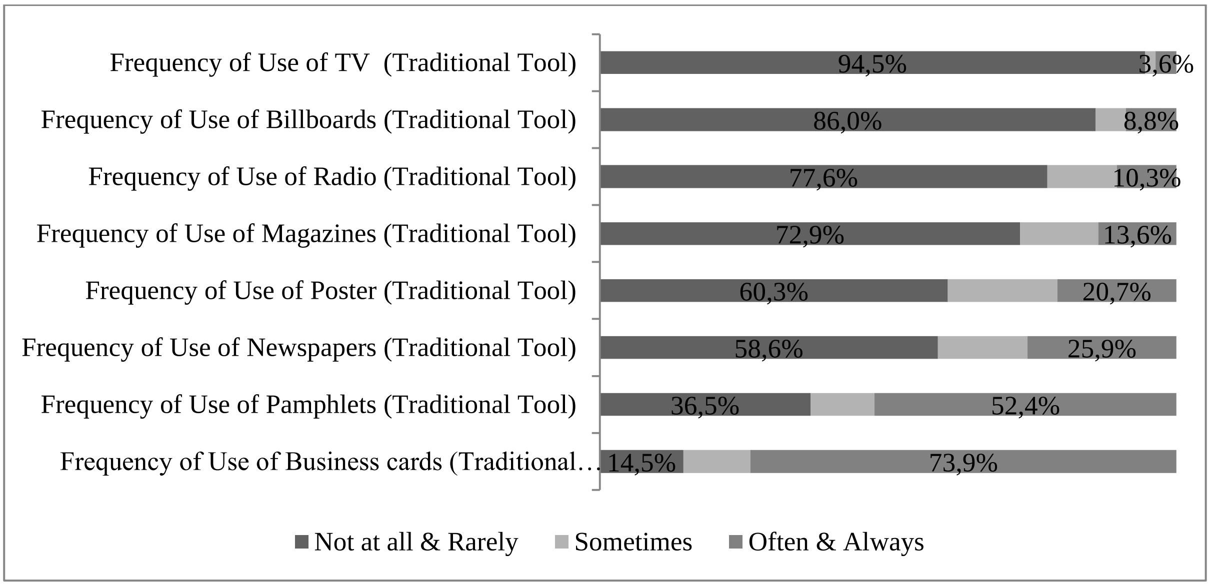
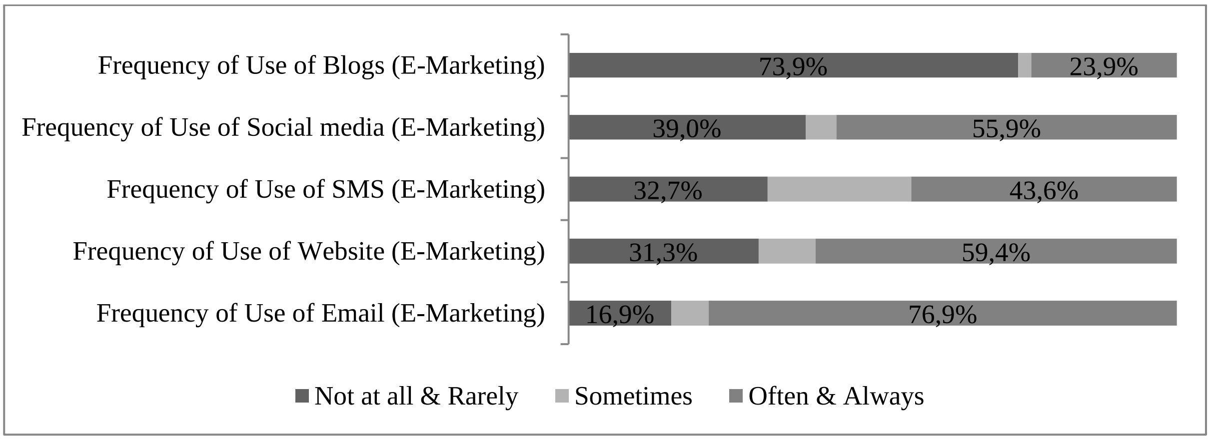


Figure 5. Frequency analysis of the frequency of using e-marketing tools



The Mann-Whitney U test results show that the two groups did not differ significantly in the percentage of respondents who indicated the frequency of use of the marketing tools as “Often and Always”, $U(11) = 33$, $p = 0.057$.

Treating the variable as continuous, and keeping in mind that higher values correspond with higher levels of agreement with a statement, one can see from the means that the two most frequently used marketing tools are business cards (Mean = 4.0) and e-mails (Mean = 4.0) (figures 6 & 7). This is followed by websites, social media, pamphlets and SMS, all with means higher than or equal to 3, which is the middle value of the scale (from 1 to 5). Four of the top 6 used marketing tools are e-marketing tools. The majority of the marketing tools least frequently used (with means lower than 3) consist mostly of the traditional marketing tools and they are: blogs, newspapers, posters, radio, magazines, billboards and TV.

Figure 6. Mean values of the ratings of the frequency of using traditional marketing tools

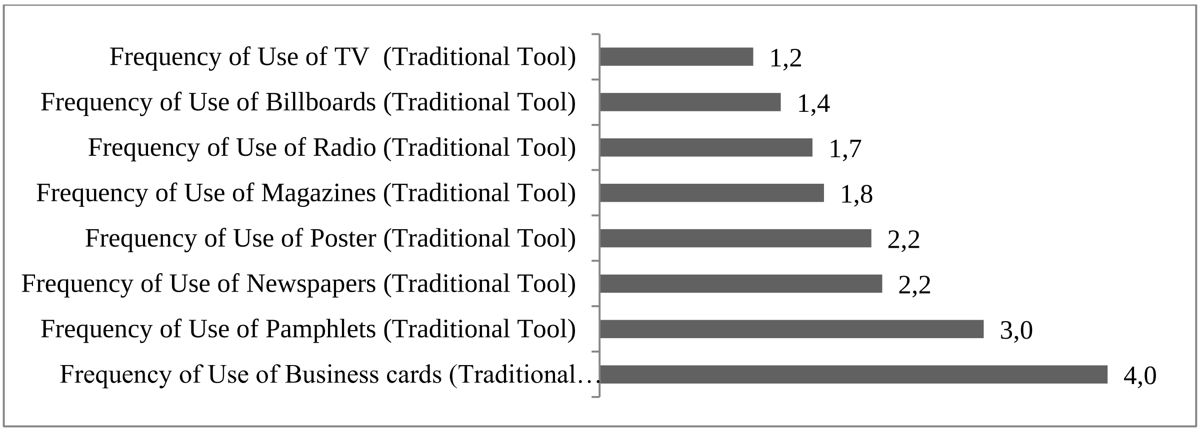
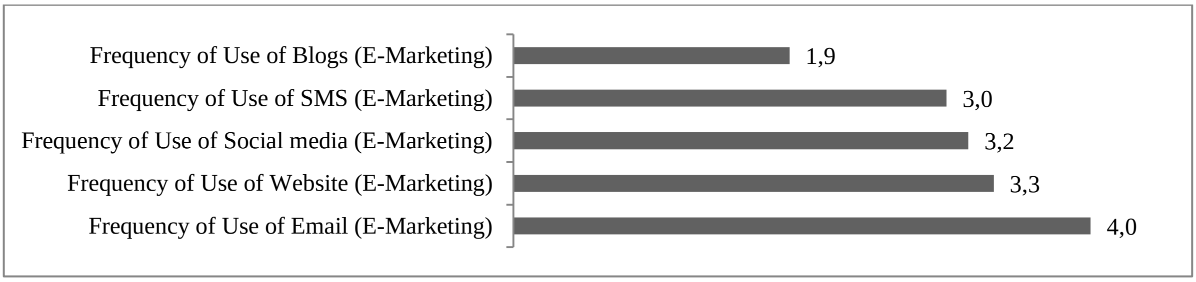


Figure 7. Mean values of the ratings of the frequency of using E-marketing tools



4.4 Descriptive analysis on the effectiveness of the use of marketing tools

From the descriptive statistics for the questions on the effectiveness of use of the different marketing tools, it is clear that the frequencies are non-normally distributed (table 3).

Table 3. Descriptive statistics for the questions on the effectiveness of use of marketing tools

	N		Mean	Median	Mode	Std. Deviation	Skewness	Std. Error of Skewness	Kurtosis	Std. Error of Kurtosis
	Valid	Missing								
Traditional Marketing tools										
Pamphlets	63	8	3.57	4.00	5	1.411	-.577	.302	-.954	.595
Business	65	6	4.12	4.00	5	1.023	-.886	.297	-.033	.586
Radio	59	12	3.49	4.00	5	1.490	-.647	.311	-.940	.613
TV	54	17	3.35	4.00	5	1.662	-.435	.325	-1.462	.639
Billboards	53	18	3.28	4.00	5	1.598	-.396	.327	-1.405	.644
Poster	54	17	3.59	4.00	5	1.381	-.602	.325	-.758	.639
Magazines	49	22	3.29	3.00	3[a]	1.500	-.359	.340	-1.171	.668
Newspapers	55	16	3.47	4.00	5	1.438	-.544	.322	-.975	.634
E-marketing tools										
Social	59	12	3.63	4.00	5	1.530	-.772	.311	-.851	.613
SMS	57	14	3.54	4.00	5	1.390	-.694	.316	-.657	.623
Website	62	9	4.06	4.00	5	1.172	-1.456	.304	1.545	.599
Blogs	51	20	3.14	3.00	1[a]	1.523	-.276	.333	-1.390	.656
E-mail	61	10	4.00	4.00	5	1.155	-1.142	.306	.533	.604

a. Multiple modes exist. The smallest value is shown

All of the traditional marketing tools are rated as either very effective or effective by most of the respondents (more than 50%), except magazines (44.9%). The top three tools rated in terms of efficiency (very effective or effective) are business cards, radios and pamphlets (figure 8). The bottoms three are posters, billboards and magazines. Similarly, all of the e-marketing tools are rated as either very effective or effective by most of the respondents (more than 50%), except blogs (49%) (figure 9).

The Mann-Whitney U test results show that the two groups did not differ significantly in the percentage of respondents who indicated the effectiveness of the marketing tools as “Effective and Very Effective”, $U(11) = 31$, $p = 0.107$.

Figure 8. Frequency analysis of the effectiveness of using traditional marketing tools

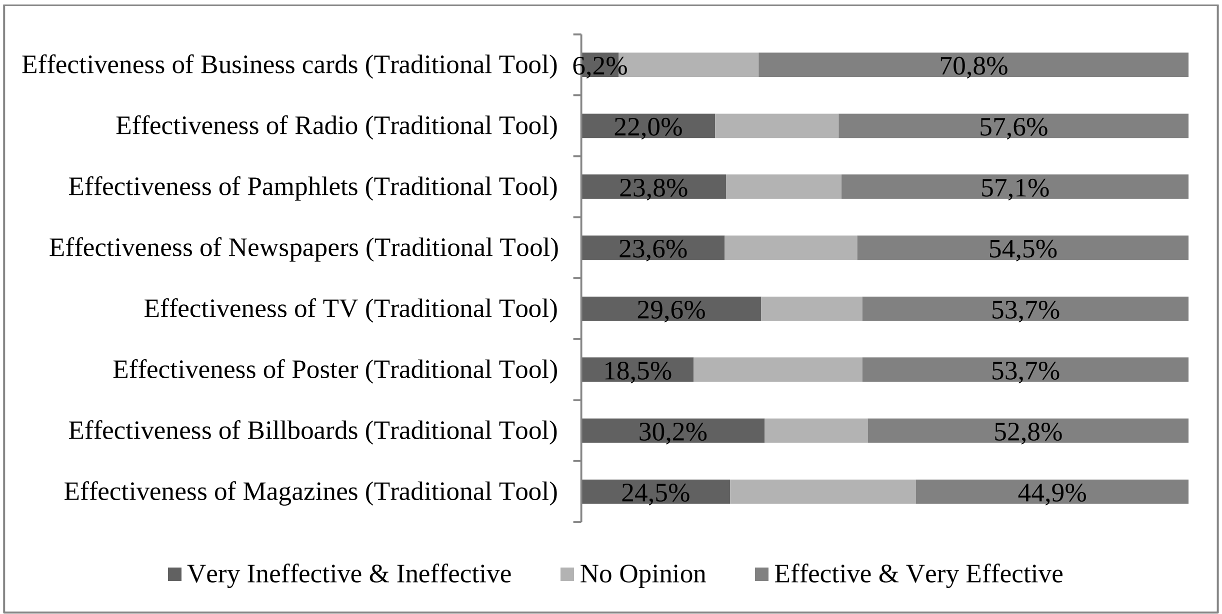
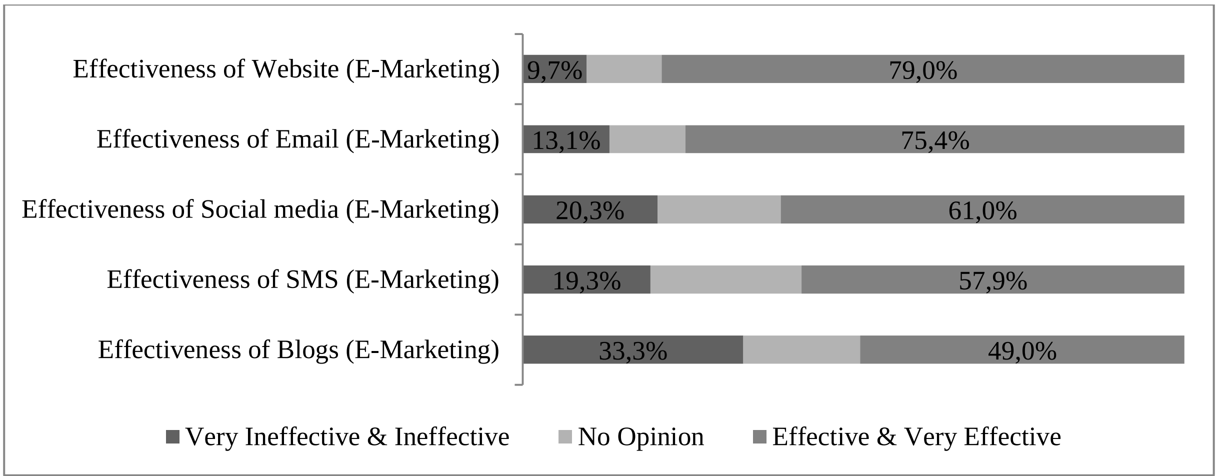


Figure 9. Frequency analysis of the effectiveness of using e-marketing tools



Treating the variable as continuous, and keeping in mind that higher values correspond with higher ratings of effectiveness, one can see that the three most effective marketing tools are perceived as business cards (mean = 4.1), websites (mean = 4.1) and e-mails (mean = 4.0) (figures 10 & 11). This is followed by the rest with all of the tools rated with an average above 3, which is the middle value of the scale (from 1 to 5).

Figure 10. Mean values of the effectiveness ratings of using traditional marketing tools

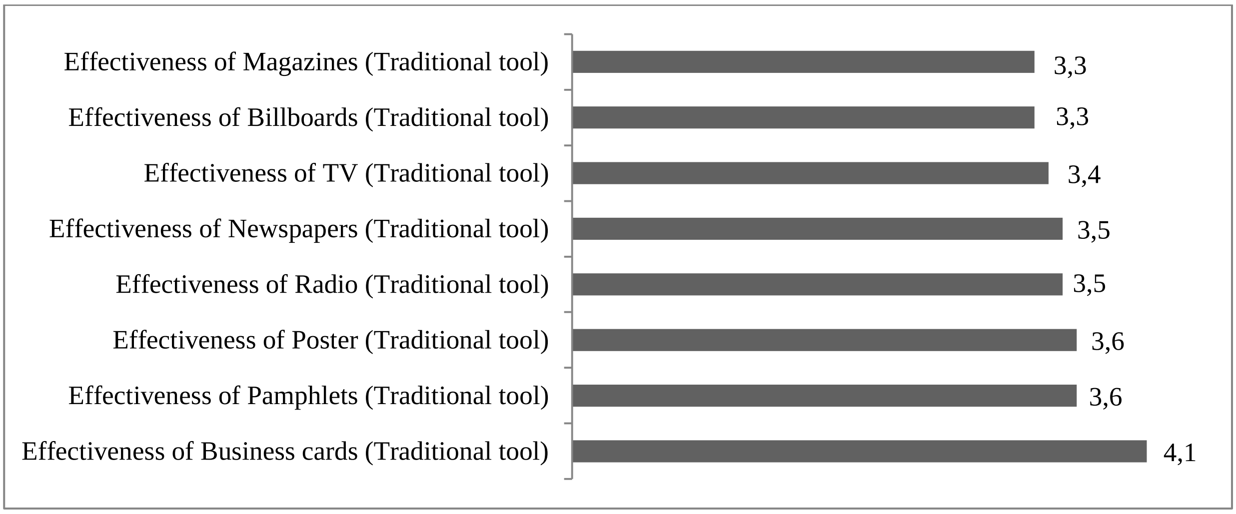
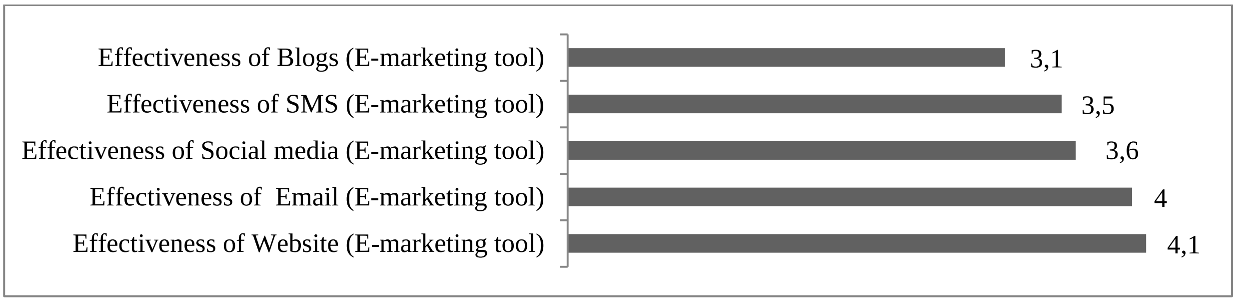


Figure 11. Mean values of the effectiveness ratings of using e-marketing tools



4.5 Descriptive analysis on the preference of the type of marketing tools

The respondents were asked which type of marketing tool they preferred to use. Most of the respondents (77.1%) preferred to use both traditional and e-marketing tools (figure 12). The preference of the respondents was non-normally distributed, with skewness of -1.743 (SE = 0.287) and kurtosis of 1.531 (SE = 0.566).

Figure 12. Preference of the type of marketing tools to use (percentage of respondents)

5. Conclusion and Recommendations

Small medium enterprises (SMEs) play a significant part in the development of the South African economy by making up roughly 91% of formal businesses, contributing between 52 and 57% of the country's gross domestic product (GDP), and making up approximately 60-61% of employment (Falkena, Abedian, Von Blottnitz, Coovadia, Davel, Madungandaba, Masilela & Rees n.d:23; Abor & Quartey 2010:218). With such a large impact on the economy it becomes important that researchers pay specific attention to the methods such entities are employing to assist in strategy development and improvement. This article investigated the techniques and materials used to communicate, inform, stimulate consumer interest and motivate action – referred to as marketing tools– used by SMEs. Traditional marketing tools involve paid print advertisements and commercials such as pamphlets, billboards, radio, magazines and newspapers. E-marketing tools involve computer software to reach and communicate with potential customers such as social media, SMS, blogs, e-mails and websites.

The study revealed that the respondents were mainly from businesses with less than 20 employees who update their marketing plans once a year and spend less than R1 000 per month on marketing activities.

The top five marketing tools which were used in the past are: business cards, e-mails, pamphlets, social media and websites. Three of these top five marketing tools used are modern e-marketing tools. Other marketing tools used in the past which were not listed in the questionnaire were promotions, online ads, Google, YouTube, vehicle logos, trade shows and WhatsApp. No significant difference was found in the percentage of respondents who were using traditional and e-marketing tools previously.

Currently the marketing tools used most frequently by more than half of the respondents are the same as the top five tools used in the past, namely: business cards, e-mails, websites, social media and pamphlets. TV, billboards, blogs, radio, magazines, newspapers and posters are not used by most of the respondents. The frequency of the use of SMSes falls between the most popular and least popular tools. The majority of the most often used tools are modern e-marketing tools, while the majority of the least frequently used tools are traditional marketing tools. No significant difference was found in the percentage of respondents who were using traditional and e-marketing tools "Often & Always".

All of the marketing tools are rated as either "Very Effective or Effective" by most of the respondents, except blogs. The top three tools rated in terms of marketing tools are websites, e-mails and business cards. The bottom three are billboards, blogs and magazines. No significant difference was found in the percentage of respondents who rated the effectiveness of e-marketing tools and traditional marketing tools as "Effective & Very Effective".

There is no preference in using either e-marketing or traditional marketing tools, with most of the respondents preferring to use both. Although e-marketing tools are not preferred above traditional marketing tools, the study shows that the majority of the marketing tools which are currently used are e-marketing tools and the majority of the most effective rated tools are also e-marketing tools.

It is therefore recommended that SME's invest in human resources and infrastructure for the optimum use of traditional and e-marketing tools as they will stimulate the growth of the enterprise. Given the small sample size that was used (n = 71), the results only give a general indication and can therefore not be generalised as being representative of all South African SMEs. Further research in this area is therefore recommended.

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FROM TRIAL TO TRIUMPH: HOW CANADA'S PAST FINANCIAL CRISES HELPED SHAPE A SUPERIOR REGULATORY SYSTEM

Lawrie Savage*

Abstract

As anyone paying attention during the 2008–2009 financial crisis is aware, the Canadian financial system weathered the storm uniquely well. Exactly why Canada's system remained so comparatively stable, while so many other foreign systems broke down, is a question that remains largely unsettled. One explanation may be that the regulatory system that emerged from a very specific history of prior crises had both prepared Canada well for such a crisis, and responded effectively as the crisis unfolded. But the very regulatory system that provided stability in recent years may also be at risk of becoming warped by its own success, with regulators so emboldened by the acclaim for their recent achievements that they overreach to ensure their track record remains unblemished in the future. The stunning collapse of a pair of western Canadian banks, a number of major Canadian trust companies and several insurance companies, as well as some other precarious near misses in the 1980s and 1990s, were a shock to the financial regulatory system, highlighting deficiencies that would be addressed with new regulations and, most notably, the creation of the Office of the Superintendent of Financial Institutions (OSFI). Canada's centralized regulatory approach, through the OSFI and just four other major regulatory bodies, has proved both more elegant and effective than, for instance, the more complicated, more convoluted and more decentralized American financial-oversight system. But some regulated companies, insurers in particular, have long maintained that the concentration of power in Canada's large banks has resulted in a one-size-fits-all regulatory approach that does not offer a relatively lighter burden for smaller institutions, potentially stifling growth. In other words, an over-emphasis on stability may be hampering market efficiency. Nor is there any economic evidence to shed light on whether those and other costs of regulating stability are justified by the costs spared by avoiding instability. Received wisdom would naturally assume that avoiding certain institutional collapses are worth any cost, but of course there must be some limits to that logic. To be clear, Canada's regulatory model almost certainly appears to be a better-functioning one than that of many in its peer group, and the OSFI approach is gaining acceptance by many countries, particularly in emerging markets that are implementing cohesive regulatory systems for the first time, using the Canadian framework as a template. This does not, however, mean that Canada's regulatory system cannot still be refined and improved. Suggestions for improvement include: the possibility of creating an industry-based collaboration committee — similar to the regulators' Financial Institutions Supervisory Committee — that would monitor industry risk over time; the modernization of the Winding-up and Restructuring Act, conceived more than a century ago, to address the modern reality of immense and complex institutions of today, providing regulators the flexibility to resolve such entities when they become troubled; and the strengthening of board structures for large institutions, which remain much as they were in the 1980s, including the possibility of appointing permanent, full-time, independent directors and requirements for boards to better train directors and utilize outside expertise when warranted. Canada's regulatory system is arguably one of the most effective in existence, but its success through the recent financial crisis is no guarantee that it will be sufficiently prepared for the next.**

Key Words: Financial Crises, Canada, Regulatory System

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*** This paper was previously published in The School of Public Policy Research Papers, University of Calgary, Canada*

Introduction

The primary objective of this paper is to describe the evolution of the Canadian government's regulation of the financial services industry, with particular regard to the businesses of banking and insurance. A secondary objective is to consider whether there are aspects of the Canadian financial regulatory framework that explain, or partially explain, why Canada is now generally perceived to be a "high achiever" in this field. By most measures, the Canadian economy and Canada's financial institutions have had a more stable and predictable performance than most other jurisdictions since the onset of the financial crisis in 2008. If there are particular features of the Canadian financial regulatory system that have contributed to stable and predictable performance, it will obviously be beneficial to discern what they are, if only to enable other interested parties to consider how such features might be successfully incorporated into the financial regulatory frameworks of their own jurisdictions. It is also hoped that this paper will provide a useful backdrop for additional papers and research that will be prepared under the sponsorship of the Financial Markets Regulation Program at the University of Calgary's School of Public Policy.

At the outset, we need to be clear on the objective of financial services industry regulation. In our view, it is to ensure system stability and to protect depositors and policyholders within a global financial marketplace. Members of the public — who provide the bulk of the required funding for banks and insurers through their deposits and premiums, respectively — must be able to have a high degree of confidence in the obligations and promises undertaken by their financial institutions. Lacking this confidence, the financial system would quickly fall into disorder, with dramatic impact on the economy as a whole. At the same time, a balance must be maintained between the need to maintain citizens' confidence in the system, and the need to provide shareholders with an opportunity to earn a satisfactory risk-adjusted return on capital. If this latter circumstance does not also prevail, shareholders will not invest, which again would result in the inability of the financial system to function. In endeavouring to maintain the appropriate balance between these competing objectives, the cost of regulation (including not just the monetary cost but also the potential cost in terms of burdening the efficiency and effectiveness of financial markets) must also be part of the equation. The over-arching purpose of the financial regulatory system is to achieve a satisfactory balance between these competing objectives.

The need for well-designed systems of financial regulation has never been greater given the devastating impact of the recent financial crisis and the increasingly global nature of the financial services industries.

Survey of Historical Developments

Since Confederation in 1867, the Canadian financial system has been the subject of six major reviews: the MacTavish Royal Commission on Life Insurance in 1906; the McKeown Royal Commission to Inquire into and Report upon the Affairs of the Home Bank of Canada in 1924; the MacMillan Royal Commission on Banking and Currency in Canada in 1933; the Porter Royal Commission on Banking and Finance in 1964; the Estey Inquiry into the Collapse of the

CCB and Northland Bank in 1986; and the McKay Task Force — dubbed "Reforming Canada's Financial Services Sector" — in 1996. In addition to these in-depth government reviews, in 1985, the Department of Finance — responding to a series of financial-institution failures — released a major green paper, *The Regulation of Canadian Financial Institutions: Proposals for Discussion*. Also in 1985, there was the *Final Report of the Working Committee on the Canada Deposit Insurance Corporation*, known as "The Wyman Report." Each of these latter two papers commented extensively on perceived inadequacies in the regulatory system and put forward recommendations for action.

Some of these inquiries and papers have had financial regulation as a major focus of their investigations; others have not. But at the very least, each has provided an invaluable overview of the financial system, viewed from the perspective of the times in which they were written. These extensive reviews and papers, all commissioned by the government of Canada, have provided much of the historical input for this paper, supported by various scholarly papers and other sources as referenced.

The Early Days of Canadian Banking

The origins for banking in Canada were in the United States, where a bank charter was granted by Alexander Hamilton, the first secretary of the Treasury, to the First Bank of the United States in 1791. The Canadian banking system is a direct descendant of the First Bank, which itself was in part modelled after the Bank of England.[1]

The first modern bank incorporated in Canada, by an act of the then-province of Lower Canada, was the Bank of Montreal, which opened for business in 1817. A number of banks had been incorporated prior to 1817, but each of these disappeared through merger or failure.[2] The Bank of Montreal Act of Incorporation served as a model for the incorporation of other banks in later years.

The Canada Life Assurance Company was Canada's first incorporated life insurer, established in 1849 by an act of the province of Upper Canada.[3] As was the case with the Bank of Montreal, the company's special act contained investment powers and other features that were later used as the model for special act incorporations of other life insurers.

The First Bank Act and Revisions

In 1871, the first Bank Act was adopted by the newly formed Canadian Parliament, authorizing Canadian banks to “open branches and agencies or offices of discount and deposit and transact business at any place or places in the Dominion.”[4] This was the genesis of the branch banking system that has been a hallmark of Canadian banking practice. (See page 11 for a discussion of the growth of a national, branch banking system in Canada, versus the system in the United States, where small regional banks tended to be the norm.) A particularly far-sighted provision of the original Bank Act was that it was to expire in 1881, laying the foundation for the system of mandatory decennial revision.[5] Mandatory revision of financial services industry statutes (today, every five years) is undoubtedly a worthwhile regulatory practice — one that few jurisdictions have adopted, and which, in our view, has been to their disadvantage.

The new act limited bank dividend payments to eight per cent per annum until such time as a surplus account had been built up to a level of 20 per cent of paid capital.[6] The act required initial capital of $500,000, of which $100,000 had to be paid in before commencing business, with a further $100,000 within two years. The remainder could be called on as required by the bank. (The estimated current value of $100,000 in 1871 is about $7.6 million.)[7]

An interesting feature of the 1871 Bank Act, modeled on then existing banking laws in the United States,[8] was the so-called “double liability” requirement. The terminology refers to the fact that, in the event of insolvency, bank shareholders stood to lose not only their investment, but additionally, they would be assessed for an amount up to the par value of the shares they owned. At that time, bank shares were almost always $100 par value, with treasury shares offered at par. Thus, in the event of liquidation, every shareholder would be assessed for an additional contribution up to the par value of shares owned. Some U.S. state legislatures actually provided that state bank shareholders would be assessed for multiples of the par value of their shares (Colorado, for example, adopted triple liability) and in California, the principle of limited liability for corporate shareholders was entirely suspended, with bank shareholders being subject to unlimited liability to depositors. Although such provisions would have had a substantial negative impact on the ability of banks to raise capital, Benjamin Beckhart, in his seminal 1929 publication, *The Banking System of Canada*, states that the double-liability feature “has been of real protection to the depositors.”[9] Nevertheless, in the U.S. and Canada over the course of the Depression years, all variations of the double-liability provision were abandoned as policymakers became convinced that the benefits for depositors were not sufficient to offset the economic repercussions of making it so difficult for banks to raise capital.[10]

Commenting on that first Bank Act in 1871, Beckhart indicates: “Through the adoption of this legislation, Canada had perhaps the most elaborate and detailed banking code of the British Empire.”[11] But notwithstanding that accolade, we find that in the 22 years after Confederation — i.e., between 1867 and 1889 — 10 banks failed and nine others ceased transacting business, involving heavy losses to depositors and shareholders.[12] Canada endured a period of recession during the 1880s, making life particularly difficult for the country’s evolving banking industry. According to Beckhart, “the banking failures occurring in the eighties convinced some of the necessity of a more stringent supervision of banks, and of independent audits.”[13]

In the 1891 Bank Act review, the government tightened the financial requirements for banks, adopting legislation that compelled banks to deposit with the minister of finance five per cent of their notes in circulation. As well, the paid-in capital requirement was raised to $250,000 (this figure equates to about $10.7 million in current dollars [14]). The five per cent requirement can be considered to be a proxy for a modern-day leverage requirement and, interestingly, it is in line with the current Office of the Superintendent of Financial Institutions’ (OSFI) leverage cap of about 20 times. Another change required directors to hold a certain amount of paid-up stock, rather than subscribed stock, as a qualification for holding office. The revisions also enabled banks to make loans on the security of warehouse goods, which greatly increased the amount that could be loaned to a single debtor, as the previous limit had been related to the capital base of the borrowing firm. (A problem that had to be rectified in later years was that, by this means, a bank could have a first lien on the goods of a producer, but this fact would not be known to other lenders, who could discover later on that the apparent security of their loan was pre-empted by a bank lien.)

In 1891, the Canadian Bankers Association (CBA) was established after it had become clear to bankers and the government that a formal banking organization was required along the lines of what already existed in the United States and Britain.[15] The organization was formally incorporated by an act of Parliament in 1900. The CBA was granted specific powers, including, in Section 7, the power “… to establish and regulate clearing houses …” This authority was retained until the 1980 Bank Act repealed Section 7 of the CBA Act and responsibility for the operation of the clearing system was transferred to the Canadian Payments Association. In 1900, the president of the CBA was also given the power to appoint a curator, which arose from the establishment under the 1890 Bank Act of the “Bank Circulation Redemption Fund.” Under the fund, all circulating notes from a failed bank (at that time banks issued their own notes — the Bank of Canada took over the function in 1935, although technically banks retained the right to issue their own notes until 1967) would be redeemed from the fund, the money in which was provided by the banks. So, as the other banks were providing the funds to redeem any outstanding notes of a failed bank, and would obviously want to ensure that it was done effectively and properly, it was understandable why the CBA Act initially granted the president of the association the power to appoint a curator.[16]

According to the MacMillan commission, "the period from 1900 to 1913 was one of unprecedented economic development in Canada, in which the banks played a very important part."[17] To reflect the changing circumstances, the Bank Act was subject to a number of amendments during this period, but only one of these, in 1913, was of a nature that we would today consider to be central to the regulatory process: provision was made for a shareholders' audit of each bank, by auditors chosen by the shareholders, from a panel selected by the Canadian Bankers Association and approved by the minister of finance.

Economic conditions in Canada in the early 1920s were difficult, especially for the farming community, which at that time represented a significant proportion of the Canadian populace. Many farm operators were members of the Progressive party, which held the balance of power in Parliament between the ruling Liberals and the Conservatives. Beckhart indicates that the Progressive party promoted a view that "the banking system was diabolically responsible for the economic maladjustments in which the farmers had become enmeshed."[18] This view was no doubt helped along by the fact that Merchants Bank of Canada had become insolvent in 1922. This failure, combined with the economic recession, gave rise to a strong sense among many voters that the government needed to make changes to the laws on banking.

Some of the key amendments in the 1923 Bank Act revisions were:[19]

- Pension funds of bank employees must be invested in securities that would be eligible investments for trustees under the Trust Companies Act. (The employee pension fund of Merchants Bank had been fully invested in shares of the bank.)
- The attendance record of directors was to be sent to shareholders along with the notice of the annual meeting. (There was evidence that some directors of Merchants Bank had rarely attended meetings and paid little attention to the bank's affairs.)
- There were to be clearer and more detailed bank financial filings with the Ministry of Finance.
- The provisions for the shareholders' audits were rewritten and greatly strengthened.

The subject of possible government inspection of the banks was a hot topic in 1923, sparking a number of animated debates in the House of Commons. According to Beckhart,[20] "bankers were unalterably opposed" to the idea of government inspection and in 1923 the CBA produced a pamphlet entitled *Banks and Banking*, in which "several pages were devoted in an effort to convince the public of the impossibility of government inspection." Accordingly, the government decided not to proceed.

Shortly thereafter, however, the Home Bank failed and "the opposition to government bank inspection vanished in thin air."[21] Accordingly, there were additional amendments to the act in 1924, the most significant being the establishment of the Office of the Inspector General of Banks (OIGB). More comments on the amendments of 1923 and 1924, including with regard to the OIGB, follow later in this paper.

The Armstrong Inquiry in the U.S. and the MacTavish Royal Commission on Life Insurance

In 1905, in New York State, directors and senior executives of several of the largest life insurers in the U.S. became the focus of international attention as a result of their extravagant lifestyles. (This would be akin to situations that have arisen in the past few years where there has been significant media coverage regarding the levels of compensation and bonuses paid to CEOs and other executives whose organizations received vast amounts of taxpayer support in order to avoid liquidation.) The displays of wealth in 1905 were considered especially improper because the life insurers concerned had large numbers of participating policyholders who clearly were not earning high returns on their life insurance investments. Ultimately, the New York State Legislature appointed Senator William W. Armstrong to hold a formal inquiry into the life insurance business in the state.

The importance of this inquiry cannot be exaggerated insofar as life insurance is concerned, but its influence extended far beyond the life insurance industry.[22] The investigation was confined to the "Big Three" U.S. life insurance companies of the time: Equitable of the U.S., Mutual of New York and New York Life. The inquiry found that the funds of these U.S. life insurers were being ruthlessly exploited "for the personal advantage of the officers and directors and that nepotism was rampant."[23] The inquiry ended up generating some 10 volumes of testimony and uncovered a whole series of abuses, including the fact that policies frequently contained provisions that made it difficult to claim some of the important benefits that were purportedly available under the contracts, especially accumulated cash values. Another practice exposed by the inquiry involved the propensity for large life insurers to actually incorporate and operate public utility companies, railroads and other significant businesses. The inquiry concluded that it was inappropriate for life insurers to be running other corporations rather than focusing their endeavours on the areas for which they were originally incorporated: the underwriting of life insurance policies. It was also evident from the inquiry hearings that the use of policyholder funds in these other businesses led to many additional business and "insider"-type investment opportunities for directors and senior officers of the life insurer. In terms of financial dealings, the inquiry brought to light the fact that some of the insurers were engaged in misleading investment transactions, designed to hide investment losses and involving illegal activities such as forgery of documents and the fictitious sale of various securities. The inquiry led to the indictment of senior officers of a number of the life insurers involved.

According to the Canadian Life and Health Insurance Association, "The inquiry must be viewed as part of the social and economic history of the U.S. at the turn of the century. It was the culmination of the doctrine of laissez-faire in economic matters: that in business and manufacturing the law of the jungle should prevail and by the survival of the fittest, true progress would be achieved."[24]

Responding to the inquiry's findings, the New York State Legislature enacted a series of new regulations, including the introduction of certain standard provisions to be included in life insurance policies. While the actual wording for inclusion in policies was not dictated by the new law, contracts were required to provide certain minimum benefits (such as non-forfeiture provisions that would ensure that values built up in life insurance policies were not completely lost solely on account of premiums being briefly overdue), expressed in language that was acceptable to the regulator. Investment powers were also constrained significantly.

Interestingly, one of the reforms prohibited any one company from writing more than $150 million in new insurance if it had $1 billion or more of insurance in force. This can be seen as an early effort to rein in the growth of what we would today refer to as "too big to fail" financial institutions. (The provision was revoked in a subsequent sitting of the legislature. If that had not been the case, and if parallel provisions had been applied to banks and investment companies, the financial landscape might be very different than it is today.) Life insurers were also restricted in the amounts they could invest in the shares of other corporations.

The Armstrong committee revelations also had an important impact in Canada. Largely as a result of the revelations south of the border, in 1906, the MacTavish Royal Commission on Life Insurance was established to look into the situation in Canada. The commission investigated the operations of every one of the then-active domestic life insurers. The commission found that although the scale of problems was far less than what had been found south of the border, and no instances of actual fraud or other criminal activities were unearthed, there were numerous instances of conflicts of interest whereby directors and officers were placed in favoured positions by means of the investment operations of the insurance companies they represented. It is clear from the testimony of directors and officers at the time that their view was that these benefits were entitlements of their positions.

For reasons that are now unclear, no one seems to have wondered what was happening in Canada's chartered banks at this time. If directors and senior officers of life insurance companies took the view that they were entitled to benefit personally from the investment and other business activities of their companies, one might expect that not entirely different views may well have been held by at least some directors and shareholders of Canadian banks.

However, no investigation along these lines took place. In light of that, it is interesting to note that the failure of the Home Bank, reported on in the next section, was found by investigators to be significantly attributable to self-dealing by its directors and officers.

In any case, the main recommendations of the MacTavish report, corresponding to those of the Armstrong inquiry, were adopted by the government of Canada by means of a new Insurance Act in 1910. To ensure greater transparency in insurance, the superintendent of insurance was required to publish annual reports setting out the income statements and financial positions of insurers in great detail. Providing greater emphasis to the concept of moral suasion, the superintendent was also empowered to publish any correspondence with insurance companies which might be instrumental in revealing improper operational policies, and from time to time that was actually done. (This is an approach known today as "name and shame," but it is no longer a significant part of the Canadian financial regulatory framework.) The new provisions served to lay the foundation for insurance legislation in Canada, and remained its cornerstone until the introduction of a much-revised Insurance Companies Act in 1992.

Although there were no specific implications for banking legislation as a result of the MacTavish commission, in a move towards increased transparency, the Bank Act was amended in 1923 to require registration and publicity with regard to loans made under certain provisions of the Bank Act. This would enable members of the public to know when banks had a prior lien on certain assets of borrowers. Also, banks were required to provide the regulator with financial statements for any corporations in which bank or bank-related operations were being carried out. (It is regrettable that in modern times, AIG Financial Products Corporation was not subject to such a requirement under either U.S. or U.K. laws. In that event, insurance regulators would not have been so unaware of its operations, which were the primary cause of AIG's perilous exposure to risk. See page 44 for more on AIG.) According to the Estey inquiry report, "By 1923, the bank audit provisions required two auditors for each bank selected from different firms and subject to replacement every two years. The auditors were required by the Act to report to the general manager and directors of the bank on any loan exceeding one per cent of paid-up capital which appeared to be inadequately secured."[25] The 1923 revisions also prohibited loans or advances to bank officers in an amount of more than $10,000 (or $156,000 in 2013 dollars [26]), a relatively small amount by today's standards. Under the current Bank Act, subsection 496(2), a bank may make a loan to an officer that does not exceed the larger of twice the officer's annual salary or $100,000.

Failure of the Home Bank and the McKeown Royal Commission of 1924

In 1923, the Home Bank failed, giving rise to significant public controversy and political pressure on the government of the day. The bank had been incorporated in 1903 and had focused on building its business in Western Canada through a regional office in Winnipeg. With significant numbers of loans to the agricultural sector, it found itself exposed when that sector ran into hard times with declining grain prices in the early 1920s. In an effort to continue to operate, the bank took to capitalizing interest on overdue loans and rewriting them as new loans in order to avoid booking losses. Other practices generally regarded as unacceptable were also adopted to make the bank's position look better than was actually the case. Related-party transactions were substantial relative to the bank's financial resources. The independent auditor never qualified the bank's financial statements, on the grounds that the auditor's job was "not to second-guess management practices." Several members of the board of directors, lacking any semblance of proper corporate governance, aided and abetted the deception. The minister of finance had been alerted to bad practices by several other Home Bank directors as early as 1915 and again in 1918, but for whatever reason no action was ever taken by the government.[27]

The McKeown royal commission was appointed to look into the Home Bank failure. According to Lew and Richardson, "The Commission determined that the bank was probably insolvent at the time of the complaints to the Minister of Finance and that statements issued by management and attested to by the auditor did not fairly reflect the financial position of the bank. The president, vice-president, five directors and the bank accountant were all convicted of fraud."[28]

The liquidator of the bank, G.T. Clarkson, is quoted in the *Globe* newspaper of Dec. 7, 1923, as saying "the bank's insolvency is due to the fact that there was no proper fulfilment of the functions for which it was chartered, and because of the lack of experienced management, disregard of the safeguards by which the business of all efficiently managed banks are protected, and lastly because of serious losses incurred from loans in which executive officers were interested or loans which were made to companies in which certain of the directors or officers were shareholders."

In another edition of the *Globe* (Nov. 10, 1923, page 4) a member of Parliament who had carried out a survey of the officers of U.S. banks, reported that one of his experts from south of the border indicated: "Nearly all bank failures can be attributed to crookedness, wildcatting or mismanagement; there have been very few failures due to conditions over which the bank had no control."

The failure of the Home Bank was front-page news across the country for many months. In many cases, meetings of depositors almost came to blows with the government and legal experts who were attempting to deal with the failure in an orderly manner. The general feeling, expressed with considerable passion, was that the government should make all the depositors whole. As one depositor indicated to the *Globe* (Dec. 8, 1923): "When the Government gives a certain group of men a charter to carry on a banking business and take the people's money in trust, it should make sure that those men are capable and competent."

As a result of its investigation, the McKeown commission concluded that the government had a moral, if not a legal responsibility to depositors, this arising as a result of not having acted on the complaints of improper practices which were lodged with the minister of finance in earlier years. After the bank failed, the government partially compensated depositors for their losses (35 per cent of deposits for amounts of less than $500 and 25 per cent of other deposits),[29] mainly because of the commission's findings of moral responsibility. The commission determined, based on financial information available at the time, that had action been taken in 1918 when some directors of the bank were filing complaints with the minister of finance, it would have been possible to merge the bank with a stronger institution, or even to wind down its affairs, and depositors would not have suffered losses.

In Parliament, there was much debate as to what steps should be taken to strengthen the bank regulatory system, with broad and varied provisions given consideration, including the possibility of deposit insurance and the establishment of a central bank. In the end, the main result was to amend the Bank Act in 1924 to provide for the creation of the Office of the Inspector General of Banks. But according to Lew and Richardson, not much really changed: "The inspector's responsibilities did not differ greatly from those held previously by the Minister and he would have few staff, further limiting an expansion of authority through the office."[30]

There had previously been reluctance by government to introduce a requirement for bank inspections because there was a fear that that would make the government liable for any failures. The new law contained a specific provision that the government would not become liable as a result of the power of inspection contained in the 1924 amendments to the Bank Act.

Beckhart indicates, with regard to the 1924 version of the act, "the statute is a lengthy document of some 90 pages, which makes it a close rival in size to the National Bank Act of the United States, and as a matter of passing interest, it is the most complete and detailed general banking law existing in any part of the British Empire."[31]

Lew and Richardson recap the development of banking regulation in Canada: "In 1867 note insurance was provided to all banks, then in 1871 with the Bank Act, formal barriers to entry were erected. However, to deflect the growing potential financial liability or fiscal crisis facing the state in the event of bank failures, operational responsibility was gradually moved to 'independent' agencies. First, an independent bank audit was instituted in 1910, upgraded to require a state-sanctioned professionally incorporated auditor in 1923, and finally in 1924 a state inspector was introduced."

The dual-audit system introduced in 1923 and the creation of the OIGB with inspection powers in 1924 comprised the basic system of bank regulation in Canada until the mid-1980s.

The MacMillan Royal Commission on Banking and Currency

In the preceding sections of this report, we have made reference to the 1933 MacMillan commission. One of the important terms of reference for that commission was to consider whether Canada should have a central bank. It is worth reminding ourselves that this commission was acting in the depths of the Great Depression. Nevertheless, as the commission expresses in its report, "The Canadian banks give admirable evidence of security, efficiency and convenience. In a time of universal economic difficulty, the Canadian banks have stood firm and have continued to render to the people of the Dominion the same high quality and the same wide variety of services as in the past."[32]

Based on the text of the commission report, it is clear that with the severe economic trials posed by the Depression, international consensus was converging on the view that modern financial systems, and especially the derivation and application of monetary policy by governments, required independent advice from professionals, such as would be provided through a central bank. As well, these were the early days of economic policy making — the report indicates that at the time of writing in 1933: "new methods and new terms are, as a result of manifold and prudent experiment, steadily but effectively gaining acceptance."[33]

The MacMillan commission report states: "By a majority, (The Chairman, Sir Charles Addis and Mr. Brownlee; Sir Thomas White and Mr. Beaudry Leman dissenting) we recommend that a central bank for Canada be forthwith established."[34] So, despite the strong statements of support for a central bank that were included in the body of the report, the favourable recommendation was made with a majority of only one commissioner.[35] The government accepted the commission's recommendation and the Bank of Canada was founded in 1934 and became a Crown corporation in 1938. Its basic objective has not changed since its creation: "to regulate credit and currency in the best interests of the economic life of the nation." The bank functions as an independent agency accountable to the government of Canada.

> While Canada was developing a banking system comprised of a small number of large banks, each having local branches, in the United States, small, local banks were the norm. The Bank of Canada website provides the following insights into the reasons for this completely different pattern of development:
>
> "The banking system that developed in Canada was quite different from that in the neighbouring United States. South of the border, a different philosophy encouraged the development of independent local banks and a larger population, clustered in established communities, made it workable.
>
> "In Canada, the continuing British influence was reflected in the preference for a limited number of banks with multiple branches. In the years leading up to Confederation, small rural settlements spread over an extended area made branch banking a practical approach. In a relatively undeveloped economy, branch banks could be established with less capital and fewer skilled officers than would have been required for independent banks at each location.
>
> "The branch bank network was sufficient to the nation's needs for almost a century. The chartered banks provided the bulk of notes in circulation and could meet seasonal or unexpected demands. The larger banks were able to deal with government business without strain, and the branch network gradually developed a system for clearing cheques between banks."

From shortly after the time of Confederation to the mid-1900s, one cannot help but take note of the tremendous degree of consolidation that took place in the banking industry. At the time of Confederation there were 35 active banks, and the number increased to 51 by 1874, a number that would not be attained again until the revision of the Bank Act to permit Schedule B banks in 1980.[36] By 1900, the number of chartered banks had reduced by 24; seven had been merged with other banks and 17 had failed or had their charters repealed.[37] By 1918, the number had declined to 19, and by the time the MacMillan commission reported in 1933, the number was down to 10.[38] By 1961, there were only eight chartered banks in Canada.[39] The reduction in numbers over time was, not surprisingly, accompanied by a concentration of assets in the largest banks. "By the 1920's over 50 per cent of banking assets were held by the three largest banks, three quarters by the largest nine."[40] By the time of the Porter commission in 1964, the three largest banks owned a striking 70 per cent of total banking assets.[41, 42]

However, quoting from the Estey inquiry report, "In the late 1960's, interest in the formation of new banks revived." The Bank of British Columbia was established in 1967 along with the Bank of Western Canada which never came into operation. The Unity Bank of Canada was established in 1972."[43] There was particular pressure from Western Canada for additional banks to be headquartered in that part of the country. At a Western Economic Opportunities conference in 1973, the premiers of the four western provinces released a joint statement: "The branch banking system, characterized by the five major Canadian chartered banks with branches coast to coast, and head offices in central Canada, has not been adequately responsive to western needs."

Investors stepped in to fill this apparent market niche and, in 1975, Canadian Commercial Bank and Northland Bank were incorporated and headquartered in Calgary and Edmonton, respectively. But as most readers of this paper will be aware, neither case had a happy ending. Their stories will be briefly recounted later in this paper.

The Porter Royal Commission on Banking and Finance

In 1964, the Porter commission was charged with responsibility "(a) to enquire into and report upon the structure and methods of operation of the Canadian financial system, including the banking and monetary system and the institutions and processes involved in the flow of funds through the capital-market; and (b) to make recommendations for the improvement of the structure and operations of the financial system".

By the date of the commencement of the Porter commission, it noted that the Canadian economy had grown significantly in size compared to 1933 when Lord MacMillan oversaw the preparation of his royal-commission report. Total financial institution assets at the earlier date were just $5.5 billion, compared to $47 billion when Porter's commission was at work. In 1964, Canadian banks continued to be small in number but large in assets, with eight chartered banks as compared to 10 at the time of the MacMillan commission in 1933. However, the largest three banks continued to represent 70 per cent of total assets, as was the case in 1933.

The Bank Act had been amended in 1954 to give banks the power to make National Housing Association (i.e., government-guaranteed) mortgage loans, and to make personal loans secured by chattel mortgages on personal property (e.g., car loans). At the same time, the Canadian Mortgage and Housing Corp. introduced mortgage loan insurance, taking on the mortgage risk for cases where there was at least a 25 per cent down payment, thereby making home ownership significantly more accessible to Canadians. These amendments permitted banks to enter the business of household lending in a serious way.

Following the recommendations of the Porter commission, in 1967, bank powers were further broadened to remove the previously established interest rate ceiling of six per cent on bank loans, which, as interest rates rose above this level during the 1960s, had effectively forced banks out of the mortgage-lending market. The Porter commission also recommended that banks should have freedom to make conventional (i.e., uninsured) mortgage loans, and that the maximum loan-to-value ratio be increased from 66.67 per cent to 75 per cent. Both of these recommendations were accepted and the Bank Act was amended accordingly in 1967. Banks were now in a position to help fuel the rapidly increasing demand for residential housing and their mortgage-loan books grew substantially as a result. Mainly because of the restrictions on mortgage lending, which did not apply to trust companies and credit unions, banks' assets as a per cent of total financial system assets had declined over the 30 years since the MacMillan commission and, according to the Porter commission report, this was from 44.4 per cent of the total in 1935 to 34.9 per cent by 1962.[44]

The Porter commission report also points out that between 1933 and 1964, the credit union and caisse populaire movement expanded substantially, having had total assets of less than $10 million in 1933 but by 1964 having become a more significant factor in the Canadian financial system with total assets of $1.5 billion. At the time of the Porter commission, mutual funds were proliferating and by then accounting for 1.7 per cent of financial-institution assets,[45] while they were unknown in 1933. Strong demand for consumer goods between 1933 and 1964 had caused the total assets of sales-finance companies to grow from $75 million to $2 billion over the period. With the growth in population and family formation, especially after the Second World War, we see that pension funds also show a strong surge in growth, from a minuscule percentage of system assets in 1935 to fully 10.8 per cent of total financial system assets by 1962.[46] Given that these were the early years when baby boomers were entering the workforce, it is perhaps not surprising that the Porter commission report refers to "the relatively new" pension business.

The Porter commission was not specifically charged with considering the regulatory landscape, but it did recommend that all significant transactions involving bank share ownership should be subject to prior governmental approval. The commission report mentions[47] that, while not ruling out bank mergers or acquisitions, such approval requirements would "ensure that an excessive concentration of power does not develop." In fact, rather than adopting the "transaction approval" approach recommended by Porter, the government of the day chose, in the 1967 amendments to the Bank Act, to introduce specific share-ownership restrictions for Canadian banks: no individual shareholder, or group of related shareholders, would be permitted to control more than 10 per cent of the shares of a chartered bank. In addition to meeting the Porter commission objective of ensuring that no one entity would have inordinate influence over the Canadian economy, the rule also served to prevent foreign takeovers of Canadian chartered banks. The so-called "10 per cent rule" also served to somewhat mitigate the risk of self-dealing in the banking field because, with the ownership constraint, it would be difficult for any individual shareholder to engineer transactions that would be primarily for its own benefit.

One other noteworthy aspect of the Porter commission recommendations is that the commission seemed to have an almost prescient approach to a philosophy that is today being adopted by more progressive regulatory authorities, with Canada at the forefront. For example, the report indicates "we have tried to make recommendations which meet the need without at the same time bequeathing a legacy of unnecessary rigidities and obsolete rules which leave the financial system no discretion at all to develop those traits of vigorous innovation and creative competition we deem essential to its success."[48] This is a good description of the benefits of a principle-based approach as compared to a rule-based approach to regulation.

Turning more specifically to bank regulation, we obtain a sense of the bank regulatory environment of the times when, on page 114 of the Porter commission report, the commissioners comment on the requirements for the establishment of a new bank: "The Inspector General told us that apart from expecting the bank to have somewhat more capital than the law requires and having an interest in the character and standing of the group making application, the government does not set out other requirements." The report goes on to mention that the board of directors is responsible for the bank's affairs and that "The only restriction on their powers appears in Section 75 [of the Bank Act] which specifies that loans in excess of 5 per cent of paid-up capital 'to a director of the bank or to any firm or corporation of which a director or the general manager of the bank is a member or shareholder' must be approved by two-thirds of the directors present, and the director may not be present at the discussion of any loan in which he has an interest. About 30 per cent of the banks' authorized lines of credit of $100,000 or more at the end of 1962 were to directors, their firms, or corporations of which they were officers or directors, or were guaranteed by them." Today, transactions with related parties are much more restricted than was the case at the time of the Porter commission.

A Time of Change — 1965 to 1985

The Porter commission brings us up to the mid-1960s in our look back over milestone events in the evolution of Canada's financial regulatory system. Between 1965 and 1985, there were no royal commissions or other major investigations of the financial system so let us continue this story by briefly adopting a more personal perspective — that of the author of this paper, who in 1966 was a new recruit at the Department of Insurance (DOI), one of the two predecessor organizations to today's OSFI.[49]

At that time, the largest life insurance companies were the Canadian mutuals: Canada Life, Confederation Life, Great-West Life, London Life, Manufacturers Life and Sun Life. The property/casualty insurance business was highly fragmented, but most of the larger insurers were members of international groups with professional management. Canadian-owned property/casualty insurers tended to be smaller and were mostly controlled by members of the Canadian establishment. In fact, at that time, the financial system as a whole tended to be relationship-driven with, for example, significant lending decisions being based more on the identity of the principals than on the underlying terms of the proposed deal. No insurance companies were publicly listed. All of the insurers of the day followed conservative operating policies and had low levels of leverage. Minimum solvency requirements for property/casualty insurers, albeit unsophisticated, were included in the law. (For example, section 103 of the Canadian and British Insurance Companies Act (the C&B Act) required general insurers to maintain a minimum margin of assets over liabilities equal to 15 per cent of total unearned premiums and outstanding claim provisions.) Life insurance companies were not subject to any specified minimum solvency requirement, mainly because at that time, the actuarial reserves tended to be so conservatively determined that even if a life insurer had liabilities equal to its assets (i.e., no equity at all), it was thought that it would still be able to meet all policyholder obligations.

Insurance companies were required to submit detailed annual financial filings to the department for review, supplemented by interim financial and investment filings during the year. The annual filings were extensive, running to more than 80 pages, and were in addition to a requirement for annual audited financial statements. Insurers' investments were highly constrained, having to be judged "eligible" under the conservative investment provisions of the

C&B Act. For example, common shares were only eligible if they had paid a dividend of at least four per cent of their value in the capital-stock account of the company in at least four of the previous five years. This effectively limited common share investments to so-called blue chip stocks. Notwithstanding this high standard for common share investments, the total common share investment of each insurer was limited to a maximum of 20 per cent of assets. Few insurers were anywhere near the 20 per cent limit. Debt securities were subject to a strict interest-coverage test, but if a corporation's common stock qualified for investment, then all of its debt securities also qualified. The C&B Act included a "basket clause," which provided relief from the strict investment rules, for up to seven per cent of total assets. Even so, few insurers had any basket-clause holdings. These conservative investment rules were a legacy of the MacTavish commission recommendations of some 50 years earlier.

While the regulatory framework of the Canadian and British Insurance Companies Act restricted straightforward related-party transactions, such as the loaning of insurance company funds to other corporations controlled by the controlling shareholder of the insurance company, there remained plenty of scope for self-dealing. For example, it was possible for shareholders to purchase an insurance company on a 100 per cent leveraged basis, but then for the new owners to strip surplus funds from the insurer by way of management fees and other transactions, which in turn would be used to liquidate the borrowings that had been used to fund the original purchase. In other words, the insurer's own funds could be used to pay for its purchase, but leave the insurer in a weaker financial position and its policyholders insured but with a much less secure institution.

However, during the latter part of the 1970s, it began to become clear that the winds of change were blowing through the relatively tranquil insurance world described above. This was evidenced by changes taking place in the underlying ownership and management structure of the industry, along with the appearance of new market entrants, which had previously been few and far between. Entrepreneurial players began to be attracted to the business, probably for two reasons. First, there was a view, which had some basis in fact, that the insurance business was somewhat sleepy but had the potential to generate a high return on investment. And second, the then-simplistic regulatory environment with its lack of effective controls on self-dealing, offered considerable potential for accessing what some perceived to be "excess" capital, which in their view could be better employed in other businesses.

This change in the outlook and approach of financial system players during these years was commented on by Ron Suskind in his recent book, *Confidence Men*.[50] He refers to Paul Volcker, the former U.S. Treasury secretary, as "part of the mid-century's community of prudent men, referees on the field of play, making sure conduct was fair, and cheap shots led to real penalties — and to social sanction. Nothing was worth risking that." Suskind then quotes Volcker, speaking about the obvious abuses that were revealed as a result of the sub-prime mortgage crisis: "There are those like me who say the heart of this system ought to be the banking system, like it was historically, and it ought to be a service organization to take care of the basic needs for its clients … Its big job is providing someplace for their money, transferring funds around the country, making loans, helping them with investments and the rest. They shouldn't get off doing hedge funds and equity and trying to make all their money by trading. That's my view."

By the end of the 1970s, it was also becoming clear that the rule-based investment regime set out in the insurance law was being subjected to considerable "reinterpretation." In a classic illustration of the weaknesses of rule-based systems, legal firms began to purchase tiny corporate entities, such as companies that had been owned by retiring dentists, strictly to take advantage of the entity's established dividend record. Then, the tiny corporation with the five- year dividend record could be restructured, merged with an existing corporation and its dividend record utilized to facilitate a huge IPO, which would be deemed to be an eligible investment for insurance companies registered under the C&B Act and the Foreign Insurance Companies Act. Many investment trusts and other investment schemes required the "legal for life" designation as a standard for investment purposes, so a positive opinion with regard to being an eligible investment for insurers also opened the door to many other potential buyers of the security concerned.

As a result of these and other similar machinations, the apparently conservative investment rules began to have less and less significance in terms of their implications for market risk of insurance companies. Clearly, the world that currently surrounds us is very different from the world that Paul Volcker was most familiar with — and with the world we have described in the insurance field in the mid-1960s.

We have been speaking in general terms about rising risk profiles and entrepreneurialism, but to actually provide the flavour of the times, let us briefly describe a few of the actual scenarios that played out on the regulatory front for non-life insurance companies:

- There was the case of the insurance company that was reinsuring with a bogus reinsurance broker in the London market, and was accepting the risks in the name of another Canadian insurer, but without any notification to the latter insurer, with reinsurance monies disappearing somewhere in the chain of transactions. The ceding insurer was rendered insolvent.

- There was the case of the insurance company CEO who was defrauding his insurer. The regulator gathered evidence and wrote to the board members, pointing out the evidence without naming who might be responsible for the losses. The board members refused to take any action. The CEO was subsequently found guilty of fraud, but the company was insolvent by the time he could be arrested and charged.
- There was the insurer that was ceding business to a reinsurer in a tax-haven jurisdiction, while hiding the fact that that reinsurer was actually owned by the shareholders of the insurance company — that is, it was a non-arm's-length situation and the reinsurance arrangements were rigged so as to deplete the capital base of the insurer while transferring funds tax-free from the Canadian insurance company to its shareholders in the tax-haven jurisdiction. This type of situation actually arose with a number of insurers.
- There was the case of the Canadian insurer with an inadequate capital level that undertook a huge volume of high-risk motorcycle business in the U.S., this after having signed an undertaking with the DOI that it would not write any significant volume of such business unless it first bolstered its capital base by a substantial amount. The undertaking notwithstanding, and with no additional capital, the company went ahead with a grand expansion of the U.S. business, which it did not report in its monthly returns to the DOI. When the real financial figures became available, the company had been rendered insolvent. As to the undertaking with regard to the U.S. business, the company merely stated that the undertaking had been inadvertently overlooked.
- There was the case of the entrepreneur who purchased an ailing insurer, subject to the condition that, in order to maintain the company's licence, additional capital would be injected. The capital was increased by about half of the agreed-upon amount, with the other half to be paid within a few months. On the strength of that, the company's licence was renewed and the transfer of ownership took place. Shortly thereafter, when DOI inspectors visited the company, they found that the newly injected capital had been transferred back to the personal bank account of the entrepreneur. The Department of Justice, representing the DOI, sued the entrepreneur for the missing funds, plus the funds that had been promised. But while the legal wrangling carried on, the insurer had to be closed due to insolvency.

The non-arm's-length practices and other gyrations mentioned above were not generally precluded by the insurance law of the time, although the risks to policyholders could be significant. In fact, we can say that most of the situations described above would have simply been unimaginable in the 1960s. However, as the 1970s progressed, the implications of the changing environment were becoming clear to the insurance regulators of the day.

Nevertheless, they were powerless to do anything other than harangue the concerned companies and shareholders in an effort to get them to change their practices. Unfortunately, by that point in time (the late 1970s and early 1980s), the concept of moral suasion had become pretty much meaningless to those for whom the message really mattered.

To be clear, these types of situations were certainly not occurring with main-line insurers, which continued to go about their business in a professional manner. Nevertheless, insurers like the ones mentioned above, and others that we could mention, tended to take up huge amounts of regulatory resources. As well, the Property and Casualty Insurance Compensation Corporation (the "deposit insurance" parallel for general insurance companies) was only established in 1987, so for cases between 1980 and 1985, some policyholders were badly hurt. When a property/casualty insurer fails, most policyholders (i.e., those with no claim outstanding) lose a relatively small amount — the amount of their unearned premium. But if you happen to be one of the unfortunate ones with an outstanding claim — say your house has burned down and you now find that your insurance is worthless — it is a life-changing event. The pain of the insolvency falls disproportionately on those who have experienced claims.

The run of insurer insolvencies actually extended into the 1990s, with Canada's first-ever life insurance company failures: Les Coopérants in 1992, followed by Sovereign Life in 1993 and then, in 1994, one of Canada's largest and oldest life insurance companies, Confederation Life. And as we will discuss in more detail below, both the Canadian Commercial Bank and the Northland Bank failed in 1986, more than 60 years since the time of the Home Bank collapse in 1923. Finally, as we will also comment on in more detail below, the 1980s saw the collapse of some 23 trust companies in Canada.

We suggest that, substantially due to the increasingly entrepreneurial approach to insurance and other financial businesses, a long period of quite stable financial-institution operation was drawing to an end. For example, after almost 50 years without a significant failure, in the six- year period between 1979 and 1985, seven Canadian property/casualty insurers became insolvent.[51] For most of those seven insurers (Mennonite Mutual was an exception), the CEO was also a controlling or substantial shareholder, and in a number of those cases, the CEO was also the chair of the board of directors. Also, in a number of the cases, the CEO/shareholder had other business interests, and in the recessionary climate of the early 1980s, the insurance companies were sometimes regarded as a ready source of funding. For insurers involved in self-dealing, as well as other improper and high-risk practices, efforts to apply moral suasion were typically greeted by the phrase "where does it say in the law that we cannot do that?" Corporate governance was virtually non-existent for these insurers, although that did not mean that they were contravening the requirements of the C&B Act.

Officers of the Department of Insurance lacked the relatively sophisticated methods of risk assessment and risk classification that are in use by the OSFI today, but it was nevertheless clear at the time that these were high-risk situations. Fortunately, there was ample documentation of the extensive correspondence and minutes of meetings involving the troubled companies, with clear regulatory diagnoses of the problems and urgent requests for action by management and shareholders (often the same people). The House standing committee on finance, chaired by MP Don Blenkarn, held hearings into these insurance company failures. The initial reaction of committee members was that "the regulators must have been asleep at the switch to allow this to happen." However, when all the evidence was in, there was, to our knowledge, no criticism of the DOI. And shortly thereafter, in 1985, an important point in the federal government's green paper on regulatory reform was the need to provide regulators with power to intervene directly in companies' affairs when circumstances clearly dictate that action is required.

With hindsight, we can see that the changing conditions in the financial markets were part of a more fundamental shift in the entire socio-economic environment that was emerging at that time. Technological change was occurring at an exponential rate, facilitating a more rapid pace of business activity generally, and leading to new products such as daily-interest chequing accounts and to the introduction of ATM machines, greatly increasing consumer convenience. (But as pointed out in the Wyman Report discussed below, the new technology also facilitated "rapid transfers of short term funds in large amounts across international boundaries at the slightest hint of danger.") This period also saw the coming of age of the baby boom generation, with higher levels of education and increased mobility of citizens, all leading to decreasing customer loyalty and growing expectations for improved service and more innovative products.

All in all, these developments were giving rise to an increasingly competitive marketplace for all types of products, including financial services. And the competitive environment was not limited to consumer products and services: competition exists for shareholder funds as well as for primary-level products, and many financial institutions were finding it necessary to accept higher levels of risk in order to generate returns that would be judged acceptable by their shareholders.

The Estey Inquiry into the Collapse of the CCB and Northland Bank

The small western banks that failed in 1986, Canadian Commercial Bank (CCB) and Northland Bank, were part of this new spirit of financial entrepreneurialism that was emerging in North American financial markets. The main problem for both CCB and Northland was that these banks lacked the gravitas to attract large clients, and thus, found that most of their business consisted of loans to small, western-based businesses, and often to entities whose loan applications had already been declined by the large chartered banks. Their loan portfolios, therefore, typically consisted of transactions with a less credit-worthy sector of the economy, often including members of cyclical real-estate and energy businesses. It was precisely these types of businesses that were the hardest hit by the early-1980s recession, which was particularly severe in western Canada.

According to the Estey inquiry report, "The evidence is open to the interpretation that the improvident lending practices of these banks created a demand from those lacking in the capacity to repay their borrowings and to whom credit should not have been extended."[52]

Unlike the situation with the insurance companies, the bank regulator of the day, the Office of the Inspector General of Banks, did not seem to be aware of the significant risk levels that were building up in the two small banks. With regard to the failure of Northland Bank, the Estey commission commented: "It is necessary in the face of the record compiled by this Commission to conclude that although the OIGB was in possession of all the information essential to a true comprehension of the state of affairs in Northland, awareness did not come. Even if it had, the will to respond was missing."[53]

Regulatory ineffectiveness was also cited by Estey as a significant factor in the ultimate failure of CCB: "The OIGB, by reason of its position in the statutory pattern for the regulation of banks, must bear much, but not all of the blame for this condition and for what transpired. As mentioned earlier, the Inspector General was aware of the state of the bank and failed to act."[54]

One must recall that while the Office of the Inspector General of Banks had been established in the 1920s, even some 60 years later in the 1980s there was no established tradition of hands-on bank regulation in Canada. The mandate of the OIGB was essentially to rely on the auditor and the audited financial statements as being sufficient to reveal the true financial position of every bank. The OIGB carried out no on-site inspections and had no tradition of probing to understand the operational details behind the reported figures. In the U.K., which as in many areas of activity had great influence on the pattern for Canada, there was no bank regulatory statute at all until 1979, and in fact it was only in 1987 when the impact of European Union rules began to be felt that the Bank of England was given the power to request information from banks and to carry out inspections.[55] From today's perspective this historical information about U.K. bank regulation seems almost incredible.

The marked differences between the regulatory regimes for banking and insurance during the 1980s and prior were reflected in the staffing requirements of the respective insurance and banking regulatory bodies. In the early 1980s, the Department of Insurance had a total of approximately 75 employees operating out of offices in Ottawa, Toronto, Halifax, Montreal, Winnipeg and Vancouver.[56] By contrast, in 1984 the Office of the Inspector General of Banks had only 14 employees classified as inspectors, analysts or the equivalent, working from a single office in Ottawa.[57] A sense of the somewhat hands-off approach of the bank regulators is also conveyed by the comments mentioned earlier (see page 12) from the Porter commission, indicating that the OIGB did not have particularly stringent requirements for new bank incorporations. Banks were, in a sense, expected to self-regulate, as the provisions in the Bank Act and regulations were much more substantial than were the resources allocated for their oversight.

One might reasonably wonder about how two federal financial regulatory agencies, the OIGB and DOI, could be following such different operational policies. We suspect that the DOI's more hands-on approach to regulation was grounded in the MacTavish commission's findings early in the century, which recommended quite detailed oversight for insurance companies.

Comparable recommendations were never made in the banking area, even after the failure of Home Bank in 1923. As to why the differences persisted, apparently without any attention being given to the policy dichotomy between the two agencies, we can only suspect that as often seems to happen, organizations do not have a natural tendency to work together: during some periods, their head offices were actually located in the same office building in Ottawa.

The Trust Companies

A trust company is similar to a bank except for three important differences. First, while banking is an exclusively federal concern, the federal government as well as provincial governments is able to incorporate and regulate trust companies. Thus, in each province of Canada that has incorporated trust companies, there is a department or ministry that is responsible for their regulation. (Federal trust companies are regulated by the OSFI, and before the OSFI was created, they were regulated by the Department of Insurance.) So, for example, Ontario-incorporated trust companies are overseen by the Financial Services Commission of Ontario. Second, banks are the only financial institutions to have unfettered commercial lending powers. Trust company powers in this area differ by jurisdiction of incorporation but generally speaking, commercial lending limits are based on capital levels. The third and perhaps most important distinguishing feature is that trust companies are empowered to administer trusts and to hold assets in trust for their clients. Banks do not have this power.

While developments in bank regulation have been outlined above, the actual business powers of banks were somewhat limited until the latter half of the 20th century. As mentioned under the heading for the Porter commission, until 1967, banks were not empowered to engage in conventional mortgage lending. This left a significant market niche for non-bank financial institutions, especially after the Second World War, when the Canadian economy was growing rapidly and the emergence of the baby boomers into their years of family formation meant that new home purchases and concomitant mortgage lending was also subject to a vast expansion.

The market niche was mainly filled by trust companies and credit unions, which were able to grow quickly because of the demand for their services, which included the power to issue residential mortgages. According to Lew and Richardson (quoting Neufeld), "in 1950 the chartered banking sector held over half of all financial assets, but by 1965 it had declined to only one third, due to growth in these competing sectors."[58]

Trust companies reached their zenith during the 1970s and early 1980s, but relaxation of the rules constraining banks' ability to participate in the mortgage market enabled the banks to gradually but inexorably increase their share of that business, at the expense of the trust companies. Banks were also keen to be able to provide the broadest possible range of financial services to their clients. Although trust powers were not available to them, they were able to overcome this difficulty by acquiring trust companies and holding them as subsidiaries. An additional factor prompting the acquisition of major trusts by chartered banks was the federal government's decision in 1998 not to allow mergers between Canada's chartered banks. With that decision, Canada's chartered banks began to look elsewhere for growth by acquisition, and the more substantial trust companies were logical targets. By 2000, with the acquisition of Canada Trust by TD Bank, almost all of Canada's major trust companies had become affiliated with chartered banks.

The website of the Canada Deposit Insurance Corporation (CDIC) indicates that since 1970, 43 deposit-taking institutions have failed, including CCB and Northland. Although this period of CDIC payouts covers more than four decades, fully 53 per cent of the total number of failures occurred during the 1980s, and except for the two banks, virtually all of the failed institutions were trust companies. (Insurance companies are, of course, not members of CDIC.)

In 1983, there was considerable public concern when the government of Ontario felt that it had no choice but to take control of Seaway Trust, Greymac Trust and Crown Trust, as well as several associated companies. The collapse of these institutions, widely known as "the trust companies affair," involved significant fraud, and the key principals, Leonard Rosenberg, William Player and several cronies, were found guilty and served time in jail (Player was sentenced to 15 years; Rosenberg to five years). Essentially the fraud involved the pyramiding of property flips based on dodgy appraisals, with the "profits" from one flip being used to finance larger flips, aided by financing provided by the trust companies that were controlled by the principals. The final "deal" involved the resale of 10,931 apartment units in Toronto, which had ostensibly been purchased for $271 million, with the entire package being flipped and then flipped again, all within a few days. The final "sale," supposedly to a group of Saudi investors, was to be for a payment of $500 million. The sustained losses represented a substantial claim on the CDIC depositor protection fund, to say nothing of uninsured losses of individual depositors.

The failure of a significant number of trust companies over a 40-year period, with a particular concentration in the 1980s, was relevant to the evolution of financial regulation because, in combination with the bank and insurance company failures, it emphasized that there was a newly emerged volatility in the financial system, which was having substantial impact on financial institutions. In turn, this galvanized governments with regard to the need for a significant restructuring of Canada's financial regulatory system as a whole. At the same time it has to be said that the failures of both the insurance companies and the trust companies were not very significant to the financial system per se, because the failed institutions were small relative to most other institutions in the financial sector. In the case of the trust companies it was also the case that most were regulated by provincial governments and therefore subject to regulatory regimes that were not necessarily representative of those applicable to the much larger, federally supervised banks and insurance companies.

The 1980s: Lessons Learned

The previous pages have described how an evolving business environment for banks and insurance companies during the 1970s was accompanied by a rising tide of incipient financial risk. Altogether, between 1981 and 1985, the time of the federal green paper on financial regulation, there were seven insurance company failures, 11 trust and mortgage loan company failures, and a support package had to be extended to a small chartered bank (that being CCB, which would ultimately fail along with Northland Bank in the following year).[59] According to the CDIC web site, 10 of the trust company failures occurred in just two years: 1985 and 1986.

In 1985, the federal government undertook a comprehensive policy review of the whole area of financial regulation. This was accomplished through two main initiatives: (1) The Working Committee on the Canada Deposit Insurance System (the Wyman committee) and (2) the green paper issued by the Department of Finance: "The Regulation of Canadian Financial Institutions: Proposals for Discussion."

Although the remit of the Wyman committee was focused on the role and operations of CDIC, the committee felt that it should consider policy options for CDIC in the broadest possible context, and accordingly looked at the then-existing framework for financial-institution regulation. The committee identified many shortcomings and made valuable suggestions for improvement. Some of the key recommendations made by the Wyman committee, which were subsequently adapted by the government to be part of the new framework, are outlined below:[60]

- The regulator should take a leadership role in determining uniform examination standards and develop an early warning system to detect problems at an early stage.
- The regulator should develop a "performance rating system" for institutions, including determination of appropriate "break points," which would correspond to "various levels of difficulty in order to standardize appropriate courses of remedial action." (This corresponds to the OSFI's Guide to Intervention, which is an important component of the current risk- based operational framework.)
- The regulator should be able to levy significant penalties against regulated institutions, including their management, directors and professional advisers, to ensure compliance with the statutes, regulations and guidelines.
- The regulator should have the power to become "directly involved in the affairs of problem institutions."
- The regulator should develop detailed standards for leverage.

It should be noted that most of the above references to "the regulator," were actually envisaged by the Wyman committee as being CDIC — i.e., in order to protect its position as an insurer, CDIC would itself have a number of direct regulatory powers. The government ultimately opted for a more neutral role for CDIC, with the main regulatory powers to be exercised through the OSFI, but the thrust of the recommendations were considered to be worthwhile.

The federal green paper acknowledged that the existing financial regulatory system was outmoded, with increasing numbers of deposit-taking institutions and insurance companies getting into financial difficulty, and the grave consequences this had had for affected consumers, along with the potentially disruptive impact that this trend could have on the greater economy. (The year was 1985, with the failure of Canadian Commercial Bank and Northland Bank still to come in 1986, to be followed by other failures, including the insolvency of the massive Confederation Life in 1994.) Accordingly, the paper emphasized, inter alia, the following key areas for attention:

- Strictly controlling self-dealing by essentially “banning” such transactions for all federally regulated financial institutions.
- Guarding against conflicts of interest by enhancing and clarifying the regime applicable to conflicts of interest and also by establishing a new public body to investigate consumer and other complaints where conflict-of-interest abuses are suspected.

Enhancing the powers of regulators to enable them to properly carry out their responsibilities.

- Clarifying and simplifying the regulatory structure, possibly by consolidating the Office of the Inspector General of Banks and the Department of Insurance.
- Ensuring the soundness of financial institutions and the stability of the financial system.

In addition to the two most prominent investigations of the time — the federal green paper and the Wyman report — there were numerous other bodies that carried out investigations and made recommendations for change. These various analyses were all prompted by the spate of financial institution insolvencies in the 1980s, and in their totality they gave rise to a powerful consensus that major change was needed. Table 1 below outlines key issues that were identified after the financial failures in the 1980s, along with the important measures that were introduced by the federal government to address them:

Table 1. Financial failures in the 1980s and corrective measures of the regulators in Canada

Identified Weakness	Corrective Measure (1987 OSFI Act and 1992 New Legislation)
Lack of co-ordination between Office of the Inspector General of Banks and Department of Insurance, even though there was increasing convergence between banking and insurance (banks owning insurance company subsidiaries and life insurance companies increasingly promoting wealth-management and savings products).	Formation of the OSFI to take over regulation of all federal financial institutions. Also, formation of the Financial Institutions Supervisory Committee (FISC), which meets quarterly to discuss systemic risk issues and developments with regard to federally regulated financial institutions. Members of FISC are: The OSFI, the Department of Finance, the Bank of Canada, the Canada Deposit Insurance Corporation and the Financial Consumer Agency of Canada.
Lack of effective controls with regard to related-party transactions.	Related-party transactions effectively prohibited, except for those of nominal value. New requirement for conduct review committee of board (majority of independent directors) to approve “nominal” transactions based on being at market value and in interests of institution.
Obvious ability of players to “get around” rule- based regulatory regimes.	Much greater emphasis on principle-based approach, with guidance as to interpretation.
Lack of a comprehensive regulatory regime for banking, including minimum capital requirements and on-site inspections.	Harmonization of regulatory framework for banking and insurance, which means banks are subject to minimum capital requirements and regular on-site inspections. Increasing adoption by the OSFI of international regulatory standards in banking and insurance. (In fact, as an active member on international committees, the The OSFI has a significant influence on the development of these standards.).

Identified Weakness	Corrective Measure (1987 OSFI Act and 1992 New Legislation)
Lack of meaningful standards with regard to corporate governance, risk management and internal controls.	New legislation sets out detailed responsibilities of boards of directors, including in respect of governance, risk management, internal controls and other key areas of financial-institution management. Also imposes clear conflict of interest disclosure requirements and stringent "duty of care" for directors and officers. High standards of corporate governance are front and centre in the new financial regulatory framework.
Lack of a risk-based perspective by both the Office of the Inspector General of Banks and the Department of Insurance.	The OSFI develops a comprehensive risk-based approach to its regulation of financial institutions. This requires a formalized, consistent and as-objective-as-possible methodology for assessing risks across the range of financial institutions. The OSFI develops a "Guide to Intervention" for the benefit of its own personnel and for industry members, setting out the types of OSFI responses that can be expected at different levels of risk in
Although the Department of Insurance carried out on-site inspections and received a considerable amount of financial data from insurers, its regulatory processes were mainly based on long-ago developed routines and procedures, many of which were outmoded and inefficient. Information obtained from on- site inspections was not interpreted in a consistent, risk-oriented manner.	All processes are reviewed to incorporate a risk-based perspective and a principle-based approach to regulatory operations. Many "old" procedures are considered to provide insufficient value-added for resources expended, and are dropped. Replaced by risk-based procedures that are designed to focus resources where there are the greatest risks to individual institutions and to the financial system as a whole.
Insufficient recognition by government of importance of financial regulation, as attested to by negligible resources dedicated to bank oversight and (by today's standards) to insurance regulation. Salary levels were linked to public service, which made it difficult (although not impossible) to attract staff members who had qualifications and expertise comparable to industry counterparts, making it hard to oversee the financial industry in an effective manner.	The OSFI currently has in the neighbourhood of 600 employees and is authorized to follow industry norms when establishing salary levels. This means that the OSFI can employ professional actuaries, risk-management experts, financial engineers and other personnel that are critical to staying on top of developments in the financial industry.
Financial institutions are diversifying into new types of businesses, directly and through acquisitions, and this is blurring the lines of the traditional financial pillars.	In order to ensure transparency and regulatory coherence within policy boundaries for new business development, a formal system of financial holding companies is adopted. This will enable institutions to accommodate new types of business within a single corporate grouping, primarily by requiring each type of regulated business to be carried out within a regulated entity that sits downstream from the regulated holding company.

These were far-reaching revisions: after many years of gradual, evolutionary change in the regulatory laws and practices governing financial institutions, there was suddenly a tremendous burst of creative activity. Our view is that the regulatory innovations that mostly had their genesis in the mid-1980s and early 1990s, were an important contributing factor with regard to Canada's excellent performance through the recent financial crisis.

An Apparent Paradox?

At first glance it might seem as though arguments developed in the foregoing pages give rise to something of a paradox. On the one hand, we suggest that, to a material extent, the excellent performance of the Canadian financial system through the recent financial crisis is largely attributable to developments that commenced with the creation of the OSFI and the new legislation of 1992. But on the other hand, as can be seen from the historical sections of this paper, no Canadian banks or insurance companies had to be closed during the Great Depression, which was an even steeper decline than that experienced during the recent crisis.

We have asserted that until the creation of the OSFI in 1987, and certainly during the 1930s, bank regulation was relatively minimal. And, as was demonstrated by the failure of a number of insurance companies in the 1980s and 1990s, insurance regulation was also far from optimal, including during the time of the Great Depression. Taken together, these points might suggest that the factors leading to the resilience of Canadian financial institutions must have been in place long before the events of the 1980s and early 1990s. How do we reconcile an argument that recent improvements in the regulatory framework have given rise to a world-class system when, even 50 or 60 years before the development of that system, Canadian institutions seemed to be able to satisfactorily ride out the greatest economic decline the developed world has experienced?

A situation that is not typically referenced among the historical milestones of Canadian financial-institution development is that during the 1930s, a number of Canada's life insurers, most notably Sun Life, which was the largest Canadian life insurer at that time, were in fact technically insolvent. This was common knowledge among staff members at the Department of Insurance during the author's tenure with the DOI. To confirm that this was not some kind of organizational legend having no basis in fact, one may access various scholarly references on the subject. For example, Kryzanowski and Roberts state that their research "provides extensive evidence of the insolvency of Canada's largest life insurance company of the day, Sun Life. It also shows that six of nine of Sun Life's Canadian competitors were also probably insolvent."[61] In an earlier paper*62* the authors presented evidence to show that one of Canada's largest banks, the Bank of Montreal, was insolvent on a market-value basis during most of the 1930s. The fact is that the government essentially colluded with the management and boards of these institutions to mask the fact that they were technically insolvent. For example, in responding to questions in the House of Commons about Sun Life's solvency, then prime minister R.B. Bennett made the following (convoluted) statement in Parliament: "My duty was to see to it that without further instructions than those which I have indicated to the House as values — that apart from that our officials should make a report which would enable me to say to the people of Canada and elsewhere, who were depending on the solvency of this great enterprise, that it was solvent."

Prior to its amalgamation with the OIGB in 1987 to create the OSFI, the Department of Insurance was responsible for an annual publication known as the *List of Securities*, which included all of the investments of federally licensed insurance companies, along with the DOI- approved year-end market value for each security, to be utilized by insurers for financial- reporting purposes. For a number of the Depression-era year-ends, the Department used what it referred to as "authorized values," which were not market values at all but were in fact considerably higher. With the use of authorized values, every Canadian insurance company was able to produce a balance sheet that showed it to be solvent. Thus the prime minister could indicate that he had a report from his officials which would enable him to say that Sun Life was solvent.[63]

These Depression-era situations might be considered as representing early application of the "too big to fail" doctrine, which in turn, would imply that there was careful analysis of the pros and cons of the various options as part of a formalized decision-making process. On the other hand, during a time when transparency was not a pervasive preoccupation the way it is today, it is also possible that no government felt that it could be seen as a messenger carrying such bad news, especially during an era of high unemployment and other dismal financial statistics, and that that the politically expedient course of action (or inaction) was to hope that the problems would gradually be cured over time. In thinking about this latter possibility, one must reflect on the fact that in the several years preceding the Home Bank failure, a number of the bank's directors wrote to the minister of finance expressing their view that the bank was likely to become insolvent, if that situation did not already exist, but no action was taken by the government of the day.

There is a fine line between regulatory forbearance as part of a well-considered "too big to fail" policy, and pure inaction because of the lack of a political will. The author of this paper has carried out many regulatory development projects in emerging market countries. It is not uncommon to find that there are insolvent institutions, sometimes among the most sizable in the marketplace, that are still actively transacting business. In most of these cases, there is no policy of "too big to fail"; there is only a fear by ministers of the government that by being the messenger bearing the bad news, they may be the ones to suffer, if not literally, then certainly at the ballot box. One of the most difficult changes to make in these jurisdictions is to get the local government and the regulator to begin meaningful measures of intervention designed to either take an institution out of the market, or on the basis of rational policy analysis, to conclude that the institution is too big to fail and to take whatever steps might best be appropriate to contain the problems rather than doing nothing and having them worsen.

The McKay Task Force — Reforming Canada's Financial Services Sector

The McKay task force, convened in 1996, was not a royal commission and it did not particularly focus on issues related to prudential regulation, nor did it feature a review of Canada's financial services history, as was the case for most of the previously cited commissions. To the extent that a regulatory perspective was adopted, it was mostly with regard to competition and consumer service. A number of recommendations were brought forward that were intended to increase competition among deposit takers, including reduced capital requirements to promote the incorporation of new banks, freeing up the ability for credit unions and caisse populaires to expand their services, and broadening the membership of the Canadian Payments Association. There were also a number of important consumer-related recommendations, including enhanced transparency of financial contracts, protection of privacy, and increased emphasis on avoidance of coercive tied selling. Consumer-protection recommendations led to the establishment of the Financial Consumer Agency of Canada and a system of financial ombudservices to look into public complaints across the financial services sector.

Overview of the Canadian System Today

In this section, we outline the main characteristics of the Canadian financial regulatory system as it exists today, with particular emphasis on the areas that we believe to be most responsible for its effectiveness.

- Integrated supervision: The job of assessing risk in the financial system can be compared to putting together a jigsaw puzzle. A person looks at all the pieces and begins to move them around looking for a pattern to emerge, which can then be further built upon. But if there are a number of players holding different pieces of the puzzle, it will take much longer for anyone to recognize the image. Similarly, when there are different regulators looking at different parts of the financial system, it is all too easy to see only a part of the picture and therefore not recognize what is really happening. Unfortunately, this difficulty is compounded by a characteristic of human nature whereby executives in different institutions usually seem reluctant to share information with their counterparts in other institutions, often because of competitive rivalries, individual egos, turf wars and so on. A single regulatory agency (or minimal number of agencies) minimizes the potential for this type of difficulty.

Another advantage of an integrated approach is that it substantially diminishes the danger that responsibility for different parts of a complex financial system, or newly developing parts of that system, will fall between the cracks, with no regulatory agency assessing the risks that may be emerging in that particular area. If something new is happening, each agency may be able to quite correctly say "that is not our responsibility." It is no one's responsibility because the new activity was not previously contemplated, and therefore, is not included in the remit of any of the individual agencies. By contrast, when any new financial institution product or activity now comes over the horizon in Canada, the OSFI, as the sole financial regulator, is expected to begin thinking about its risk implications for the system and for individual entities.

- Principle-based/outcome-based approach as opposed to rule-based/compliance-based approach: The experience of the old Department of Insurance, with its detailed investment rules, provides a good example of the way in which rules can be subverted. As well, in the course of our regulatory career, we have often come across situations where rules that were promulgated long ago have clearly become obstacles to good public policy, merely because the present landscape is entirely different from what existed when the rule was brought into play. It is far better to lay out more fundamental principles which need to be respected, with clear guidance as to what is to be achieved.

Risk-based approach: The OSFI has developed a sophisticated framework for assessing risk across different types of institutions, using formalized, consistent methodologies that are as objective as possible, to assign risk ratings to all institutions. Regulatory resources are allocated based on risk ratings, as well as the overall impact on the public in case of failure. This approach ensures that time is not wasted on activities where risk is low, as was often the case in the days of the Office of the Inspector General of Banks and the Department of Insurance.

- Sound capital requirements: The extent to which assets exceed liabilities is the fundamental measure of the quantum of loss that can be absorbed without becoming insolvent. In good times, capital relative to assets or liabilities can be quite small — say, only a few percentage points — because losses are not expected. Of course, the caveat is that losses tend never to be expected, but we know that they do occur from time to time. The OSFI has been successful in holding firm to higher capital levels in good times and bad, and there seems to be little doubt that these requirements helped Canadian financial institutions to weather the storm of the recent financial crisis. In fact, the OSFI makes it clear to regulated institutions that they are expected to maintain working-level capital positions that are at least 150 per cent of the minimum permissible level.
- Escalating intervention based on risk versus compliance-based approach: The OSFI has, and

international standards require, the power to apply preventive and corrective measures on an escalating basis as risk increases. For example, suppose the regulator notes that in an otherwise well-run institution there has been an increasingly significant series of difficulties in the IT area, leading to control and other related issues. The first step would be for the regulator to bring the situation to the attention of management and to require a well- thought-out plan to address the issue. If the plan is not effective or is not followed, the regulator would follow up, perhaps by meeting directly with the board, and insisting that steps be taken to get the problem under control. If there continues to be no effective action, the regulator might consider other possible interventions, such as requiring the institution to increase its capital base to offset the higher level of risk, or requiring that the institution bring in new management with respect to the area of concern. The point is that the regulatory agency is adopting the same approach that would be followed by any competent management team in addressing a business issue: first there will be a plan to be implemented and tracked and, if it is not doing the job, more serious measures will be identified and implemented by management as required. The regulatory agency is merely requiring management and the board to follow the same path as should be adopted by them in dealing with any business weakness.

This is to be compared with a compliance-based approach, where the regulator imposes fines and other penalties for "breaking the rules." When institutions pay fines, the payments only reduce the financial resources of the institution. More importantly, fines are paid by the institution, not by the managers who are making the decisions, so they tend to have a minimal effect on the decision-making process, which is where the changes need to take place. And we would say, most important of all, fines and other compliance-based actions are, by definition, only imposed when the rules have been broken, by which time the damage may already have been done. Effective regulatory oversight is based on risk assessment and working with management, backed up with the ability to enforce change when it is clearly required. Fines and other penalties don't do the trick.

- High standards of corporate governance: The quality of governance within an institution is the foundation for effective management of that institution. The board must establish a clear framework for the organization's strategic direction, control framework and risk appetite across the risk areas that are relevant to the institution's operations. In this regard, one of the clear messages from the failures in the early 1980s was that boards of directors had not focused on the importance of effective systems of corporate governance. Many critical decisions were made by managers in different functional areas, without board oversight, resulting in highly inconsistent risk decisions and internal standards for different parts of the business. Rather than making sure that they were satisfied that the business was being operated in an effective fashion, including risk management, internal controls, internal audit, etc., boards tended to be comprised of friends of the CEO and controlling shareholders, without much consideration of their responsibilities and the expertise these directors might bring to the boardroom table. Today, one of the OSFI's main areas of focus, including assessing the overall risk level of the institution, is the quality and effectiveness of the institution's corporate governance framework. The statutes set out in considerable detail the responsibilities of board members, including the particular duties of members serving on the obligatory audit committee and conduct-review committee, both of which require a majority of independent-director members.
- Strong "duty of care" provisions: Although part of the corporate governance requirements, the duty-of-care provisions in Canada's financial institution laws (which are the same as are applicable to other corporations under the Canada Business Corporations Act), make the significance of directors' and officers' responsibilities very clear. For example, there is a duty to act in the best interests of the *institution*, which includes key stakeholders such as depositors and policyholders. Thus, if a proposition were to come before a bank board which was clearly favourable to the bank's shareholders but very unfavourable to the bank's depositors, the board members would have to strike a balance that is beneficial to the institution as a whole. Our view is also that clear, strongly worded duty-of-care provisions have a highly beneficial impact on the operation of the system as a whole, in terms of fostering an overall risk-tolerance level that is appropriate for a financial institution. However, this is a subject for future investigation, as we are presently not aware of any quantitative studies or other research that would substantiate this "hunch."
- Control of related-party transactions: Another important cause of institutional failure was the ability of financial institutions to enter into transactions with related parties. Financial institutions have, by their nature, access to large amounts of cash and liquid assets. When institutions have controlling shareholders that own other businesses, those shareholders can be tempted to reach into the controlled institution to obtain funding. For example: by making loans

to themselves on extremely favourable terms, by "buying" real estate and other assets at below market value, by selling assets to the institution for cash and at values that are higher than market value, and so on. The 1992 legislation introduced a general prohibition on related-party transactions in both banking and insurance, except for those of nominal value. Even those, however, are required to be pre-approved by the conduct-review committee, which must have a majority of independent directors, and also subject to the criteria that the transaction be on terms that are at least as favourable as market value. (Note that related-party transactions were more of a regulatory issue for insurance than for banking because, as previously mentioned, the Bank Act revisions of 1967 prevented any individual shareholder, or group of related shareholders, from controlling more than 10 per cent of the shares of a chartered bank.)

– Disclosure of conflicts of interest: The laws now require directors and officers to fully disclose to the board any conflict of interest that may arise in connection with their responsibilities to the financial institution. The director or officer concerned cannot be a party to any discussions related to the transaction in question. Failure to disclose a conflict of interest results in the disqualification of the individual from his or her position and renders him or her ineligible to act as a director of a federal financial institution for five years from the date of the contravention.
– "Fit and Proper" requirements for all directors, officers, shareholders and key professional advisers required to be appointed by law: International standards, to which Canada ascribes, require all key personnel to be fit and proper. This means that there must be nothing in their backgrounds that would provide reason to believe that they may be inclined not to act in the best interests of the public. Obviously a prior history of illegal activity or inappropriate role in an institutional insolvency would be grounds for the regulator to block an individual's appointment. Another area that could give rise to a regulatory veto would be a lack of qualifications in terms of education or experience. The point is that if there are reasons to believe that, from a public policy perspective, it would be inappropriate for an individual to be appointed to a key position in a financial institution, then the appointment should be blocked by the regulator.
– Existence of Consumer Compensation Plans: Although Canada is certainly not alone in this regard, the entire regulatory system is underpinned by a series of consumer compensation schemes that provide assurance to members of the public that, even if their financial institution becomes insolvent, they will be protected within the limits of the relevant plan. The Canada Deposit Insurance Corporation, for deposit-taking institutions, established in 1967, is of course the most significant of these plans. But there is also, for life insurance, Assuris, established in 1990, and the Property and Casualty Insurance Compensation Corporation (PACICC) for general insurance, established in 1987. Each of these plans provides limited coverage so as to minimize the potential impact of moral hazard — i.e., the possibility that the existence of the plans will take away the incentive of consumers to deal with the most reputable and well-managed enterprises, rather than merely those that pay the highest rates of interest or have the lowest insurance premiums. As someone with regulatory experience, the author can also attest to the fact that the presence of these plans is conducive to early and objective intervention by the regulator. Without such plans, regulators cannot help but be mindful of the fact that the act of closing an institution's doors will plunge large numbers of innocent consumers into a nightmare of financial disruption — and this knowledge seems inevitable to cause some delay in "pulling the trigger" on closure, as there is hope (or rather, wishful thinking) that something may materialize to make this unnecessary.

The OSFI supervisory framework is described in considerable detail on its website at: http://www.osfi-bsif.gc.ca/eng/fi-if/rai-eri/sp-ps/pages/sff.aspx. (Note that, in international parlance, which is used by the OSFI, "supervision" generally refers to the practices, policies and procedures utilized by the agency to meet its objectives. On the other hand, "regulation" generally refers to the legal and statutory requirements applicable to licensees.)

The International Monetary Fund (IMF) and the World Bank conduct the Financial Sector Assessment Program (FSAP), where teams of investigators are sent to specific countries (with the agreement and co-operation of the country concerned) to painstakingly compare the local regulatory framework with the applicable international standards. The most recently available IMF FSAP for the Canadian financial system (January 2014) indicated that "Canada has a very high level of compliance with the Basel Core Principles for Effective Banking Supervision (BCPs). In response to the challenges and structure of its market, the Canadian banking supervisor (OSFI) has developed, and is a strong proponent of, risk based, proportionate, supervisory practices and applies a 'close touch' approach to its supervised entities. The supervisory approach is well structured, forward looking and maintained on as dynamic a basis as possible. Entry to the Canadian market is subject to demanding prudential entry standards."

As a generalization, one can say that institutions are required, first at a primary level by the basic terms of the statutes, but secondly and more profoundly at an operational level by the OSFI's policies and guidelines, to adhere to sound business and financial practices in the transaction of their businesses. In other words, the Canadian requirements for financial institutions are consistent with what one might include in an MBA textbook intended to guide management in the operation of a sound institution. We say: "How can any regulatory system do better than that?" In contrast, we find it impossible to believe that any prescriptive framework, acting over a diverse group of financial institutions, could ever hope to approach a situation of optimality in terms of meeting desired regulatory objectives.

We also suspect that Canadian corporate governance requirements for financial institutions are more stringent than those applicable to most other jurisdictions and particularly to U.S. financial institutions. However, to reasonably compare the Canadian and U.S. systems across this dimension requires knowledge not only of what the laws in each country state, but also how the courts have interpreted those laws. That is outside the scope of this paper, but we flag it as a possible area for future research.

Of course, no system is perfect or incapable of improvement. While systems can be designed in theory, in the real world, there are usually issues with implementation and administration that conspire to produce results that are sub-optimal compared to theory. According to the OSFI's mission statement and other documents, its role is not to prevent the *failure* of financial institutions, which is the responsibility of institution managers and boards of directors, but rather "to protect depositors and policyholders from undue loss." In this regard, a possible emerging issue, based only on speculative comments by some industry members, is that after receiving international accolades for good performance of the Canadian financial system during the crisis, the OSFI may now be overly conservative in its application of the supervisory framework, feeling that it cannot allow its good record to be tarnished by a failure.

If the foregoing point has any credibility, it would be adding to one concern that we have heard expressed for as long as the OSFI has been applying its guidelines and policies. In the documents laying out those guidelines and policies, the OSFI always indicates that the agency "recognizes that regulated institutions may have different practices depending on their size, ownership structure, nature, scope and complexity of operations, corporate strategy, and risk profile." In other words, we have written our policy or guidance to apply to a large chartered bank, but don't worry, if you are a small operation we will take account of that when we interpret the policy for your particular institution. Many of our industry contacts are in the property/casualty insurance field, where company sizes tend to be a minuscule fraction of the size of a chartered bank. Many of them suggest that while the OSFI *says* size and complexity will be taken into account, the regulatory troops on the ground will want to ensure that they are not criticized by their superiors who will be reviewing their reports. We suspect that from the perspective of frontline workers who are inspecting the companies, they believe they will be more likely to be criticized for missing something in the application of a guideline than to be complimented for their thoughtful interpretation that fully takes account of the size and complexity of the regulated entity. Thus, the feedback we get from insurers is that there is a tendency, despite the caveat about size and complexity, to apply the full weight, or at least *much* of the weight of big-institution requirements to small institutions.

Most of this paper is about the regulatory framework and how it works to ensure system stability. At the outset of the paper though, we recognized that a good system must also balance that particular goal with the overall efficiency of the markets. Too much regulation is definitely not a good thing. While the system may be very stable it may also have high overhead, leading to low return on investment, dissuading shareholders; and it may be so constrained as to lack innovation and product development, penalizing members of the public.

In this regard, we have to say that, in our view, the current regulatory system seems to strike a reasonable balance with regard to market efficiency. The use of principle-based and outcome- based approaches leave boards and senior managers free to design operational policies that are a good fit with their overall core competencies and strategic plans. However, the proof of the pudding is in the eating, and over the past 12 years — which includes the period of the financial crisis — Canadian banks have generated pre-tax return on equity (ROE) ranging from a low of 19 per cent in 2008 to a high of 37 per cent in 2006, with an average of 31 per cent over the period.*64* We think it would be hard to argue that, with these metrics, Canadian banks are finding themselves saddled with a regulatory regime that is stifling their ability to generate sufficient profit to be attractive to investors. (But we also acknowledge that a simple statistic like annual ROE doesn't necessarily "measure" market efficiency.)

However, that takes us back to the points made just above. If the system is market efficient for Canada's big banks, it does not necessarily mean that the same is true for small institutions such as property/casualty insurers. Indeed, the property/casualty business has certainly not enjoyed industry-wide ROEs that are comparable to those of the chartered banks, although there may be many other reasons why this would be the case. As well, if there is truth to the "street talk" with regard to an increase in the OSFI's conservatism since the time of the financial crisis, for whatever reason, then market efficiency may be declining at the expense of an over-emphasis on stability. At the end of this paper, we take note of the market-efficiency question as one for possible future research.

Other Regulatory Factors That May Have Helped Canada to Perform Well During the Crisis

In the sections above, we have outlined the main characteristics of the Canadian financial regulatory framework and have expressed the view that the system's design and operation have been significant, if not primary, reasons for Canada's ability to weather the financial storm of the sub-prime crisis.

However, it is clear that there have been other factors that have also been to Canada's benefit in terms of its recent financial system performance.

One distinguishing feature of the Canadian system is the degree to which governments of the day have been prepared to work on a collaborative basis, as opposed to an adversarial basis, with Canadian businesses. For example, when we discussed the establishment of the Canadian Bankers Association earlier in this paper, we noted that more than 100 years ago, in 1900, the Canadian government provided the CBA with powers to act as a curator in resolving failed banks, an activity that in many countries would be reserved for the ministry of finance or a regulatory agency. This willingness to work with the regulated industries has been a feature of the Canadian financial system since its earliest days and is a characteristic that is seldom found in other countries.*65* As one study reported, "It is curious and paradoxical that Canada is a country which has been largely developed around a special blend of private initiative and public policy. From the earliest days, large projects critical to the economic survival and growth of the country have tended to be joint ventures between the state and private entrepreneurs: for example, the Hudson's Bay Company and the Canadian Pacific Railway.

Nor was the close cooperation of business and government only a phenomenon of the first stages of development. Since that time, it has continued in the form of providing funding, supportive legislation and actual ownership in such industries as canals and seaways, air transportation, pipelines, broadcasting, banking and insurance, agriculture, petroleum and potash to name but a few."*66*

We believe that in the financial sector especially, the degree to which industry and governments in Canada have worked together in the public interest is relatively unique and is an important contributing factor to Canada's record of financial stability. The regulation of insurance intermediation and of investor-protection aspects of the securities industry have, to a considerable extent, been outsourced to industry-run self-regulatory organizations. The consumer ombudservices mandated by the federal government for insurance, banking and securities are run by independent boards (with some industry participation) and are funded by the respective industries. The insurance policyholder compensation plans for both the life insurance industry (Assuris) and the property and casualty insurance industry (PACICC) are additional examples of ways in which governments can outsource activities that, in many countries, are carried out directly by regulatory agencies or governments. Over the years, Canadian regulatory agencies have outsourced many important initiatives across the financial sector to the respective industry trade associations, for example, the Canadian Bankers Association, the Canadian Life and Health Insurance Association, the Insurance Bureau of Canada (the property/casualty insurance trade association) and the Canadian Securities Association. In the mid-1990s, when it was decided that there should be Standards of Sound Business Practice for insurance companies, the OSFI suggested an industry working group, including OSFI observers, to develop the basic standards. The end result was an excellent document that both industry and regulators could adopt. This same pattern has been successfully followed by Canadian financial regulators in different sectors of the financial services industry over the years.

Although we were obviously not privy to communications between senior government officials and the management of Canada's large chartered banks during the financial crisis, we are confident that there were frank and ongoing discussions that could only be helpful to the overall goal of minimizing the impact of the financial turbulence. In many countries, there is a strong adversarial relationship between governments and regulated entities, and in those cases, it would be very difficult to arrange collaborative, constructive conversations in a time of danger to the system.

Outlined below are some additional regulatory aspects that may have helped Canada's economy and its financial institutions weather the recent financial storm:

- A legal difference between Canada and the U.S. in the field of home financing is that, in most provinces of Canada, if foreclosure on a mortgage is not sufficient to repay the outstanding amount to the lender, the homeowner is not let off the hook but rather remains liable for any part of the debt that remains outstanding. By contrast, when their mortgages are "underwater" — i.e., the amount they owe the lender exceeds the market value of the property — U.S. borrowers in most states are able to walk away from their mortgages. If they do not do so, they will end up paying off a loan that is greater than the market value of their home — a losing proposition from their perspective. This exposes lending institutions to a risk that does not arise to an appreciable extent in Canada. In retrospect, it seems clear that the myth that home prices would always rise, and the existence in the U.S. of government-sponsored incentives for consumers to borrow funds for home purchases, gave rise to market distortions and the mispricing of risk by banks and other lending institutions. Similar distortions have not existed, at least to the same extent, in the Canadian marketplace.

- A significant difference in the financial-institution landscape also arises from the fact that, as previously mentioned, the Canadian banking system has been a branch-based system, as opposed to the system of local banks that emerged in the U.S. Having just a few banks, which, through their thousands of local branches, represent the major lending institutions in every corner of Canada, provides a broadly diversified base of business that can provide each bank with stability in uncertain times. When the fishing business is poor in the Atlantic provinces and loans there are going into default, the lumber business in British Columbia may be booming and loan default rates will be very low. There are also significant economies of scale to be achieved by having a few very large institutions versus a large number of small to middling institutions.

A study carried out for the U.S. Congress (CRS Report for Congress, "Financial Market Supervision: Canada's Perspective" — discussed in more detail in discussed in more detail in the Comparison of the Canadian System with that of the United States section of this paper found on page 39), emphasizes that the U.S. financial system is much more complex than the Canadian system. One area where that is likely to have a particular impact is with regard to the number of institutions that must be regulated. Other things being equal, it should be less difficult to successfully oversee the operations of five very large banks than to keep on top of developments with respect to thousands of smaller banks: according to the Federal Deposit Insurance Corporation's 2012 annual report, FDIC was at that time insuring the deposits of 7,181 institutions! So having a relatively small number of institutions to oversee probably does facilitate the delivery of regulatory activities.

- Another factor that may be relevant to Canada's "success" in terms of financial-institution stability is the way in which ownership rules developed over time. To maintain domestic control and to prevent commercial ownership of banks, the 1967 Bank Act placed a 10 per cent ownership limit on bank shares, and this also helped to avoid problems of self-dealing. (Insurance companies were not subject to this restriction, which is why self-dealing was a much more common problem in that industry, at least for stock companies. Self-dealing was not a concern for the large mutuals because, being owned by their policyholders, they have no shareholders in the traditional sense.) Downstream control situations had, for many years, also been limited for both banks and insurance companies, so they were not able to control other businesses as subsidiaries. However, in recognition of competitive and other business-related considerations, the 1987 Bank Act amendments, along with changes in Ontario law, lifted the restrictions having to do with banks owning securities dealers, with the result that all of Canada's major securities dealers were soon acquired by the chartered banks. The comprehensive 1992 legislation, described in Table 1, introduced the financial holding-company concept, which provided a formal regulatory framework for cross-sector enterprises. In any event, the result has been that in Canada, since 1987, there have been no major securities dealers that are not owned by chartered banks.[67]

This may be relevant because being aligned with owners who have a "banking mentality" may have served to lower the risk profiles of what the investment firms may have become if they had different ownership. In the United States, where the big brokerage firms and investment banks were not owned by traditional banks, some grew to be gigantic enterprises, but of these some were thinly capitalized relative to their liabilities and were more directly involved in the risk-taking business.

- Each of the five federal agencies with shared responsibility for ensuring the efficiency and stability of the Canadian financial system — the OSFI, the CDIC, the Bank of Canada, the Department of Finance and the Financial Consumer Agency of Canada — has a clear mandate which doesn't overlap with the mandates of other agencies. As in most areas, clearly defined, non-overlapping responsibility is an important attribute of successful operation.

Although the OSFI is an integrated regulator, the concept of integration is extended to the maximum degree by the existence of a number of formalized arrangements within the government. For example, representatives of the OSFI, the CDIC, the Bank of Canada, the Department of Finance and the Financial Consumer Agency of Canada, comprise the Financial Institution Supervisory Committee (FISC). The FISC's mandate is "to address the issues and challenges facing the financial sector, and to refine regulatory requirements that promote sound practices and procedures to manage risk."[68] The Auditor General of Canada, in his 2010 review of the OSFI's operations, found evidence that these committees meet as required and that their discussions are substantive. He also noted that during the financial crisis, meetings were held much more frequently than in normal times.[69]

In the course of researching this paper, we have not found any quantitative analyses that shed light on the potential validity or importance of the above factors, although several articles in the popular press have commented on the possibilities.*70*

The media and others have also suggested additional factors, unrelated to the regulatory environment, that may have affected the extent to which the Canadian economy was impacted by the financial crisis, such as: actions by the Bank of Canada, the degree of Canadian banking linkages with foreign jurisdictions, the general quality of mortgage loan portfolios in Canada compared to the United States, and so on. Some have even speculated that much of the "good performance" of Canadian financial institutions can be attributed to a basic inclination of Canadians to be risk-averse compared to their U.S. counterparts. However, all such hypotheses are outside the scope of this paper and we leave it to other researchers to quantify their significance, if any.

Corresponding Regulatory Developments in the United Kingdom

As mentioned earlier, the U.K. did not adopt its first bank regulatory regime until 1979. The basic reason for this state of affairs was that, in the U.K., the historical approach to financial regulation has been somewhat along the same lines as the approach in most countries to securities regulation, which is to say that as long as users of the system are well informed and there is full disclosure with regard to the details of the financial transactions they are entering into, the state need not interfere. This shifts the focus of regulation away from the realm of prudential regulation and more to conduct of business regulation. The typical regulatory approach for securities is exemplified by the website for the Ontario Securities Commission, which indicates: "it is the general requirement in securities legislation to provide 'full, true and plain disclosure' of all material facts relating to the securities issued or proposed to be distributed."

Thus, in the case of securities it is the expectation of regulators that prospective investors are sophisticated and capable of assessing the risks for any particular investment opportunity they may want to consider, so they will be able to make an informed decision as long as all material facts have been disclosed. However, the situation with respect to banking, insurance and dealings with other types of financial institutions, is quite different. The average individual who is seeking a mortgage to buy a house, or who wishes to obtain an automobile insurance policy, is not an expert in the workings of the financial markets and will generally not be in a position to evaluate the risks that the transaction may entail. With these types of common financial transactions, the power of knowledge all rests with the institution that has prepared the contract. This fact is formally recognized in the law through the treatment of insurance and many other financial contracts as "contracts of adhesion"— i.e., a contract is 100 per cent prepared by one party and the other party can decide to adhere to the contract as presented, or refuse it. The view from North America has been that merely requiring the institution to provide the consumer with a bundle of explanatory brochures will not serve to level the playing field to any appreciable extent. But in any case, in many situations where consumers are dealing with financial institutions, one of the most significant risk areas relates to the financial health of the institution rather than to the details of the transaction, and almost no individual will have sufficient technical expertise to meaningfully assess the financial health of a bank or insurance company. Also, most consumers of financial services are generally less mindful of the consumer-law principle of *caveat emptor*, or "let the buyer beware," than is the case with the purchase of more tangible consumer goods such as automobiles (where the tires can actually be kicked).

Another difference between the traditional U.K. model and the North American approach is that, in the U.K., there are very few restrictions on the business powers of financial institutions. They can engage in almost any business they wish, but through separate subsidiaries. For example, a number of grocery stores have incorporated their own banks to provide services to their customers. "In effect, firms have virtually no regulatory limits imposed on them with respect to what business they can conduct, but regulation and monitoring with respect to how business is conducted with consumers is strong, detailed, prescriptive, and extensive."*71*

As the U.K. has moved to adopt the rules of the European Union, as expectations regarding compliance with international standards have become more important, and as the financial services business has become increasingly complex, the U.K. has gradually adopted an institutional safety-and-soundness-focused model, closer to what we are used to in North America. However, there continues to be a strong tradition of marketplace supervision and consumer protection at the transactional level.

Comparison of the Canadian System with That of the United States

The key features of the Canadian financial regulatory system have been described above.

After the financial crisis, the United States Congress was aware of the apparently good performance of Canadian financial institutions and asked its research group to produce a report describing the Canadian system and determining whether it could have application for the

U.S.*72* Included in the report, dated April 4, 2013, are the following two diagrams illustrating the structures of the respective systems.

Figure 1. The U. S. Regulation system

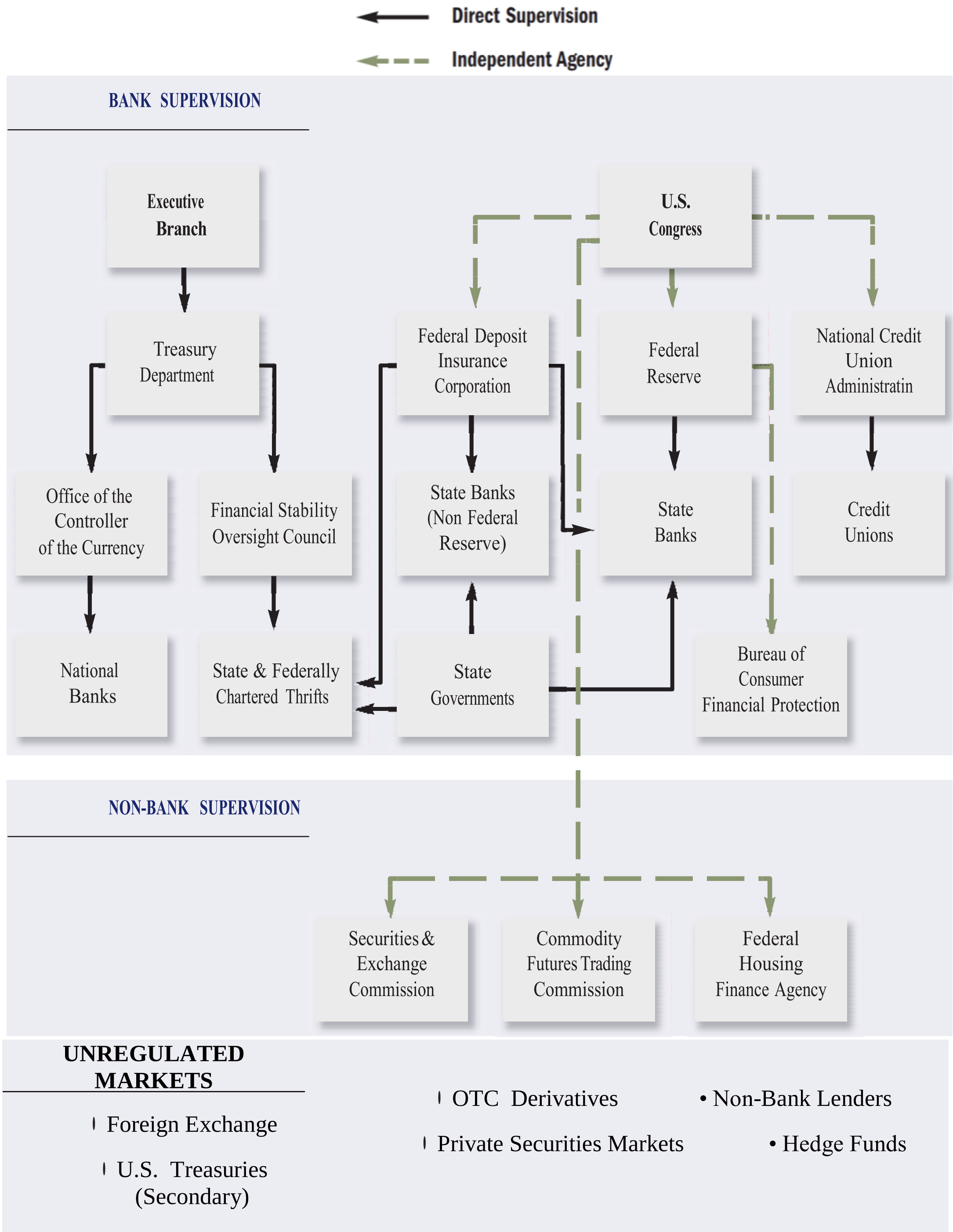
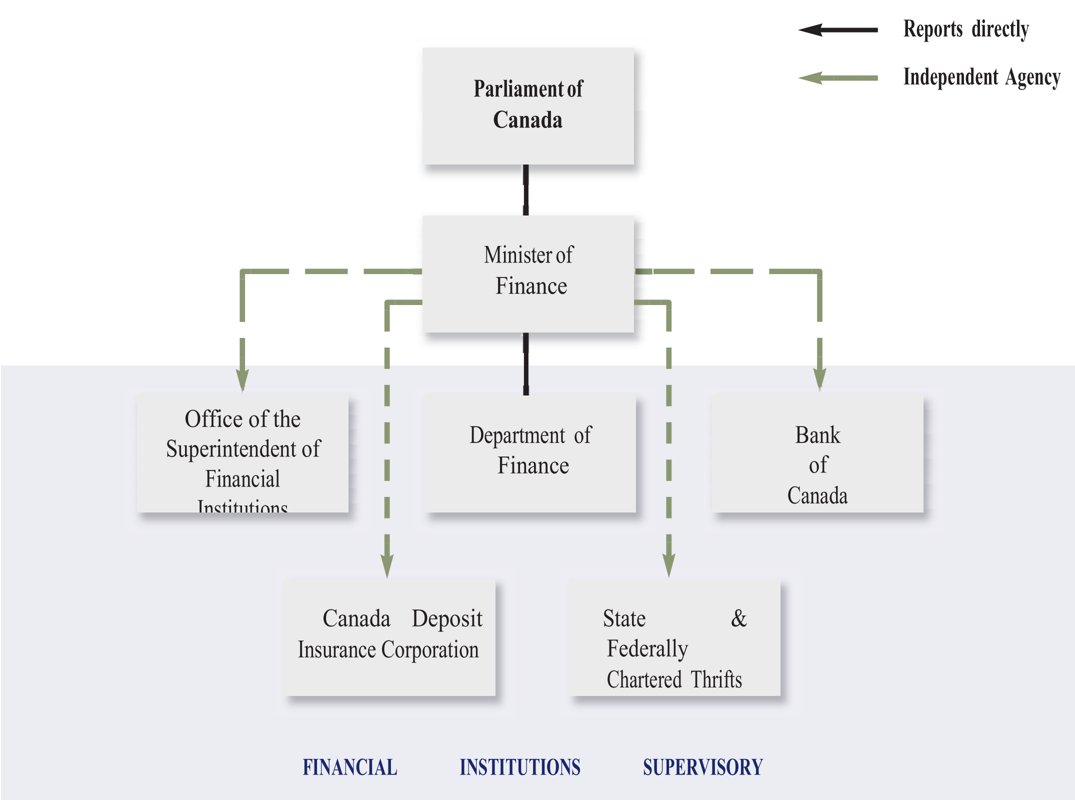


Figure 2. Canadian Regulative System[73]



The author of the report concludes: "There likely are aspects of Canada's financial supervisory framework that may offer an approach to supervising financial markets that may be useful for the United States to consider. However, the smaller scope of Canada's financial system and its economy likely lessen the transferability of systems or procedures used in Canada to the vastly more complex U.S. financial system."[74]

It is clear from the diagrams that the U.S. framework, even in summary form, is far more complicated than the Canadian framework. As well, the diagram for the U.S. only applies to banking. Other types of institutions would have different diagrams, possibly even more complicated than for banking. For example, the insurance business in the U.S. is separately regulated by each of the 50 states. However, the Canadian diagram covers the entire financial system except for the securities industry, which is provincially regulated, and except for other provincially regulated financial companies, which account for only a small part of the overall financial system. Thus, we can see that, in addition to its relative simplicity, the diagram for Canada pertains to a much greater percentage of the entire financial system than is the case for the U.S. diagram.

However, we do not agree that because the U.S. financial system is undoubtedly vast and complex it necessarily requires a complex system for its oversight. In fact, the OSFI, which is responsible for by far the bulk of regulatory responsibilities within the Canadian framework, is not a monolithic entity but is comprised of a number of specialist groups, functionally focused divisions, and so on. When viewed at a level of detail, even the insurance system is somewhat complex. At a primary level, there are different entities transacting life insurance, property/casualty insurance and other specialty lines of insurance. However, overlaid on that primary level of business is the reinsurance business, which sees reinsurance companies providing specialized reinsurance coverage to insurance companies but not to members of the public. The different types of insurance businesses, especially life versus property/casualty, must be staffed by, and regulated by, people having different technical knowledge and professional training. In fact, the old Department of Insurance was organized by type of entity supervised, with a life insurance division, a property/casualty division, a trust and loan division, and so on. But no one would seriously argue that because all of these types of businesses have different characteristics, they need to be regulated by stand-alone regulatory agencies.

Another issue, related to integration of supervision, is that in Canada, consumer affairs, including matters directly related to the making of contracts (such as insurance), are entirely within the jurisdiction of the provincial governments. Thus, all of our discussions about the OSFI are in respect of safety-and-soundness considerations, not direct consumer-related issues. In the U.S. on the other hand, each state government is responsible for both insurer solvency and direct consumer protection arising from insurance contract disputes, licensing of agents and brokers, etc. State governments also have some responsibilities for bank supervision within their jurisdictions. Some observers have suggested that the U.S. system would be improved if the states were left to concentrate on consumer protection (as is the case for the provinces in Canada), with the federal government taking on a much more integrated role in overseeing insurer solvency.*75*

We do not suggest that the complexities of the U.S. financial system would somehow become less complex within an integrated regulatory environment, but instead, that by combining many of the regulatory responsibilities within one or two agencies, there would be the potential for substantial improvement in efficiency and effectiveness. This would arise, not from in any way simplifying the underlying system, but rather from providing the regulatory agency (or agencies) with a far more comprehensive and cohesive overview of the system at large, with the potential for achieving more efficient and effective internal communication and analysis of risk areas.

Real-life implications of the lack of integration are revealed in the Levin-Coburn report, which was instigated by the U.S. Senate to investigate the causes of the sub-prime crisis and to make recommendations for the future. One section of the report describes, as an example, the situation at Washington Mutual Bank, which was among the eight-largest financial institutions insured by the Federal Deposit Insurance Corporation (FDIC). Because "WaMu," as it was generally known, was technically a savings-and-loan company rather than a bank, it was subject to direct supervision by the Office of Thrift Supervision (OTS). After an extensive description of WaMu's high-risk business philosophy and operations, which in some cases included fraudulent practices — none of which were ever effectively challenged by the regulator — as well as documenting OTS's refusal to co-operate with FDIC reviewers, the report indicates "OTS officials allowed the bank's short term profits to excuse its risky practices and failed to evaluate the bank's actions in the context of the U.S. financial system as a whole. *Its narrow regulatory focus* prevented OTS from analyzing or acknowledging until it was too late that WaMu's practices could harm the broader economy"*76* (emphasis added). So, OTS is a perfect example of a non-integrated regulator failing to perceive the big picture, with disastrous results.

We should add that, in outlining the benefits Canada has enjoyed as a result of its integrated, principle-based approach, we do not mean to suggest that simply combining different agencies under one roof will necessarily give rise to some sort of magical gain in efficiency or effectiveness. However, over time, with good leadership, cross training of staff, and other tactics designed to lead to a harmonized organization, the benefits of integrated regulation will almost certainly become apparent.

There are several other important differences between the two systems, not reflected on the charts above. One is that, in Canada, every OSFI-supervised institution is subject to a consistent risk-assessment system. This is not the situation in the United States — a point that also came up in numerous instances in the Levin-Coburn report. As well, most U.S.-based regulators have a much more rule-based approach than is the case in Canada, where principle- based and outcome-based approaches, supplemented with detailed guidance, are the norm. We are also of the view that Canada's standards of corporate governance tend to be higher, with a more stringent duty-of-care provision than exists in most U.S. jurisdictions. However, as we have already noted, quantifying the relevance of any differences in corporate governance and duty of care will require more in-depth research.

Another difference between the two systems is the simple matter of Canada's mandatory review of banking and insurance legislation every five years. As far back as 1929, Benjamin Beckhart, in *The Banking System of Canada*, commented on page 302 regarding the then- required system of decennial revision: "These frequent revisions have been of real advantage in preventing the Act from becoming obsolete, in contrast to the policy followed in the United States, where reform comes not through periodic revisions but through the addition here and there of patch-like provisions which serve more to confuse and complicate the measure."

We have described how, in Canada during the 1980s, there was a series of financial institution insolvencies and high-risk situations, which led to a complete reshaping of the financial regulatory framework. We associate that reshaping and improvements since that time with the current good performance of the Canadian system. However, in the U.S., there was no such regulatory epiphany, with the possible exception of the adoption of the Sarbanes-Oxley Act (SOX) of 2002. However, the SOX requirements apply to all publicly listed companies and are not particularly geared to financial institutions. As well, in keeping with U.S. approaches generally, they are heavily compliance-based, rather than principle-based, so that an already complex system became significantly more complex under the SOX rules.

The AIG Situation

The near-failure of AIG was a critical development in the sub-prime meltdown. It is worth taking a closer look at how this occurred, in the context of the above discussion about the risks inherent when there is fragmented regulation of institutions.

During the most difficult days of the financial crisis, when AIG was known to be on the brink of failure, there was considerable confusion evident in the media about the regulatory agency responsible for this insurer, one of the world's largest. It was well-known within the insurance industry that AIG's insurance operations had historically been subject to regulation by the New York State Insurance Department. However, the identity of the regulator of AIG's parent holding company, if said regulator existed at all, was a question mark for knowledgeable people in both the industry and the financial media. To the surprise of many, it transpired that the holding company was regulated by the Office of Thrift Supervision (OTS). A system is extremely fragmented when seasoned industry executives*77* do not know the identity of the regulatory agency responsible for overseeing one of its largest members.

Why would what was purportedly the world's largest insurance business be subject to regulation by the OTS? The answer is that, after the savings and loan (S&L) crisis of the 1980s, U.S. law was amended to put the OTS in charge of any holding company having an S&L association as one of its members. Somewhere within the vast corporate domain of AIG, there was a small S&L — which, under the law, brought the entire AIG domain within the remit of the OTS. It is pretty clear, especially in hindsight, that the OTS had little or no familiarity with insurance and insurance-like risks and therefore was not in a position to understand the significance of the sophisticated financial instruments being issued by a non- insuring member of the AIG organization. (The OTS had many other issues as well and, largely on the recommendation of the U.S. Senate following the Levin-Coburn report — which recommended "complete OTS dismantling" — the agency has been disbanded and its responsibilities have been absorbed into other regulatory agencies.)

As for the credit default swaps being issued by AIG Financial Products (and other issuers) that were at the root of most of the difficulty, they were like insurance policies but without the traditional insurance requirement that the purchaser must have an insurable interest in the cover being offered. In other words, credit default swaps (CDS) were akin to naked bets on whether particular securities would default or not.

The insurable-interest requirement means that the insured will bear an economic loss should the insured event occur. If individuals could insure against events having no direct bearing on their own economic situations, they could enter into speculative contracts that would encourage them to wish for losses to befall others; not considered to be a socially desirable situation.

Even more relevant, however, is the fact that unlimited numbers of individuals might decide to insure (i.e., "bet") on a particular outcome in which they have no financial or other interest, resulting in an aggregation of risks and possible catastrophic loss to the insurer. And that is exactly what happened to AIG.

One can never know with any certainty "what might have happened if … ", but with regard to AIG, it seems probable to us that if there were an integrated approach to financial regulation, or at least to insurance regulation, the insurance specialists within the regulatory agency would have been looking into the activities of the U.K. subsidiary that was issuing the credit default swaps, would have been aware of the tremendous leverage and associated risk that was involved, would have recognized the dangers in issuing insurance-like products with no insurable-interest requirement, and would have moved to curb AIG's activities in this area.

We feel that as long as there is such a fragmented system of prudential regulation in the U.S., it will be very challenging for the government to establish an effective mechanism for macro-prudential oversight, without which it will be difficult to avoid future risk bubbles.

The System-Wide Perspective

To this point, we have said virtually nothing about system-wide considerations. This is because the evolution of financial regulation in Canada, and other jurisdictions as well, has mostly been about doing whatever can be done to assure the viability of individual institutions. Prior to 1987 and the creation of the OSFI, the idea was generally that if institutions follow the laws and regulations that are applicable to them, that is the best we can do. In the late 1990s and early 2000s, there was much talk at the international level of the need to "ring fence" vulnerable institutions. It now seems naïve to believe that somehow huge financial institutions could simply be shuttled into a kind of financial isolation ward where they would be nursed back to good health without implications for the system as a whole. In historical terms, the realm of system-wide risk and its implications for individual institutions has tended to be more the concern of the professional economist than of the financial regulator or regulatory policymaker.

The sub-prime crisis has illustrated, more dramatically than any previous financial crisis, that simply complying with a series of basic rules and regulations will be no guarantee of survival. When the crisis was at its worst, many international financial markets froze up due to a collapse of confidence within the system as a whole. In such circumstances, institutions could not afford to take the risk of entering into transactions with other institutions because of concerns that their counterparties would be unable to honour their side of the transactions. A number of very large, but thinly capitalized institutions had upcoming transactions that they had every reason to believe would be low risk. But at the height of the crisis, all bets were off, and what would be considered to be uneventful transactions in normal times turned out to be impossible to complete during the crisis. Without the benefit of government bailouts and support of the system overall, the failure of those thinly capitalized institutions would have further damaged confidence, leading to greater paralysis of markets and more widespread failures, and so the cycle would go on to who-knows-what end. These developments highlight the fallacy in merely considering the positions of individual financial institutions when thinking about problems of system stability.

However, Canadian markets performed much better than described above. We have already discussed characteristics of the Canadian financial regulatory system that might have contributed to this result. Since the creation of the OSFI as an integrated regulator, we have had somewhat of a system-wide perspective here in Canada, because *one* regulator is now thinking about risks in different types of institutions. As well, the interactions of the FISC members no doubt help to bring a more systemic perspective to oversight of the financial system. The recent inclusion of Canada Mortgage and Housing Corporation under the OSFI's remit will also help to broaden the OSFI's breadth of perspective in the housing and mortgage arena.

Nevertheless, the fact that there is much to be done on the system-wide front is well illustrated by the sub-prime crisis. It is incredible to think that even with the OSFI as an integrated regulator, and the discussions taking place at the FISC group level, the huge risk bubble that gave rise to the crisis did not get onto the radar screen of the OSFI — or of any other regulatory agency, anywhere in the world.

This points out that every jurisdiction will have to do more, both within its own borders and working with international counterparts, to assess system-wide risks. (It goes without saying that in this globalized financial world, system risk cannot be thought of as falling only within specific geographical borders. It will have to be monitored on an international basis.) In the United States, which was clearly the birthplace of the crisis, the cumulative impact of the wide-ranging incentives designed to encourage home ownership, and the many unforeseen consequences of those incentives, turned out to be hugely greater than was anticipated by the authorities or was recognized by the authorities until after the crisis. If the enormous system- wide distortion that was building up had been more accurately monitored and identified, it might have been possible to defuse the sub-prime crisis before it began. Recent steps by Canada's minister of finance clearly demonstrate how risk levels in the housing and mortgage- lending fields can be tempered by judicious adjustment of mortgage-lending rules and other fine-tuning of system parameters.

Thinking of Canada's successful tradition of working closely with the regulated institutions, we wonder if system-risk awareness could not be significantly improved by having something like a financial-industry-based parallel to the FISC group, which would include senior-level representatives of the banking, securities, insurance and pension businesses in Canada and which would be charged with monitoring system risk in their industries over time. It may be possible to derive industry-specific ratios and other indicators that could provide a quantitative dimension to the committee's discussions. This would be important because the evidence of the financial crisis is clearly that people in the industry, like the regulators, did not recognize the extent to which risk was accumulating in the system. (Our impression is that, from an industry perspective, and particularly in the U.S. market, as long as everyone seemed to be making money, no one had any incentive to look too closely at what might be happening beneath the surface.) The industry committee would meet with the government's FISC on a regular periodic basis to provide input to the latter group's policymaking deliberations. Such a collaborative effort could prove to be beneficial to both government and industry, and of course ultimately it would be hoped, to the public. Ideally, such an industry group in Canada could be paralleled by similar groups in other countries, which could then establish a macro-prudential risk forum at the international level. (At the present time, our observation — which may be incorrect — is that within the international standard-setting bodies we mainly have regulators talking to other regulators, with relatively little input from industry members.)

Too Big To Fail

The "too big to fail" issue is a difficult one. The regulatory framework we have described is designed to avoid institutional failure, and fortunately has mostly been quite successful.

However, each of our five major banks is systemically important in the Canadian context; given the extraordinarily important role that each plays in the Canadian financial system, and the overall economy, each must be regarded as too big to fail. There have been advantages in allowing five huge banks to deliver almost all of our banking services — in terms of regulatory efficacy for example — but at the same time, we have placed ourselves behind the 8-ball in case there were to be a failure. Not only is there the obviously enormous problem of direct damage to the financial system in the event of a failure, there is also an underlying problem of moral hazard — i.e., assuming that each of the major banks is too big to fail, they will be able to operate in a manner that need not fully take account of risk, aware that if trouble arises they will be "saved" by the taxpayers.

Regulatory forbearance, rather than bailout, served the purpose during the Great Depression (see the An Apparent Paradox section of this report on page 26), but it is questionable whether similar tactics could work in today's environment. During the '30s, it was feasible to keep the potential import of the situation somewhat wrapped in a hazy world of imprecise statements and fuzzy documentation. But such would certainly not be possible in the modern, transparent world. Would Canadians be prepared to accept government assurances that "all will be well in time"? Or would there be rioting in the streets with demands that the government take immediate action to "make things right"? Canadians do generally seem to have confidence in their governments, and don't seem prone to rioting in the streets. If the minister of finance and/or the prime minister of whatever party might be in power were to say "we will ride through these problems," it is possible that a majority of Canadians might just be inclined to continue to provide them with political support, partly in recognition of the fact that there may be no viable alternatives.

However, this presupposes that one or more banks are *technically* insolvent but still able to continue to operate, as was the case in the 1930s. In today's world, that would not likely be the situation; during the financial crisis, there was evidence that the entire system was freezing up, which is a different circumstance entirely. So what would the alternatives be in that event?

One alternative is the one that we saw widely applied in the United States during the crisis, through the Troubled Asset Relief Program (TARP), where huge amounts of taxpayer funds were used to recapitalize institutions so that they could continue to operate. However, this type of financing from the public purse always carries the risk that taxpayers will not be paid back for the amounts they have contributed.

Another alternative being discussed at the international level is the "bail-in." This approach would require large institutions to sell special debt securities that, in the event of financial difficulty, would be converted to equity, diluting existing shareholders. The "haircut" would be to the debt holders and to the existing shareholders rather than potentially to the taxpayers. At first glance, this option seems to have considerable merit, but it is not without problems. As pointed out by widely respected finance professor, Avinash Persaud,*78* as financial difficulty increases, bail-in securities would become increasingly high risk and could quickly become a barometer forecasting the onset of serious financial problems. This, in turn, could merely aggravate an emerging financial crisis, spreading the contagion more quickly than would be the case without the bail-in option. As Persaud also points out, there is no free lunch. In good times bail-in bonds would be considered appropriate for long-term investors, such as pension plans, but if times suddenly turn bad, pensioners would, in effect, "be thrown under the bus" in order to bail out other bank stakeholders. Although not meeting the bail-in concept in terms of being *legally required* for large institutions, some Canadian banks and insurance companies make use of "Tier 2" capital in the form of subordinated debt, which is provided for in international standards and which is accepted by the OSFI subject to terms and conditions — one of the most important being that, in liquidation, such debentures are subordinate to the interests of depositors and policyholders, as the case may be. Thus, in liquidation, the holders of the Tier 2 subordinated debt would have the same status as common shareholders, somewhat in keeping with the bail-in concept.

International standard-setting organizations are calling for higher capital levels for systemically important financial institutions, with this additional capital serving in a sense as insurance against failure. Canadian banks are already meeting higher capital standards than their counterparts in other countries. Basically then, we must hope that the financial regulatory framework, including higher capital levels, will serve to prevent the failure of any one of our major institutions. In the meantime, as suggested in the Final Thoughts section of this report found on page 50, we should at least modernize the Winding-up and Restructuring Act so as to provide increased flexibility in the resolution of large financial entities.

The Role of International Financial Regulatory Policies

In different jurisdictions, at different times, there has been an emerging realization that the modern financial network has become sufficiently complex, while its significance to citizens, businesses and whole economies has become so critically important and globally connected, that greater international co-ordination and integration of regulatory practices is a necessity. These emerging concepts found their first supporters in multi-lateral organizations such as the Bank for International Settlements (BIS). Although the BIS was founded in 1930 and played a role in a number of important economic and banking developments in Europe during its early years, it was only after a number of significant financial institution failures in Europe and in the United States (in particular, Franklin National Bank, which at one point in time was the 12th largest bank in the U.S.)*79* that the BIS began to focus on the implications of international banking operations and bank solvency in general.

The Basel Committee on Banking Supervision was established in 1974 and, according to the BIS website, its objective is "to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision."

Other international organizations have established core regulatory principles for insurance (the International Association of Insurance Supervisors, or IAIS) and securities regulation (the International Organization of Security Commissions, or IOSCO), while corresponding standards are now being developed for pensions by the International Organization of Pension Supervisors (IOPS).

Another international organization that is having a very substantial impact on financial institutions, in Canada and other countries, is the International Accounting Standards Board, which is the authority for prescribing International Financial Reporting Standards (IFRS).

There are many good reasons for wanting to standardize financial-reporting requirements across the globe, but at the same time, finding apparent solutions to some problems seems often to lead to new ones in other areas, and always with the possibility of unintended consequences. For example, the "mark to market" rules, among other requirements of IFRS, give rise to difficult issues for institutions such as life insurers and pension funds, which have long-term liabilities.

Some observers have expressed concern about the fact that these international organizations are asserting a form of extra-jurisdictional power by implying that all member countries must fully adopt the standards dictated by the international organizations.

In the financial regulatory area, for example, it is true that the IMF and the World Bank exert pressure on individual jurisdictions to adopt international standards of regulation: as mentioned earlier, these two organizations conduct the Financial Sector Assessment Program to determine the extent to which local regulatory frameworks comply with international standards.

Relatively minor variations from international standards can sometimes result in downgrading of the "report card" for the particular part of the financial sector concerned. The IMF and World Bank strongly encourage governments to improve their FSAP report cards, generally by modifying the laws and regulations so as incorporate the principles of the international standards and then making sure that the new laws are properly and fully implemented.

One can quarrel with the implicit assumption in the FSAP process that international standards are "correct" and that even small deviations therefrom may be considered "incorrect." Conditions are different in different countries and it is almost certainly true that one size does not fit all in the realm of international financial regulation.

At the same time, we believe it is also true to say that international standards in financial regulation have played a tremendously beneficial role in assisting jurisdictions in improving their overall regulatory frameworks. We have personally witnessed the situation in many jurisdictions where there is no formal legal framework for regulation of financial institutions, and no conception of the policies that should be adopted to provide greater financial security to citizens and public confidence in financial systems as a whole. International standards provide a concrete framework towards which countries can aspire or that they can build upon. So while one can question the exercise of quasi-legal powers by these international organizations, and argue about some details in the international standards, we would say that on balance, their existence is very beneficial. If anyone has a better way to proceed in terms of raising the effectiveness of financial regulation in countries around the world, we have not yet seen evidence of it.

The international standards for banking and insurance are detailed and pervasive, covering the baseline conditions for effective regulation, the principles that need to be enshrined in the laws, and the methodologies that should be adopted by agencies in their supervision of the financial institutions. As well, they are now being augmented with additional material on capital standards, too-big-to-fail/systemically important institutions and macro-prudential regulation.

We should specifically comment on the role Canada has played in the development of international regulatory standards. This country's directions in modern financial regulation long pre-date the development of international standards by the various international agencies just referred to. For example, we can say with certainty that, in the late 1970s and early 1980s the Department of Insurance was beginning to implement processes that would now be identified as precursors to "risk-based supervision," i.e., developing different risk indicators and focusing regulatory attention on entities where research indicated there was a higher probability of failure. By the early 1990s, the OSFI was well into its process of developing a regulatory framework based on risk assessment, guiding principles and high standards of corporate governance, the latter recognizing that boards of directors and senior managers are ultimately responsible and accountable for overseeing their institutions' operations and properly mitigating the risks they take on. Of course, these measures were less sophisticated than is currently the case, but the adoption of the new approaches marked the critically important first steps.

As a designer and early adopter of these new regulatory approaches, the OSFI has played a lead role in the development of international standards. Senior OSFI officials have frequently held high-level positions in the international standard-setting organizations for banking and insurance, and the secretariats of these organizations almost always include OSFI officers who have been seconded to the international entities.

Final Thoughts

Thinking about what might be done to improve the Canadian system, and having in mind the tremendous emphasis on the role of the board of directors, one has to admit that boards of directors and senior managers are not superhuman. They already have many responsibilities and more are being added all the time. Perhaps it is time to consider strengthening the board structure for our largest institutions. Looked at through the lens of history, it seems that board structures have not changed much over the past 30 or 40 years. However, since 1992, the responsibilities of boards at financial institutions have exploded. In the Canadian and British Insurance Companies Act of the 1970s, "corporate governance" essentially dealt with the procedures for the calling of shareholder meetings, appointment of the auditor and other prosaic responsibilities. The whole gamut of important board responsibilities we have described, were absent.

One possible change would be for boards to have some permanent, independent directors working full time on behalf of the entire board. This would not be the same as having a group of institutional employees assigned to do research on issues raised by the board. Full-time, independent directors would be bound by the duty-of-care and other directorial responsibilities and would have to maintain an impartial perspective in addressing the issues of interest. As with the rest of the board members, their objective would not be to oppose management, but rather to provide directors with additional assurance with regard to management recommendations. For example, in modern-day banks it is not unusual for directors on credit committees to be faced with lengthy submissions from management with regard to proposed loans and other transactions. At present, although directors will almost always conscientiously review all the material they are asked to review, in most cases they do not have unlimited time available. As a double check, we think it would be beneficial to have a more focused review by full-time directors who would then be able to provide increased confidence that any contentious issues or other matters for debate, are fully aired with all members of the committee or the board.

It might also be helpful for the law to place a specific responsibility on institutional boards (for institutions over a certain size) to engage independent, external professional advisers when they are required to consider complex or particularly technical issues. Of course, any institution is currently free to retain whatever advisers it wishes to employ, and no doubt some institutions do that. However, our impression, gained over the years, is that boards are sometimes hesitant to consult with outside advisers, other than with respect to particular transactions, such as mergers and acquisitions. Generally speaking, we think directors may feel that they are on the board because of their extensive experience and that therefore they should be able to provide required input, without running up the additional cost of outside advisers. We think this bias would be countered if there were a specific legal requirement along the lines that "the board has a responsibility to seek input from independent professional advisers when there is an issue for which the majority of the board members believe that such outside advice could be beneficial to the institution and its clients." Most board members would probably prefer to err on the side of caution, and therefore if the situation were such that outside professional advice *might* be beneficial, it would be sought. We think this would encourage boards to assess issues in the most effective and unbiased manner possible.

Another area that we believe could represent a public-policy improvement, would be to require not only that every board have a significant proportion of independent directors, but to also require that those directors have at least a certain minimum level of knowledge about the business in question, including the fundamental principles and key risk variables with respect to the financial business concerned, as well an understanding of the legal/regulatory framework within which the institution must operate. At the present time, although independent directors will almost always have achieved considerable success in their main field of interest — otherwise they would not be invited to join the board — their prominence is sometimes in areas that are not related to the operations of financial institutions. This diverse experience likely serves the institutions well by bringing new perspectives to the consideration of important issues facing the institution. However, the other side of the coin is that without knowledge or experience regarding financial institution operations, there may be occasions when they are not in a position to fully participate in board discussions. This could dilute the benefits that were anticipated by policymakers when mandating the need for boards to include independent directors.

Some "director training courses" currently exist of course, but there is no consistent requirement that independent directors partake of such courses, nor are they — to the best of our knowledge — focused on providing core information about particular industries such as banking or insurance. (There would probably have to be separate programs for banking and insurance because the details of the business are different. On the other hand, it wouldn't hurt for bank directors to know something about insurance and vice versa.) Based on our experience in providing these types of training courses to independent directors of insurance companies (in foreign jurisdictions), we would say that, at most, one week should be sufficient to provide a rudimentary but practical understanding of the fundamentals of the particular financial business and its regulation. We might add that the feedback from directors about these programs was uniformly positive.

Many independent directors do have extensive, directly relevant experience, in which case institution-specific training would not be required. It might be satisfactory for the law to make boards themselves responsible for determining in particular cases, whether they think newly appointed independent board members should participate in a training program, or not. Except in cases where the background of the individual obviously makes such training unnecessary, we expect that, in most cases, the board, and the directors concerned, would decide in favour of the training.

In terms of the regulatory regime more generally, we hope that Canada will not become overly reliant on the use of models for determination of such basic operational parameters as minimum acceptable capital levels. This is a trend that seems to be gaining favour in a number of international jurisdictions. Models are undoubtedly useful tools but the data used for input can never be entirely representative of the real universe of possibilities. We also wonder how many regulatory agencies, including in Canada, will be able to accurately assess the models to understand any potential shortcomings. As well, the models say nothing about the potential surprises that may lurk in the tail-values of distributions. As the financial crisis demonstrated, those uncharted scenarios can be so extraordinary as to completely dwarf what were considered to be the more likely possibilities. Many of the razor-thin capital margins that were accepted by regulators in other countries were accepted on the strength of model predictions that purported to show capital levels would be sufficient at a 99.5 per cent level of confidence. Models are a one-way street: no institution will submit a model for regulatory approval that demonstrates that it requires a *higher* level of capital, only the opposite.

One area where we think the Canadian system could be improved is in the area of resolution. The relevant statute for winding up a bank or insurance company is the Winding-up and Restructuring Act (WURA). Fortunately, the need for its application has been infrequent, but the statute is more than 100 years old. Although it has been subject to minor amendments over the years, it does not contemplate the liquidation of a huge, modern institution such as one of Canada's major chartered banks, with their myriad types of financial instruments, off-balance-sheet items, global interconnectedness and so on. Nor does it provide flexibility with regard to possible restructuring of debt or other innovative means by which a modern-day liquidator, with the approval of the Superintendent of Financial Institutions and the court, might find to be desirable in terms of reducing the burden of loss that would otherwise fall too heavily on depositors or taxpayers. Legislation (with the exception of Canada's requirement for five-year reviews of financial legislation) is often only amended after some sort of disaster shows that amendment is required. But if one of Canada's large banks ever got into financial difficulty, it would be too late to consider amending the WURA to facilitate what would need to be done.

The time to act is before there is an urgent need to apply the provisions of the act.

In thinking about possible future financial crises, we should mention a field of scholarly research having to do with so-called "normal accidents."*80* The theory of normal accidents holds that there are some situations where, over time, a catastrophic accident is inevitable. This is because some processes are so incredibly complex that if they become out of control, which they inevitably will, then there are an almost infinite number of directions the process can take, with the possibility of completely unpredictable feedback loops and other random developments, so that no effective form of intervention will be possible in the short term. The most frequently cited examples involve out-of-control nuclear reactors, such as we recently saw with the Fukushima Daiichi nuclear disaster in Japan after the 2011 earthquake and tsunami.

There is plenty of evidence that the international financial system is incredibly complex, and given the fact that there are no "on/off" buttons or other direct controls on the system, some have argued that the system constitutes one that is vulnerable to normal accidents. However, unlike the case with nuclear reactors, the financial system is ultimately controlled by individuals who, with an appropriate level of international co-ordination, are in a position to quickly change their operational practices. The great difficulty is that, in the heat of the moment, there is usually no consensus as to what should be done. Nevertheless, there is the *potential* for effective action, which in our view, distinguishes the financial system from the normal-accident-type situation. This reinforces the view that international agreements and co- ordinating practices need to be given much greater attention than has been the case in the past, so that when a global crisis threatens international financial stability, pre-determined game plans can quickly be put into practice.

Conclusion

The Canadian financial regulatory system has indeed undergone dramatic changes over the years. During the early period, there was an implicit assumption that the calibre of individuals involved with the operation of financial institutions was such that detailed requirements and standards were not really necessary. As well, there was a certain amount of naivete with respect to what might occur, for example, in the area of related-party transactions. As the world evolved, it became clear that a much more comprehensive framework was required. That was ultimately accomplished primarily by two main initiatives: the creation of the OSFI in 1987 and the adoption of the new federal financial institution statutes in 1992.

The financial crisis has evoked a storm of discussion regarding the potential need for more regulation, for less regulation, for different types of regulation or a different regulatory focus. It is no doubt the case that every financial crisis sparks a somewhat similar debate, but the fact remains that financial crises continue to occur. However, with globalization and the vast increase in magnitude of the financial sector relative to world GDP,[81] financial crises are no longer of primary interest to bankers, regulators and wealthy members of society. The current crisis has wreaked havoc on property owners in many countries around the world, on middle- aged individuals whose life savings have been slashed, on retiring members of defined- contribution pension plans, and on businesses and many of their former employees.

Given the present state of the art, it seems to us that if it were to be applied in many jurisdictions, the OSFI approach would represent the current best bet for avoiding international financial disasters.

And in fact, this point of view is gaining acceptance with many countries — especially emerging market countries, which have not previously implemented a cohesive system of financial regulation — using the Canadian framework as a template, modified as necessary to take account of local circumstances. The OSFI frequently hosts delegations from regulatory agencies in other countries who are seeking to observe the Canadian system first hand. The government of Canada and a number of international sponsors, including the Swedish International Development Cooperation Agency, the World Bank and IMF, also support such development through the Toronto Centre, a non-profit organization established in 1998 in the aftermath of the Asian Financial Crisis. The Toronto Centre has an objective "to promote financial stability and access to financial services globally by building the capacity of financial sector regulators and supervisors, particularly in emerging markets and low income countries to help improve their agencies' crisis preparedness and to promote change that will lead to more sound and inclusive financial systems." The centre uses the best supervisory methodologies from Canada and other jurisdictions, but adapted to local capacities, cultures and circumstances. Because of its evident success, the Canadian approach is also receiving more attention from international organizations and regulatory agencies in general. Some developed countries, such as Australia — which also demonstrated good experience during the financial crisis — already have a system in place that is quite similar to Canada's, and in fact Canada and Australia have conferred on the development of a number of regulatory policies.

The Canadian framework is comprehensive, is principle-based, is consistent across the financial institution playing field, is focused on risk, and is administered on an integrated basis. It minimizes prescriptive rule-making; benefits from, but does not rely on, internal models that will never reliably predict what will happen in the tail of the distribution; and does not, by implication, suggest that regulatory agencies know better what is good for institutions than do the institutions themselves. The result of all this is to provide Canada with a regulatory framework that, arguably, is one of the most effective in existence. However, in the aftermath of the financial crisis there are still many new approaches being debated, some of which may ultimately further improve the world's ability to understand and effectively oversee its financial system.

While, as discussed earlier, other factors have likely also played a role, our view is that the regulatory system has been substantially responsible for Canada's better-than-average performance over the course of the recent financial crisis and that it currently provides a reasonable balance between stability and market efficiency.

Notes:

1. Report from the Commission of Inquiry into the Collapse of the Canadian Commercial Bank (CCB) and the Northland Bank (Estey Inquiry), 1986, Appendix A, 349.
2. Bank of Montreal website, http://www.bmo.com/home/about/banking/corporate-information/history.
3. 12 Vic, chap 168.
4. Estey Inquiry Report, Appendix A, 351.
5. Benjamin Beckhart, The Banking System of Canada (New York: Henry Holt and Company, 1929), 301.
6. Ibid.
7. Estimated, based on the Bank of Canada's inflation calculator, which covers the 99 years between 1914 and today, and assuming that the 3.1 per cent average rate of inflation over that period can be extended back an additional 43 years to 1871.
8. Double liability was adopted by the U.S. Congress as part of the National Bank Act of 1863.
9. Beckhart, The Banking System, 482.
10. For more information on the subject of double liability, see: Benjamin C. Esty, "The Impact of Contingent Liability on Commercial Bank Risk Taking," Graduate School of Business Administration, Harvard University, Journal of Financial Economics 47 (1998). Using U.S. data from 1900 to 1915, Esty demonstrates that "banks subject to stricter liability rules have lower equity and asset volatility, hold a lower proportion of risky assets, and are less likely to increase their investment in risky assets when their net worth declines, consistent with the hypothesis that stricter liability discourages commercial bank risk taking."
11. Beckhart, The Banking System, 301.

12. Report from the Royal Commission on Banking and Currency in Canada (The MacMillan Commission), 1933, paragraphs 30 to 32.
13. Beckhart, The Banking System, 303.
14. Estimated, based on the Bank of Canada's inflation calculator, which covers the 99 years between 1914 and today, and assuming that the 3.1 per cent average rate of inflation over that period can be extended back an additional 24 years to 1890.
15. The information in this paragraph was graciously supplied by the Canadian Bankers Association.
16. For further details, see: Crawford and Falconbridge on Banking and Bills of Exchange, Eighth Edition (1986).
17. The MacMillan Commission, paragraph 38.
18. Beckhart, The Banking System, 308.
19. Ibid.
20. Ibid., 442.
21. Ibid.
22. Canadian Life and Health Insurance Association, "Canada's Life and Health Insurance Industry: The Regulatory Environment," submission to the Task Force on the Future of the Canadian Financial Services Sector (1997), 2-9.
23. Ibid., 2-10.
24. Ibid., page 2-11.
25. Estey Inquiry Report, Appendix A, page 352.
26. Bank of Canada Inflation Calculator.
27. Byron Lew and Alan J. Richardson, "Institutional Responses to Bank Failure: A Comparative Case Study of the Home Bank (1923) and Canadian Commercial Bank (1985) Failures," Critical Perspectives on Accounting 3 (1992): 163-183.
28. Ibid., 171.
29. Beckhart, The Banking System, 481.
30. Lew and Richardson, "Institutional Responses," 172.
31. Beckhart, The Banking System, 321.
32. Report of the MacMillan Royal Commission on Banking and Currency, Volume II, 61.
33. Ibid., 62.
34. Ibid., Chapter VIII, paragraph 293.
35. Perhaps we receive a hint of the Canadian irritation — which may have been widespread at the time — in being regarded as a colonial possession, when the dissenting Beaudry Leman of Montreal commenced his minority report with the somewhat sarcastic remarks: "It will undoubtedly be considered presumptuous that I should express opinions at variance with with those of my colleagues, and particularly of the emminent and experienced gentlemen from Great Britain, who have been requested to study our Canadian financial problems and to advise the Dominion government in regard to their solution."
36. Estey Inquiry, Appendix A, 364.
37. Ibid.
38. Report from the Royal Commission on Banking and Currency in Canada (1933), paragraph 42.
39. Estey inquiry, Appendix A, 364.
40. Lew and Richardson, "Institutional Responses," 94, 99.
41. Report of the Royal Commission on Banking and Finance (Porter Commission).
42. Commenting on the decline in the number of banks up until 1929, the publication date of The Banking System of Canada, Beckhart reports (page 325): "The tendency toward fewer and larger banks has been perhaps the outstanding characteristic of the banking structure of Canada within recent years. Not that the disappearance of banking institutions is a condition peculiar to the Dominion, for the same condition has manifested itself also in other countries." And in a footnote on page 328, in relation to the trend of consolidation, he points out: "It might be noted that such a condition leads inevitably into a kind of government guarantee of banking. The Canadian government could not allow any of the larger banks to fail for such would be most disastrous to the entire economic structure of the country."
43. Estey Inquiry, Appendix A, 364.
44. Porter Commission, Volume 1, Table 6-3, 107.
45. Ibid.
46. Ibid.
47. Ibid., Volume 4, 564.
48. Porter Commission, Volume 1, 8.
49. The Department of Insurance and the Office of the Inspector General of Banks were merged in 1987 to form the Office of the Superintendent of Financial Institutions (OSFI).
50. Ron Suskind, Confidence Men: Wall Street, Washington and the Education of a President (New York: Harper Collins, 2011): 288.
51. Property and Casualty Insurance Compensation Corporation website at www.pacicc.com. The companies were: Strathcona General Insurance, Pitts Insurance, Cardinal Insurance, Northern Union Insurance, Canadian Great Lakes Surety, Mennonite Mutual Hail Insurance and Northumberland Insurance.
52. Estey Inquiry Report, Volume 1, 2.
53. Ibid., 10.
54. Ibid., 17.
55. Charles Proctor, The Law and Practice of International Banking (Oxford: Oxford University Press, 2010), paragraph 1.04.
56. Personal recollection by author.
57. Estey Inquiry Report, 45.
58. Lew and Richardson, "Institutional Responses," 173.
59. Green Paper: "The Regulation of Canadian Financial Institutions: Proposals for Discussion," 11.
60. Points are taken from the Executive Summary of The Final Report of the Working Committee on the Canada Deposit Insurance Corporation (the Wyman Report).
61. Lawrence Kryzanowski and Gordon S. Roberts, "Capital Forbearance: Depression-era Experience of Life Insurance Companies," Canadian Journal of Administrative Sciences (March 1998).
62. Lawrence Kryzanowski and Gordon S. Roberts, "Canadian Banking Solvency, 1922-1940," Journal of Money, Credit and Banking 25, 3 (August 1993): Part 1, 361-376.
63. Ibid.
64. Standard & Poor's, A Tale Of Two Countries: U.S. And Canadian Banks' Contrasting Profitability Dynamics, Report, November 13, 2012.
65. Personal observation by the author, who has carried out regulatory projects in many countries around the world.
66. V. V. Murray and C. J. McMillan, "Business Government Relations in Canada — a Conceptual Map," Canadian Public Administration (1983): 592.
67. Information in this paragraph largely extracted from: Charles Freedman, "The Canadian Banking System." Conference on Developments in the Financial System: National and International Perspectives, The Jerome Levy Economics Institute of Bard College, April 1997.

68. OSFI web site at http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/Pages/default.aspx.
69. Office of the Auditor General of Canada, 2010 Fall Report to the Parliament of Canada, "Chapter 5: Office of the Superintendent of Financial Institutions."
70. See, for example: Andrew Coyne, "Our So-called Genius Banks," Maclean's (April 2009).
71. David T. Llewellyn, "Financial Regulation: A Perspective from the United Kingdom," Journal of Financial Services Research (2000): 311.
72. James K. Jackson, Financial Market Supervision: Canada's Perspective, Congressional Research Service, Report for Congress 7-5700, April 2013.
73. This diagram, published as part of the U.S. Congress report, shows the minister of finance reporting directly to the Parliament of Canada. To be more precise, the minister reports to the cabinet, chaired by the prime minister and consisting of the ministers of the Crown. Government policy decisions are made at the cabinet level and the minister of finance would be in frequent consultation with the prime minister and, from time to time, the cabinet as a whole. According to the government of Canada's website, the Doctrine of Ministerial Responsibility can be stated briefly as follows: "ministers are broadly accountable to the Prime Minister and the House of Commons [i.e. Parliament], on behalf of the people, for their exercise of the responsibilities assigned to them when they are appointed, including the powers and duties provided by Parliament through legislation."
74. Jackson, Financial Market.
75. See, for example: David Zaring, "It's Time to Rethink Insurance Regulation" The New York Times "Dealbook" blog, January 22, 2014, http://dealbook.nytimes.com/2014/01/22/it-is-time-to-rethink-insurance-regulation/?_php=true&_type=blogs&goback=%2Egde_890207_member_5832476394906484736&_r=0#%21.
76. United States Senate, Permanent Committee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, 5.
77. Even some state insurance regulators were unaware that the OTS was the legal supervisor of AIG. This came up at an international conference in the fall of 2008, attended by the author, when panelists, including some U.S. state insurance commissioners, were not aware of the OTS role in overseeing AIG.
78. Avinash Persaud, "Bail-ins are no better than fool's gold," The Financial Times, December 10, 2013.
79. Joan E. Spero, The Failure of Franklin National Bank: Challenge to the International Banking System (New York: Beardbooks, 1999), 11.
80. There are two classic references on this subject. One is Normal Accidents: Living with High-Risk Technologies, by Yale University professor Charles Perrow, published in 1984. The other is The Limits of Safety: Organizations, Accidents, and Nuclear Weapons, by Stanford University professor Scott D. Sagan, published in 1993.
81. By 2006, total market capitalization of world stock markets, plus the total value of domestic and international bonds, equalled 2.4 times the world's total GDP. Niall Ferguson, The Ascent of Money (New York: Penguin, 2008), 5.

PUBLIC WORKS PROGRAMMES IN SOUTH AFRICA: EXPERIENCE AND THE PROBLEM OF THEIR LIMITED USE

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Abstract

South Africa is experiencing high (and possibly rising) levels of unemployment and poverty despite government efforts to reduce them. Public works programme (PWPs) is one of the strategies used by the government to tackle unemployment and poverty. The aim of this paper is to provide a survey of alternative specifications, or design options, which may be adopted --with some illustrations from cross country experience and some evidence about the comparative desirability of some of the options. And to shed some light on the South African experience in recent years with PWPs. The interesting question here will be what prospects there are for a successful expansion of the scale on which they are run and why these prospects are not better than they appear to be.

Key Words: Public Works, Unemployment Rates, Government Policy

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Introduction

Despite allegations that employment has been rising, there is undeniable evidence that South African unemployment and poverty are very high by international standards. The unemployment rate using a broad definition is sitting at 40% while poverty is somewhere between 40% to 46%. Different strategies (i.e. GEAR and New Growth Path) have been used in tackling these problem. More recently, the South African government has placed a lot of emphasis on a Public Works Programme. For example, in 2004 the government introduced the Extended Public Works Programme. The focus of this paper will be on PWPs. It is consoling that South African government is doing something about poverty and unemployment, but is it doing enough? Put it another way, is the scale and impact of PWPs at comparable levels with those of successful schemes elsewhere. If not, why? Can the success of these other schemes be attributed to the economic structure and political framework within which they are organized? What are the prospects for the use of PWP in South Africa? This paper will attempt to pursue the above questions and other related issues.

Public works programmes (PWPs) are worth investigating because there is evidence that they have had some success. Lipton (1998:73) writes: “Third World experience with public works to reduce poverty via employment income is quite hopeful”, but he follows this with the warning: “However, care is needed” In the discussion that follows an attempt will be made to explain the two sides to Lipton’s judgment. Initially (in section 1) public works programmes will be described in general terms. In the following Section 2, some terms will be defined which are necessary for stating (and measuring) the effectiveness of public works programme. There will then (in Section 3) be a survey of alternative specifications, or design options, which may be adopted --with some illustrations from cross country experience and some evidence about the comparative desirability of some of the options. In Section 4 the discussion will shift to South African experience in recent years with PWPs. The interesting question here will be what prospects there are for a successful expansion of the scale on which they are run and why these prospects are not better than they appear to be.

1. Public Works Programmes: Their character and objectives

What are PWPs? They have employment creation as their immediate target. Public funds are used to pay volunteer workers (from the unemployment pool, or perhaps from those not at present in the labour force) a relatively low wage to work on (usually) infrastructure -- creation projects in areas where unemployment or low labour force participation, or both are concentrated. This description is repeated with one additional feature in McCord’s statement (2002): “The primary purpose of PWP is poverty alleviation through labour absorption, and this is frequently achieved through the creation of public assets using labour intensive methods”. Examples of the type of “works”, or projects, frequently undertaken may be inferred from the statement that the Employment Guarantee Scheme (EGS) in Maharashtra State in India is multi-sectoral with "the main sectors…irrigation, agriculture and soil conservation, forestry and rural roads". (Joshi and Moore, 2000:35).

2. The effectiveness of a PWP: Some conceptual issues

Given its objectives, we say that the effectiveness of a PWP depends on the benefits (direct and indirect) it confers on the poor, on the costs of participation it requires, or imposes, and on the way it is financed. We take notice of the direct/indirect benefit distinction but do not make much of it because little seems to have been done to measure the indirect benefits. They consist of multiplier effects and capital effects (Lipton, 1998:75-6). The former are the employment and labour income due to spending out of the incomes created by the PWP. The latter are net extra incomes earned from employment in using and maintaining new assets or skills created by the programme. Below we shall note that the direct or indirect distinction also applies to costs.

We now concentrate on direct benefits and introduce a distinction between two types –transfer benefits and stabilization benefits. Both types derive from the receipt of wage income from work. Transfer benefits refer to the increase in income which is earned from the employment created by the scheme. Stabilization benefits are received if the timing of the work and income provided is such as to offset (to some extent at least) the anticipated and or unanticipated declines in local non-scheme economic activity, or increases in spending needs. Such income offsets stabilize incomes over time and make possible consumption - smoothing--without the need for such emergency adjustments as "distress selling of productive assets in bad agricultural years" (Subbarao, 1997:3). The transfer benefits perform a distribution function, and the stabilization (or risk) benefits have an insurance function. In some environments, presumably where the poor face particularly severe risks, "the risk benefits … can be as important as the transfer benefits to the poor" (Subbarao, 1997:3). By emphasizing the insurance function of PWPs we are reminded that in developed economies, the use of PWPs in the twentieth century was closely associated with counter-cyclical policy aimed at stabilizing employment (and incomes) over the business cycle.

We now turn to examine the possible costs that individual poor and (in some sense) unemployed persons incur in pursuit of the benefits the PWP provides. We may distinguish between (1) participation costs, such as the cost of transport to the project site, extra food-intake, possibly payments (bribes) to obtain access and (2) foregone earnings in cases where some participating in the project would (in the absence of the project) undertake less desirable or lower-paid work, or work on own account on small farms or craft enterprises etc. Using the distinction introduced above we might say that participation costs are direct and foregone earnings indirect. The latter in some contexts may be substantial: 20-30% of direct benefits (Lipton, (1998:76), in discussion of the Employment Guarantee Schemes (EGS).)

An obvious question that arises at this stage is whether anything useful and general can be said about the determinants of these benefit and cost variables. Particularly on the benefit side there are some factors that can be identified, and it seems worth listing them here so that we can be on the lookout for them later when considering cross-country evidence and South African experiences and prospects. For the individual participant the transfer benefits will approximate to (1) the programme wage multiplied by (2) the duration of work performed. Net transfer benefits will of course be less than these since we would expect participation costs and foregone earnings to be non-zero. (It has been argued that in some contexts where the impact of the programme on the local labour market will be to raise the market wage, the net transfer benefits may be higher then the programme wage. We ignore this possibility here).

For the programme (or more narrowly, the project) as a whole the transfer benefits will be obtained by aggregating the benefits of individual participants. The results will depend on (3) the scale on which the programme is operated, measured by the number of persons, or person-hours, employed per reference period. Alternatively, if we measure scale by total monetary expenditure on the programme, for a given wage the transfer benefits will vary directly with expenditure and (4) the share of wages in total expenditure – which in turn is related to technical and organizational features which determine the shares of material input costs and management costs.

Individual and aggregate stabilization benefits will be related to (5) the timing of the programme and (6) whether, and to what extent, employment on the programme is rationed, or whether it is readily available either because of excess supply or legal guarantee. There are some further factors influencing benefits and costs which Subbarao (1997:3) refers to as (7) "design features". He appears to be referring to "the institutional framework and the type of implementing agencies (e.g. line-ministries of the government, private contractors, non-governmental agencies or a combination of the above"). His point is that for a given expenditure, share of wages, wage-rate, duration, timing and availability/rationing there will be a maximum potential net benefit (of both types) which might accrue to the poor / unemployed. However, the design / institutional framework details may have an effect on the benefits the programme in fact transfers. On the one hand, benefits may be reduced in the presence of leakages (payments to officials, contractors or politicians; or avoidable participation / transactions costs). On the other hand, design features may be such as to benefit particularly vulnerable groups: "payment of wages in-kind or piece-wage payment may attract more women than men to worksites" (Subbarao, 1997:4).

The previous paragraph referred to benefits accruing from the programme to "the poor/unemployed." What guarantees that the beneficiaries of a PWP are in fact from this category (or categories)? Clearly if the PWP is (to some extent) transferring workers from existing jobs to more attractive jobs (wage, conditions, location etc.), and failing to meet the needs of the chronically poor (aged, disabled, sick, malnourished) its effectiveness will be less than it appears to be. This brief discussion introduces a further determinant of net benefits viz (8) targeting: the extent to which the actual beneficiaries are the intended beneficiaries.

At the beginning of this section (2) we listed benefits, costs and financing as determinants of the effectiveness of a PWP. So far we have considered benefits and costs. We now turn to financing. The discussion will be brief – for lack of discussion in the literature or of available quantitative evidence.

Of the aggregate net benefits accruing to the participants of PWP it is always in principle necessary to ask the question: What alternative uses were there for the resources used to finance the programme? If employment creation is entirely aid-financed, it is possible to regard the benefits as straight-forward and not subject to opportunity–cost deductions at the indirect economy-wide level. If however the PWP is financed from domestically generated tax revenues then the question of alternative uses does arise. Subbarao (1997:3) pursues this issue by asking two questions: a) Would the participants have received greater benefits from some alternative expenditure of budgetary resources? b) Has the PWP expanded at the expense of other activities which produce "non-labour income for the poor" (e.g. educational or hospital services)?

It is not entirely clear what the difference is between these two questions. Assuming that (b) is relatively self-explanatory, we focus on (a). Some comments of Dasgupta (1993:535) may shed light on the meaning of Subbarao's question. "Public works", says Dasgupta", can be (and often have been) a potent route to the prevention of hunger and destitution, but they retard growth in net national product if the investments are unproductive. And all too often they have not been productive: the projects have been ill-conceived and badly managed, yielding little….This is a constant problem in poor countries". From the point of view of the aggregate economy, slower growth of NNP is a clear loss or cost. From the point of view of the poor / unemployed (and those who would wish to prioritize their needs) slower growth of NNP may amount to little less, depending on the poor's marginal share in NNP growth and the labour-absorptive character of growth.

However, this theoretical discussion does not help very much at this stage. After raising these questions, Subbarao complains: "Rarely does one find empirical evidence on either issue" (1997:3). And so we leave them at this point.

3. Programme and design features: available options, cross-country experience, and the conditions for PWP success

As indicated in the previous section, planners and managers of PWPs need to make choices between alternatives. Do they set the programme wage-rate below, equal to or above the market wage for similar work? Do they attempt to target their job-offers at the poor? If they do, how should the targeting take place i.e. how should the selection of workers be made so as to ensure a large proportion is drawn from the poor? Can PWPs be organized so as to involve a substantial share of the labour force? What of duration? What of training during the year, or between years and so on? This is not a complete list, but it illustrates the sorts of features to be discussed below.

Two further introductory points (to this section 3) need to be made. (1) The survey of alternative ways of designing and managing PWPs that will be undertaken here is not intended to be seriously comprehensive. For instance, Lipton (1998) presents a 30-page discussion of 13 rules for "success in reducing poverty … through employment": To follow him through all of this detail would make this paper far too long and disturb its balance.

(2) Much written on public works relates to economic environments rather different from that to be encountered in South Africa. The largest PWPs are to be found in India and Bangladesh where levels of "open unemployment" are lower than our 30% to 40%. Also they possess rural sectors which may accurately be described as based on peasant agriculture. The absence of such a small-scale agriculture which has market linkages but is imperfectly integrated into the market economy is in fact thought to be a major contributing factor to the high levels of "open unemployment" recorded in South Africa. It is possible then that a certain amount of the analysis and discussion of optimal anti-poverty PWP design in the literature may not apply fully in the South African case. And to decide for certain whether it is, or is not, relevant is particularly difficult at this early stage of experimentation with PWPs in present day South Africa. We shall come back to aspects of this matter in section 4.

3.1 Scale

Is there evidence which suggests that PWPs can be, and have been operated on a scale sufficient to involve a substantial proportion of the labour force and so reduce aggregate unemployment and poverty significantly? Evidence is clearer in answer to the first question than the second. We present it schematically for South America and Africa (1980s and 1990s); and employ a separate table for Asia (mainly India).

Table 1. Public works programme in South America and Africa

Country	Date	Employment (person; worker-days)	%Labour Force	Effects
Bolivia	Mid-1987	30 000 workers	3%	Average earnings raised by 45%
Chile	1976		6%	
	1983		13%	
Honduras	1990-1993		5%	20% cut in open unemployment
Costa Rica	1991-1994	8,9m. person-days		
Cape Verde	1983		30%	Checks mortality in face of prolonged drought
Botswana	1985-1986	74000 workers (3m. person – days)	20%-25%	Also relief in drought context
Ghana	1988-1991		0,5%	
Kenya	1992-1993	1m.person-days annually	0,5%-0,6%	

Source: compiled from Subbarao 1997 and Lipton 1998

Table2. Public works programmes in Asia

Country	Date	Employment (person; worker-days)	%Labour Force	Other scale indicators	Effects
Philippines	1990		0,3%		
Maharashtra State (India) employment Guarantee Scheme(EGS)	1975-76 to present	1975/76 to1997/98: average annual workdays - 132m. Peak:190m.(1986)		1986 peak: 15% State budget; 10-About 20% 132m. State govt capital spending budget	Reduces rural unemployment by 10-35%. In survey villages about 50% participants' wage employment from EGS (20—35% of total income)
India National Employment Programme (NREP)	1980-1989	320/370m. person-days per year			
JRY (includes expanded NREP etc)	1989/90 to 1992/93	830m. Person – days per year			
"Intensified JRY"	1993-1994	>1b.persondays			
All major employment schemes in India (including EGS)	Mid 1990s(still expanding)	2.2m. "fulltime equivalent working years"	Well below the 2% rural workforce		(Not all additional employment)

Source: compiled from Subbarao 1997 and Lipton 1998

Unfortunately the data presented above in tables 1 and 2 is not uniform and information is not complete in several cases. The effects of PWPs on poverty- and unemployment reduction are by and large not available. But at least it is clear that work-creation has been achieved in various countries on a large scale-- although even there problems arise in assessment. India in the mid-to-late-1990s was annually creating about 2.2 million working years but this was equivalent to less than 2% of their rural workforce; On the other hand in Cape Verde and Botswana in the 1980s the effects of drought were combated by creating public works employment for 20% to 30% of their labour forces –but in absolute numbers the jobs created were few (74 000 in Botswana and these do not seem to have been full-time equivalents; measuring in FTES reduces employment created to less than 3.3% of the labour force, so that the proportionate scale contrast with India disappears).

It would be interesting to know more about why the scale of PWP activity has varied across countries to the extent it has. {Subbarao (1997: 5) does not take things very far when he says, "Depending upon historical circumstances and source of financing, scale of operation varied across countries"}. Presumably there is a "demand" side to this (or supply of poor and underemployed would be workers), a "supply" side related to political will and available financing and possibly technical factors such as the backlog of infrastructure, population density and so on. It would be particularly interesting to know more about the Botswana case – given its proximity to South Africa.

What can be concluded from tables 1 and 2 is that at least in some cases it has been possible to reduce unemployment and poverty significantly (see final column in the tables); and that at least in Maharashtra State in India substantial fiscal resources have been employed in the E.G.S. (15% of the state budget at the peak). On the basis of much the same evidence as we have set out here Lipton (1998:77) concludes (1) that India's public works schemes since the early 1980s " represent a significant success in poverty reduction" ; and (2) that "on scale, several works schemes, in a wide range of developing countries, have created very many workdays since about 1980. There has been great improvement on the dismal earlier record (World Bank 1976). This is mainly because schemes are much better pre-planned, reducing real cost (especially non-wage cost) per job and per unit of real assets created."

3.2 Wage and Targeting

If state (or other) agencies concerned with the incidence of poverty and employment in the population , use public funds to design programmes of relief which offer attractive employment on public works (with good wages and conditions) what will ensure that the relief reaches those whose poverty is severe and those without employment? If the employment is attractive enough what is to prevent some of those with social and economic status and capacity from acquiring a significant share of the employment and income on offer? These questions raise the issue of targeting.

An apparently simple answer to these questions is to say: "you determine who are the poor are, and how poor they are, and you establish who are unemployed." Allocation of jobs is then made to those applicants who are in these categories. If there is a need for rationing, perhaps depth or severity of household poverty can serve as the ultimate criterion. Such procedures would constitute what is known as direct targeting.

There are however major difficulties to be encountered if one proceeds in their way .First, the informational requirements are huge and there are incentives for people to provide inaccurate information. Secondly, using proxies to reduce the informational requirements (such as landlessness as a proxy for poverty) involves the risk of considerable imprecision -- more so, of course, in some rural contexts than in others. Thirdly, such direct targeting often in practice puts power into the hands of managers, officials and politicians and this makes leakages (bribes or taxes of one or another sort) more likely.

It is in this context that the argument for indirect targeting becomes more compelling. The trick is to set wages (and possibly working conditions) at a level such that the poor will self select -- and more well-favored inhabitants of the project areas will drop out of the pool of applicants. A straight forward version of this approach would be to set the programme (project) wage below or at about the level of the market wage for similar, usually unskilled work. If there is a minimum- wage applicable to the sort of work undertaken in the programme, the wage setting issue becomes more complicated. As Subbarao says (1997: 5) "political and legal constraints may make it difficult to maintain the programme level at levels less than the minimum wage" -- assuming that for there to be some point to a minimum wage it must be set above the market wage ; though of course over time , if it left unadjusted , it may fall below the market level.

There is a further serious limitation to self-selection by the poor when the wage is set at (or below) the prevailing market wage for unskilled work. For certain groups among the poor whom it may be wished especially to target – women in general the ill and the weak, and those with major child-care obligations – manipulation of the wage alone will not ensure participation. Programme design may help – such as availability of transport, crèches, payment by task (piece-rates) and other devices to make work hours flexible.

In addition to this limitation to what the wage can do to ensure desired indirect targeting, Lipton insists that wage effects are complex (1998:83-6). For one thing, transfer benefits are lower with a lower wage -- an obvious point not yet stressed. Secondly it is obviously not sensible to lower the wage without limit. At a very low wage only the weakest and least competent may be attracted. Thirdly if programme resources allow it, setting the wage slightly above contemporary market levels may pull up private wage rates -- a good secondary outcome for the very poor.

A final point to be made about the appropriate level at which the programme wage is to be set, concerns conditions under which self-selection by the poor (thus removing the need for rationing) does not take place. The relevant conditions exist when unemployment and poverty levels are severe and the scale of PWPs is small. McCord quotes Devereaux to this effect in Zambia: "self-targeting in Zambia s cash for work programe was undermined by the massive scale of rural poverty (estimated at 86%)."As we shall see in the next section (4) this seems to apply also in the South African case. This is not an argument for not setting the wage at or below the prevailing wage rate, but a recognition of the need under conditions of mass unemployment for additional interventions (involving presumably some type of more direct targeting).

3.3 Duration and timing of employment

If PWPs are composed mainly of short-term projects each lasting for only a few months their main effect may be "only to churn the unemployed , replacing one cohort of the unemployed with another in short term employment projects removing them temporarily from the pool of unemployed labour, rather than addressing either the underlying problem of unemployment or having a significant or sustained impact on the livelihoods of participants…. In this context prolonged public works schemes are needed that will offer sustained employment". This statement by McCord (2003:28-29 draws attention forcefully to the importance of the duration of PWPs.

Exactly how to formulate the point she is making is not as easy as it might seem, however. Suppose that a substantial part of unemployment in a particular region of some economy is seasonal. Surely 3-6 months projects in such a context, provided their timing within the year is synchronized with the agricultural slack season, will confer valuable stabilization benefits. What does prolonged or sustained mean in this context? Presumably that these relatively short term projects are available for an uninterrupted sequence of years. Presumably availability must have some spatial dimension as well, but we are unable to probe these details any further now.

3.4 Other programme and design features

In section 2 some further design features (including the share of wage costs in total on expenditure) were referred to as determining the effectiveness of PWPS as means of the transfer of benefits to the poor and unemployed. It would be possible to continue this section 3, accumulating information on these further features as they have appeared, or failed to appear, in cross-country experience. But this survey of experience has already become somewhat over-extended, and it is necessary to turn at this point to a consideration of the use of, and prospects for, PWPs in South Africa.

4. PWPs in the South African case: Experience and prospects

This investigation will require (1) some assessment of the experience with relatively small scale public works that has accumulated locally in recent years, and (2) a consideration of the cost (and hence likehood) of public works programmes being launched here – with the appropriate features and on the scale required if a significant impact is to be made on the high levels of poverty and unemployment in South Africa.

4.1 Experience

It is perhaps worth noting that public works were employed in South Africa during the 1920s and 1930s as part of the response to the so-called "Poor White" problem – which was produced by a combination of short- and long-term factors. Interestingly, expenditures on such projects reached close to 16% of the total State budget at their peak (McCord, 2003: 17).

An interest in public works programmes in South Africa began to re-emerge during the last quarter of the 20th century as the rate of growth of GDP declined in the 1970s and 1980s and overall income per capita began to decline. The Second Carnegie inquiry into Poverty and Development convened in 1984 (the first had focused on the poor white problem). More than 200 papers were presented many of them dealing with aspects of poverty in Southern Africa and they included a study by Norman Reynolds attempting to apply the experience of the Maharashtra Employment Guarantee Scheme (MEGS) to the South African realities.(Reynolds,1984). Extensive further research was undertaken by Abedian and Standish (1989).

In the early 1990s negotiations took place between organized labour, the construction industry and government over issues arising from the use of labour intensive construction methods. These generated a temporary Framework Agreement, the principles of which later became part of the Code of

Good Practice for Special Public Work Programme formally gazette later in 2002 after further negotiations. After a substantial investigation into the feasibility of labour intensive PWPs they were included in the Reconstruction and Development Programme under the name “National Public Works Programme” (NPWP) as a critical element of job creation efforts (Phillips, 2004:3).

a) National Publics Works Programme

According to Phillips (ibid) the NPWP had two strategy thrusts. The first was a community based public works programme (CBPWP). Initially funds were allocated to community based organizations (CBOs) to undertake projects, but once democratic local government elections have been held, municipalities received the funds and became responsible for organizing the projects. The second strategic thrust of the NPWP was an attempt to reorient mainstream public infrastructure projects towards the use of more labour intensive techniques. Unfortunately reports Phillips (2004: 3), the “NPWPs goal of achieving a major reorientation of public expenditure was not realized.” We shall make some kind of return to this issue when discussing prospects for the future including the currently planned Extended PWP which includes a renewed attempt at increasing the labour intensity of techniques across a broad front.

(b) Community Based Public Works Programme

As implied above this was the main programme used in the 1990s and first years of the new century for job creation with public funds. It was certainly not the only programme of this kind. There was a range of others under the Special Public Works Programme – some of which were environmental PWPs such as Working for water- but these other programmes are “ considerably smaller” than CBPWP, apart from Working for Water. Some provinces and municipalities have also launched their own programmes and we will note some of them later.

What was the scale of CBPWP? What success did it have with job creation? Phillips (2004:3) says as its peak it was allocated roughly R350m p.a. and it created approximately 130 000 work opportunities between 1998 and 2004. McCord (2003:10-13) provides somewhat more detail. After discussing problems of measurement (What is a “job” in terms of days worked? It is often not clear in data what is being assumed) she compares the days of work created with unemployment also measured in days for the period 1996/97 to 2001/2 (6 years). Her results are that:

- work days created as % of total official (narrow) unemployment range between 0,24% and a maximum of 0,48%; and .
- workdays created as % of total broad unemployment range between 0,11% and a maximum of 0,27%.

“This suggests that the scale of job creation over this period been negligible in terms of the magnitude of current employment and does not offers a significant response to the problem of mass unemployment”, (McCord, 2003:13). A “significant” response offered by way of illustration is MEGS. In the 1980s and 1990s job creation was greater than 100m workdays per year which constitute 10-30% of total unemployed workdays in the state of Maharashtra. (see Table 2).

(c) 2 provincially-initiated infrastructure PWPs

As noted above there are and have been, programmes additional to CBPWP although by and large their scale has been small. Phillips writes, despite this, of their “rich diversity and innovativeness” (2004:4) and produces 2 examples viz. the Gundo Lashu Programe in Limpopo and the Zibambele programme in KwaZulu Natal.

Gundo Lashu

This was initiated by Limpopo provincial government in 2001. It is concerned with road upgrading and construction. 24 aspirant small contractors (each with 2 higher-level supervisors) were chosen in an open competitive process and sent for a 3 year full- time training programme in labour intensive construction-run in Lesotho by the Minister of Works Labour Construction Unit training school. The intention is for them to compete on the open market for “tenders specifying the use of labour intensive construction methods” (2004:4). Contractors move from project to project with their supervisory staff -- employing 60-100 local workers on a task-based payment system (on average for about 4 months per upgrading project).

Zibambele

This was initiated by the KZN Department of Transport in 2000. Its objectives are to carry out routine maintenance on province’s “rural access roads and provide poor rural households which have no other source of income with regular income” (2004:5). The programme is based on the ‘length person’ contract system. In return for 8 days of work a month spent carrying out maintenance work to an agreed standard on an agreed length of roads, households receive a transfer of R334 per month. Each household is a contractor, and so no employer-employee relationships exist. This gives freedom from some of the constraints involved in the agreement with organized labour. The continuous nature of routine road maintenance makes it possible to create longer term work opportunities. In 2002/3 there were 10 000 contractors (working on approximately 1/3 of the rural access road network). Plans were to increase them to 14 000 by the end of 2002/3 financial year and ultimately to a maximum of 40 000 poor households.

(d) Targeting in South African PWPs.

It is clear from the above that within the first ten years of experience under the new political regime in S.A., the scale on which public works have been operated has been small -- certainly small in relation to reported levels of unemployment and poverty. At the same time there has been a certain amount of innovativeness in the field.

Is there evidence that expenditure on PWPs has at least been reaching the poor and creating employment for the unemployed? In so far as programmes are producing infrastructure are they siting it in areas with severe infrastructural deficits, or not? It appears that there are no straightforward answers to such questions, because at this stage of things South African monitoring is lagging behind programme development. Early national evaluations carried out in 1996 and 1997 are said to "find little evidence that the neediest within communities are being targeted" (Adato and Haddad, 2002). The authors just cited themselves carried out a study of 101 public works projects run by seven programmes in the Western Cape Province and which were initiated and completed between 1993 and 1997. Socio-economic and infrastructural information was also gathered on a magisterial district basis for this part of the country. One conclusion of their study was that "Between districts, the 101 public works are not well-targeted in terms of poverty, unemployment, and infrastructure" (Adato and Haddad, 2002:31). Some districts with very high poverty and unemployment had no labour-intensive public works projects, and some districts with low poverty rates had several.

As regards targeting within districts and within communities "jobs went to the poor and unemployed, though not always the poorest, and did well in reaching women despite local gender bias. Targeting guidelines of the state are mediated by diverse and sometimes conflicting priorities that emerge in programmes with multiple objectives, by local perception of need and entitlement, and by competing voices within civil society" (Ibid:1).

In brief explanation of this judgment it is possible to point to some of the following factors: Adato and Haddad take the view that the "multiple objectives" of PWPs in South Africa are "without precedent elsewhere in the world" (p4). In particular, the stress on "trainings and on "community capacity building" imply probable trade-offs with simple job-creation for the poor. The very poor may not have the basic training or skills necessary for training of the kind that will fit then for the labour market and which is supposedly on offer as an integral part of programme employment. The community emphasis (present in the very name of the main programme) led in contexts they studied to considerable involvement by CBOs not only in setting up the projects but in the selection (directly targeting) of participants. Frequently the view was taken that the leadership of the CBOs (and their families) deserved employment. Moreover equality of opportunity was often given high priority, and achieved by using a random selection procedure.

The use of the wage rate -- set at, or below, local unskilled market rates --as a device for promoting self – selection by the poorest was beset with obstacles. (i) Given the small scale of most projects and programmes and given the high estimated levels of unemployment and poverty (though lower for the Western cape than for S.A. as whole), there appears to be excess demand for jobs on typical projects even at below-market wage-rates -- requiring rationing. (ii) The authors report that 78% of projects studied set wages below market wage levels but since selection of participants was made by "the community" the wage-level presumably promoted wider coverage rather than targeting on the poor. Anyhow, it seems also to have been the case that setting below-market-level wage-rates faced opposition. Many of the Western Cape projects were in relatively urban areas and comparisons with formal sector wages were easily made. "Often workers accept the offered public works wage, but later strike for higher wages. Many of the projects in our study started at a low wage, but wages were raised at a later point". (Ibid:32). (iii) There were a few cases where wages were lowered--given an understanding of the benefits from the project and/ or of the connection between the wage and increased coverage.

(e) Other design features in S.A. PWPs

In section 3 we noted some design and programme features of PWPs, which would be most pro-poor and produce most effective programmes. In this section (4), where we are examining South African experience, we have so far considered scale and targeting on the poor--but have not written much about duration, timing, ways of reducing participation costs, the share of non-wage costs in programme expenditures and so on. In fact since overall survey-based information is not readily available on these matters, we shall not attempt to tackle them here. We wish to point in passing however to admirable work done by McCord (2002). She includes a case study of Zibambele and is able both to report comparative figures for cost per job and cost per rand transferred, and also to say something (based on interviews with participants) about how benefits are perceived by them. The micro section of her joint work with van Seventer (2004) contain similar report on the Gundu Lashu programme. We turn now to the future and consider what role PWPs may have, and perhaps ought to have, in the struggle against poverty and unemployment in this country.

4.2 Prospects for the use of PWPs in S.A.

Government is now committed to an Expanded Public Works Programme (EPWP). The President referred to it in his State of the Nation speeches in both 2003 and 2004. On the latter occasion he announced that the programme was planned to create "one million work opportunities in its first five years". (Phillips, 2004:7) In the next subsection we shall look at the Expanded Public Works Programme in a little more detail and consider what contribution it may be expected to make to poverty- and unemployment—reduction given its project scale and on the other hand the scale of the problems it is aimed at.

4.2.1 The Expanded Public Works Programme

This account will depend on a presentation by Sean Phillips, Chief Operations Officer, National Department of Public Works (Phillips, 2004:1-14). Despite the importance of such matters in practice it will try to avoid discussion of administrative detail.

(i) The EPWP is a broad framework in order to allow for the diversity of existing programmes and provide flexibility for future expansion.

(ii) It is a "programme of the whole of government-- it is not just a Public Works Department programme". It aims "to utilize public sector budgets to alleviate unemployment by creating temporary productive employment opportunities coupled with training". As indicated by the underlined phrase, a switch is being made from financing poverty relief through a special fund to funding it through the normal budgeting process. In addition Departments should only undertake poverty relief programmes in their "core functional areas". Thus funds for the CBPWP which were originally allocated to the DPW have been reallocated to the Department of Provincial and Local Government for transmission to the municipalities as part of their Municipal Infracture Grant allocations. So the EPWP is funded "by earmarking funds on the budgets of line-function departments, provinces and municipalities".

(iii) The following sectors have been identified as likely to be able to create EPWP employment opportunities

- Infrastructure (increasing labour intensity of government funded infrastructure projects)
- Environment (public environmental improvement programmes)
- Social (public social programmes- e.g home-based care, and early childhood development)
- Economic ("e.g. income generating projects and programmes to utilize government expenditure on goods and services to provide the work experience component of small enterprise learnership/ incubation programmes").

(iv) Scale: R15 billion of the conditional infrastructure grants going to provinces and municipalities over the next 5 years will be earmarked for the EPWP. Similarly R4 billion for environmental EPWP programmes over the same period, and at least R600 million to social sector EPWP programmes i.e approximately R20 billion in total. Approximately one million work opportunities--perhaps (given the varying durations) equivalent to about 500 000 person-years of employment (or an average of 100 000 person-years per year)

(v) Phillips stresses that "The EPWP is not a solution to the unemployment problem….. The employment creation which will result from the EPWP is small in comparison to the scale of the unemployment problem". (Ibid:13). The averaged figure for annual employment creation over the first five years just reported above was 100 000 person years, whereas in 2003 4.6 million people were unemployed in terms of the strict definition and 8.3 million in terms of the broad definition.

(vi) Phillips calculates that if EPWP is to reduce unemployment by 30%, it would need to create at least 8 million person-years of employment over its first five years (apparently using the strict definition of unemployment). If funds were allocated to sectors in the same proportion as currently planned, and if capacity constraints were not a problem, such a scale would require expenditure of R 64 billion per annum.

(vii) Figures in the same kind of range are estimated by McCord, 2003:22. She puts the cost of a 30% reduction of the official measure of unemployment by creating 3,2million part-time jobs at between R16.8 billion and R 28.0 billion per year (using 2002/3 wage levels). 3,2 m full-time jobs would cost in the range of R37 billion to R61.60 billion- the upper bound of which range is close to Phillips's figure of R64 billion, but would produce double the reduction in official unemployment levels (66%). (It does not seem profitable here to dig more deeply into the probable costs of PWP schemes operated on a scale large enough to reduce unemployment by 30% or more).

(viii) What we can say is that these costs would constitute a substantial share of the total government budget in recent years. On McCord's estimates, for the 3,2m full-time jobs annually costs would constitute 11-18% of the total 2003/4 government budget. If costs are scaled by comparing them with the anticipated total Social Security and Welfare budget allocation of approximately R46 billion in 2004/5, it emerges that the whole of that budget allocation in its entirely would be absorbed by PWP expenditures. Noting this fact and also that the sum involved is of a similar order to the estimated net cost of a universal basic income grant, McCord (2003:22) writes of fears about “ the potentially negative fiscal shock” that would result.

4.2.2 Institutional constraints to Large Scale Employment Creation using PWPs.

In addition to doubts about the “fiscal feasibility” of PWPs on a required scale to reduce unemployment by say 30%, there are obstacles in the way of large scale versions of such programmes which are caused by “institutional constraints”. McCord (2003:22-25) lists and explains three such constraints as follows: (i) Limitations of Institutional capacity and project management skills at government and community levels. What these problems amount to is the “lack of a strategic or programme approach to public works, which results in a multiplicity of individual project-based interventions”. The proliferation of small projects is inefficient because it.

- intensifies the shortage of management skills; and
- makes identification of appropriate projects difficult in the absence of an overall coherent programme, and so makes spending of allocated funds difficult.

Under these circumstances employment--creation per unit of expenditure is lower than is in principle feasible, and this is reinforced by the short time-scales of many (small) projects- which involve high set-up costs but terminate before the benefits of optimal scale (linked to duration) are reached.

(ii) Lack of credible incentives for provincial ministries to use labour-incentives techniques. McCord’s discussion of this hinges on the choice of techniques private sector companies are likely to make when tendering for projects financed by provincial ministries. At the time of writing (2003) her view was that there was a considerable “degree of skepticism…within the civil engineering sector regarding labour-intensity”. Despite evidence produced by McCutcheon and others about the competitiveness in cost terms of labour-intensive methods, many figures in the industry regarded conventional methods as cheaper and less arduous for workers. Moreover a common view has been that road construction (say) should be expected to contribute to employment-creation through the use of the roads (once constructed) rather than through the processes of construction. Furthermore, labour intensification was thought likely to involve “the incorporation of a social development agenda into the construction work plan”- and thus to lead to increased management complexity, delays and costs. This being the case, substantial and credible incentives would have to be developed to swing the industry round (at least to some extent) to the desired methods.

(iii) Lack of skills and experience in labour-intensive construction within the industry. Presumably this lack is at least part of the reason for the views about labour-intensity reported in the previous paragraph. The view of McCutcheon and Taylor Parkins (2003) about the competitiveness of labour intensive method depends critically on “training in labour intensive construction…at all levels of management, from consultants to contractors…”, site supervisors and community liaison staff’ The current lack of people trained in this way was, and is, a major obstacle to the rapid expansion of PWPs.

4.2.3 Reducing institutional constraints to PWP expansion

Since these constraints seem plausible--and serious--it is encouraging that the discussion by Phillips (2004) of the Extended P.W.P provides evidence that these constraints have been noted and that efforts are being made to relax them.

In the first place, the limits on the capacity to manage, co-ordinate and sustain programmes over time are being addressed by removing PWPs from the status of special add-on activities-with their own special funding--and making them the responsibility of line-ministries, provinces and municipalities which receive funding in the normal way. Some part of this funding will be earmarked for PWP activity. There will be a sector-coordinating Department for each of the 4 sectors involved and the Department of Public Works (which co-ordinates the infrastructure sector with an EPWP unit with 15 professional positions) will be responsible for overall co-ordination.

In the second place, the problem of anti-labour-intensive bias is being confronted by the introduction of conditions imposed on the use of earmarked funds received via the Provincial Infrastructure Grant (PIG) and the Municipal Infrastructure Grant (MIG). These conditions are specified in the 2004 Division of Revenue Act (DORA) which requires provinces and municipalities “to execute all low-volume roads, storm water drains, and trenching work (funded through PIG and MIG) in a labour-intensive way, in accordance with guidelines produced by DPW, and approved by SALGA and National Treasury :”(Phillips, 2004:11)

Finally, the absence of experience and training in the use of labour – intensive methods is being addressed in various ways. The DPW is providing special training for provincial and municipal officials on the use of the guideline. The guidelines require that only contractors and consulting engineers may be appointed to undertake these projects who undergo training in “the design, supervision and management of labour intensive works”- in line with standards and skills programmes put in place by the Construction SETA.

Also, a “labour intensive contractor and supervisor learnership programme” has been launched by the DPW and the Construction SETA- with the intention of expanding the use of the approach adopted in the Gundo Lashu programme to other provinces. Over 1000 learnerships had been applied for by October 2004.

4.3 PWPs in South Africa: a preliminary summing up

It seems clear that PWPs have a contribution to make to the reduction of unemployment and poverty in South Africa. However- contrary to what one might initially imagine-the contribution is unlikely to be immediate and, even in the long-run, it is doubtful that it will amount to a major reduction in unemployment. (Less can be said about the poverty impact). During the next 5 years the EPWP is intended to create half a million person years of employment (over against annual unemployment rates of between 4.6 million and 8.3 million). Correctly Phillips refers to this as a “modest” contribution. Even this however will require R4 billion worth of expenditure per annum-ten times bigger than the CBPWP at its peak. And to make a 30% cut in unemployment (8 million person-years created) would require R64 billion per annum, sixteen times the current planned annual expenditures. Such a scale of operation is not fiscally feasible at present, nor does the institutional capacity exist to make an effective job of so large and complex an undertaking. That of course is not a reason for abandoning PWPs, but perhaps a reason for building programmes and capacity steadily and (if possible) in an innovative manner. As Phillips (2004:14): writes “The immediate challenge is to ensure that the programme’s current targets are met. Once the programme is established and is shown to be economically effective, then motivations can be made for increased funding levels to take the programme to a larger scale.

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INVESTIGATING THE RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND BANKS' FINANCIAL PERFORMANCE: EGYPT CASE

Amr Youssef*, Mohamed Bayoumi**

Abstract

In the last few decades, policy makers around the world have focused on corporate governance reform since the Asian financial crisis and scandals in the United States such as the Enron debacle. In addition, there is no doubt that banks have significant position in the welfare of any economy. Corporate governance involves in how banks' businesses and affairs are governed by its board of directors that raises a fundamental question of how this could affect banks' financial performance. The focus of this research is to investigate the relationships between some of the corporate governance variables that are related to the board of directors on the financial performance of these banks working in the Egyptian market. Thirteen banks that are listed in the Egyptian Stock Exchange were selected with data collected for the period from 2011 till 2013 which is the post Egyptian revolution era. Research analyses adopted in this study are descriptive, correlation and regression analyses to test the research hypotheses. Findings of this research provide evidence that some of these variables such as board independence, foreign board members ratio, women board members ratio and board educational ratio have significant effect on the financial performance of these banks; however, board size and CEO qualities do not have any significant effect on banks' performance. The research reaches some implications that are important to different stakeholders on practical and academic levels.

Key Words: Corporate Governance, Performance Measurement, Agency Theory, Conventional Banks, Developing Countries, Egypt

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1. Introduction

In the 20th century the management was the focus, however; corporate governance is the focal point for the 21st century (Tricker, 2012). The term corporate governance drives from an analogy between the governance of corporations and the government of nations (Becht *et al.*, 2002). The word governance is ancient and it comes from the Greek word steering (Carrol and Bucholtz, 2009). However, the phrase corporate governance is young. Recent corporate governance scandals make the corporate governance field receives a lot of attention from all interest groups and an increase in media coverage which turned terms like transparency, governance failure and weak board of directors as house hold phrases (Tirole, 2006).

From the banking industry perspective, corporate governance involves the manner in which how the banks' businesses and affairs are governed by its board of directors and its senior management. The board of directors is elected by the shareholders as the decision making body of the bank which has as one of its responsibilities to formulate bank loan strategy (Sumner and Webb, 2005). And since the higher cost of capital will hurt the overall economic development, so the governance of banks is different from unregulated non-financial companies for several reasons, for one is that the number of parties with a stake complicate the governance of banks, in addition to investors, depositors and regulators have a direct interest in banks performance. One more reason is that regulators are more concerned with the effect that governance has on the performance of banks because the health of the overall economy depends upon banks performance (Adams and Mehran, 2003).

The international financial landscape is changing rapidly; acquisitions and mergers wave has changed the banking industry shape. All things changed in that new global banking industry except for one thing remains unchanged which is the need to have a strong banking system with good corporate governance practices which will help any bank to survive in that increasingly open environment (Kaheeru, 2001). Banking supervision functions are affected if the corporate governance system reliability

ASSESSMENT OF ENVIRONMENTAL MANAGEMENT ACCOUNTING AT SOUTH AFRICAN UNIVERSITIES: CASE OF TSHWANE UNIVERSITY OF TECHNOLOGY

Cosmas M Ambe*, Queen Ntombikayise Ambe**, Ganda Fortune***

Abstract

The overall objective of the paper is to assess the application of environmental management accounting (EMA) at Tshwane University of Technology (TUT) as a service organization and examine how the institution manages, account and report environmental cost. Data was collected by means of exploratory and explanatory research techniques using two data sets; documentary and fourteen in-depth individual face-to-face interviews employing a semi-structured questionnaire with closed and open ended questions to collect primary data. The results indicate that; the implementation of EMA and general governance for environmental responsibility and accountability is extremely weak. The potential use of EMA is neglected and, as such, EMA implementation is not considered a priority. Three barriers to the adoption of EMA within TUT were identified as: institutional pressures, a low profile of accounting for the environment, and management's attitudes. A general ledger model and action plan for the implementation of EMA at TUT utilizing the use of activity based costing has been suggested.

Key Words: Environmental Management Accounting; Environmental Costs; Environmental Impacts; Activity-Based Costing; Service Organization

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1. Introduction

Despite growing concern of environmental issues including climate change and greenhouse gas emissions as demonstrated in a number of global conventions such as the recently concluded climate change conference in Lima Peru in December 2014, little attention has been paid to how the service sector impacts the environment and how related environmental costs are accounted for. Conversely, there is a general lack of consideration given to environmental impacts, environmental responsibility, accountability, environmental costs and potential cost savings within university settings (Clarke and Kouri 2009; Gray, 2010). Moreover, a review of available literature indicates that, there is little attention given to how the service sector impacts the environment and how environmental related cost is accounted for, despite the dominance of this sector in the world economy over the past decade (Creighton, 1998; Parker, 2000; Chang and Deegan, 2006; Deegan and Soltys, 2007). Therefore, there is lack of consideration given to environmental impacts, costs and potential costs savings within a university setting (Chang and Deegan, 2006; Clarke and Kouri 2009; Gray, 2010). Blair and Hitchcook (2001) assert that;

"Every activity that occupies a building uses energy in heating, lighting and equipment. Service industry contribute to pollution through the travel of their employees and clients, produce waste from canteens, consume water and materials and almost certainly produce large volumes of paper waste. Every service activity has some environmental impact, however slight".

It is generally perceived that environmental pressures or opportunities for the service sector are less observable or less important than other sectors, such as mining or manufacturing. Nevertheless, the fact that the impact is less obvious does not mean that they do not exist. The growing importance of the service sector implies the accompanying level of resources consumed will have significant environmental implications. Relevant environmental cost also have financial impact on the service sector and hence universities (Chang and Deegan, 2006; Evangelinos, Jones and Panoriou, 2009; Gray, 2010).

Based on the above background, ***Environmental Management Accounting is defined as -*** the management of environmental and economic performance through the development and implementation of appropriate environment-related accounting systems and practices. While this may include reporting and auditing in some companies, environmental management accounting typically involves life-cycle costing, full cost accounting, benefits assessment, and strategic planning for environmental management (IFAC, 2005; Jasch, 2001; Lohmann, 2009).

The need for environmental management accounting (EMA) was conceived in recognition of some of the limitations of conventional management accounting approaches for management activities and decisions involving significant environmental costs and/or significant environmental consequences/impacts. For example, the following conventional management accounting practices might contribute to the inadequate consideration of environmental costs in internal decision-making:

- The unintentional "hiding" of many environmental costs in overhead accounts
- Inaccurate allocation of environmental costs from overhead accounts back to processes, products, and process lines;
- Inaccurate characterization of environmental costs as "fixed" when they may actually be variable (or vice-versa);
- Inaccurate accounting for volumes (and thus costs) of wasted raw materials, and
- The actual lack of inclusion of relevant and significant environmental costs in the accounting records at all (Jasch, 2001; IFAC, 2005; Schaltergger and Burritt 2009).

Furthermore, non- accounting related reasons for EMA include:

- Increasing pressure from stakeholders interested in environmental issues;
- Growing demand for integrated consideration of financial and physical aspects of environmental management;
- The concepts of sustainable development and corporate social responsibility require a combined consideration of financial, environmental and social aspects and;
- Increasing importance of environment-related costs (IFAC, 2005).

The overall objective of this paper is to assess the application of environmental management accounting at Tshwane University of Technology. This will be achieved by investigating the environmental impacts associated with the operations of Tshwane University of Technology as a service organization and examines how the institution manages, account and report environmental cost. The specific objectives of the study include:

- To investigate governance for environmental responsibility and accountability within TUT.
- To examine how environmental impacts, cost and savings are accounted for within the University;
- To determine the factors facilitating/ inhibiting change needed in the management accounting system of TUT to implement environmental management accounting (EMA).

The paper will be structured as follows: Section two that follows will present the theoretical framework of the paper and section three discuss the methodology utilized for the study. Section four will present the findings and discussions and finally in section five the paper will be concluded and recommendations for further study presented.

2. Theoretical Framework

The role of management accounting in improving both environmental and financial performance through enhanced accountability is attracting increased recognition. However, universities have typically failed to be the focus of attention, generally, because of a mistaken belief that they generate only insignificant environmental impacts (Chang and Deegan, 2008). Contrary to the lack of significance to environmental impacts by universities as attributed above, there has been a number of international initiatives promoting the consideration of environmental issues by universities. To this regard, over 600 universities worldwide have committed themselves towards sustainability by signing international agreements and convention such as the Bologna Charter, The Halifax Declaration, the Talloires Declaration and the Copernicus Charter for Sustainable Development (signed to date by over 240 European universities).

Conversely, many universities in South Africa have shown interest on environmental issues including Rhodes University, University of KwaZulu Natal and the University of Cape Town whose environmental policy statement and objectives. Different environmental management approaches have been adopted as environmental accountability attracts increasing attention within universities especially in North America, Europe and Australasia. For example, a number of universities have embarked on initiatives to increase energy efficiency and reduce wastes (e.g. Bekessy et al. 2002; Forum for the Future 2004; NWF 2004; Uhl and Anderson 2001), conducted environmental audits (e.g. Creighton 1998; Delakowitz and Hoffmann 2000; Uhl et al. 1996), provided sustainability reporting (e.g. HEEPI 2007; Towns and Cocklin 2006), and gone all the way to ISO14001 certification (e.g. Arvidsson 2004; NWF 2004; Simkins and Nolan 2004). Guides and best-practices are currently available and documented (for examples, see C2E2 2003; EAUC 2007).

Various environmental management initiatives are undertaken but a gap seems to exist between the commitment and the outcome. It is argued that at universities in both North America and Europe most of the environmental initiatives undertaken are patchy and strategic planning for environmental management is still lacking (Dahle and Neumayer 2001; Herremans and Allwright 2000). A survey conducted by Carpenter and Meehan (2002) also points out that "environmental management cannot be considered a mainstream business activity" within Australian universities. Environmental management has found its way into universities as an approach towards sustainability but progress to move universities along the continuum of sustainability seems slow. Studies show that the majority of university staff who are deeply involved with environmental sustainability issues are from either the natural sciences or environmental engineering disciplines (Filho and Carpenter 2006).

2.1. Accounting for Environmental Cost

Gray and Bebbington (2001) argue that "without a 'greener accounting' many environmental initiatives will simply not get off the ground." Unfortunately, the potential contributions that accounting can make have not gained much attention and accountants are not as widely involved in the environmental agenda as they could and should be within universities as will be further explained on accounting for environmental cost that follows.

There is growing evidence internationally on the application of Environmental Management Accounting in organizations and by applying Environmental Management Accounting methodology, some organization have been able to track close to 20% of total annual operating costs not currently recognised as environmental costs and could realise the large imbedded savings potential and revenue gains. Managing and avoiding environmental costs requires recognizing that these costs exist, ensuring that the costs are recognized by the parties responsible, and provides incentives to reduce these costs (Conway–Schempf, 2003). According to van Heeren (2001) (citing Bennet and James 1997) there is an increase potential for environmental – related management accounting to make a substantial contribution to both business success and sustainable development.

The dominance of the service sector in the world economy has grown in the past decades, and according to Chun–chang and Deegan (2006) literature reviewed brings to light that little attention has been paid to how the service sector impacts the environment and how related environmental costs are encountered for. It is generally perceived that sustainability pressures and opportunities for the service sector are less observable and less important than other sectors in the economy. For the fact that the impact is less obvious does not mean that they do not exist (Chun–chang and Deegan 2006). Chun–chang and Deegan (2006) state that, "a review of available research shows there is a general lack of consideration given to environmental costs and potential cost savings within university settings.

In Australia, a comprehensive survey of all 38 universities was conducted in 2002 to determine the current progress towards sustainability within Australian universities. The results returned that 47% of the universities have an environmental management system in use and 69% of the universities have energy reduction programmes in place; however, only 32% of these universities believed that their programmes are quite or 'very' effective (Chun-Chang and Deegan 2006) (citing Bekessy et al. 2002). Environmental Management Accounting enables universities to focus on hidden environmental cost drivers and potentially manage cost savings. Estimating the environmental impacts of universities demands taking stock of the diverse materials 'consumed' in the process of campus operations. "Previous efforts stressed conducting campus audits as a means of impact estimation. However, such simple measures neglect the impacts both 'upstream' and 'downstream' that are associated with these resources. Taking a life cycle approach to material flows provides a better understanding of environmental impacts, enabling campus decision makers to conceptualize better how their decisions translate into the 'ecological footprint' of the campus" (Eflin, 2005).

In the United States, alone, there exist over 4,000 colleges and universities that represent an important sector of the nation's economy. As in any sector, each institution has inputs and outputs of materials, energy, information, and people, and each has pronounced environmental impacts – which may or may not reflect those of their surrounding communities or the nation at large. It is apparent that universities use a considerable amount of papers, electricity, oil, natural gas, water and chemicals and may be the largest user in the community in the region where the university is located (Creighton 1998). To date, however, few universities have completely understood what their major environmental impact is, or have tried to reduce the impact and taken the opportunities to save resources and money. If relevant environmental costs were unknown, actions would be taken to manage the costs. Implementing EMA within universities, relevant environmental costs necessarily need to be made available.

To date some universities have started to monitor their environmental impact. For example the United States, Pennsylvania State University has issued a comprehensive report on one of its major buildings about how the building environmental impact could be significantly reduced with detailed knowledge of physical environmental costs and cost saving data presented as well. Another example is the University of Florida, who is the first university in the world to disclose social, ecological and financial metrics according to the international guideline developed by Global reporting Initiative (GRI) (Newport and Chesnes 2001). The literature reviewed clearly pointed out that these universities related project or cases typically involve people within environmental management functions rather than those within accounting functions. Further, environmental information, if any, provided by those studies tends to be aggregated. Without further breakdown, the aggregated information is of less use in improving environmental performance. Without accountants' involvement, further breakdown of the aggregated environmental information also seems problematic.

In the business world, accounting is not the most obvious place to start when seeking to manage environmental impact. This holds true for universities as well. However (Gray and Bebbington 2001) argue that "without a 'greener accounting' many environmental initiatives will simply not get off the ground". Their argument might provide a possible avenue towards addressing the ineffectiveness of environmental management programmes within Universities. Problems with environmental related costs being accumulated or 'lumped in' with overheads are well documented, such as in (Ditz, Ranganathan and Banks, 1995) for manufacturing industries (Deegan, 2002) for service industries. It is evident that managing environment will remain a difficult challenge for universities if environmental costs are unknown and effectively hidden from management decisions. From an accounting perspective, external sustainability reporting and environmental auditing have received some attention for discharging environmental accountability by universities. However the potential of EMA in this regard is still neglected.

Accountability requires data, not only external environmental reporting but also for internal management. (Parker, 2000) argues that not enough attention has been paid to the improvement of environmental accountability through management accounting and reporting for internal decision makers in the world of business. Although (Adams, 2002) observes that organizations producing social and environmental reporting develop better internal control systems and better decision-makings, Parker (2000) indicates that "*while considerable information on corporate environmental disclosure practices in annual reports is now available, little is known about the internal environmental decision and control information systems in use, and corporate attitudes particularly to environmental costing".* Parker's argument highlights an imbalance deserving attention, giving that while accounting can play a role in post hoc environmental reporting; it has the potential to make a significant contribution to the ex ante decision process involved in managing environmental impacts and improving environmental performance (Parker, 2000)

Environmental management approaches such as Life Cycle Analysis (LCA) have been employed to identify the impact associated with campus operations. However, those approaches typically do not go further to be used in financial management decisions, like capital decision (Epstein, 1996). To improve environmental performance, integrating environmental information into management decision is critical. If the fundamental purpose of environmental management is considered to control environmental impact, then improve environmental impact and then improve environmental performance, it increases the apparent need for the more aggressive involvements of accounting professions.

Chang and Deegan (2008) uses a case-study of an Australian university to demonstrates that there is a general lack of consideration given to the management of environmental costs and related cost-savings, due partly to a perceived lack of appreciation by senior management of the extent of environmental costs being incurred. Further, in the absence of relevant environmental cost information, although environmental sustainability itself is promoted as important, efforts to improve internal environmental accountability from an accounting perspective are lacking. This study shows that perceived institutional pressures and a low profile of accounting for the environment, and management's attitudes influence the adoption of EMA within universities.

3. Methodological Framework

The paper made use of Tshwane University of Technology as case study. Data was collected by means of exploratory and explanatory research techniques in this research using two data sets as follows:

Documentary data to establish an understanding of the environmental issues at Tshwane University of Technology and along with the literature review will formed the basis of the interview questions. Documentary and interview data was transcribed and reduced through descriptive statistics and a process of selection, focusing, simplification, abstraction and transformation of the data enabling categories, themes and patterns to be identified.

Documentary data: Internal from TUT (e.g., Institutional operational plan, environmental related policies and procedures waste management procedures, and financial reports) and external (e.g., print media, industry associations).

The second set of data was derived from fourteen in-depth individual face-to-face interviews employing a semi-structured questionnaire with closed and open ended questions to collect primary data. The interviews were conducted with personnel of two main divisions involved with EMA related information Building and Estate and Finance.

Interview data: from 14 different personnel's of TUT including staff from estate and planning, finance, residence, procurement, and top management.

Face to face individual interviews are preferred to a mail questionnaire for the purpose of this study, as the mailed questionnaire was less likely to enable the collection of exploratory type of information to be gathered using interviews. Data for this study was transcribed by recording the word-by-word conversation between the interviewer and interviewees. These data was reduced through descriptive statistics and a process of selection, focusing, simplification, abstraction and transformation of the data enabling categories, themes and patterns to be identified (Miles and Huberman, 1994:12).

This study made use of content analysis that entails categorizing, ordering, manipulating and summarizing data and describing them in meaningful terms. As the data that was collected are verbal of nature, content analysis using open coding was done according to (Creswell 1994). According to Strauss and Corbin (1990), open coding is when the data are divided into segments and then scrutinized for commonalities that reflect categories or themes. Data analysis began during the data gathering process. The raw data is kept with the researcher. Data was collected in terms of how TUT treats environmental impacts and account for environmental cost. Analysis in qualitative studies involves the examination of words. According to Mouton (2001), the aim of analysis is to understand the various constitutive elements.

In this study, validity was achieved by using multiple sources of evidence for triangulation, establishing a chain of evidence and having the draft findings of study reviewed (Yin 1994). To ensure reliability in this study, an overview of the project was developed prior to and through the data collection phase illustrating the emerging findings. Notes detailing the names of the interviewees, their job position, and the date, time and location of the interview were kept in the researcher's journal. Once each interview transcript had been prepared and reviewed it was noted, as such, in the researcher's journal. When the interview questions were being prepared a form of checklist was used to assist in the refinement of the questions. A report framework was compiled illustrating the preliminary plan of how the findings would be presented.

The study database allows for the collection and collation of all of the data obtained for the study. It consists of at least four levels (Yin 1994; Brownell 1995): case notes, documentation and artifacts, tabular materials and narratives. In this study, the case notes were hand-written into the researcher's journal and include thoughts on the un-transcribed and transcribed interviews, the different documentary data, and journal as the data was refined. The documents that were collected include those from annual reports, information from government web sites and documents and media releases from industry associations. The narratives in this study were the transcribed interviews of 14 interviews. A spreadsheet, which allowed easy access and analysis to the summary data, was maintained. Prior to the interviews, a pilot interview was performed. This ensured timing of the interview to be reviewed along with the refinement of questions to improve readability and comprehension (Yin 1994).

4. Findings And Discussion

The case study population for this study comprises of 14 respondents working for TUT. Figure 4.1 to 4.4 below provides the demographics of the respondents based on work specialization, longevity of service, age and gender.

Majority of the respondents (64%) as presented in figure 1 below were from the Building and Estate Division that includes institutional planning, landscaping, logistical services, transport and printing, while 36% of interviewees were from the finance division. It was important to make use of both financial and environmental specialist to solicit a balanced perspective of both the technical and monetary aspects of EMA.

Figure 1. Work specialisation

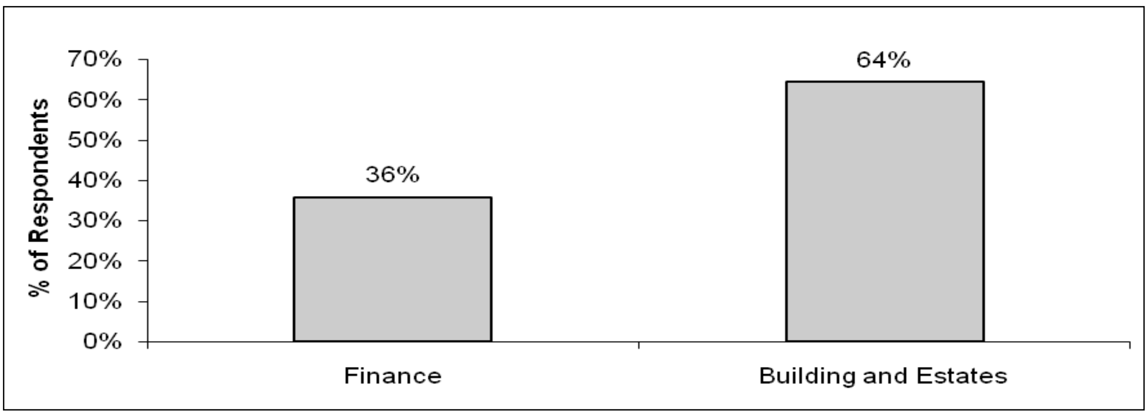
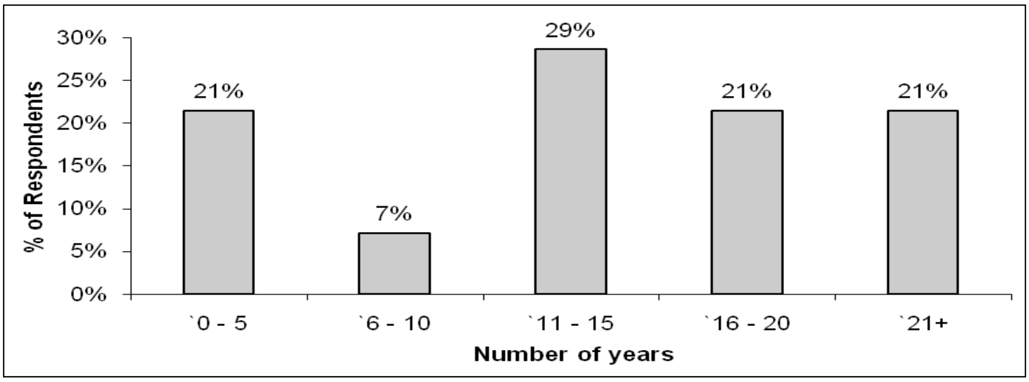


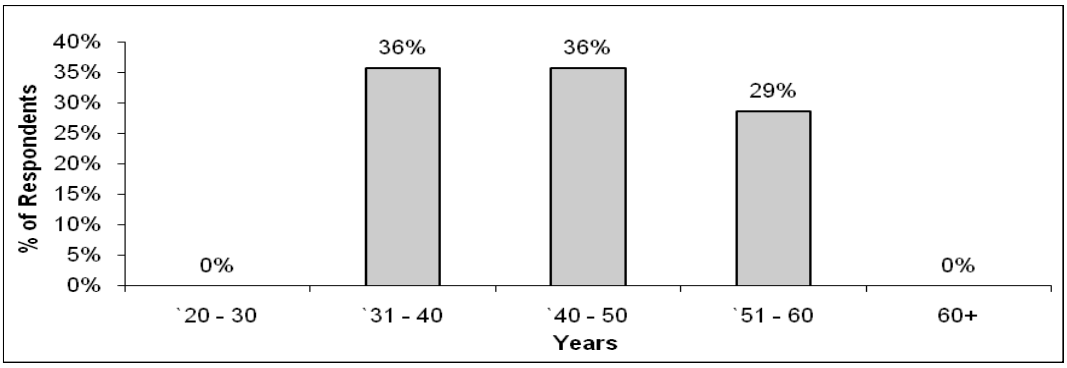
Figure 2 below depicts longevity of services of the respondents. The analysis show that more than 70% of the respondents have worked for TUT for more than 10 years. This imply that most of the opinion provided during the interviews can be trausted to come from authoritative minds and people who know the operations of the organization.

Figure 2. Longevity of service



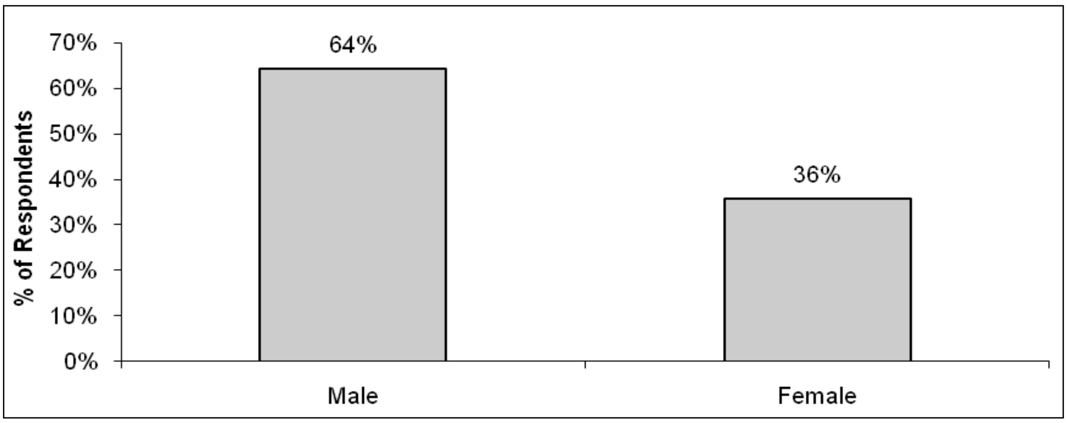
Furthermore, figure 3 below depicts that all responedents were above 30 years of age supporting the maturity of the respondents as in figure 2 above.

Figure 3. Age group



Finally on demographics of the respondents for this study, figure 4 demonstrates 64% of interviewees being male and 36% female. While the gender balance was biased, this demonstrated the configuration of the general staff population of the university and also in line with labour trends in the country and does not negatively affects the results of this study.

Figure 4. Gender



The demographical data for this study has been presented and its implication to the study discussed. The next section presents findings of the study with respect to environmental responsibility and accountability of TUT.

4.1. Environmental Responsibility and Accountability

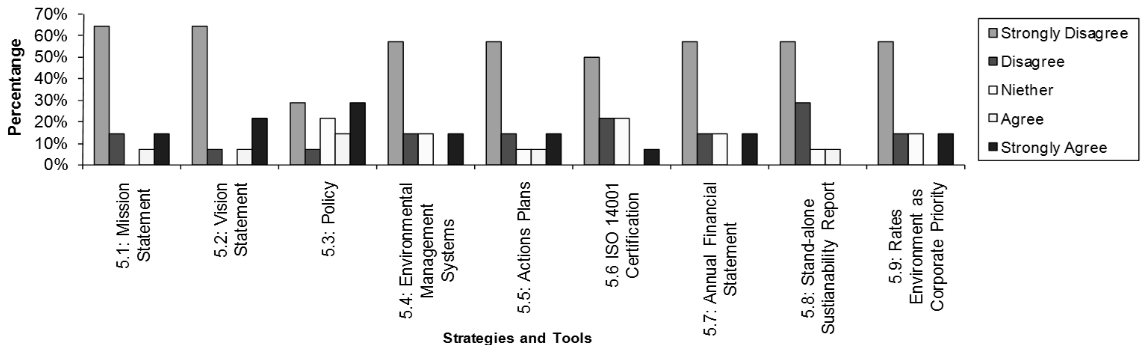
A significant objective of this study was to investigate governance for environmental responsibility and accountability within TUT. An analysis of the mission of TUT requires the university to make a significant contribution to sustainability through teaching and research. However there is no specific attention to sustainable consumption of resources such as energy, water, fuel, papers and consumable materials or to change consumption behaviour by both students and staff. Although the focus of universities is on teaching and learning, they still have to be financially sustainable and are directly accountable to government for their financial performance. From an environmental cost control perspective whether universities are operating in an environmentally sustainable way or people within universities are behaving in an environmentally responsible way should not be a secondary issue. Accountability leads to better performance (Adams 2002) but TUT practice did not mirror an attempt to make people accountable for their environmental performance.

An examination of governance for environmental responsibility and accountability was conducted by assessing environmental strategies, tools and drivers. The presentation is demonstrated in Figure 5.

Environmental Strategies, Tools and Drivers

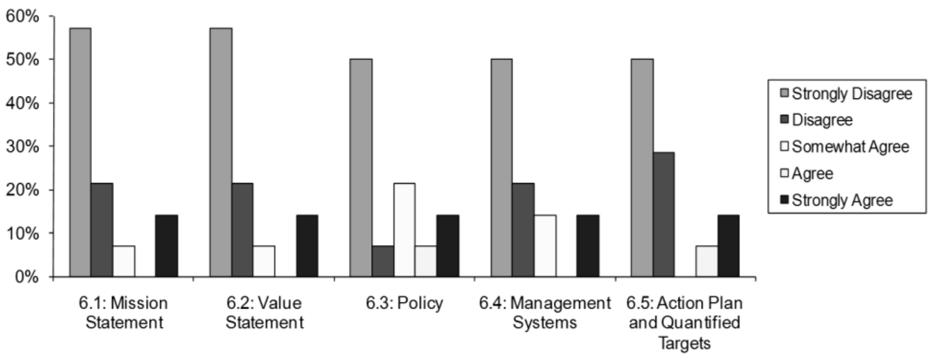
Figure 5 below indicates that only environmental management policy exist within TUT as an environmental strategy and tool, there is no environmental mission statement, vision statement, environmental management system, and environmental action plan. Figure 4.5 further illustrates that TUT is not ISO14001 certified, has no environmental section in its annual financial statement, no stand-alone sustainability report and TUT doesn't rate the environment as corporate priority. The implication of figure 4.5 is that governance of TUT environmental responsibility and accountability is weak.

Figure 5. Existence of Environmental Strategies and Tools



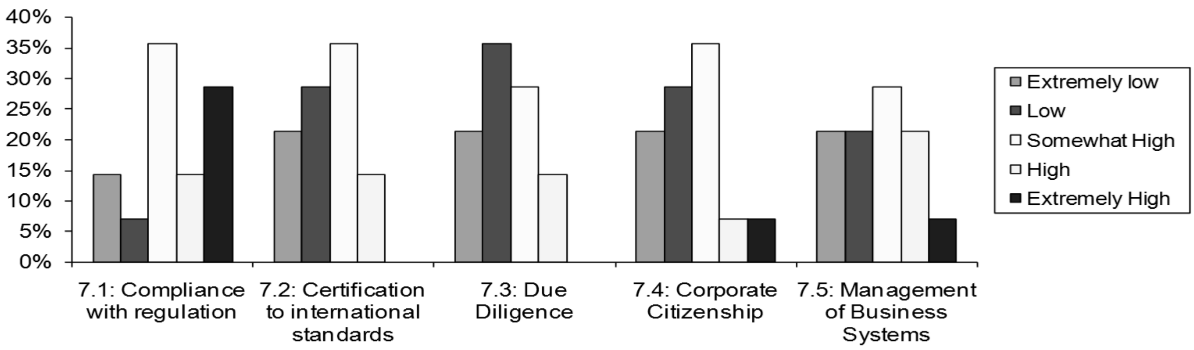
Due to the lack of environmental strategies and tools as shown in figure 5 above, TUT doesn't implement any environmental strategies and tools even its environmental management policy as depicted in figure 6 below.

Figure 6. Implementation of Environmental Strategies and Tools



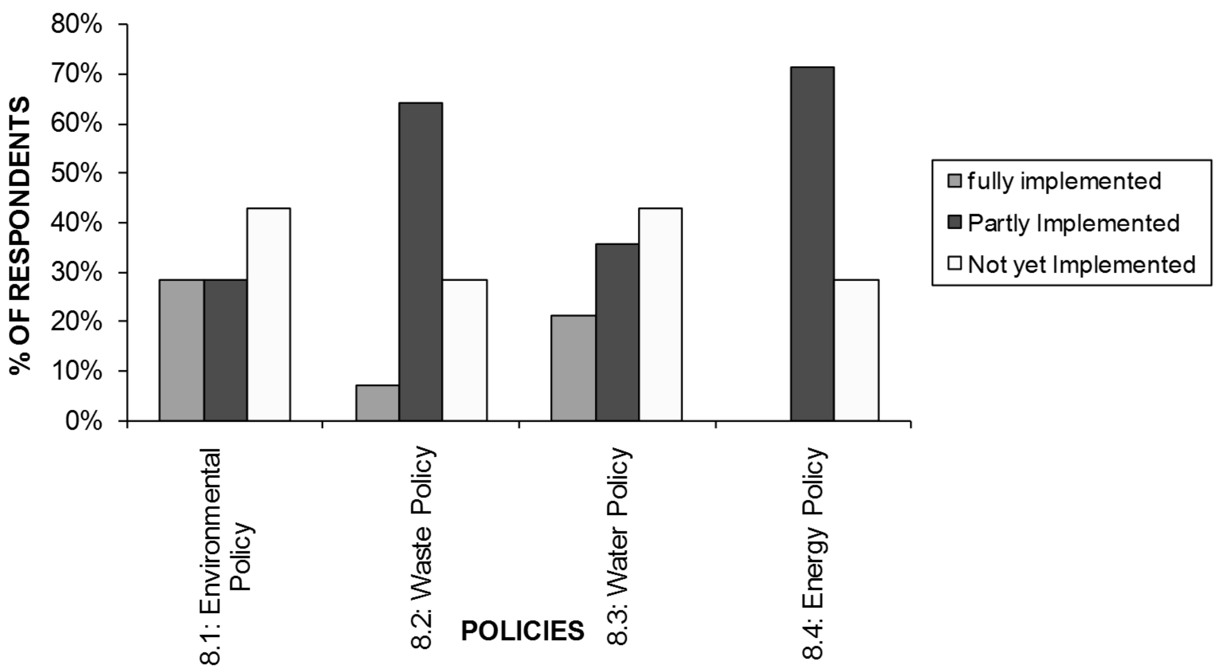
While TUT does not have a developed environmental management systems as in figures 5 and 6 above, its planning for environmental responsibility and accountability are driven by compliance to regulation, certification to international standard, corporate citizenship and management of business system as depicted in figure 7 below.

Figure 7. Drivers for TUT Environmental Management Systems



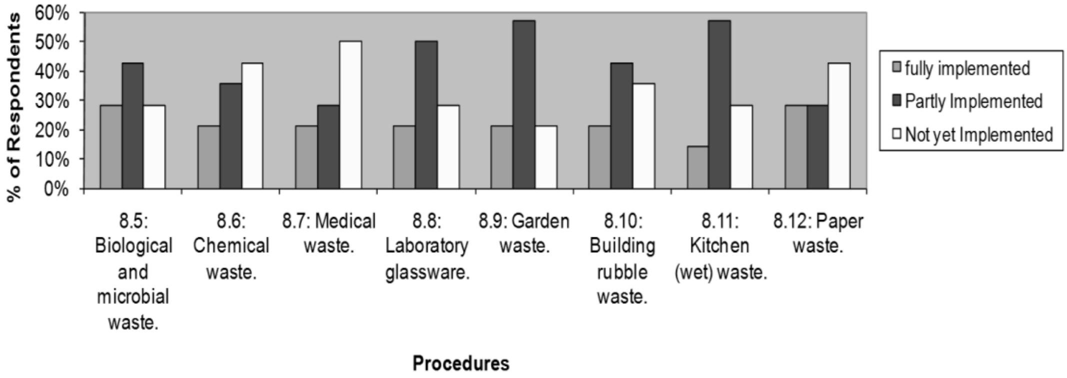
Implementing Environmental Policy and Procedures: TUT has developed environmental policies and procedures including; environmental policy, waste management policy, water policy and energy policy approved in 2005. The development of these policies and the appointment of an environmental officer depicted strong strategic direction and responsiveness to environmental issues by the university. However, figure 8(A) below depicts that by the year of study 2009-2010 (after five years), none of these policies or procedures are fully implemented.

Figure 8 (A). Implementation of Environmental Policies Developed and Approved in 2005



Further to figure 8(A), TUT's responsiveness to environmental issues has been enhanced through the development of a good number of environmental procedures such as: procedures for the disposal of biological, medical, chemical, laboratory glass ware, garden, building rubble, Kitchen and paper waste. The implementation of these procedures is either not yet or partially implemented as depicted by figure 8(B) below.

Figure 8 (B). Implementation of Environmental Procedures Developed and Approved in 2005



Figures 5, 6 7, 8(A) and 8(B) has demonstrated that, while there are evidence of some environmental policies, procedures and strategy, the implementation and general governance for environmental responsibility and accountability is extremely weak. Section 4.4 below provides an assessment of how TUT accounts for environmental impact, cost and savings.

4.2 Accounting or Environmental Impacts and Costs

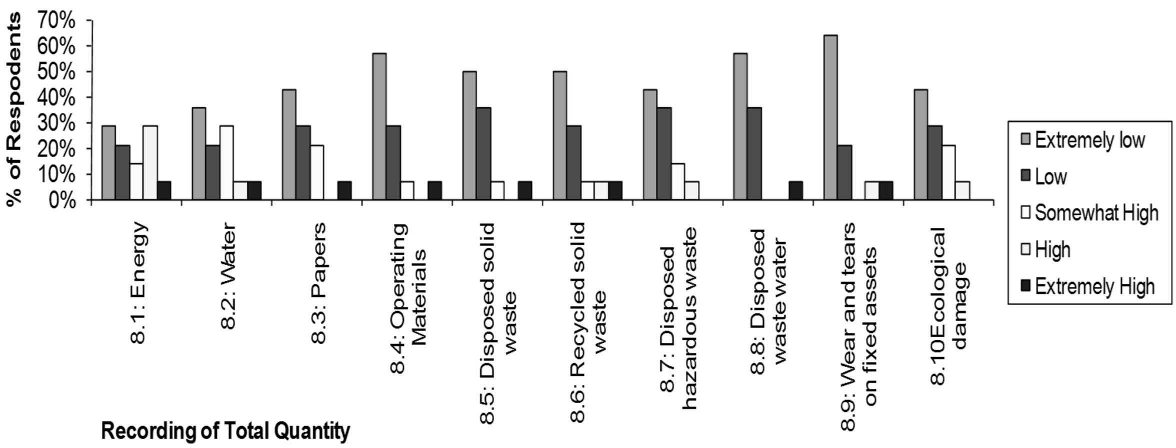
Tshwane University of Technology (TUT) has no link between the systems for collecting financial and non-financial data. Costs are captured within the financial system for the whole University but the usage data that comes with the costs information collected are not captured or included in the accounting system. When asked whether there should be a link between the systems for collecting financial and non-financial data and whether accountants could be involved in helping to analyze such information the respondent doubted whether accountants are interested:

"I would think that would be valuable, because right now we spend a lot of time with our benchmarking data. We look at the global picture for our particular area of the facilities. I don't think our finance people look at these. They're bottom-line people"(Respondent A).

The International Federation of Accountants (IFAC) identified two types of EMA information for internal decision making – physical and monetary information. The generation and use of each of this EMA information type was investigated within TUT and the results are presented and discussed in sections 4.4.1 and 4.4.2 below.

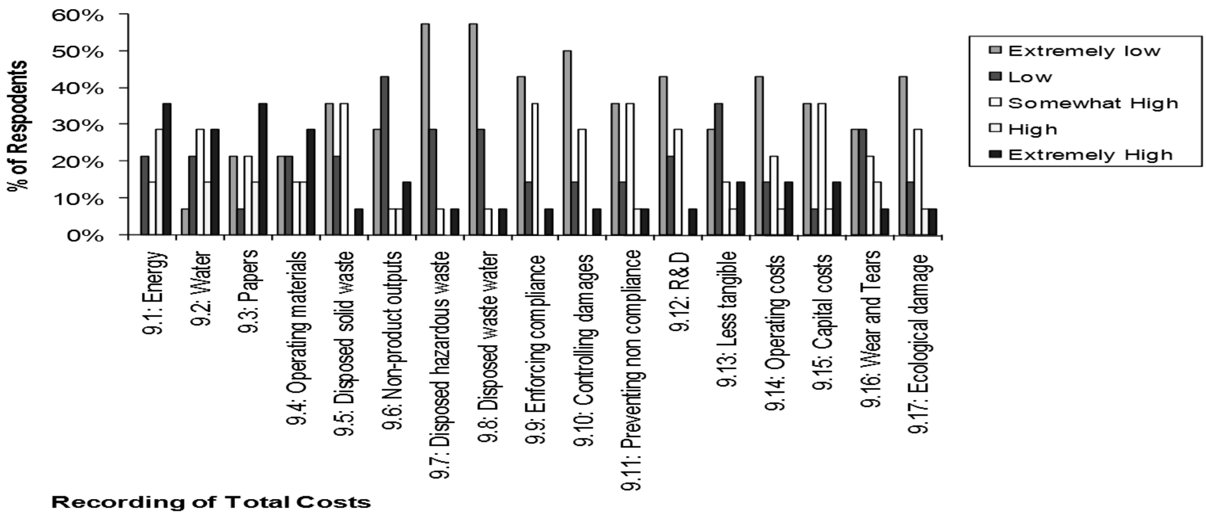
Physical Environmental Management Accounting: Physical Environmental Management Accounting (PEMA) is the generation and recording of physical data on material and energy input, material flows, products, waste and emissions for internal decision-making (Savage and Jasch, 2005). For the purpose of this study, energy, water, papers, operating materials, solid waste, recycled waste, hazardous waste, waste water, wear and tear of fixed assets and ecological damage were identified as relevant physical elements of TUT EMA information and respondents were requested to provide responses to their generation and use for internal decision making. Figure 9 below demonstrates that, the generation and use of physical information for most of the category is extremely low to low; except for energy, water and paper where the accounting for physical quantities has partial implementation.

Figure 9. Recording of Physical EMA Information



Monetary Environmental Management Accounting: Monetary environmental management accounting (MEMA) is a sub-system of environmental accounting that deals only with the financial impacts of environmental performance. It allows management to better evaluate the monetary aspects of products and projects when making business decisions (Savage and Jasch, 2005). Table 10 below depicts that the recording and use of monetary EMA information for energy, water and paper are partially implemented while the implementation of MEMA relating to cost of operating materials, disposal of solid waste, non-product outputs, disposing hazardous waste in solid form, disposing waste water, implementing and enforcing environmental regulatory compliance, controlling environmental damages and activities, preventing non regulatory compliance, research and development projects related to environmental issues, less tangible environmental issues, environmental operating expenditure, wear and tears on fixed assets, and cost on ecological damage is extremely low to low.

Figure 10. Recording of Monetary EMA Information



The lack of information on environmental costs also reduces the opportunity to improve environmental accountability which is important in driving behaviour change.

Respondent M indicated that: "*Without active cultural change agents working within the organization, people become complacent. They're just blasé about how they treat the facilities and electricity consumption….At the end of the day; people have to be responsible for themselves. If people were aware to start off with, the lights and computers couldn't be left on in the first place and they could have made sure the there is no tap of water left open and the toilets are not just flushed unnecessary. It's something that management can not fully control. It's a culture change and individual discipline issue, which can be enforced by awareness and education".*

Due to limited environmental accountability, management seems uninterested in environmental cost control and the savings that could be made, which in turn, has direct implications for the demand to put EMA in place. As Respondent J explained:

"EMA is not management main focus…. It's not monitored, and is not one of their key accountabilities…. They're not really held accountable for environmental usage. If environmental sustainability is not one of their key accountabilities, then it's not going to be in their minds. They are currently only focusing on putting off fires and if environmental sustainability can be in lime light then something will be done about it".

Figure 9 and 10 above shows that TUT record partial physical and monetary environmental management information especially information on energy, water, papers, fuel and operating material, while waste management, research and development costs is not recorded in the system as depicted in figure 10.

Accounting for Environmental Cost: The major environmental costs were examined to determine how they were managed and treated in the accounting system. Their absolute amount (if available) and relative scale are also discussed. TUT uses Integrated Tertiary System (ITS) for the purposes of both financial accounting and management accounting.

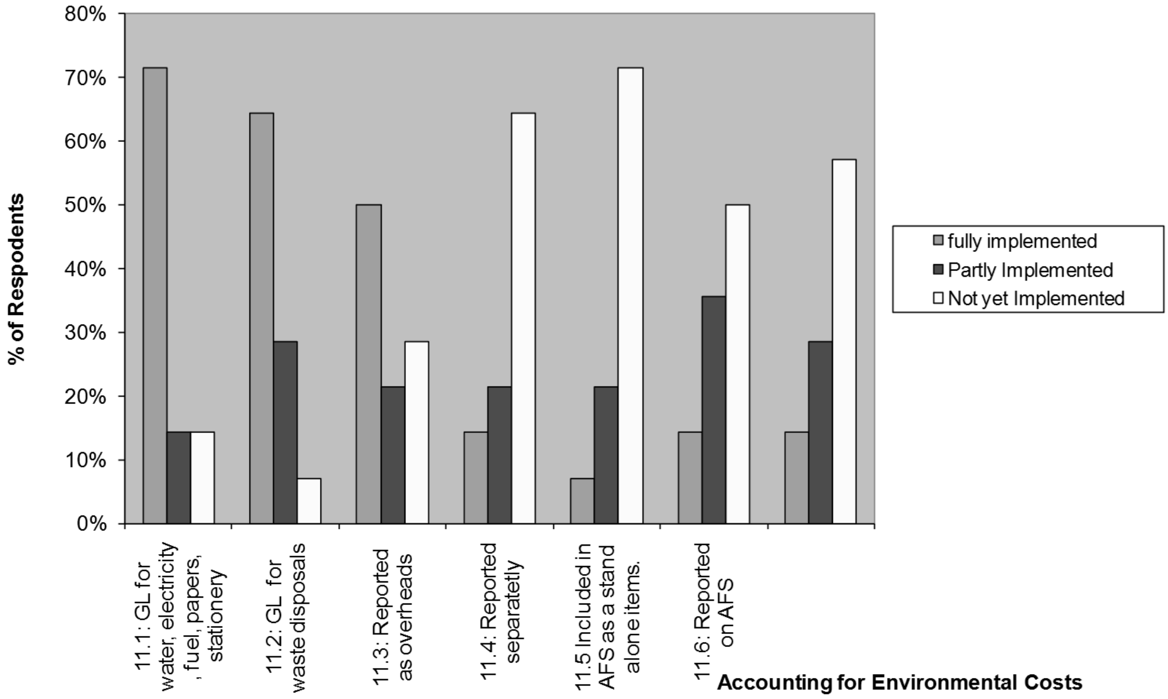
A review and analysis of the ITS financial system (general ledger) and processes indicated the following:

- The general ledger combines electricity, gas, water, waste removal and maintenance costs under building & estates running costs account, fuel under vehicle expense account, uses a combined 'stationery and printing' account for paper cost, cartridges and stationery, A 'service contract' account to include costs incurred on service contracts that support facilities management and for reporting purposes all these expenditure are group together and called operating expenditure.

- For those environmental costs captured within the accounting system only financial information is provided. Non-financial information on the type or quantity of goods or services procured (e.g. electricity and paper) is not currently available within the system
- Operating costs including electricity, gas, fuel, water, and waste removal are combined as part of the 'overhead expenses' overhead for the whole University.
- Consistent with many organizations "waste costs" are recognized as including only the costs incurred in having waste removed from the organization. Waste costs are therefore understated (and therefore largely unaccounted for) because there is no explicit consideration given to the costs of bought-in resources that end up in waste

Figure 11 below provides a solid evidence on how TUT account for its environmental costs. It has a separate general ledger accounts for water & electricity, fuel, papers, stationery and printing and all those accounts are grouped and reported as overheads (operating costs) not separately as a stand-alone item in the monthly management report and the annual financial statement. TUT also doesn't have a sustainability reporting section in its annual financial statement.

Figure 11. Classification, Analysing, Recording and Reporting Environmental Costs



Management of Major Environmental Costs: As above monthly management report are produced by TUT's for reviewing current operations and assessing performance against the budget. The major environmental costs for the University (electricity, paper, water, fuel and waste management) are obscured within the accounts, for example, by being included in aggregated accounts titled 'overheads' and ' 'operating costs'. At the present time there was no further classification or analysis and no form of responsibility-centred budgeting for these aggregated costs.

The main reason for this was that there had been no prior focus on the need for environmental costs information. As one interviewee stated: "*No one has ever come to me and said: 'Tell me the environmental cost of what we do.' So the chart of accounts is not set up to record anything that way…. It's one thing that we've never been requested for, even though it's not a new concept. We've never been requested to provide specific information about it. From what I see, not that I see everything, it maintains a low profile"* (Respondent N).

Senior management across the University would not know the extent of environmental costs—however, it was not clear that the senior management would actually monitor such information. When asked if environmental costs information could be separately identified and reported Respondent N indicated: "*Also we've different accounts. So we* *think: 'Ok, how can we capture costs properly?' You know, at the end of the day, what are management interested in? They're interested in how much we spend on travel and how much we spend on consumables. So would they ask how much we spend on the environment (environmental cost)? ... They never have, or it hasn't come through to me.... They may discuss it at different forums. But it would be very hard to measure. I wouldn't even try to do a chart of accounts. I wouldn't expect to cost it in a ledger, nor then will I be able to give a report to someone, and say: "Here it is exactly and here's an idea of it".... I don't think we're there".*

This has consequently tended to hide various environmental costs, obstruct the management of environmental performance, and reduce further the chances of uncovering potential cost-saving opportunities.

4.3. Future Direction and Opportunities

The third and final objective for this paper was to determine the factors that are facilitating or inhibiting change needed to implement EMA at TUT. TUT's practices with respect to environmental responsibility, accountability and the accounting for environmental impacts discussed above were not surprising and were common to most service-based organizations (e.g. Deegan 2003). Fortunately, guides and best practices, although limited in service-based organizations, are available. TUT has the potential to change its practices.

Restructure the Accounting System (General Ledger):

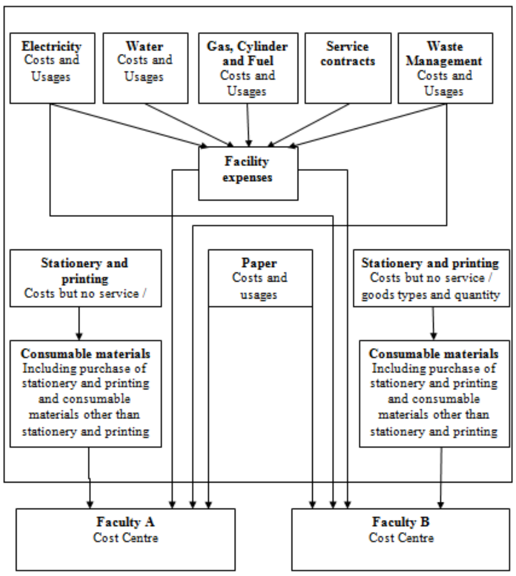
Interviewee responded by saying:

If the organization was passionate about this, they could design a process so the information was collected as the invoice came to hand.... If we need to report upon it, you can either report upon it as an ad-hoc process or design it as part of an ongoing process. As an ongoing, it's more efficient than ad-hoc (Respondent A).

Create Financial Incentives: At present there is a lack of responsibility-centred budgeting for major environmental costs because, except for Facility Management, these costs are not borne by any academic faculties, departments and even administrative and support divisions which in turn directly impacts improvement in environmental performance. The need to create incentives geared to promote environmental awareness and behavior change is evident. Two suggestions might help: *you could do it as an environmental accountability or straight out financial. You can give certain environmental targets, or you can express those targets financially, meaning you go about it if you build it in as a key performance indicator, and then you're going to get action. But you could probably do a lot of it through your financial incentives, even without necessarily introducing the notion of environmental impact. Like we were talking about before, handing back savings on utility costs would be one way, or on other office expenses that have an environmental impact, floor space, heating, paper, all that, hand it all back, any savings that are made (Respondent H).*

The ideas mentioned could be an effective solution for the excuse of budget constraint and could provide financial incentives to reduce resources used. However, the benefit could be achieved only by providing better information (actual or charged back costs for resources used) as suggested previously. Suggested changes to the financial system for achieving the benefits are shown in Figure 12.

Figure 12. TUT's Suggested Treatment of Major Environmental Costs In General Ledger



Based on interviews with the key players with different types of management roles within TUT the following three barriers were highlighted including: *Absence of Institutional Pressures; Low Profile of Accounting for Environmental Costs and Attitudes and Views of Key Players.*

It was previously acknowledged that the amounts that major environmental costs represent might not be significant enough to influence decision-making from a financial point-of-view. Nevertheless, it was also pointed out that views and attitudes might be changed if the implications of these costs are placed in the wider context of growing community environmental concern. The above quotations show that the benefits that EMA can deliver are still not well understood and as such EMA is not really an issue that captures the hearts and minds of both senior and middle management.

This section has presented the demographical data of respondents and demonstrated the extend to which TUT is responsive to environmental issues through the development of environmental policy, energy policy and water policy and a number of environmental procedures detailing the disposal of various types of waste. However while there seems to be a good number of environmental initiatives, the implementation of most of these initiative that started in 2005 has not fully been achieved. Furthermore generation, recording and use of physical environmental information for internal decision making is partial and monetary environmental information partially available for water, energy and paper but non-existent for majority of the elements of EMA. TUT need to restructure their accounting and ledger system to implement EMA. A roadblock towards the implementation of EMA at TUT includes the absence of institutional pressures, a low profile of accounting for environmental costs and negative attitudes of key players.

The next section presents the summary of the findings and conclusion of this mini-dissertation. It also provides direction for future research on EMA for Universities and other service organizations.

5. Conclusion

There is no doubt that universities as educators should provide environmental education. However, do they practice what they preach? The case-study demonstrated the potential for what is achievable at TUT but found that management accounting for environmental costs tends to be ignored especially when associated financial benefits are not readily visible and achievable in the short-term. This is not a problem unique to the organization investigated in this study and unfortunately appears common to many universities and service-based organizations. Other pressures or drivers would be required to assist in the debate for EMA as a means of managing environmental costs. Three barriers to the adoption of EMA within universities were identified institutional pressures, a low profile of accounting for the environment, and management's attitudes. Senior managers are not held personally accountable or responsible for environmental performance, which, as a result, discourages the discharge of environmental accountability. Although some institutional pressures are present they are limited and placed on people involved in the environmental function rather than those involved in the management accounting function. However, without accountants being involved in the process EMA is less likely to be adopted.

The majority of South African universities are directly funded by the government and accountable to government for their financial performance (in particular, that they do not incur large operating deficits). Unfortunately, the South African Government does not require much accountability for universities' environmental performances. This lack of accountability at the top-level flows through the various accounting systems within South African universities. Arguably, it is incumbent on government to address this issue. While some tentative conclusions can be drawn from this study it should be borne in mind that this is only a single case-study which limits how far generalisations can be made. Whilst the results are perhaps somewhat critical of TUT, anecdotal evidence suggests that other South African universities are also lacking in terms of establishing systems to manage their environmental costs and hence criticisms of TUT could equally be levelled at those other universities. Indeed, it is somewhat surprising that TUT, which in many other facets of environmental practice leads the way, has not led the way in this area too. However, key staff are ready to consider the issue, shown by the openness and transparency demonstrated in this research. In concluding, the results of the study highlight the potential use of EMA and its ability to improve environmental sustainability through enhanced accountability within universities. Let us wait and see which university takes the necessary lead.

Taken into cognizance the lack of institutional pressures, a low profile of accounting for the environment, and management's attitudes at TUT and Learning from experience, locally, internationally and through the case study participants (IFAC, 1998; Savage and Jasch, 2005) the management accountant of TUT should be involved in:

- Implementing the proposed general ledger model in Figure 12 to enhance the treatment and accounting for environmental impact and costs.
- Ensuring that its environmental strategy is fully integrated into the overall business strategy;
- Developing environmental performance measures, setting improvement targets and establishing monitoring procedures;

- Ensuring that environmental performance management systems are integrated into business management systems of TUT so that environmental impacts can be fully incorporated into business decision-making;
- Incorporating environmental considerations into capital budgeting decisions and selection of capital equipment;
- Identifying and calculating any environmental contingent liabilities;
- Identifying and estimating costs caused by the organization's activities which have to be met by others – eg the organization pours chemicals down the drain and pollutes the water;
- Producing and analyzing environmental management information. By making environmental costs more visible, managers can be made accountable for the environmental costs that they generate and environmental performance can be incorporated into management incentives;
- Identifying internal energy or water costs and allocating these to products and processes for example, rather than treating electricity as an overhead, rather ensure that there is adequate metering to enable electricity be treated as a direct cost for each department;
- Sponsoring environmental consciousness and EMA in all employees through training and communication;
- Involve employees in environmental activities.

Future research will benefit from evaluating the implementation of the model in Figure 12 and recommended action plan in Table 1 towards environmental management accounting at Universities. Investigating the role of government in promoting EMA at Universities will enhance the institutional pressures needed to support environmental responsibility and accountability by universities, increase its profile and enhance management attitudes. Another area for future research emanating from this study is the investigation of sustainability reporting by Universities. Future research will also benefit by extending this study to other South African Universities and identifying the cost savings generated from implementing EMA.

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