EXECUTIVE SUMMARY

Index

Table of graphs, charts, diagrams and tables

EXECUTIVE SUMMARY

I BACKGROUND

A Terms of reference

1 The President of the Republic of South Africa appointed the Commission of Inquiry into the rapid depreciation of the Rand and related matters.

2 The Terms of Reference[1] are to enquire into and report on whether between 1 January and 31 December 2001:

- any person or any other juristic entity, directly or indirectly, entered into, concluded or caused any transactions which contributed or gave rise to the rapid depreciation of the value of the rand during the relevant period relative to other currencies, and whether any such transactions were illegal or unethical;
- any of the transactions in question involved collusion and resulted in any improper gain or avoided loss;

[1] See Annexure A Part A

- in respect of any of the transactions in question, any authorized dealer in foreign exchange deviated from the terms and conditions of its appointment;
- in respect of any of the transactions in question, existing regulations and/or restrictions on the export of capital from South Africa were contravened;
- in respect of any of the transactions in question, regulations and/or restrictions on the maximum period within which exports proceeds must be repatriated to South Africa were contravened;
- in respect of any of the transactions in question, transactions were entered into that were in contravention of the letter or spirit of the exchange control regulations.

3 The Commission is also required to advise the President on any relevant recommendations, including:

- the effectiveness of the current administrative system of ensuring adherence to exchange controls and other regulatory measures in guarding against the occurrence of such transactions; and
- possible action that could be taken against any person or juristic entity identified as having participated in any such transactions.

4 An interim report was submitted on 30 April 2002 to the President pursuant to paragraph 3 of the terms of reference. The Interim Report did not make any findings or recommendations. Parts B, C and D of the Interim Report, suitably amended by additional evidence form an integral part of this Final Report.

B The Commission's interpretation of the terms of reference

5 The Terms of Reference as provided by the President to the Commission, in essence, require an investigation which is focused on analysing *transactions*[2] which contributed to or gave rise to the rapid depreciation of the rand in 2001.

6 Whereas every transaction which is concluded in the forex market has a potential effect on the price of a currency, a transaction which would contribute or give rise to a depreciation of the rand would be one which resulted in an outflow of foreign currency or had a negative impact on the foreign reserves. The net movement of the currency on a particular day would not determine the effect of a specific transaction on the currency. Preventing an appreciation of the currency is regarded as tantamount to causing a depreciation of the currency.

---

2 See §1.1 of the terms of reference, Annexure A Part A

7 The extent of the impact of a transaction on the price of a currency is considered to be determined by:

- the size of the transaction relative to the volume of trading on a particular day;
- the liquidity in the market; and
- the conjoint influence of the transaction with other transactions, as well as other factors[3] which influence the market.

8 It was transactions as described above that were the subject of the Commission's work.

9 The Commission had no difficulty with interpreting the notion of illegality in the Terms of Reference. For the purposes of this Inquiry, a transaction was regarded as illegal if it was in contravention of any applicable legislation.

What was more problematic was what was meant by "unethical transactions". The Commission had difficulty with interpreting the notion of "unethical transactions". In the context of the foreign exchange ("forex") market, a transaction as described in §'s 6 and 7 above, was considered to be unethical, albeit legal, when it was

[3] See Subsection F §27-54 hereof.

contrary to one definition of ethics in the Shorter Oxford English Dictionary: "the rules of conduct recognised in certain limited departments of human life". The Commission procured evidence of the "rules of conduct" in the forex market. While there were differences of opinion on what conduct would be regarded as unethical, the following conduct can safely be assumed to be unethical:

- a failure to adhere to the recommendations of the ACI contained in the Model Code relating to gifts, gambling, personal account trading, confidentiality and misinformation and rumours;[4]
- breaches of confidentiality falling short of insider trading;
- price manipulation through rumour mongering;
- spreading rumours deliberately to trigger market "stock losses"; and
- "position parking;[5]

A transaction as described in §'s 6 and 7 above, was regarded as contrary to the "spirit of exchange controls"[6], albeit legal, when it ran contrary to the recognised and generally accepted purpose of exchange controls, which, inter alia, includes the protection of the foreign reserves of the country.

---

4 See §'s 1 – 3 Part G
5 See §8 Part G
6 See §1.3.4 of the Terms of Reference, Annexure A Part A

10 The resulting gain or avoidance of loss in respect of transactions was considered in the following context. Making a gain or profit or avoiding a loss is what participants in the forex markets do in the ordinary course of their participation in the market. It is, however, difficult to establish when making a gain or avoiding a loss becomes "unacceptable." Leaving aside contraventions of exchange control, the one activity in which it may be contended that the gain made is unacceptable is that of the naked short who transacts in the market, without any underlying transaction, in order to make a turn or profit on the bet that the rand would continue to depreciate.

11 As any number of the millions of forex transactions which were concluded in 2001 could have led to the depreciation of the rand, the Commission's interpretation of §1 of the Terms of Reference is that it must enquire into and report on whether any *particular* transactions contributed or gave rise to the rapid depreciation of the rand. One must not underestimate how difficult it is to do so in a market with a turnover of between approximately USD5.5 billion and USD10 billion a day and in which 5.6 million transactions were reported to the Reserve Bank in 2001 – and that total does not reflect *all* the transactions.

C The Process of Inquiry[7]

12 The Commission appointed assistants to investigate matters raised in the Terms of Reference.

13 Experts who had the requisite knowledge, experience and expertise on the rand and forex markets, locally and globally, and on factors that in their view might have contributed to the rapid depreciation of the rand, were requested to testify before the Commission.

14 Mr Kevin Wakeford and the parties mentioned by him in his report to the President of 8 January 2002 were called upon to testify before the Commission.

15 The South African Reserve Bank, the National Treasury, the authorised dealers and other relevant witnesses were also called upon to testify on matters pertaining to the Terms of Reference.

16 All the evidence was led in public before the Commission in compliance with section 4 of the Commissions Act, no 8 of 1947, save for two hearings which were held in camera.

---

7 See Part A: The Investigation

D Scope of the investigation

Period covered

17 As per the Terms of Reference, the period 1 January 2001 to 31 December 2001 was considered.

18 Investigations, other than those on specific alleged transactions, were focused on the period September to December 2001 while not ignoring the rest of the year, because the major part of the depreciation of the rand occurred during this period.[8]

The transactions population

19 The transaction categories that are concluded globally are spot, forward, swap and option transactions. Spot, forward and option transactions affect an exchange rate. Swap transactions, on the evidence presented to the Commission, do not have an impact.[9]

---

8 See generally Parts J and K
9 §1.2 Part C

20 Each one of the millions of transactions in the global rand market has the potential to impact on the value of the rand. Foreign exchange transactions arise, inter alia, from investment, hedging, trade, financing or capital transactions, including dividend payments.[10]

21 The daily turnover of global forex transactions in all currencies was approximately USD 1.2 trillion in 2001. Forex trading in South Africa was 0.6% of global trading in 2001. The daily turnover in *South Africa* in April 2001 was USD 8 billion. The rand is an internationalised currency with the bulk of off-shore trading taking place in London and to a lesser extent in New York.

22 The *global* trading in the rand in April 2001 was USD 11.3 billion, made up as follows:

USD 3.3 billion: off-shore/off-shore;

USD 3.5 billion: on-shore/on-shore;

USD 4.5 billion: on-shore/off-shore.[11]

A total of 5.6 million foreign currency transactions concluded in *South Africa* were reported to Exchange Control during 2001. Many more transactions took place.[12]

10 <u>§3 Part K</u>
11 See <u>§'s 1 and 2 Part C</u>

Scope limitations

23 The scope of the Commission's work was limited to transactions:

- between South African residents, including authorised dealers (on-shore/on-shore); and
- between South African residents and non-residents (on-shore/off-shore).

24 Transactions between non-residents (offshore/offshore transactions) were excluded because there is no record of those transactions in South Africa and the Commission had no power offshore to investigate those transactions[13].

25 The Commission, through the Reserve Bank, requested the Bank of England to supply it with information on transactions between non-resident banks (offshore-offshore transactions). The Commission was advised by the Bank of England that, due to practical problems with

---

12 See §16.3 Part I. The 5.6 million transactions did not include:
- the off-shore/off-shore transactions; and
- all the on-shore/on-shore transactions.

13 See §25 Part C

regard to obtaining the information from the non-resident banks, no meaningful information could be provided[14].

E The rand in 2001[15]

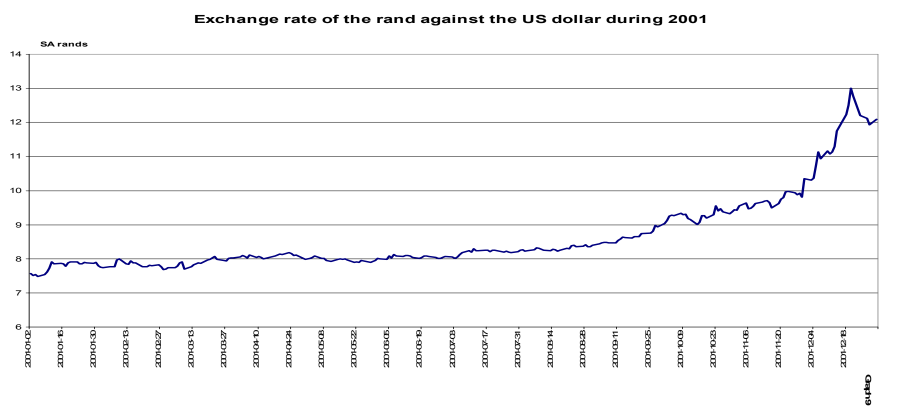
26 The rand declined in value from R7.60 to the US dollar at the beginning of 2001 and reached an all-time low of R13.84 to the US dollar on 21 December 2001. There were two distinct periods of the decline:

- for the period 1 January to 31 August 2001 the rand depreciated by 10.7% or an average of 1.3% per month;
- from 1 September to 31 December 2001 the rand weakened by 42%, an average of 10.5% per month.[16]

---

14 See §2.6 Part C
15 See generally Part B
16 See §2 Part B

Graph 9 Bundle SARB (07) 65



F Context of the forex markets

27 Before attempting to identify the possible causes for the depreciation of the rand in 2001, it is considered essential to obtain a basic understanding of the context in which currencies, and particularly the rand, is traded, and what is considered to determine the price of a currency.

28 The exchange rate of the rand is determined by millions of decisions taken daily by:

- South African consumers, corporates, foreign exchange dealers, institutional investors and various arms of government;

- foreign banks, foreign corporates, foreign institutional investors, foreign governments, multi-lateral institutions (such as the International Monetary Fund ("IMF") and the World Bank) and foreign individuals such as tourists and consumers of South African products.[17]

29 The specific factors which have been presented to the Commission as generally affecting the price of a currency can be summarised as follows[18].

Supply and demand

30 In a market where the exchange rate should be free to find its own level, the supply of and demand for foreign exchange are the main factors which determine the level of the exchange rate of a currency. An excess *supply* of *foreign* exchange is usually associated with an *appreciation* in the exchange rate of the *domestic* currency. Conversely, a shortage of foreign exchange can be expected to cause a *depreciation* of the exchange rate of the domestic currency.[19]

---

17 See §2 Part D
18 See Part D
19 See §5.1 Part D

Globalisation

31 Globalisation and the integration of world financial markets has had a major impact on the process of exchange rate determination. Dramatic increases occurred in private sector international capital flows. Volumes in the global forex market assumed astronomical dimensions and the ability of central banks to influence market conditions through intervention diminished.[20]

32 One of the thrusts of Government's economic policy since 1994 has been re-integration with the global economy. Globalisation is characterised by rising trade and capital flows between countries. Another policy to which the Government is committed, is the liberalisation of exchange controls. To a large extent the Government has been able to manage capital outflows.

33 Another consequence of the re-entry of South Africa into the globalised financial markets was the increase in participation by non-residents in the domestic financial markets, and the consequent increase in the sophistication, size and liquidity in these markets.

---

[20] See §4 Part C

Global economic conditions and events

34 Demand for, and supply of a currency are influenced by the state of the global economy which has a direct impact on the hard currency liquidity in the market and consequently exercises up- or downward pressure on a particular currency.

35 Similarly, the effects of global economic events, such as the attacks on the World Trade Centre and the Pentagon on 11 September 2001, on the financial markets has a direct impact on the behaviour of the forex markets and the underlying currencies. [21]

Market liquidity

36 Market liquidity, which refers to the ease with which a trade may be executed without causing a significant movement in the price, was considered throughout the evidence in the context of the effect that it has on the relative extent of the impact of any particular exchange rate determinant. A decline in liquidity is normally associated with

---

[21] See §5 Part D

increased volatility and relatively small transactions could move the currency to a much larger extent.[22]

The performance of the other financial markets

37 The markets for equities and bonds are organically interrelated with the market for the foreign value of the currency. Thus a well-functioning equities market, underpinned by a well-performing economy is likely to reflect in the forex market in the form of a strengthening foreign value of the currency. Both actual and expected volumes and prices in equities and bonds markets have a direct impact on the forex market.

38 To a large extent, the forex markets subsume all the inadequacies of the other financial markets. As a result, developments in the forex markets are generally more pronounced and more socially consequential.[23]

---

22 See Part D

23 Abedian Expert bundle §2.9(c) p 262

The Balance of Payments

39 The demand for, and supply of a currency are also influenced by the state and performance of the local economy as represented by the balance of payments.

40 The surplus or deficit of the current account of the balance of payments over the in- or outflows of international capital is also perceived as a major source of exchange rate stability.[24]

Interest rates and inflation

41 The internal purchasing power (determined by inflation) of a currency and its external value (exchange rate) are broadly related and tend to move together over time. It has been observed that if the internal value (inflation) of any one currency falls faster than the internal value of another, the external value of that currency would, over time, reflect that difference in a downward trend.[25]

---

24 See §5 Part D

25 See §1.1 and 4.1 Part D

42 In the same way, a country with above average inflation, and a currency that tends to depreciate, will tend to have higher interest rates. Raising interest rates tends to support the domestic currency by making it more attractive to hold and more expensive to borrow or short.[26]

Relative strength of the currencies of major trading partners

43 It has been observed that the performance of a currency like the rand has to be seen in the perspective of the relative strength, for a variety of reasons, of the currencies of the major trading partners of that country. This can be clearly seen when comparing the performance of the trade weighted index of a currency with the performance of the currency in itself.

44 Therefore, while a currency may appear to be strengthening or weakening, this may be caused solely or largely by an actual strengthening or weakening in the currency against which it is quoted, e.g. US dollar.

---

[26] See §1.3 Part D

Contagion

45 Contagion in financial markets can be distinguished from the original use of the word in medical terms in that it does not require any physical contact. In financial market terms contagion can be classified as:

- contagion based on trade links between two or more countries competing in world markets, where the value of the currency impacts on the competitiveness of a particular country's exports and vice versa;
- contagion based on similarity which occurs where there are similarities in the economic circumstances, asset classification or policy or regimes of any two or more countries; and
- contagion based on profit and loss where losses from one exchange rate can permit or force positioning in or withdrawal from another exchange rate.[27]

---

[27] See §1.6 Part D

Exchange controls and central bank activities and actions

46 A central bank can affect the currency through buying and selling transactions in the forex market, just as any other forex transaction.

47 A central bank can also attempt to manage the behaviour of the financial markets and thereby the exchange rate through the following instruments:

- "open mouth" policy where a person in authority makes a statement about the exchange rate with the objective of influencing the exchange rate;
- intervention to support the currency, which can be done quietly through, for example, signals about potential increases in interest rates, or openly through the purchase of the domestic currency;
- raising interest rates to defend the currency, making the currency more attractive to hold and more expensive to borrow or short; or
- imposing or tightening exchange controls which can immediately lift the domestic currency, but also has some negative impacts in the longer term.[28]

---

[28] See §7 Part D

Leading and lagging behaviour

48 Leads and lags can be considered to be a type of portfolio shift which occurs in the financing of imports and exports.

49 An exporter who anticipates a more favourable (declining) exchange rate delays converting export proceeds in the foreign currency into the domestic currency ("lags"). An importer who fears a worse (declining) exchange rate can accelerate payments for imports by buying the foreign currency forward ("leads").

50 It is considered that every month of lead in a payment and lag in receipts represents an outflow of a twelfth of trade, which makes the distinction between goods and financial services seem artificial in practice. [29]

Dynamics of the trading environment

51 The rand is traded by traders employed by the authorised dealers. Typically the treasury of an authorised dealer would be divided into

---

[29] See §'s 1.5, 25.3.2 and 25.3.5 Part D

different departments. One of the departments is the front office. The front office is divided into different desks. One of the desks is the forex desk. The spot rand desk and the spot rand trader are the focal point of rand activity in the trading room. A number of factors influence a trader's view of a currency.

One factor is the information which appears on the screen of a service provider such as Reuters in front of the trader. A spot trader will react to the headline on the screen within seconds, the direction of the trade dependent on his perception of the impact of the headline on the direction of the market.

<u>Sentiment and perceptions</u>

52 It is clear from the evidence that transactions which are aimed at risk management, i.e. hedging transactions, and transactions aimed at profit making, i.e. market making/proprietary trading and pure speculation, are based on medium to short to very short term views of the market participants on the prospects of the rand. These views determine the market sentiment and may not always in the short term be based on complete or accurate information. Sentiment has been widely acknowledged as having an important influence on the general direction of the currency, as well as the sharp movements which may

occur from time to time. Sentiment may also be an important factor considered by longer-term investors when considering the potential risks associated with an investment in South Africa.

53 In determining market sentiment, views on, inter alia, the following are considered important:

- actual and prospective economic growth
- political stability
- potential inflows of capital from privatisation.[30]

Speculation

54 In a well-developed market there is a need for short, medium and long-term investors and for buyers and sellers of a variety of spot and forward instruments. The speculator has an important part to play in an effective price discovery mechanism, based on the principles of demand and supply operating in an amorphous market. Speculators can help make a liquid market while there is a healthy demand for and supply of a currency, and where the burden of the spread is tight. The deeper, the more liquid the market, the more likely it will be that speculators will be “bubbles on a steady stream”. However, in thin

30 See §6 Part D

markets speculators will have a greater impact, even with very small transactions.[31]

II FINDINGS IN RESPECT OF SPECIFIC TRANSACTIONS

A The Wakeford allegations[32]

55 The four corporates identified by Mr Wakeford as possibly being parties to dubious share placement transactions with Deutsche Bank AG, Johannesburg Branch ("DBJ") were Sasol, Nampak, M-Cell and Billiton.[33]

56 The information in regard to Billiton was inaccurate as Billiton did not conclude any share placement transactions in 2001.

57 The nature of the share placement transactions of the three other corporates is described in detail in Part E.[34]

---

31 See §'s 17 to 29 Part D
32 The Wakeford allegations are analysed in detail in Part E.
33 See, generally, Part E
34 See §'s 15 – 17 Part E

58 The hedging, funding and related transactions undertaken by Deutsche Bank in respect of each of the share placements were controversial. The nature of those transactions is described in detail in Part E.[35] Commencing in October 2001 and concluding in May 2002, Exchange Control reviewed those transactions in meetings and correspondence with DBJ.

59 Exchange Control's material concerns about the hedging, funding and related transactions put in place by Deutsche Bank in respect of the Sasol, Nampak and M-Cell share placements were that:

- the applications for share placements did not disclose all the related or subsequent transactions which were implemented or were to be implemented, i.e. the hedging, funding and related transactions; and
- some or all of the hedging, funding and other transactions prejudiced the obligation placed on DBJ to ensure reserves neutrality.

60 Exchange Control expressed the view that had it been made aware, at the time the applications were made, that the hedging, funding and

---

[35] See §'s 20-22 Part E

other transactions would be concluded, they would not have approved the share placements.[36]

61 DBJ disputed that Exchange Control should have had any concerns about the hedging, funding and related transactions in that:

- the hedging, funding and related transactions were either specifically approved by Exchange Control or fell within general exchange control approvals; and
- the hedging, funding and related transactions maintained reserves neutrality in that the transactions, considered in total, did not result in a net outflow of rand from South Africa.[37]

62 Furthermore, the two parties disputed whether or not the hedging, funding and related transactions were in breach of administrative law duties.

63 It is common cause between them that, in aggregate, the transactions did not contribute to the rapid depreciation of the rand.

---

36 See §'s 23-24, 28 Part E

37 See §'s 25 and 26 Part E

64 The opinion of the team of assistants appointed by the Commission to investigate the Wakeford allegations was that the hedging, funding and related transactions (in regard to the Sasol and Nampak share placements specifically) had the effect that the foreign currency reserves of South Africa were reduced or depleted by Euro 250 million (Sasol) and £15 million and £5 million (Nampak).[38]

65 The question of whether or not DBJ had complied with exchange controls in implementing the hedging, funding and related transactions was canvassed at length in evidence before the Commission over a number of days. The evidence in public ended in a stand-off between Exchange Control and DBJ.

66 A separate review process initiated by the Reserve Bank culminated in a Settlement Agreement between Exchange Control and DBJ.[39]

67 The material terms of the Settlement Agreement were that DBJ and Exchange Control agreed that the Deutsche Bank group would implement a set of transactions described in Annexure 1 to the Settlement Agreement.

---

38 See <u>§27 Part E</u>

39 <u>Annexure C to Part E</u>

68 The Settlement Agreement addresses Exchange Control's concerns regarding reserves neutrality, while at the same time not requiring the unwinding of any of the share placements asset swaps and related transactions (Clause 2). As and when Sasol and Nampak shares are on-placed and the equity hedge (forward) on those stocks unwind, the Settlement Agreement transactions will be unwound on a pro-rata basis (Clause 3). As security for the undertaking by DBJ to ensure that the Deutsche Bank Group would enter into the transactions, DBJ would deposit R10 million with the Reserve Bank on the business day following signature of the Settlement Agreement. The deposit would be interest free. The deposit would be repaid to DBJ once DBJ provided Exchange Control with documentary evidence confirming completion of the transactions set out in Annexure 1 of the Settlement Agreement.

69 The findings of the Commission in regard to the Sasol, Nampak and M-Cell *share placements* are that, viewed in isolation and excluding the funding, hedging and related transactions, such transactions would be considered legal and in accordance with Exchange Control approvals.[40]Furthermore, the *share placements*, viewed in isolation and excluding the funding, hedging and related transactions, when

---

40 See <u>§18 Part E</u>

implemented, would not have impacted negatively on the forex reserves and consequently would not have contributed to the depreciation of the rand.[41]

70 The findings of the Commission in regard to the Deutsche Bank *hedging, funding and related transactions* with respect to the depreciation of the rand in 2001, are as follows:

- the *Sasol* transactions: on the days the currency conversion was effected, 19 and 20 February 2001, the rand appreciated in value on a net daily basis. However, the currency conversions resulted in an outflow of foreign currency at the time of the transaction to the extent that the rand was exchanged for foreign currency in the local forex market. Based on the Commission's definition of the impact of a transaction on the currency, the currency conversion can be considered to have contributed to the longer term depreciation of the rand in 2001;
- the *Nampak* transactions: the rand appreciated in value on a net daily basis on 26 June and 2 August 2001 but depreciated on 27 June 2001, the days the currency conversions were effected. However, the currency conversions resulted in an outflow of foreign currency at the time of the transaction to the extent that the

41 See <u>§18.1 Part E</u>

rand was exchanged for foreign currency in the local forex market. Based on the Commission's definition of the impact of a transaction on the currency, the currency conversion can be considered to have contributed to the longer term depreciation of the rand in 2001;

- the *M-Cell* transactions: Deutsche Bank utilised its own funds to underwrite the transaction and Deutsche Bank London exchanged R231 million for USD20 million on 8 January 2002.[42] The M-Cell hedging, funding and related transactions were reserves neutral and could not have contributed to the depreciation of the rand in 2001;

71 The findings of the Commission in regard to the legality and ethics of the Deutsche Bank *hedging, funding and related transactions* for the Sasol and Nampak share placements are as follows:

- based on the evidence presented to the Commission, the Commission is not able to make a positive finding on whether DBJ was in breach of exchange controls and its administrative law duties[43]. The legal position is not as clear and unequivocal as the two parties contend. It is presumably for that reason, amongst others, that Exchange Control and DBJ settled their differences concluding the Settlement Agreement;

---

42 See § 27 Part E
43 See §37 Part E

- the transactions cannot be regarded as unethical in terms of the conduct characterised as unethical in §9 of the Executive Summary;
- Clearly, the intention of approving “share placements” is to allow the financing of off-shore investments using local funds in a controlled manner to protect the reserves of the country.

Therefore, based on the Commission’s definition of what constitutes a breach of the “spirit of exchange controls”, the transactions ran contrary to the “spirit of exchange controls” in that there was a lack of up front and complete disclosure with regard to the transactions and the foreign reserves were depleted to the extent that rand was exchanged for foreign currency in the local forex market.

In a sophisticated and dynamic market place, it is accepted that a financial services provider will be pro-actively looking for new products and services to meet the needs of their clients and, at the same time, maximise revenues. However, through a process like this Commission, all market participants are reminded of their responsibilities towards a sustainable economy and the commitment towards business practices which support the regulatory and other structures implemented by the Government.

72 No evidence was found that the *share placements* and the *hedging, funding and related transactions* satisfied any of the other requirements for a reportable transaction in terms of the Terms of Reference.

B South African corporates

73 The KPMG team found that there were a number of large or unusual transactions of South African corporates that "might have" contributed to the rapid depreciation of the rand.[44]

74 All the transactions, with one possible exception discussed below, appear to have been concluded in the ordinary course of business of the corporates and no evidence was found that these transactions were illegal or unethical or satisfied any of the other requirements for a reportable transaction in terms of the terms of reference.

75 During the week ending 7 December 2001, Equity Diamond Cutting Works (Pty) Ltd ("Equity Diamonds") bought and sold amounts of USD that were out of proportion to its underlying commitments. These transactions may have contributed to the rapid depreciation of the rand during this week.

---

[44] See §11.1(b)-(g) Part J

76 These transactions would be in contravention of exchange controls. The transactions were reported to Exchange Control.

C The activities of financial market participants[45]

77 Based on the Deloitte and Touche team analysis of the activities of market participants in order to identify potential transaction types for further investigation, no evidence was found of specific transactions which may have contributed or given rise to the rapid depreciation of the rand in 2001.

78 The analysis performed indicated that the activities of the financial markets participants reflected a uni-directional response to market factors, primarily regulatory, economic and political. The depreciation of the rand and the extent of the exchange rate spread was a reflection of uncertainty, reduced liquidity, a pervasive negative sentiment and a reversal of demand for the rand by foreign institutions.

79 The analysis concluded that the millions of transactions that make up the market, the combined impact of which reflected a demand for

---

[45] Generally, see Part K

foreign currency and an aversion to holding rand, contributed to the rapid depreciation of the exchange rate of the rand.

D <u>Institutional investors – Circular D346</u>

80 On 13 November 2001 Exchange Control issued Circular D346 which permitted fund managers to invest a portion of their funds off-shore. Following on that permission, applications totalling R1.9 billion were received in November 2001 and approved by Exchange Control in December 2001. The approvals expired within 30 days or at the latest 31 December 2001. In order to utilise their allowances before expiry, the institutional investors bought foreign currency to buy shares and/or placed the foreign currency on deposit in anticipation of buying shares in 2002. As a consequence, the foreign currency equivalent of R1.765 billion was bought by institutional investors in an illiquid and volatile market.

81 There was no evidence that these transactions were illegal or unethical, in contravention of exchange controls or satisfied any of the other requirements for a reportable transaction in terms of the Terms of Reference.

III FINDINGS IN RESPECT OF FACTORS OTHER THAN TRANSACTIONS

A Factors affecting the rand in 2001

The strength of the US dollar

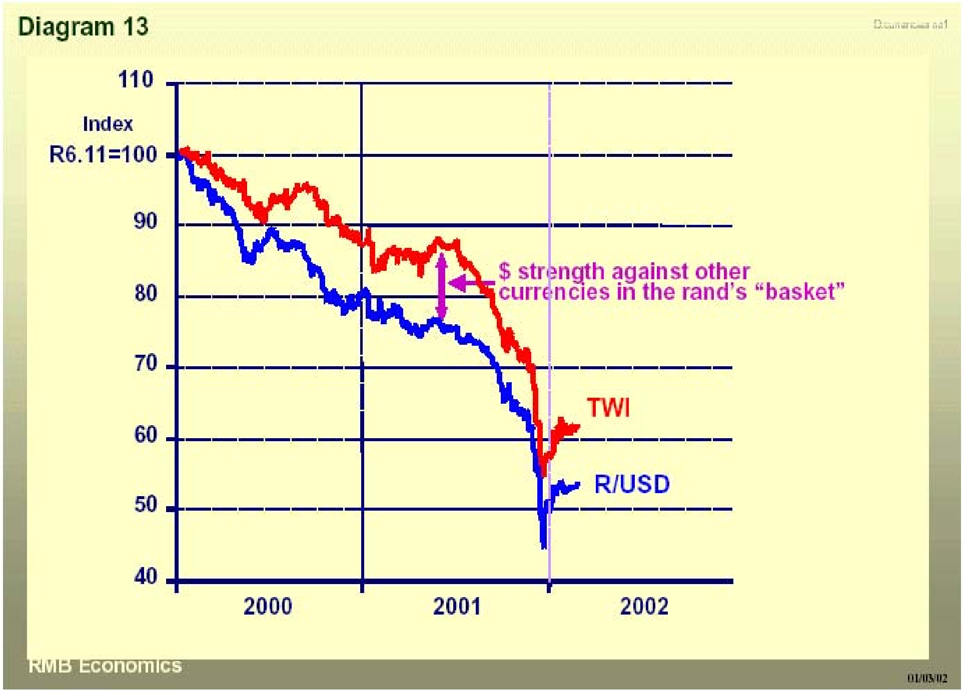
82 It is important to appreciate that the dollar strengthened against three major currencies (the Japanese yen, pound sterling and euro) – not only against the rand.[46]

83 The Commission finds that the decline of the rand can partly be explained by the strength of the US dollar.[47]

---

46 See §1.3 Part C
47 See §4.2 Part D

Diagram 13 Expert Bundle 124, Part D p 10



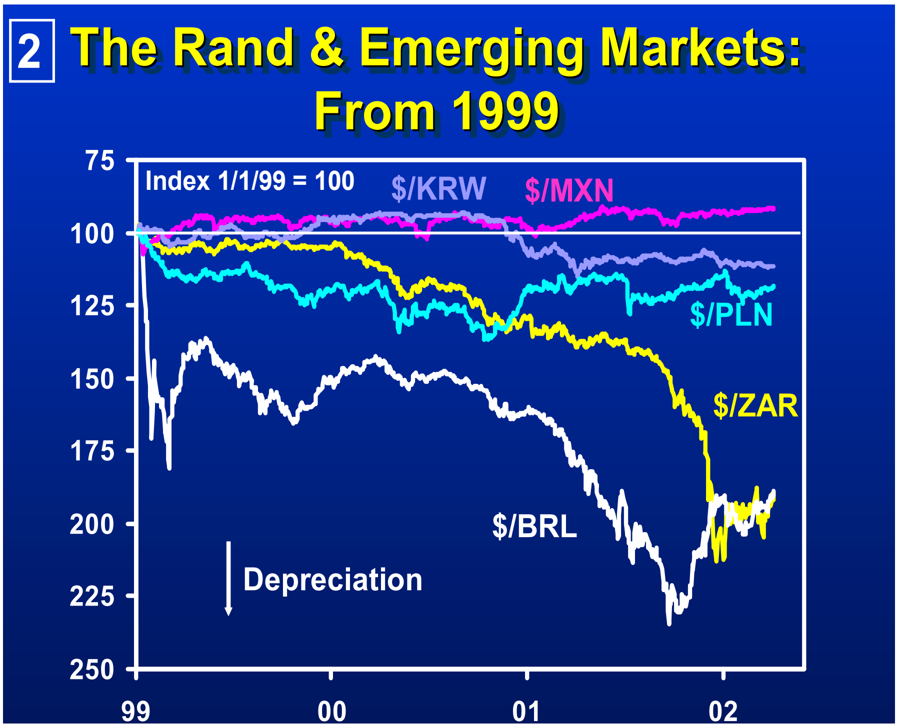
The rand compared to similar currencies

84 The Commission finds that it was not only the rand that depreciated in 2001. The rand performed as well, or as badly, as other similar currencies until about the last quarter of 2001. When one measures the performance of the rand:

- against other *emerging market* currencies, such as the Brazilian real, Korean won, Polish zloty and Mexican peso, the rand was not weaker until about September 2001;[48]

- against other *commodity* currencies, such as the Australian dollar, the New Zealand dollar, the Norwegian krone and the Swedish krone, the rand performed as well, until September/October 2001.[49] It was only in the fourth quarter that the rand became a special case.[50]

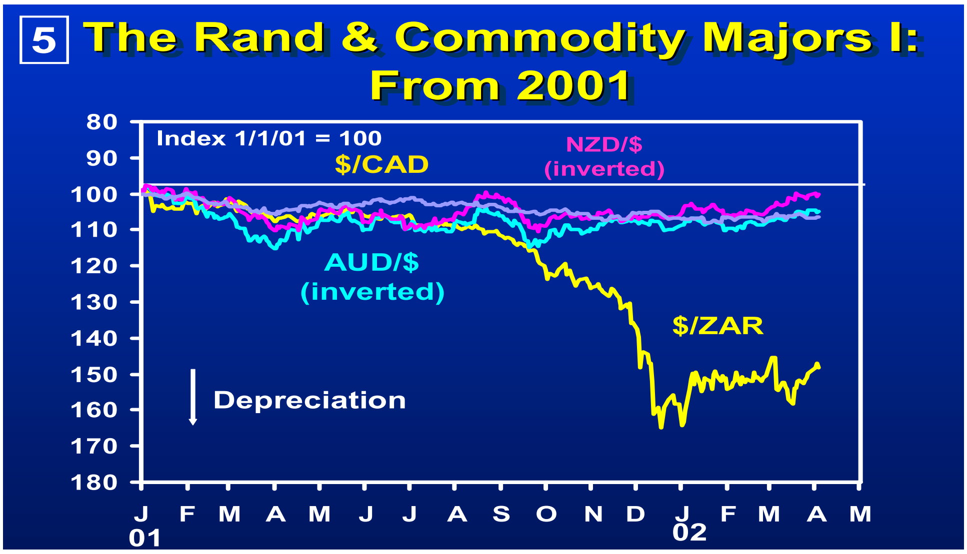
Slide 2, O'Neill Bundle 3, §3.2 Part B



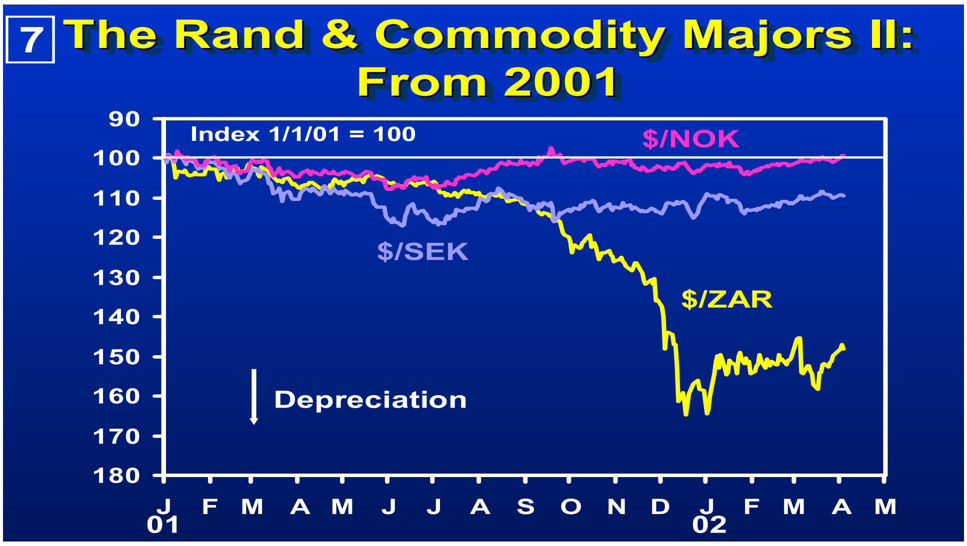
---

48 See §3.2 Part B
49 See §3.3 Part B
50 See §3.1 Part B

Slide 5, O'Neill Bundle 6; §3.3 Part B



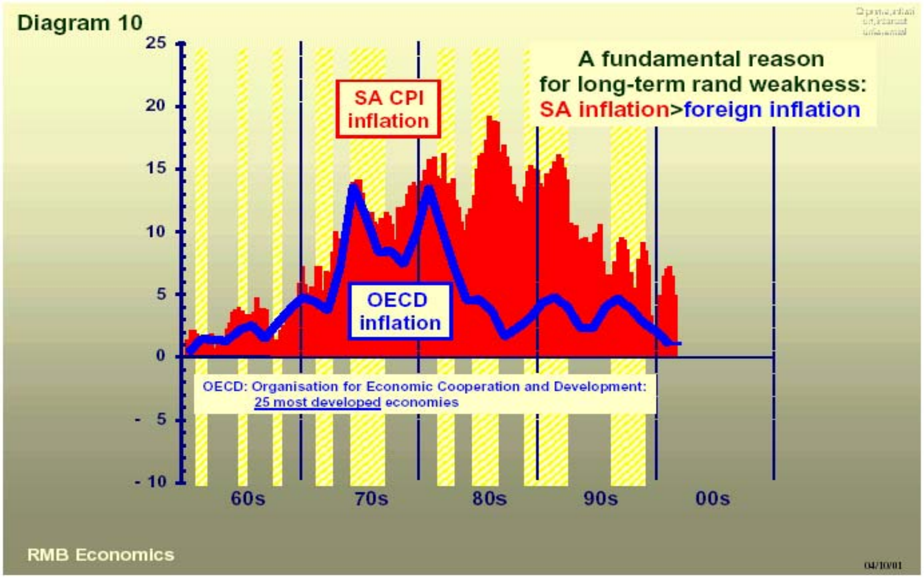
Slide 7, O'Neill Bundle 8; §3.3 Part B



Inflation Differential

85 The Commission finds that a fundamental reason for the long-term decline of the rand was that the South African inflation rate was higher than that of its trading partners.[51]

Diagram 10 Expert Bundle 122; Part D §4.1



Global Economy

86 There was a decline in the performance of the global economy commencing in 2000 and continuing in 2001.

51 See §1.1 and 4 Part D

87 The Commission finds that the deterioration in the global economy had a negative effect on the rand in at least two respects:-

- there was a decline in hard currency liquidity in the market, and
- the flow of capital to emerging markets, including South Africa, reduced.[52]

Contagion

88 The Commission finds that one of the reasons for the negative sentiment which added to the downward pressure on the rand was contagion through similarity. South Africa and Argentina, for example, are grouped together as emerging markets. Consequently, South Africa and its currency, the rand, were negatively impacted by the Argentinean crisis in 2001. A further way in which contagion operated negatively for the rand was by South Africa's proximity to Zimbabwe.[53]

---

52 See §'s 5.2 and 5.4 Part D
53 See §'s 1.6 and 6.1 Part D

The Balance of Payments and the flight of capital after 11 September 2001

89 The effects of the attacks on the World Trade Centre and the Pentagon on 11 September 2001 were inter alia:

- a crash in global equity markets;
- increased risk aversion towards emerging markets;
- fund managers withdrew funds from what they regarded as vulnerable economies in a flight to a safe haven (ironically the United States of America). [54]

90 In quarter 4 total domestic expenditure exceeded total disposable income. The excess of total domestic expenditure over total disposable income was expressed in a deficit on the current account on the balance of payments which was not matched by an inflow of foreign investment capital into South Africa.[55]

91 The imbalance on the financial account of the balance of payments changed from a surplus (or an inflow of capital) of R4.7 billion in quarter 3 to a deficit (or outflow of capital) of R1.5 billion in quarter 4.

---

54 See §'s 5.3 and 5.4 Part D
55 See §5.9 Part D

- Foreign direct investment ("FDI")

On a net basis, offsetting changes in direct foreign assets against changes in direct foreign liabilities, FDI changed from an inflow of R3.6 billion in quarter 3 to an outflow of R7.3 billion in quarter 4, thus contributing to the weakness of the rand.

- Portfolio investment

The net outward movement of portfolio capital totalled R3.4 billion in quarter 4.[56] This raised the total net value of international portfolio capital outflows to R67.6 billion in 2001 as a whole compared with net outflows of R13.8 billion in 2000.

- Other investment

On a net basis, other foreign investment amounted to an outflow of R29.3 billion in 2001.[57]

92 The Commission finds that, in fact, capital *left* the country in the fourth quarter of 2001, thereby putting further downward pressure on the rand.

---

56 See §5.8(2) Part D; §6 Part J; §10.2.5.2-3 Part K
57 §5.8 Part D

The Broad Basic Balance of Payments as an indicator of rand performance

93 The impact of the weaknesses in the current account, foreign direct in investment and portfolio investment on the rand is best illustrated by the correlation between the performance of the rand and the "broad basic balance of payments" ("BBoP"). [58]

94 A country with a BBoP deficit is likely to have a weak currency and a country with a BBoP surplus is likely to have a strong currency. So, for example, despite having a large current account balance of payments deficit, the US dollar has strengthened against other major currencies because the USA BBoP has remained in surplus. In order to take into account the South African net open forward position ("NOFP"), one speaks of an adjusted BBoP (the current account plus FDI plus portfolio flows plus the change in the NOFP).

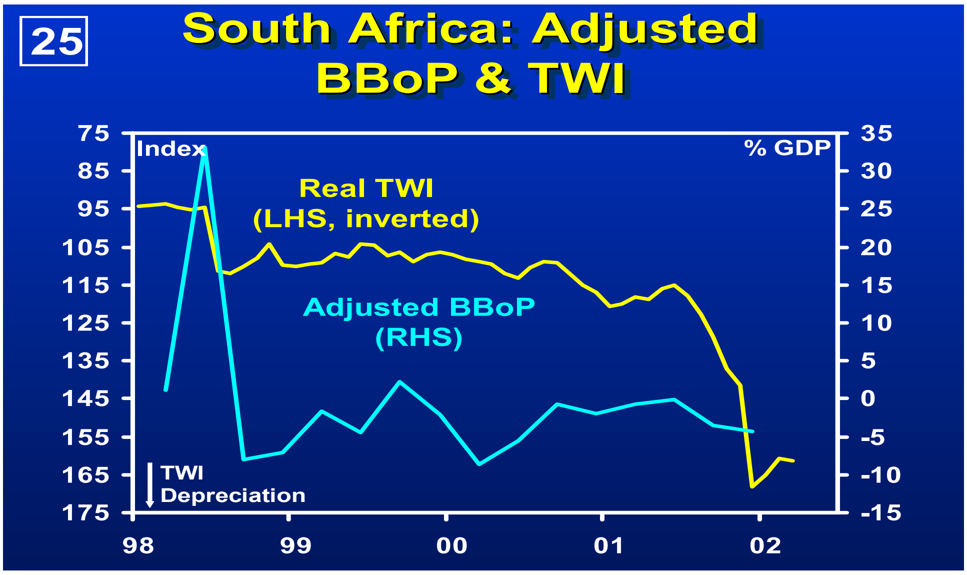
95 As illustrated by the adjusted BBoP which has been in deficit since 1998, the rand has depreciated in value:[59]

---

[58] BBoP is defined as the current account plus net FDI plus net portfolio flows.

[59] See §5.10 Part D

Slide 25, O'Neill Bundle 26; Part D p30



Privatisation

96 It was conservatively estimated that foreign currency inflows from privatisation in 2001 would be about R18 billion. The actual inflows were R2.3 billion. Investors saw privatisation as a litmus test of the Government's commitment to investor friendly economic policies.

97 The Commission finds that the non-occurrence of privatisation transactions to the anticipated extent had perceptual and actual capital

inflow consequences, which resulted in further downward pressure on the rand.[60]

Reserve Bank's policy of non-intervention

98 The Reserve Bank took the entirely justifiable decision not to use the forward book (as it had done in 1998) to finance intervention in support of the rand in 2001. The policy of non-intervention was made public by the Reserve Bank. Participants in the forex market then formed the view that in the absence of support for the rand by the Reserve Bank, the rand would continue to depreciate.

99 The Commission finds that the policy of non-intervention became an element of the "one-way bet" view of the rand.[61]

---

60 See §6.5 Part D

61 See §13.6 and 13.7 Part D

NOFP[62]

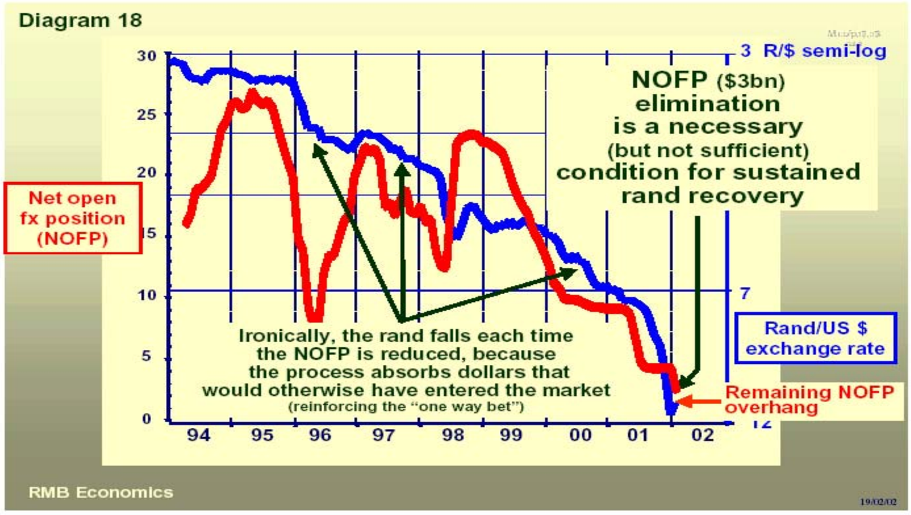
100 The Reserve Bank and National Treasury took a decision to reduce the NOFP. The decision was made public. Total purchases of foreign exchange by the Reserve Bank in 2001 amounted to USD 4.4 billion. The decline of the NOFP (which had been USD 23 billion in 1998) during 2001 was as follows as measured at the end of each quarter:

Quarter 1	:	USD 9.4 billion
Quarter 2	:	USD 5.3 billion
Quarter 3	:	USD 4.7 billion
Quarter 4	:	USD 4.8 billion.

101 The apparent correlation between the reduction of the NOFP and the depreciation of the rand is shown in this graph:

62 NOFP is expressed in US dollar terms and is defined as the sum of the net reserves (gross gold and foreign currency reserves minus foreign loans) of the Reserve Bank and its oversold forward book, i.e. the extent to which the Reserve Bank's future obligations to deliver US dollars are not covered by the Reserve Bank's net reserves.

Graph 18, Expert Bundle 126; Final Report Part D §14.5 p50



102 The Reserve Bank's commitment – commendable as it was – to reduce the NOFP (by buying US dollars) contributed to the perception that the rand was a one-way bet.

103 In the statement of 14 October 2001, however, the Reserve Bank made it clear that it would no longer intervene by purchasing foreign exchange from the market for purposes of reducing the NOFP. The NOFP would instead be expunged by using cash flows derived from the proceeds of Government's off-shore borrowings and privatisation.

From then on the NOFP should not have been seen as an element of the one-way bet.[63]

104 The Commission finds that the mere existence of the NOFP is viewed negatively by the forex markets and thus continues to contribute to a longer term depreciation of the rand. The manner in which the NOFP was reduced during 2001, through “mopping up” foreign currency from the forex markets, contributed to the depreciation of the rand.

<u>The meeting of 14 October 2001 and the communications that followed</u>

105 The Reserve Bank became concerned about comments from the market that speculative transactions, particularly by non-residents, were adding to volatility and rand weakness. The decision was then taken – and conveyed to the authorised dealers at a meeting on 14 October 2001 – that the Reserve Bank would take appropriate steps against trading activities inconsistent with exchange control rules. Existing rules would be enforced to ensure that only legitimate transactions would take place in the forex market. What was targeted was the financing of short rand positions in the domestic markets, which was inconsistent with the

---

[63] See <u>§14 Part D</u>

requirement that domestic borrowing by non-resident investors was subject to certain restrictions.

106 In about the first two days after the meeting of 14 October 2001, the rand appreciated. On 16 October 2001 the Reserve Bank issued Circular D342, in which it was stated inter alia that "…when dealing with a non-resident counter-party, other than a correspondent bank, supporting documentary evidence must be obtained confirming that such non-resident counter-party has a legitimate South African exposure resulting from an accrual, investment or asset denominated in rand."

107 By 19 October 2001 it was clear that non-residents could continue trading in the spot market.

108 On or about 25 October 2001 non-residents banks were informed of the requirement that the compliance officer of a non-resident bank was obliged to sign a "compliance letter" certifying that all transactions were in compliance with exchange control rules and regulations.

109 The banks indicated that between 35% and 45% of foreign counterparties acknowledged compliance in the manner required.[64]

110 The statement of 14 October 2001 and the follow-up Circular D342 and the notice of 25 October 2001 was followed by a decline in the average net daily rand forex market turnover from:

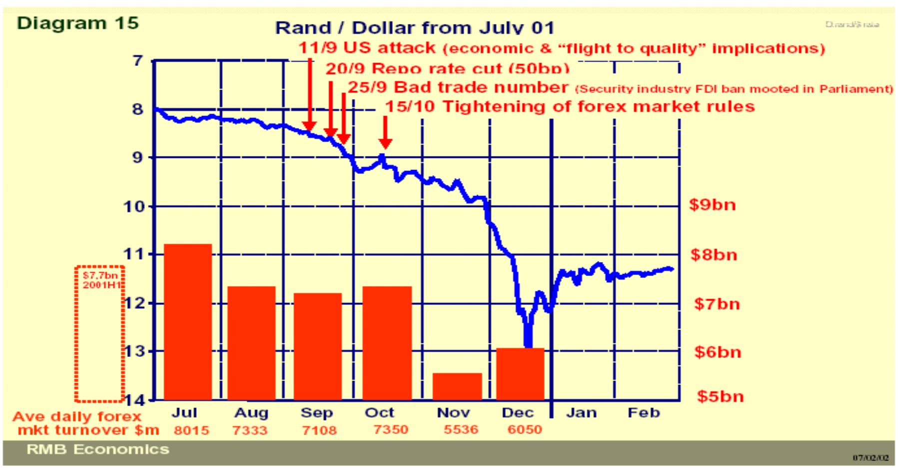
USD 8 billion in July 2001 to

USD 7.3 billion in October 2001 to

USD 5.5 billion in November 2001 and then increased to

USD 6 billion in December 2001.

<u>Diagram 15, Expert Bundle 125; Part D p60</u>



64 See <u>§15.11 Part D</u>

111 The decline in liquidity and the volatility in the market in the last quarter are common cause between the Reserve Bank and the authorised dealers.

112 What is in issue is the causality between turnover and volatility in the market and the depreciation of the rand.

113 In general, the authorised dealers unanimously testified that the stricter enforcement of exchange controls on non-residents and/or the confusion which arose from differences in the interpretation of the communication, following the 14 October 2001 statement and Circular D342, resulted in an immediate liquidity drain as a result of market participants ensuring compliance with the circular. Further perceived consequences were the expansion of the second-tier rand market outside of South Africa, widening of bid offer spreads and a decrease in the pool of market participants. The increased risk of holding rand resulted in a preference to avoid being long rand. In a nervous illiquid market panic quickly takes hold and nobody wished to get “stuck in a position”. The predominant rational was “get out” of any positions and the market moves were that much more pronounced. For these reasons, the banks considered the circular to be one of the many factors, which contributed to the depreciation of the rand as it drew attention to

concerns about the market but did not prevent ongoing speculation against the rand.

114 The Reserve Bank contended that the statement of 14 October 2001 did not contribute to the rapid depreciation of the rand.

115 The Reserve Bank disputed that there was a causal link between turnover and the value of the rand by referring to periods prior, and subsequent, to 2001 when there was no such link. For example, in 1998 the rand depreciated from USD1 = R 4.90 in February 1998 to USD1 = R 6.20 in July 1998, a depreciation of 26.4%, at a time when the total average daily turnover increased by some 139% from USD3 billion in February 1998 to USD7.4 billion in July 1998. [65]

116 There was, however, a general view expressed by economists and authorised dealers that the effect of the 14 October statements and the communications that followed was negative for the rand in that it drained liquidity from the forex market by a stricter application of exchange controls, and the decline in the spot market might well have contributed to the size or speed of the depreciation of the rand. [66] It was

---

65 For other examples see §15.14 Part D
66 See §15.8 Part D

viewed that with the volumes out of the market and no speculators active in the market, the conditions were so much more favourable for a "run on the currency";[67]

117 The Commission finds that the 14 October 2001 statement and Circular D342 changed the behaviour of market participants and were amongst many factors which contributed to the decline in liquidity and increase in volatility in the forex markets, thereby contributing to the depreciation of the rand.

118 The Commission, furthermore, finds that the 14 October 2001 statement and Circular D342 reduced the activities of speculators in the market, but did not fully achieve the originally intended purpose of stemming the rapid depreciation of the rand.

Negative Sentiment

119 The Commission finds that market sentiment in 2001 and particularly during the last quarter was negative towards the rand. In addition to the factors mentioned earlier, such as Zimbabwe, Argentina, exchange controls and the lack of privatisation, there were negative perceptions,

---

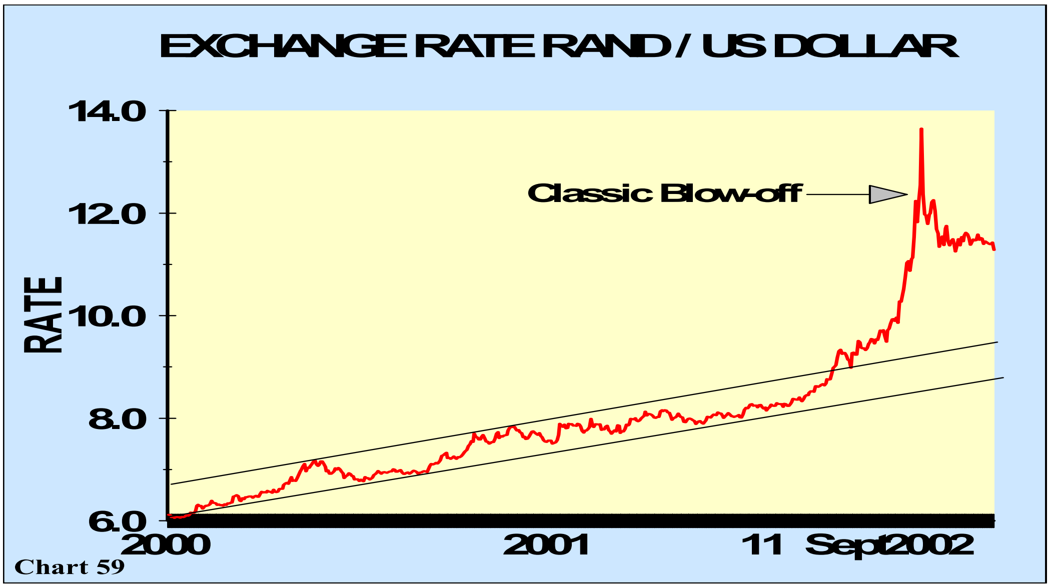
[67] See §15.13 Part D

for example, about unemployment, HIV/Aids, crime and a lack of labour market flexibility.[68]

The “blow-off” of October to December 2001

120 The depreciation of the rand from the beginning of 2000 until September 2001 was within a defined upward channel. The rand then entered unchartered territory, a “blow-off”:

Chart 59 Expert Bundle 421; Part D p97



121 The forex market became volatile. One month historical volatility of the rand’s exchange rate against the US dollar increased from a level of

68 See §6.1 – 6.4, 41 Part D

9.1% in the first nine months of 2001 to an average of 20.5% for the last quarter. These volatilities reached a high of 55% at the end of December 2001.[69]

122 During this period the authorised dealers' profits from forex activities increased significantly.[70]

The explanations for the "blow-off" as provided in evidence

123 The probabilities are that everyone who traded in the rand in the last quarter of 2001 took the view – or speculated – that the rand would continue to depreciate and acted in accordance with that view, thereby further depressing the value of the rand.

124 One must be wary of condemning all speculation without an understanding of what it entails. If speculation implies transactions entered into based on a view of the future value of a currency, then most forex transactions have a speculative element in them. In the banking industry in South Africa, speculation is understood as the adopting of a view as to the likely movement in the exchange rate of a

69 See §15.7 Part D
70 See generally Part H

currency and acting on the view with the intent of making a profit or preventing a loss. Transactions fitting that definition are transacted daily. Speculative activities of that kind are conducive to a liquid and efficient financial market. Authorised dealers view profit making from proprietary trading and market making as not unethical or improper. In the Commission's view, what may be offensive is the conduct of a "market user" who is not a "market maker" or the conduct of a "pure short seller" or "naked short" who trades in the rand, with no underlying transaction, looking to make a profit if the rand goes down.[71]

125 One view is that the steep decline in the value of the rand in quarter 4 was due to "speculators … in the financial services industry both domestically and abroad" and "pure currency speculators" in the rand to an estimated volume of USD 200 million to USD 300 million per day.[72]

126 But it is not only the conduct of "pure speculators" or "naked shorts" which must be scrutinised:-

- *Authorised dealers* are allowed to conduct proprietary trading, i.e. to trade the rand for their own account in the inter-bank market.

---

71 For a detailed discussion on "speculation" see §'s 18-22 Part D

72 See §28.3, 29, Part D

During 2001 the authorised dealers did not run huge positions against the rand. Their aggregate open positions amounted to less than 1% of their net qualifying capital in 2001. The statutory limit for those positions is 10% of net qualifying capital.[73]

- *Non-resident banks* trade rand very actively and represent some 55% of the total turnover in the rand forex market. It is because the Reserve Bank believed that non-residents were trading contrary to the exchange control rules (ie there was no underlying commitment to the transactions) that the statement of 14 October 2001 was issued.[74] In the investigation conducted by KPMG on behalf of the Commission, there was no indication that non-resident banks were responsible for the depreciation of the rand in November and December 2001. Non-resident banks were buying rand and selling US dollars to the authorised dealers for 28 out of 42 business days in November and December 2001. However, there was a demand for US dollars in the market which did not reduce over this period. This fact - and not a large scale selling of rands by non-resident banks – put pressure on the rand.[75]
- An *exporter* who anticipates a more favourable exchange rate can delay converting export proceedings in the foreign currency into the

---

73 See §25.1 Part D
74 See §25.2 Part D
75 See §7.3 Part J

domestic currency ("lags" its payment). An *importer* who fears a worse exchange rate can accelerate payments for imports by buying the foreign currency forward ("leads"). An exporter is entitled to retain foreign currency earnings in respect of the export of goods for 180 days from the date on which the funds were first credited to a CFC account.[76] With the continuous weakening of the rand in recent years, it has become common knowledge that any delay in repatriation of foreign currency is likely to make currency gains over and above trade profit.[77] The probabilities are that as the rand was seen as a one-way bet, prudent importers bought foreign currency forward and gleeful exporters delayed repatriating foreign currency. Even if exporters delayed for 180 days, acting lawfully, the negative impact on the rand would have been significant. In quarter 2 the total exports of goods and services from South Africa, at a seasonally adjusted annualised rate, amounted to some R328 billion, with imports of goods and services amounting to almost the same. Even if a small portion of those amounts were involved in leads and lags, it would have had a noticeable effect on the exchange rate.[78]

---

76 In certain circumstances, the period can be 570 days: §17.4(1) Part I

77 See <u>§25.3.6 Part D</u>

78 See <u>§25.3 Part D</u>

127 The Commission finds that there is not sufficient evidence to conclude on whether unacceptable speculation was a cause or contributing factor to the rapid depreciation of the rand in 2001.

128 Into the cauldron that the forex market became in quarter 4, went the following brew:

- a deficit on the current account on the balance of payments;
- the double whammy that the deficit was not matched by an inflow of foreign investment capital *and* capital left the country: from an inflow of capital from R4.7 billion in quarter 3 to an outflow of capital of R1.5 billion in quarter 4;
- knowledge of the Reserve Bank's policy on non-intervention;
- the thinner forex market after 14 October 2001.

Adding fuel to the fire was the pervasive negative sentiment. The rand was seen as a one-way bet. Panic set in. A herd mentality prevailed. Each transaction based on the view that the rand *would* depreciate became an element of a self-fulfilling prophecy. Everyone acted in the same way, but there was no evidence of collusion or acting in concert. The impact on the rand was nevertheless the same. Common sense asserted itself only after the joint press release of the Minister of Finance and Governor of the Reserve Bank on 21 December 2001.

IV FINDINGS IN RESPECT OF EXCHANGE CONTROL[79]

A The effectiveness of the administration of exchange controls

129 Exchange control policy is determined by the Minister of Finance. The Exchange Control Department of the Reserve Bank ("Exchange Control") is responsible for the day-to-day administration of exchange control. Although the authorised dealers are not the agents of Exchange Control but act on behalf of their customers, they are considered to be jointly responsible with Exchange Control for the administration of exchange controls.

130 The KPMG team which investigated the effectiveness of the current exchange control administration identified strengths and drawbacks.

131 The strengths of the current system are:

- Exchange Control has effective controls for ensuring the validity of applications and for ensuring that it has received all the applications submitted by authorised dealers;

---

[79] See, generally, Part I

- a response to an application requires dual control before being given to the authorised dealer to enhance control over and consistency of approvals;
- the electronic feeding of cross-border foreign exchange data from authorised dealers should help to provide timeous and complete information for balance of payments statistics;
- imports/export undertakings have removed a substantial amount of the paperwork that used to be the responsibility of authorised dealers; and
- authorised dealers have implemented processes to ensure compliance with exchange control rules and are responsible for about 99.5% of forex transactions.[80]

132 The drawbacks of the present system relate, inter alia, to export proceeds and CFC accounts; double counting; shorting the rand; staff competence; transfer pricing; weaknesses in the audit by external auditors of compliance by corporates with exchange control rules; submission of applications; compliance with approved conditions; inconsistency of approvals; accuracy of data; communication by Exchange Control, smaller transactions.[81]

---

80 See §17.3 Part I

81 For more details, see §17.4 Part I.

133 The major authorised dealers commented that:-

- Exchange control rulings are open to conflicting interpretations.
- The current requirement for the presentation of paper based documentation to support cross-border payment transactions is not necessarily effective and is open to abuse.
- The accurate matching of multiple debit transactions against credit transactions against CFC accounts can be problematic.
- Difficulty has been experienced in enforcing compliance by non-resident banks with Circular D342 of 15 October 2001.
- There is insufficient consultation by Exchange Control with authorised dealers before Rulings are made.
- It is considered impossible to ensure that non-residents comply with Exchange Control because non-residents are allowed to trade with any authorised dealer in South Africa and may have accounts with more than one authorised dealer.
- The administration of CFC accounts in order to control the 180 day rule is cumbersome.

134 The best judge of whether or not the exchange control system is effective is Exchange Control. The evidence of Exchange Control was that exchange controls are effective provided that all role players fulfil their obligations in both the spirit and the letter of the existing rules and

regulations. By and large the experience of Exchange Control is that that is the norm.

135 There were relatively few difficulties reported with the approximately 5.6 million forex transactions which were reported to Exchange Control during 2001. Difficulties, in the main, were limited to share placements. The number of transactions successfully implemented in 2001 bears testimony to the fact that exchange controls operate efficiently and effectively within the policy parameters set by the Minister of Finance.[82]

136 Exchange Control responded to the comments and recommendations of the authorised dealers, for example, as follows:

- authorised dealers report to Exchange Control when they do not receive the compliance letters from non-resident banks; in the interim it is allowing transactions to proceed in order not to interfere unduly with the smooth operation of the forex market in South Africa; compliance letters continue to be called for and non-receipt must still be reported to Exchange Control;

[82] §13 and 16.3 Part I

- a minor inconsistency or an unclear point in exchange control rules does not render the administration of exchange controls in their totality ineffective;
- authorised dealers have the opportunity to air their views on any issue relating to exchange controls at the Liaison Committee, which meets quarterly under the chairmanship of the General Manager of Exchange Control;
- every effort is made by the Reserve Bank to implement exchange controls in order to facilitate the commercial transactions of the South African economy;
- a degree of flexibility is applied in the implementation of exchange controls; and
- if, in some instances, flexibility leads to uncertainty, it is a price worth paying.[83]

137 In view of their responsibilities for exchange control, the effectiveness of the processes and procedures of the authorised dealers can be summarised as follows:

- the major part of the work (about 99.5%) is done efficiently by the authorised dealers.

---

[83] See §'s 15 & 16 Part I

- contrary to the impression that might have been created in the Commission, there is a high degree of co-operation between Exchange Control and the authorised dealers;
- Exchange Control, which holds regular inspections of the authorised dealers, did not contend that the authorised dealers were not complying with their exchange control obligations;
- in general, the authorised dealers have exchange control departments which are internally and externally audited and Exchange Control conducts inspections; and
- where breaches of exchange control occurred during 2001, the breaches were reported to Exchange Control[84]
- relatively few difficulties were reported to Exchange Control in 2001. The breaches were not material and did not have a negative impact on the rand.[85]

138 The Minister of Finance summed up the evidence before the Commission by stating that it does "… not seem to point to any systemic gaps in Exchange Control Regulation."[86]

---

85 See §1.3.4 of the Terms of Reference
86 Statement of Minister of Finance on 24 May 2002, Record 1759

139 The Commission finds that, generally, the administration of exchange controls appears to work well and is effective. There was no suggestion before the Commission that any authorised dealer in foreign exchange deviated from the terms and conditions of its appointment.[87]

140 There was not enough evidence regarding compliance with the 180 day repatriation rule for the Commission to make a conclusive finding.[88]

141 It does not follow, unfortunately, that because there is no *proof* that the 180 day period was not exceeded, that in fact exporters did *not* exceed 180 days in repatriating funds. As the KPMG team found, an exporter can illegally exceed the 180 days retention limit in the CFC accounts by opening CFC accounts with more than one authorised dealer and by then moving the foreign currency between the different CFC accounts. Exchange Control has no direct control over export proceeds until they are deposited in a CFC account or sold to an authorised dealer. Exchange Control will not know when an exporter's off-shore client pays for the goods. Neither will Exchange Control know whether the exporter has complied with a 30 day trial limit within which such export proceeds have to be credited to a CFC account or sold at spot. It

87 See §1.3.1 of the Terms of Reference

88 See §1.3.3 of the Terms of Reference

is not practical for Exchange Control or the authorised dealers to monitor this and reliance has to be placed on exporters.[89]

B Liberalisation of exchange controls[90]

142 The Minister of Finance testified that, as has been broadly recognised internationally, a gradual approach to capital account liberalisation is advisable and should occur late in the process of economic reform.

143 The Government has chosen a policy of gradual liberalisation of exchange controls based on a set of key policy and structural requirements:-

- It is imperative that the appropriate macro-economic fundamentals be put in place. These include credible and sustainable fiscal and monetary policies; pro-growth trade and investment policies and a Government spending programme that promotes redistribution and provides a safety net for the poor against the potential social costs of globalisation;

---

89 See §17.4(1) of Part I
90 See §'s18-23 of Part I

- In an environment of global integration with large and rapid shifts in capital flows, it is essential for a sound and well-regulated financial system to be in place; and
- The Government has chosen to follow a flexible exchange rate to act as a shock absorber against global developments.

144 The evidence of the experts and authorised dealers was generally supportive of the Government's policy of gradual liberalisation of exchange controls.

145 The events of the fourth quarter of 2001 raise doubts about the effectiveness of enforcing and managing exchange control, particularly in relation to off-shore participants in the rand market. It also suggests that with foreign exchange controls, one either has no controls or one has complete controls.

146 Evidence indicated that the abolition of exchange controls may lead to either a significant inflow and strengthening of the rand or a significant outflow and weakening of the rand. The latter will partly result from the expatriation of "blocked funds". In the Commissions view, one of the ways of dealing with the blocked funds may be to convert them to government bonds which have a predetermined repayment schedule. In

pursuing this option, the full implications thereof, including any potential resulting negative perceptions, as was experienced elsewhere, must be considered carefully.

147 The *KPMG team* was of the view that there were at least four good reasons to abolish exchange control:

- off-shore investors see exchange control as a major deterrent for fixed direct investment;
- in terms of their mandate, certain off-shore fund managers are not allowed to invest in countries having exchange controls;
- domestic corporates are often charged higher fees and rates to raise funds off-shore than would have been the case without exchange control; and
- off-shore listings by South African companies are often a consequence of the limitations on off-shore investments.

148 In his closing remarks to the Commission on 24 May 2002, the Minister of Finance re-affirmed the Government's commitment to a gradual process of exchange control liberalisation that takes into account critical sequencing considerations.

149 Timing and sequencing are critical. The IMF has stated that it considers the present pace of exchange control liberalisation in South Africa to be appropriate.

150 Prudent liberalisation must consider factors such as the sequencing of economic reform and the strengthening of the balance of payments. As such, it is not possible to set a time table for the gradual relaxation of exchange controls, rather such a policy will be monitored and reviewed continuously.

151 There is another benefit to a gradual approach to liberalisation and that is that gradualism may produce internal and external criticism about the slow pace of reform, but it has also avoided policy reversals in the face of currency crises. A gradual approach to exchange control liberalisation has enabled the Government to deliver a policy message which is consistent and certain. [91]

152 The Commission finds that there is no call for the tightening of exchange controls nor is there an absolute call for the big bang approach to the abolition of exchange controls. The Government's

---

[91] §'s 53 and 54 are based on §'s18 – 23 Part I

gradual approach to the liberalisation of exchange controls is therefore supported by the Commission.

V RECOMMENDATIONS

A Recommendations regarding transactions which were considered to have contributed or given rise to the rapid depreciation of the rand in 2001

153 In the light of the agreement reached between Deutsche Bank and the Exchange Control to address the negative effects of the hedging, funding and related transactions on the reserves, the Commission recommends that no further action be taken in this regard. However, the Commission makes important recommendations in §160 of the Executive Summary on what principles should apply to an application by an authorised dealer to Exchange Control to make a foreign direct investment.

154 Exchange Control should take appropriate action in relation to the Equity Diamonds transactions and report to the President in due course on the action taken.

B Recommendations regarding factors other than transactions

155 The following are some of the lessons that South Africa could learn from the events of 2001 in so far as they had an impact on the rand.

156 One must understand that South Africa has an open economy and it is inevitable that from time to time there will be turbulence. The events of late 2001 were one of the times.[92] In following a gradual approach to capital account liberalisation, the Government has had to make a number of macro-economic policy decisions to avoid potential economic instability and rising inequality. These decisions include following a flexible exchange rate to act as a shock absorber against global developments. Exchange rate adjustments help cushion the economy from external trade and capital flow shocks and mitigate the impact of economic contraction, especially in respect of the poor.[93]

157 One should appreciate that some of the factors that depressed the rand were not under the control of South Africa:

- the strength of the US dollar;

---

92 Evidence of Minister of Finance, <u>Record 1756</u>
93 Evidence of Ms Ramos, <u>National Treasury Bundle 59</u>

- the low inflation rate of the 25 most developed countries;
- the downturn in the global economy;
- the events of 11 September 2001 and their consequences, for example the flight of capital from emerging markets such as South Africa.

158 South Africa was penalised by the contagion affect. Merely by association with other countries, such as emerging market countries, or by its proximity to Zimbabwe, South Africa was tainted. Complicated, complex and difficult as it may be to do so, South Africa should make itself distinguishable from those countries and campaign to persuade foreign investors that it is unreasonable to lump South Africa with countries which are not politically or economically on a par with South Africa. South Africa must place a healthy distance – metaphorically speaking – between itself and those countries.

159 Government should identify those factors which fall within its bailiwick and address them insofar as it is possible to do so within its broad macro –and microeconomic framework:-

- Inflation

  While the South African inflation rate is higher than that of its trading partners, the rand will continue to depreciate. The

Government is committed to inflation targeting as a monetary policy with a view to reducing inflation.[94]

The effect of changes in the exchange rate on the rate of inflation should not be ignored.[95]

- Privatisation

  The non-occurrence of privatisation to the anticipated extent in 2001 had perceptual as well as capital inflow consequences for the rand. The Government remains committed to a programme of privatisation. Any major foreign investments made in South Africa in accordance with the privatisation programme will benefit the rand in the future. Having committed itself to privatise, the Government should be *seen* to be carrying out that policy. If for some reason the policy cannot be carried out in the originally intended manner, the reasons for non-implementation should be communicated pro-actively and convincingly.

- Exchange Controls

  The Government is committed to a gradual liberalisation of exchange controls. As that policy is implemented, and controls removed, the negative perception of foreign investors towards exchange controls, should change to the benefit of the rand. As was

---

94 §13 Part D

95 See evidence of Dr Stals, Expert Bundle 179

experienced in October 2001, the change in behaviour of market participants based on a perception that in enforcing existing exchange controls a reversal of the policy of liberalisation had occurred, may be negative for the rand. In future, all reasonable steps should be taken to ensure clear communication to avoid the creation of such a perception.

- NOFP

  Since the policy of reducing the NOFP by off-shore borrowings and privatisation was announced on 14 October 2001, the NOFP should no longer have a negative influence on the rand. According to the Minister of Finance the NOFP stood at USD2.9 billion at the end of March 2002 and "….has ceased to be of major concern to the international investment community".[96]

  The perception may, nevertheless, be that while the NOFP exists, that there is a risk that the exchange reserves will at some future point in time be negatively affected. Once the NOFP is eliminated, that risk will fall away. The Commission therefore recommends that the NOFP be eliminated as soon as possible through borrowings (and the borrowings could then be eliminated by privatisation proceeds).

---

[96] See <u>§14.10 Part D</u>

- Foreign investment

  The rand would benefit from the inflow of capital that would follow on foreign investment. The most attractive is FDI because of its long-term nature. Having dealt with the macro-economic reforms, the focus of the Government now is on micro-economic reforms aimed inter alia at strengthening the balance of the payments through the promotion of exports and attracting longer-term capital flows such as equity investment and FDI. This, in turn, will provide the foreign currency flows necessary to support further capital account liberalisation.[97] The Commission supports this approach.

C Recommendations regarding the effectiveness of the current system of ensuring adherence to exchange controls[98]

160 The following principles should apply to an application by an authorised dealer to Exchange Control to make a foreign direct investment:-

(1) An authorised dealer is not an uninformed layman. An authorised dealer is assumed to have a working knowledge of the purposes and policies of Exchange Control. An authorised dealer must use its

---

97 Statement of the Minister of Finance, Record 1758

98 See §1.4.1 of the Terms of Reference, Annexure A Part A

knowledge, experience and common sense in applying exchange controls.

(2) The relationship between the regulator, Exchange Control, and authorised dealer is based on trust. In applications of the kind in question, an authorised dealer must trust Exchange Control to exercise its discretion properly. And, Exchange Control is entitled to trust an authorised dealer to make full disclosure to it of all material information on which it is required to exercise its discretion to grant an application to make a foreign direct investment.

(3) There should be no doubt in the mind of any authorised dealer what Exchange Control means by South Africa's reserves. For exchange control purposes, the reserves are the total gold and foreign exchange reserves of South Africa. That much is known to anyone who reads the Reserve Bank's Quarterly Bulletin, which one assume authorised dealers do as a matter of course.

(4) An authorised dealer who makes application for a foreign direct investment must take into account that:-

- one of the purposes of exchange controls is to prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa;

- one of the pre-conditions to the grant of an application to make a foreign direct investment is that the transaction, such as a share placement, when implemented, must not have a negative impact on South Africa's total foreign exchange reserves;
- any related transaction which is concluded consequent to the share placement transaction, such as a hedging or funding transaction, must share one of the characteristics of a share placement, i.e. the transaction must be reserves neutral, otherwise – and this is a statement of the obvious – one of the purposes of exchange controls would be frustrated.

(5) By their nature, applications to make foreign direct investments will vary. There is no standard formula for the application or the approval by Exchange Control. If an authorised dealer has any doubt about the requirements of Exchange Control or the extent of its duty to make disclosure, it should consult Exchange Control. It is to the benefit of the authorised dealer, its client and the Reserve Bank that any doubts, ambiguities or concerns are addressed at the time of the application rather than in a protracted review process.

161 The Commission recommends that:

- where the Regulations, Rulings and Circulars ("exchange control rules") do not clearly spell out the duties and obligations of authorised dealers and corporates, clarity should be sought and given;
- where the exchange control rules are ambiguous, the ambiguities should be dealt with by Exchange Control, if necessary with the assistance of the person referred to in §162 below;
- routine and smaller transactions should be excluded from scrutiny by the application of materiality tests;
- Exchange Control should consider giving reasons in appropriate cases when an application is refused;
- authorised dealers should send more senior members of management to Liaison Committee meetings and engage in meaningful debate with Exchange Control on their concerns;
- Exchange Control must strive for consistency in the approval of applications for foreign direct investments;
- an application for foreign direct investment must make full disclosure of all transactions, for example, in an application based on a share placement, the share placement transactions *and* the associated transactions, such as hedging, funding and related transactions must be disclosed by the authorised dealer to Exchange Control;

- when in doubt as to the requirements of Exchange Control or the extent of its duty to make full disclosure, an authorised dealer must consult Exchange Control at the time of the application;
- the 180 day period itself should be reconsidered and the administration, monitoring and auditing of CFC accounts and the Form 178 system should be reviewed in order to make the system more effective;

162 The Commission recommends that the comments and recommendations conveyed to the Commission should be addressed by all parties concerned, specifically Exchange Control and the authorised dealers.

163 An independent person should be appointed to facilitate the resolution of disputes which arise from time to time between Exchange Control and authorised dealers, possibly with the power to adjudicate such disputes.

164 With regard to the issue of unacceptable speculation, the Commission recommends that this complex area should be investigated further by the person referred to in §163 in conjunction with Exchange Control, in order to develop monitoring processes which will ensure that these

practices can be identified and addressed appropriately on an on-going basis.

D Recommendations regarding any other periods considered necessary to be covered by the inquiry

165 The Commission does not consider it necessary to extend the inquiry to any period before or after 1 January 2001 to 31 December 2001 as the benefits derived there from will not justify the additional costs and efforts required. The Commission would rather recommend that the issue of the exchange rate be viewed with a forward looking perspective, applying the lessons learnt from and recommendations made by this process.

A The Investigation

1 In 2001 the rand depreciated by 10.7% or an average of 1.3% per month during the first eight months, and from 1 September to 31 December, the rand weakened by 42%, an average of 10.5% per month. The low point was a value of R13.84 to the US dollar on 21 December 2001.[1]

2 The rapid depreciation of the rand in the last four months of 2001 was a concern for all South Africans. One such South African, Mr Wakeford, called for a formal inquiry in to the depreciation of the rand in late December 2001 and early January 2002. Having been furnished with a written report by Mr Wakeford on 8 January 2002, the President appointed this Commission on the same day.[2] The Terms of Reference of the Commission are attached to Part A as Annexure "A".

3 The first leg of the enquiry in terms of the Terms of Reference was to enquire into and report on transactions which contributed or gave rise to the rapid depreciation of the rand in 2001. That task was a daunting one in view of the size of the foreign exchange ("forex") market. Millions of transactions measured in billions of US dollars were transacted in 2001:-

1 See generally Part B
2 See generally Part E

3.1 In April 2001 it was established that global trading in the rand was USD11.3 billion, made up as follows:

- USD3.3 billion was traded between two off-shore parties (off-shore/off-shore);
- USD3.5 billion was traded on-shore/on-shore, ie between institutions in South Africa; and
- USD4.5 billion was traded on-shore/off-shore, ie between institutions in South Africa and those outside South Africa (off-shore). About 75% of those transactions were swap transactions, which did not affect the rand.[3] It follows that about 25% (USD2.8 billion) of the transactions had to be investigated.

3.2 The number of forex transactions reported to the Reserve Bank in 2001 was 5.6 million, which did not include either any of the off-shore/off-shore transactions or all the on-shore/on-shore transactions.[4] It follows that the number of forex transactions was substantially in excess of 5.6 million in 2001.

---

3 See generally Part C

4 Record 1762

4 Besides trying to find a practical way of investigating so many forex transactions, the Commission was concerned about the costs and the duration of the enquiry. Time was of the essence. The Commission was not called upon to investigate an event which had occurred in the past and which was frozen in time, such as a mining disaster. The rand continues to be traded. If any lessons were to be learnt from the events of 2001, the sooner they were learnt the better. And yet the enquiry had to be thorough, given the practical difficulties. A superficial enquiry would have served no purpose.

5 A major concern was the public nature of the enquiry.[5] By calling on public institutions such as the National Treasury and the South African Reserve Bank ("Reserve Bank") and authorised dealers, whose numbers include the major banks in South Africa and local offices of major foreign banks, to give evidence in public, the danger was that the process itself could be damaging to those public institutions, the banking industry, South Africa and ultimately the rand. And how ironic that would have been.

At the same time, the Commission had to be sensitive to the fact that it would be dealing, in the words of the Minister of Finance "…with issues close to the hearts of all South Africans who are concerned about building an

[5] In terms of s4 of the Commissions Act, 8 of 1947.

economy that is as strong and resilient as it can be, but also one that is equitable, in which the wrongdoings of the few should not be at the expense of the many."[6]

6 Within days of being appointed, the Commission took a number of decisions which it was hoped would meet those difficulties and address those concerns:-

(1) Assistants to the Commission were to be appointed who had the necessary experience, skill and expertise in banking, treasury, exchange control, forensic auditing, the law, computer science, structured finance, finance, and so on.

(2) The co-operation of financial market participants would be sought. If the enquiry was to take place in public in a confrontational way, the risk was that the process would be costly, slow and potentially damaging in the manner described earlier.

(3) Experts, local and foreign, would be consulted, initially to advise on how one investigates a currency and ultimately with a view to giving evidence.

7 Those decisions were implemented within weeks:-

[6] Closing statement of Minister of Finance on final day of hearings, Record 1760.

(1) Assistants to the Commission were appointed who had the necessary attributes. A list of the assistants is contained in Annexure "D" to Part A.

(2) Meetings were held at the highest level with representatives of National Treasury, Reserve Bank, authorised dealers (local and foreign) and corporates. Their co-operation was solicited, promised then and given later, unequivocally.

(3) A range of experts was consulted.

8 On the basis of the input of a wide range of knowledgeable persons consulted by the Commission, the next series of decisions taken was to conduct the investigation in the following way:-

(1) Experts would be requested to give evidence. The experts would be local and foreign (if possible). The experts would cover different aspects of the enquiry, such as exchange control, forex trading, macroeconomics, and so on.

(2) National Treasury and the Reserve Bank would be requested to give evidence.

(3) All 32 authorised dealers would be requested to furnish information to the assistants to the Commission and to give evidence.

All the other forex market participants, the Reserve Bank, Bond Exchange of South Africa ("BESA"), Johannesburg Securities Exchange of South Africa ("JSE"), South African Futures Exchange ("SAFEX"), South African corporates and representative offices of foreign banks ("rep offices"), would be requested to furnish information to the assistants to the Commission and, if necessary, to give evidence.

(4) The allegations made by Mr Wakeford in his written report to the President would be investigated by one team of assistants ("Wakeford team").

(5) A team from KPMG would identify transactions that gave rise or contributed to the rapid depreciation of the rand ("KPMG team").

(6) A team from Deloitte & Touche would investigate the activities of the financial market participants ("DT team").

(7) A team from KPMG would investigate the effectiveness of the current administration of the exchange control system ("KPMG team").

(8) Two tip-off lines were to be opened on which whistle blowers who wished to remain anonymous could furnish information to the Commission.

(9) The Reserve Bank would be asked to request the Bank of England to supply it with information on off-shore/off-shore

transactions (the daily turnover of which in April 2001 was USD3.3 billion).

9 Those decisions were implemented over the course of the next few months:-

(1) Without difficulty, local experts were persuaded to give evidence. With difficulty, and with much effort, three foreign experts agreed to give evidence. A list of the experts is attached to Part A as Annexure "E". The evidence of the experts is referred to by subject matter throughout the Final Report.

(2) Mr Manuel, the Minister of Finance; Ms Ramos, the Director-General, National Treasury; Mr Mboweni, the Governor of the Reserve Bank; Mr Cross, the former Senior Deputy Governor of the Reserve bank; Mr van Zyl, the Advisor to te Governor; Mr Bruce-Brand, the General Manager, Exchange Control, and Mr Grove, Assistant General Manager, Exchange control gave evidence.

(3) Authorised dealers provided information to the DT team in reply to a questionnaire. The replies were analysed and included in the

DT report, which formed the subject matter of oral evidence by the leader of the team.[7]

All thirty-two authorised dealers gave evidence, the major authorised dealers by way of oral evidence and the other authorised dealers in the form of affidavits. A list of the witnesses who gave oral evidence on the part of the major authorised dealers is attached to Part A as Annexure "F". A list of the witnesses who provided affidavits on behalf of the other authorised dealers is attached to Part A as Annexure "G".

All the other forex market participants referred to in §8(3) above, provided information to either the KPMG team or the DT team or both, which was analysed by those teams and included in their reports to the Commission.

Mr Tucker, chief executive officer of the Banking Council, and Mr Gibbs, President of ACI (SA) testified.

(4) The Wakeford allegations were investigated by the Wakeford team. Mr Wakeford, the bank and corporates mentioned in Mr Wakeford's report to the President, Exchange Control and the leader of the Wakeford team gave evidence.[8]

---

7 See Part K

8 See Part E

(5) The KPMG team prepared a report on transactions that gave rise or contributed to the rapid depreciation of the rand and the leader of the team gave oral evidence. [9]

(6) The DT team prepared a report on the activities of the financial market participants and the leader of the team gave oral evidence.[10]

(7) The KPMG team prepared a report on the effectiveness of the current administration of the exchange control system and the leader of the team gave oral evidence.[11]

(8) Two tip-off lines were made available by KPMG and Deloitte & Touche at no cost to the Commission and at no cost to the user of the service. KPMG and Deloitte & Touche donated their services and the costs of the lines to the Commission. The Wakeford team received eighty-five reports from the tip-off lines. Ten reports were worthy of investigation. The team found no evidence of material transactions which were relevant to the Commission.

(9) At the request of the Commission, the Reserve Bank requested the Bank of England to provide information on the local gross average daily turnover (purchases and sales) in US dollars of spot, outright forwards and swaps in the forex market in the rand.

---

9 See <u>Part J</u>
10 See <u>Part K</u>
11 See <u>§17 Part I</u>

The Bank of England was also requested to state, in its opinion, what specific transactions, actions, events, factors or omissions played a part in the rapid depreciation of the rand in 2001. The Bank of England was unable to furnish the information requested, save for the profile of the rand trading month by month through 2001, benchmarked to total BIS-reported rand turnover for April 2001. A copy of the letter from the Bank of England to the Reserve Bank is attached to Part A as Annexure "H".

10

10.1 The authorised dealers were required to conduct their own internal investigations in furnishing information to the Commission on a wide variety of topics, for example, group structure; role in financial markets; risk management; compliance with exchange control; ethical standard in forex activities; CFC and vostro accounts.[12] Some of the information was subsequently confirmed under oath in evidence.

10.2 The authorised dealers assumed the responsibility of ensuring that the information was accurate. The Commission has no reason to believe that the facts placed before the assistants to the Commission or the Commission itself were not accurate: the

[12] See Annexure "A" to Part K

authorised dealers are subject to external audit and supervision by the Reserve Bank; there was the potential of a verification exercised by either the KPMG or DT teams and the risk of reputational damage if any authorised dealer knowingly misrepresented the facts to the Commission was not worth taking.

11 As it was impossible to investigate more than 5.6 million forex transactions in a limited time in a cost effective way, some judgement calls had to be made:

- the *first* was to concentrate on the activities of the ten major authorised dealers who were responsible for at least 95% of transactions in the rand market;[13]
- the *second* was to concentrate on the period 1 September to 31 December 2001, the period of greatest volatility and depreciation, although the first eight months of 2001 were not ignored;[14]
- the *third* was to analyse "hot" days" in 2001 when the most rapid depreciation occurred or when there were large movements in the US dollar/rand exchange rate;[15]

13 See §9.4 Part K
14 See §8 Part K
15 See §5 Part J; §9.3 Part K

- the *fourth* was to identify, analyse and investigate applications *exceeding R100 million* by residents to invest off-shore.

12 The authorised dealers were deeply concerned about confidentiality. Some of the information that would be supplied to the assistants to the Commission and some of the evidence of the authorised dealers, would be confidential, for example, as between bank and client, as between bank and competitor and as between bank and Reserve Bank. That concern had to be met, if possible, while respecting the Commission's right to investigate, and procure evidence of transactions, even if the transactions were confidential. In the result:

- detailed arrangements, to the satisfaction of the authorised dealers, were made to ensure that confidential information in the possession of the assistants to the Commission did not leak;
- evidence was given in such a way that very little confidential information was placed before the Commission;
- that confidential information was disclosed only to the Commissioners (and not to the public).

13

13.1 All potential witnesses were requested to prepare written statements in consultation with the lawyers who had been appointed as assistants to the Commission in order to ensure:

- a speedy investigation;
- short public hearings;
- carefully considered and coherent evidence;
- accurate reporting of the evidence by the media.

13.2 Except in the case of some experts who provided the Commission with a slide presentation, all the witnesses did make statements, which formed the basis of their evidence. The procedure worked well.

14 It was clear early on that the investigations by the three teams of assistants to the Commission would take months rather than weeks to complete. Rather than wait for all the investigations and preparatory work to be completed before commencing the public hearings, it was decided that as and when evidence became available, the Commission would hear evidence. Consequently, as early as the first week of March 2002, the Commission commenced public hearings and adjourned from time to time as evidence became available.

Part B: The performance of the rand

Index

Table of graphs, charts, diagrams and tables contained in Part B

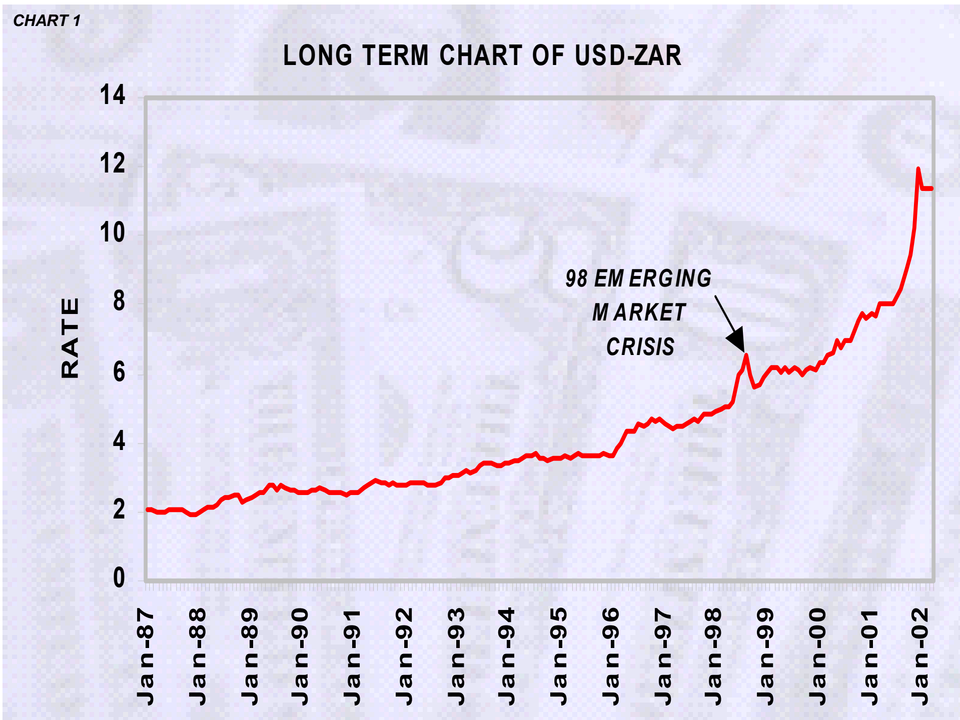
B The performance of the rand

The history of the rand

1

1.1 In the long term, the rand has moved in one general movement in favour of weakness as against the US dollar.[1]

Chart 1 Expert bundle 452



1 Glynos Expert bundle 423

1.2 The general experience during the past twenty years with the floating exchange rate system, specifically with regard to the fluctuation in the exchange rate, was the following:

- The exchange rate often fluctuated quite a lot over the short term, but followed a more rational path over the long term.
- The depreciation process never followed a smooth path and has been described as a "staircase" adjustment process, with a periodic run down a flight of stairs to a new level. The exchange rate of the rand against the US dollar tended to remain relatively stable for periods of up to two years, to be followed by a rather steep downward adjustment over a short period of time to a new (lower) level.
- In the circumstances, markets at times over-reacted. Market interest rates rose to extremely high levels, and the rand depreciated by more than the inflation differential – hence the need for a period of consolidation and stabilisation after every sharp depreciation of the rand.[2]

Highlights of the performance of the rand before 2001 were:-

1.2.1 Most of the rand's history incorporated a dual exchange rate system. The financial rand acted as a shock absorber

---

2 Stals Expert bundle 170, 171

for the commercial rand traded at a significant discount of between 15% and 55% to the commercial rand over the thirty years that this mechanism was in place.

1.2.2 On different occasions during the 1970's the commercial rand was fixed to the US dollar or to the British pound and fluctuated in line with the value of these currencies. In September 1975, specifically, government devalued the rand against the pound by 18%.

1.2.3 In the late 1970's the commercial rand was allowed to float freely against all currencies and in 1980 hit its highest level ever of USD1.35 to the rand.

1.2.4 During the debt standstill crisis in the 1980's both the commercial and financial rands plummeted, with the rand losing over 30% of its real trade weighted value in a matter of months. The only comparable decline of such magnitude in the real effective exchange rate of the rand was witnessed in November and December 2001.

1.2.5 For a period of eleven months after the abolition of the dual exchange rate system on 10 March 1995 the unified rand was stable at around R 3.60 to the US dollar.

1.2.6 1996 marked a "sell-off" of the rand with the rand losing 20% of its value reaching R 4.50 against the US dollar by June 1996.

1.2.7 Around September/October 1997, the world witnessed the start of the so-called Asian crisis. The contagion arising from this crisis hit all emerging markets in May 1998 and the rand was materially affected, as with currencies of many other developing countries.

1.2.8 Having declined by over 20% in real terms in 1998, the rand regained some of its composure through 1999, trading in a broad band between R 5.50 and R 6.40 to the US dollar during that year.

1.2.9 The long slide in the rand began with the rand trading at R 6.12 at the turn of the new millennium.[3]

1.3 Over the twenty-one month period from the beginning of 2000 to 11 September 2001 the rand maintained an almost consistent and fairly well-defined declining trend against the US dollar.

---

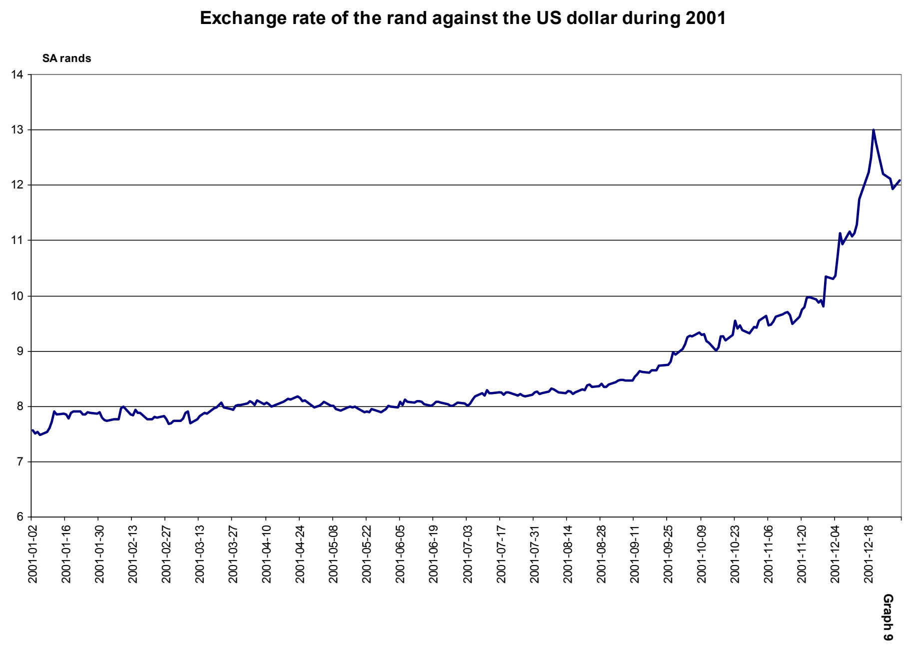
3 Jammine <u>Expert bundle 297 – 300, 303, 304, 307- 312</u>

The rand in 2001

2

2.1 The decline of the rand is illustrated in the graph below, which shows the exchange rate of the rand against the US dollar during the year 2001:

Graph 9 Bundle SARB (07) 65



The extent of the pace of depreciation of the rand during the period July 2001 to December 2001 is illustrated in the graph below. The term "big figure" is used to refer to the figure before the decimal, i.e. from R 8.00

to R 9.00. These "big figure" movements represent declines of approximately 12.5%, 11% and 40% respectively.[4]

Diagram 15 Expert bundle 125(a)

2.2 During the year 2001, the rand recorded the following exchange rates against the US dollar during the year:

- moving from around R 7.60[5] to the US dollar at the beginning of the year, the rand depreciated to over R 8.00 for the first time ever during the second quarter;[6]

---

4 Gouws Record 129, 130

5 Mboweni Bundle SARB (07) 283

6 Jammine Expert bundle 317

- the pace of depreciation increased with the rand R 8.52 to the US dollar on 11 September, R 9.03 at the end of September and R 9.44 at the end of October;
- by the end of November 2001 the rand had fallen to R 10.27 to the US dollar;[7]
- the rapid depreciation reached its crescendo with the rand hitting a new all-time low of R 13.84 to the US dollar on 21 December 2001;[8]
- for the period 1 January to 31 August 2001 the rand depreciated by 10.7% or an average of 1.3% per month, while from 1 September to 31 December 2001, the rand weakened by 42% - an average of 10.5% per month.[9]

<u>The rand against the dollar compared to other currencies</u>

3

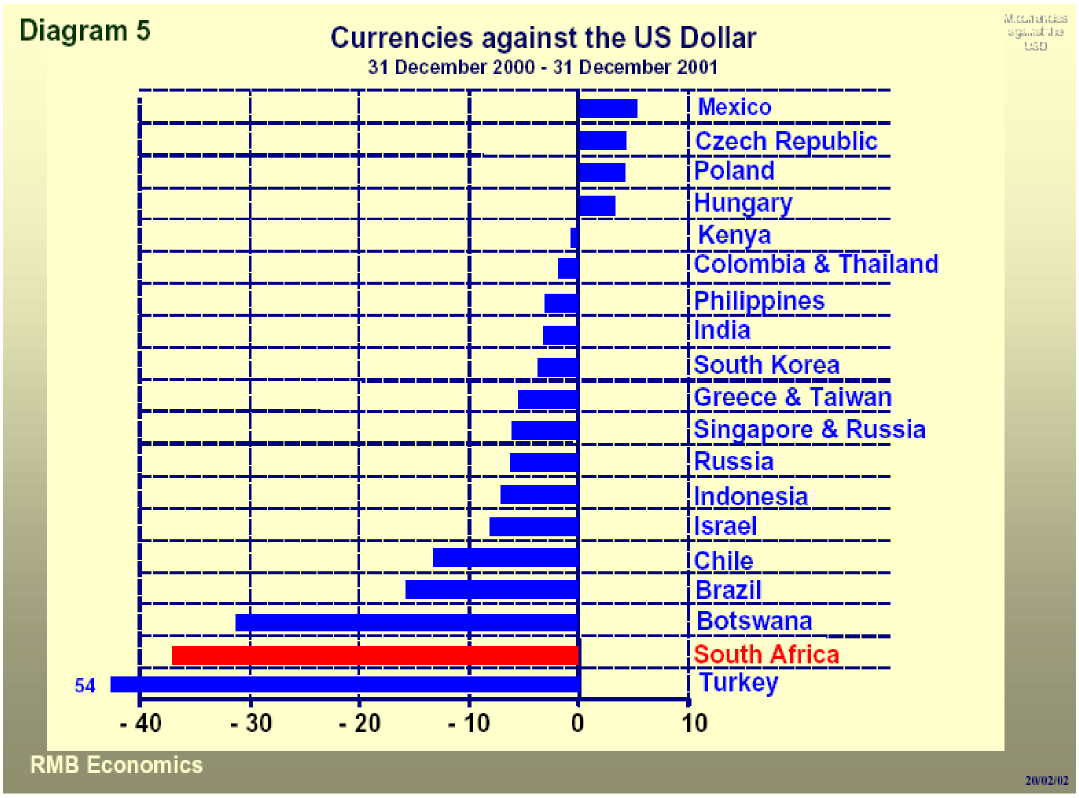
3.1 The weakness of the rand against the US dollar during 2001 compared to other comparable countries is illustrated in the

---

7 Jammine <u>Expert bundle 336</u>
8 Mboweni <u>Bundle SARB (07) 30</u>
9 See <u>Part K § 8</u>

diagram below, indicating that South Africa had become, towards the end of 2001, somewhat of a special case[10]:

Diagram 5 Expert bundle 120

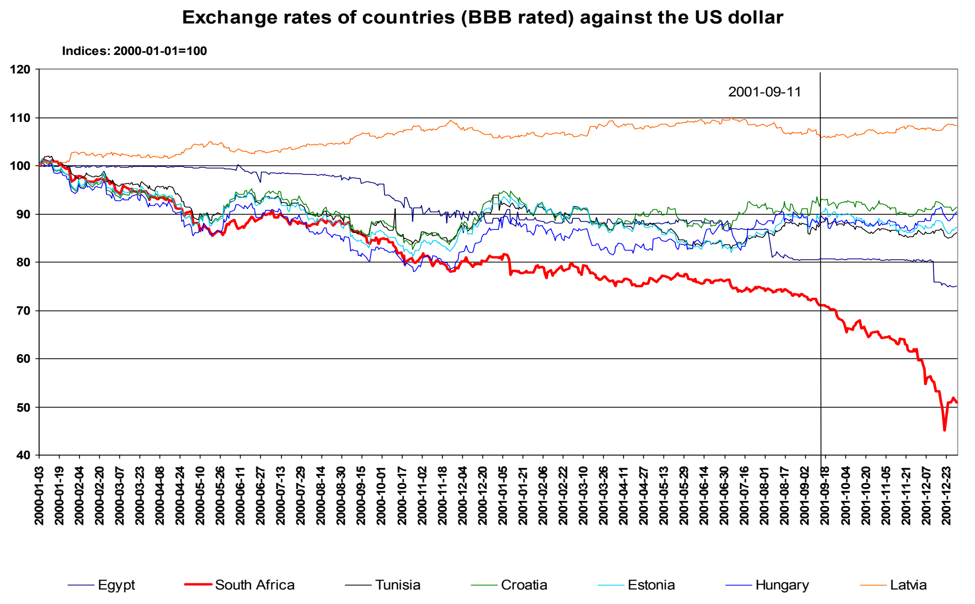


The graphs below show the rand's performance relative to the exchange rates of similarly rated countries and against those of other emerging-market economies, the thick red line indicating the South African rand:

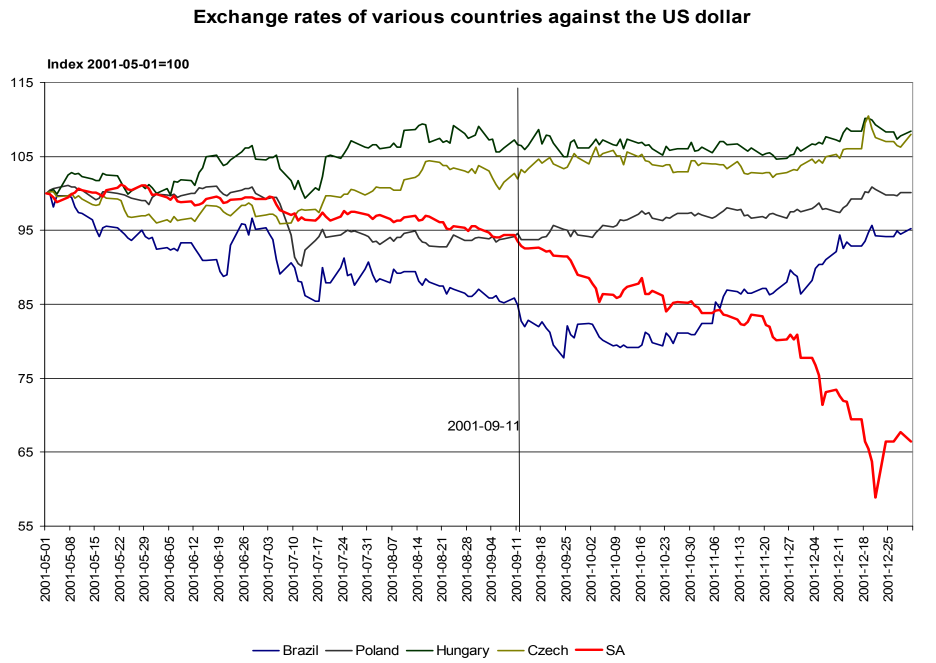
---

10 Gouws Expert Bundle 114

Graphs 11& 12 <u>Bundle SARB (07) 68-69</u>



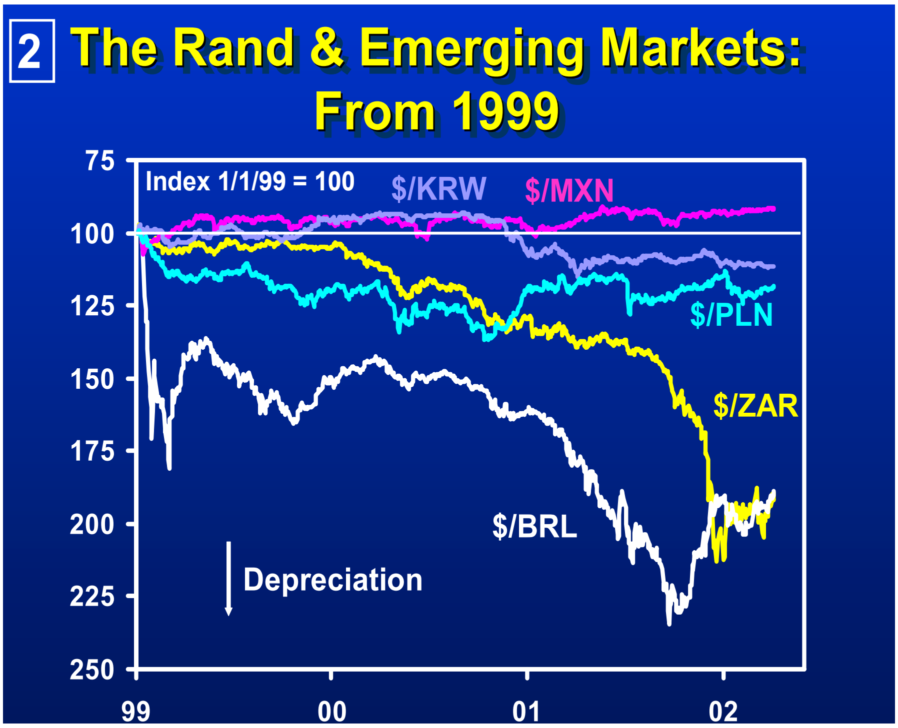
Graph 11



Graph 12

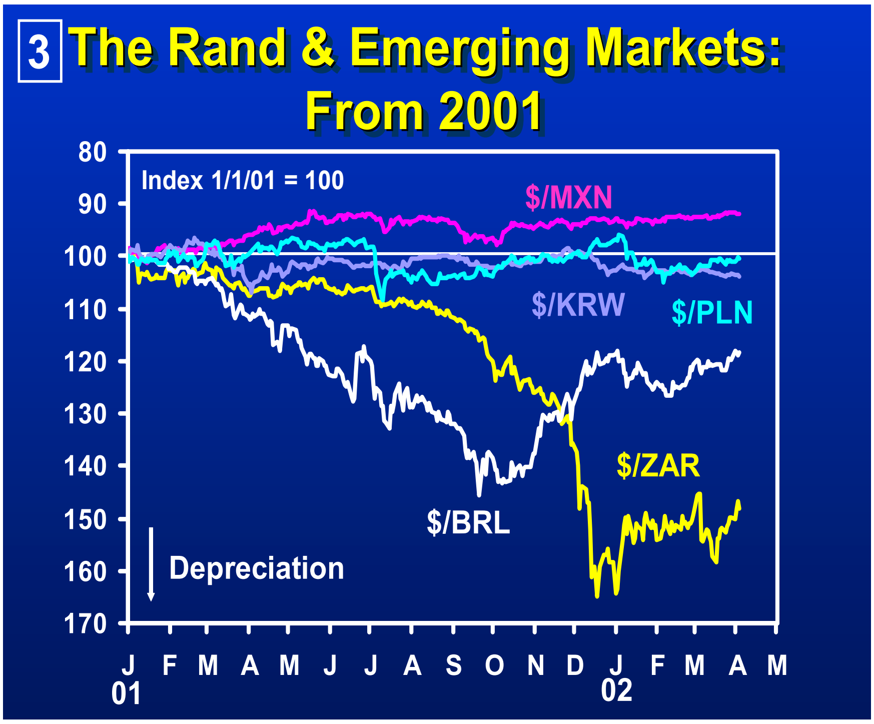
3.2 If one measures the rand against four other emerging market currencies: the Brazilian real, the Korean won, the Polish zloty and the Mexican peso, one finds that from 1999 until late 2001 there was not much difference in the value of the rand and those currencies, save that the Brazilian real was weaker.

Slide 2, <u>O'Neill Bundle 3</u>



In 2001 the rand held its own against the Korean won, the Polish zloty and the Mexican peso until September/October 2001 but then plunged in value. In December 2001 the rand became even weaker than the Brazilian real.[11]

Slide 3 O'Neill Bundle 4



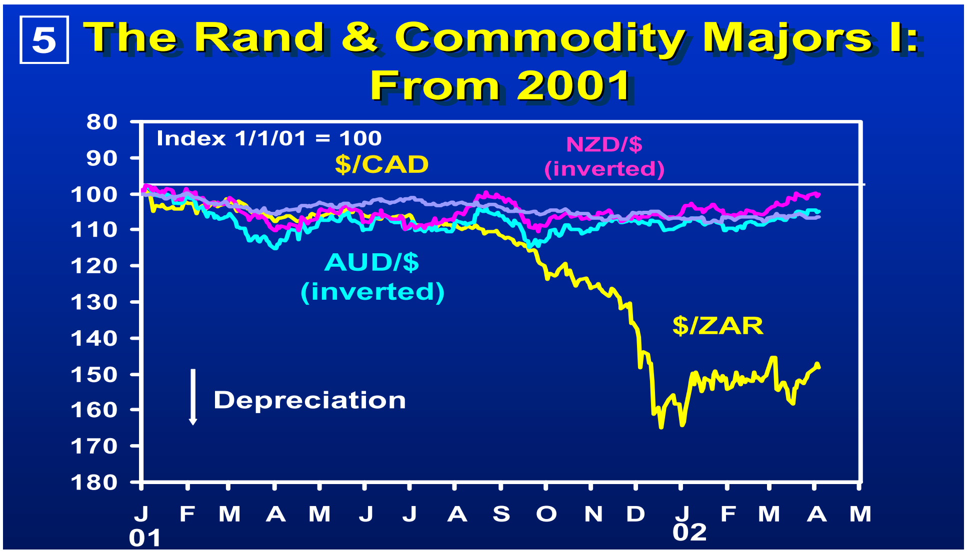
3.3 Similarly, until about September/October 2001, the rand performed as well as other commodity currencies, such as the Australian dollar, the Canadian dollar, the New Zealand dollar, the Norwegian krone and the Swedish krone. "[It] was October last

---

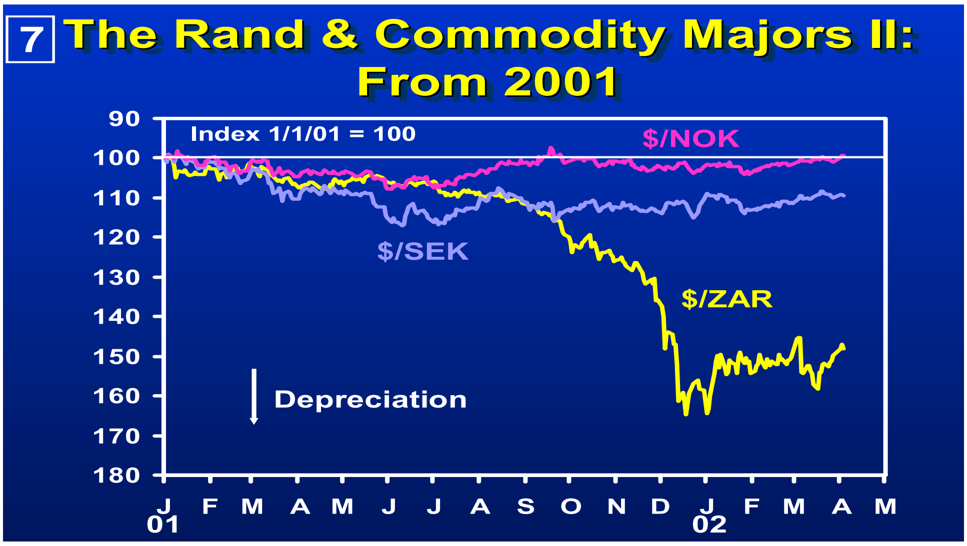
11 Evidence of Dr TJ O'Neill, Global Head of Economic Research, Goldman Sachs, Record 1464

year something seemed to happen…which caused the rand to actually under-perform those commodity majors…relative to the [US] dollar."[12]

Slide 5 <u>O'Neill Bundle 6</u>



Slide 7 <u>O'Neill Bundle 8</u>



12 Evidence of O'Neill, <u>Record 1467-8</u>

3.4 Dr O'Neill testified that in his opinion one should not spend too much time blaming one specific currency for its decline against the US dollar. In the past three years many currencies weakened against the US dollar, some of which have had weak growth, some had very strong growth, some had current account surpluses, some had current account deficits, and so on. Generally speaking, until late 2001 there was nothing that interesting from an international perspective about the rand's weakness. Given that other important currencies also weakened against the US dollar, there was not much that South Africa could do about it because it had nothing to do with South Africa.[13]

The rand against the euro

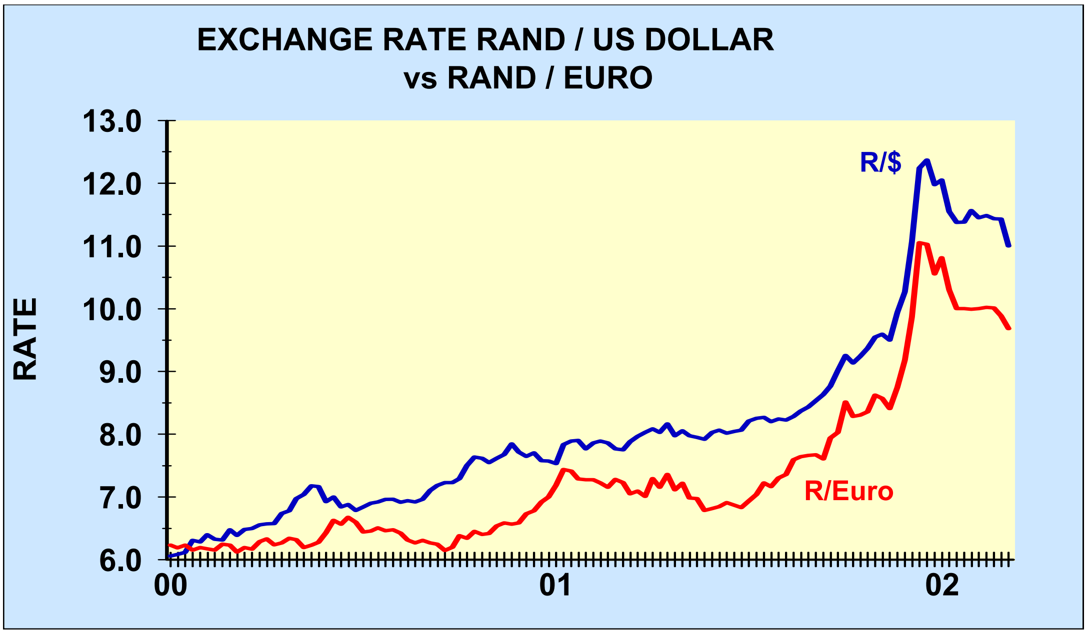
4

4.1 The performance of the rand is usually illustrated against the US dollar. Although the rand/euro exchange rate was no worse in early September 2000 than it had been when the euro was introduced, between September 2000 and November 2000, the rand suddenly began declining against all currencies, especially

13 Evidence of O'Neill, Record 1466-1469

the euro. This was at a time when the euro began strengthening against the US dollar.[14] This is illustrated in the graph below:

Chart 20 Expert bundle 369



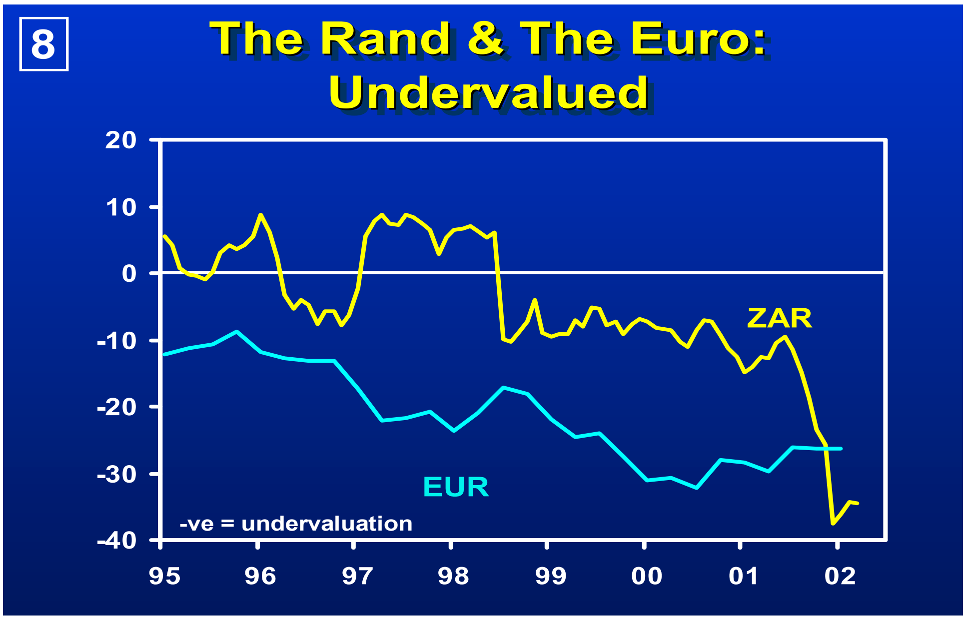
4.2 Goldman Sachs adopts a methodology to estimate the fair value of an exchange rate. Fair value is defined as the inflation adjusted exchange rate (often called purchasing power parity (PPP)) which is then adjusted for relative productivity. Conceptually, a country with stronger productivity should see its real currency appreciate relative to other currencies and a country with weak productivity should see its currency depreciate. Until late 2001, according to

---

14 Jammine Expert bundle 316

the fair value model, the Euro was more undervalued than the rand.

Slide 8, O'Neill Bundle 9



4.3 It may be that as Europe is a major trading partner of South Africa, the euro's persistent weakness relative to fair value has contributed to the rand's weakness. [15]

[15] Evidence of O'Neill, Record 1470-1

Part C: The forex and rand markets, globally and locally

Index

Table of graphs, charts, diagrams and tables contained in Part C

C The forex and rand markets, globally and locally

Global Financial Markets

1

1.1 The daily turnover of global foreign exchange ("forex") transactions in all currencies increased from about USD600 billion in 1998 to about USD1.4 trillion (1 400 billion) in 1998 and then decreased to about USD1.2 trillion in 2001. The primary reason for the decline was the consolidation of players in the forex market. Unlike globally, in South Africa there was no overall concentration of forex dealers.[1]

1.2 The transaction categories that are concluded globally are spot, forward, swap and option transactions.[2] The swap category is the most frequently used in all currencies globally. Spot, forward and option transactions affect an exchange rate, swap transactions do not.[3] The global counterparties who trade in currencies are reporting dealers, banks, securities dealers, most insurance companies, pension funds, asset managers, multinational companies, importers, exporters and retail customers.[4] The

1 Evidence of Mr Robert McCauley, the Deputy Chief Representative, the Representative Office for Asia and the Pacific, Hong Kong, of the Bank for International Settlements ("BIS"): Record 9 – 11.

2 As defined in the schedule attached hereto marked "A".

3 McCauley Record 14.

4 McCauley Record 14

1.3 dealers account for most of the volume of global currency trading.[5]

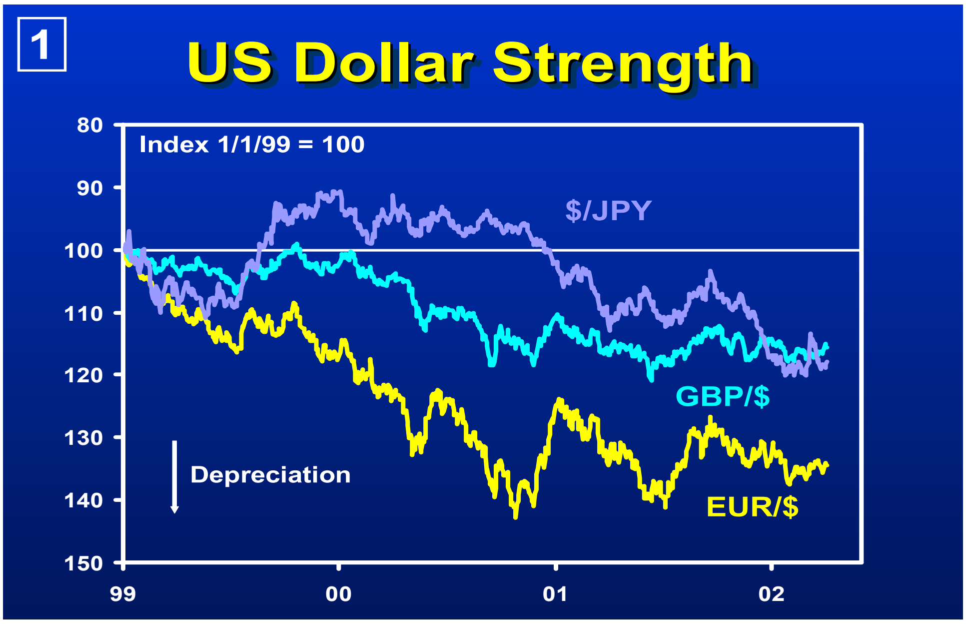
1.4 In the opinion of Dr O'Neill, the global forex market has been very peculiar since the commencement of the European Monetary Union ("EMU"). Many historical norms appear to have changed:-

- the US dollar has strengthened against three major currencies, the Japanese yen, pound sterling and euro, despite the existence and deterioration of the US current account balance of payments - the dollar should have weakened, not strengthened;
- from mid-1999 until late 2000 the Japanese yen strengthened against the dollar at a time when there was effectively no growth in the Japanese economy;
- the euro has been weak.[6]

5 McCauley Record 15

6 Evidence of O'Neill, Record 1462-4

Slide 1, O'Neill Bundle 2



The rand market

2

2.1 Unlike trading in major currencies, trading in the rand grew over the period 1998 to 2001, especially in rand terms. Forex trading in South Africa increased from 0.3% of global trading in all currencies in 1992 to 1995, to 0.5% in 1998 and to 0.6% in 2001.

The daily turnover in South Africa grew from USD2 billion in 1992 to USD8 billion in April 2001. [7]

2.2 The global daily trading in the rand, for which the off-shore trading component was specifically measured for the first time in April 2001, was USD11.3 billion, about 75% of which were swap transactions[8]. Swap transactions would have had no effect on the exchange rate. Reporting dealers do more than half the trading, other financial institutions such as insurers and pension funds do over a third and other companies such as mining companies, multinationals and local importers, do about a sixth.[9]

2.3 The rand is an internationalised currency with the bulk of offshore trading taking place in London and to a lesser extent in New York. In April 2001 USD3.3 billion was traded between two offshore parties (offshore-offshore); USD3.5 billion was traded onshore-onshore and USD4.5 billion was traded onshore-offshore, i.e. between institutions in South Africa and those outside South Africa or offshore.[10]

2.4 During 2001 one authorised dealer, Standard Bank of South Africa Ltd ("SBSA"), through its international banking division,

---

7 McCauley Record 17

8 McCauley Record 20

9 McCauley Record 20

10 McCauley Record 21

Standard Corporate and Merchant Bank ("SCMB"), alone, in its forex dealing room, transacted approximately 5 000 transactions per day, with an approximate value of USD2 billion in about 40 currencies. Rand-based transactions with a potential influence on the spot exchange rate accounted for about 15% of those transactions.[11]

2.5 It is important to note that, for the USD3.3 billion traded offshore-offshore:

- there is no record of those transactions in South Africa;
- the Commission has no power offshore to investigate those transactions; and
- the offshore-offshore trading could have affected the value of the rand.[12]

2.6 The Commission asked the Reserve Bank to request the Bank of England to supply it with information on off-shore/off-shore transactions. Information was sought on the local gross average daily turnover (purchases and sales) in US dollars of spot, outright forwards and swaps in the forex market in the rand. The Bank of England was also requested to state, in its opinion, what specific transactions, actions, events, factors or omissions played

---

11 Evidence of WJ Potgieter, Standard Bank Bundle 18
12 McCauley Record 23-24

a part in the rapid depreciation of the rand in 2001. The Bank of England was unable to furnish the information requested, save for the profile of the rand trading month by month through 2001, benchmarked to total BIS-reported rand turnover for April 2001. A copy of the letter from the Bank of England to the Reserve Bank is attached to Part A as Annexure "H".

South African Forex market

3

3.1 The forex market is the single biggest market, in terms of turnover, of the South African financial markets. Given the openness of the South African economy, this market is an extremely important market. The forex market is essentially an over-the-counter ("OTC") market. The primary aim of the forex market is to facilitate international trade and international money and capital movements by providing a market where different currencies can be exchanged for one another. In the South African forex market there are mainly two types of participants: banks authorised by the Reserve Bank to deal in foreign exchange, known as authorised dealers, and brokers. It is the activities of the authorised dealers that are particularly relevant. Authorised dealers are authorised to act as principals in the forex market which means that they can act in their own names and may also run positions in foreign currency. Probably the most important reason for allowing them to run positions and to trade in their own name is to provide liquidity in the market. Liquidity is an important factor underpinning the smooth functioning of the market. Hence the authorised dealers are market makers. Market makers in the foreign exchange market attempt to make profits by buying foreign currency at a lower price and selling it at a higher price. The difference, or the spread, is the bank's trading profit. The authorised dealers protect themselves during times of excessive volatility in the forex market. Since high volatility is normally associated with uncertain and sharp price movements, authorised dealers will tend to increase the gap or spread between the buying and selling rates. The banks are reluctant to trade during such times by virtue of the fact that the exchange rate could very quickly turn against them, possibly resulting in losses. Authorised dealers, however, are limited to the extent to which they may run open positions and are currently limited to 10% of net qualifying capital and reserve funds.

3.2 During the past decade turnover in the rand market in foreign exchange in South Africa has increased significantly. Increases were particularly noticeable in 1995/6 and in 1998. Both those periods were characterised by crises in emerging markets. The 1998 emerging market crisis was very negative for South Africa from an economic point of view but nevertheless resulted in increased turnover in the foreign exchange market. Since turnover provides a measure of market activity, and also provides a rough proxy for market liquidity, the conclusion is that liquidity in the rand market in South Africa increased significantly over time by virtue of the increase in turnover.

3.3 Liquidity in the forex market has declined. Not only did the turnover decline to lower levels in the last quarter of 2001 compared to the trend of the last few years, but an anecdotal and statistical evidence indicate that the market has become less tight in the sense of widening bid-ask spreads, less resilient, and has lost some of its depth with some transactions being difficult to execute because of the occasional reluctance by market participants to make prices.[13] According to the records of SCMB, non-resident activity in the spot market declined throughout 2001,

[13] §3 is derived from the memorandum prepared by the Reserve Bank Bundle SARB(7) 91-108

whereas resident turnover, particularly importer hedging activities, increased during the latter part of 2001.[14]

The environment within which the South African forex market operates

4

4.1 A number of developments in recent years contributed to a more market-orientated exchange rate system and increased volatility in the rand exchange rate:-

- Globalisation and the integration of world financial markets had a major impact on the process of exchange rate determination. The South African exchange rate became more exposed and subjected to international developments. In the period about 1995-1999, international investors grouped about thirty emerging market countries together and developments in one or more of those countries affected others. For example, the 1998 crisis was initiated by a financial crisis in the forex market of Thailand, which spread to other East-Asian countries and eventually to countries as far apart as Russia, Brazil and South Africa. In 2001, however, international

[14] Evidence of WJ Potgieter, Standard Bank Bundle 20

investors began differentiating between different countries within the group of emerging market economies.

- Dramatic increases occurred in private sector international capital flows. Volumes in the forex markets of the world assumed astronomical dimensions and the ability of central banks to influence market conditions through intervention diminished.
- The gradual abolition of exchange controls in South Africa introduced an element of greater volatility in the local foreign exchange market.[15]

<u>The impact of globalisation and the liberalisation of exchange controls</u>

5

5.1 The overall thrust of the Government's economic policy since 1994 has been the pursuit of growth, job creation and redistribution, supported by reintegration with the global economy. While there are risks associated with it, globalisation offers the potential for sustained and broad-based improvement in living standards. Globalisation is characterised by rising trade and capital flows between countries. As has been broadly recognised internationally, a gradual approach to capital account

15 Evidence of Dr CL Stals, former Governor of the Reserve Bank, <u>Expert Bundle 171-2</u>

liberalisation is advisable and should occur late in the process of economic reform. The Government has chosen a policy of gradual liberalisation of exchange controls based on a set of key-policy and structural requirements:-

- the appropriate macro-economic fundamentals must be put in place;
- a sound and well regulated financial system must be in place;
- a flexible exchange rate has been chosen to act as a shock absorber against global developments.[16]

5.2 Increased capital flows have the potential:

- to help fuel faster growth and narrow the gap in living standards;
- to raise investment by supplementing domestic earnings;
- to deepen domestic capital markets and raise growth with a more efficient allocation of resources among competing projects. But increased capital mobility and integration of financial markets has also led to increased volatility, particularly in portfolio flows. For example, private portfolio flows to emerging economies almost halved as a

[16] Evidence of Mr TA Manuel, Minister of Finance, National Treasury Bundle 83-85

result of the Asian crisis, falling from about USD135 billion in 1997 to about USD70 billion in 1998.[17]

5.3 A gradual approach to the liberalisation of exchange controls has to a large extent enabled the Government to manage the volume of capital outflows and allowed it to adapt the pace and strategy of liberalisation in response to changing circumstance. The pace of liberalisation has taken into account factors such as expected capital inflows, the net open forward position (NOFP)[18], foreign reserve levels and a desired path for the real exchange rate. The process of exchange control liberalisation, however, is complex due to the size of the capital flows, the number of players in the market and the number of financial instruments available. Capital inflows to South Africa have proved to be volatile. Imbalances in the forex market are more often than not a consequence of the drying up of capital inflows due to mainly external factors rather than changes in capital outflows due to the effectiveness or ineffectiveness of domestic policies.[19]

---

17 Evidence of Ms M Ramos, Director-General, National Treasury, National Treasury Bundle 25-26

18 NOFP is expressed in US dollar terms and is defined as the sum of the net reserves (gross gold and foreign currency reserves minus foreign loans) of the Reserve Bank and its oversold forward book, i.e. the extent to which the Reserve Bank's future obligations to deliver US dollars are not covered by the Reserve Bank's net reserves.

19 Ramos National Treasury Bundle 34-36

5.4 Following on the liberalisation of exchange control, the capital outflows over the period 22 February to 31 December 2001 were as follows:

Private individuals in terms of their investment allowances transferred	R 7 billion
Corporates by way of foreign direct investment transferred about	R13.5 billion
Institutional investors acquired foreign portfolio investments of	R 3.8 billion[20]

5.5 In the opinion of Mr Mboweni, the Governor of the Reserve Bank ("the Governor"), it is virtually impossible to estimate the exact extent to which exchange control liberalisation has contributed to rand weakness but there can be no doubt, as the figures above show, that it could at times have been an important structural factor.[21]

5.6 The re-entry of South Africa into the globalised financial markets and the opening-up to international competition led to a sharp increase in the participation by non-residents in the domestic financial markets. Non-residents are now responsible for about ⅓ of the turnover of the JSE Securities Exchange SA and about ⅛ of

---

20 Evidence of Mr TT Mboweni, Governor of the Reserve Bank, Bundle SARB (7) 34-35

21 Mboweni Bundle SARB (7) 35

the volumes on the South African Bond Exchange. This has caused share and bond prices, as well as the exchange rate of the rand, to be increasingly influenced by developments in the rest of the world, particularly in emerging markets.[22]

5.7 Transactions by non-residents contributed materially to substantial increases in financial sector activity in the period 1995 to 2001:

- annual turnover on the South African bond exchange increased from R2.0 trillion to R12.4 trillion;
- the total value of shares traded on the stock exchange rose from R63 billion to R606 billion;
- in the rand forex market volumes increased from a net average daily turnover of USD2.7 billion to USD7.3 billion.

5.8 Transactions of non-residents resulted in greater volatility in capital flows:

(1) Non-resident net purchases of shares on the JSE Stock Exchange SA (measured in billions of rands) were:

1995	1996	1999	2000	2001
5.3	26.2	40.6	17.4	29.8

22 Mboweni Bundle SARB (7) 35; Ramos National Treasury Bundle 40

(2) Net purchases by non-residents on the South African bond exchange were even more volatile. Net purchases increased from R3.4 billion in 1996 to R14.8 billion in 1997. Non-residents on a net basis then sold bonds to the value of R9.8 billion in 1998 and bought back R14.3 billion in 1999. They again became net sellers of bonds to the amount of R20.2 billion in 2000 and R25.9 billion in 2001. The sharp fluctuations in portfolio investments of non-residents contributed materially to greater volatility in the external value of the rand.[23]

[23] Mboweni Bundle SARB (7) 36

Part D: Factors which might have contributed to the rapid depreciation of the rand

Index

Table of graphs, charts, diagrams and tables contained in Part D

Table of graphs, charts, diagrams and tables contained in Part D (continued)

D Factors which might have contributed to the rapid depreciation of the rand in 2001

[1] Factors which in general affect an exchange rate

1

1.1 Exchange rates and inflation

Inflation is a general rise in prices or a particular fall in the value of the currency in purchasing power terms. The internal purchasing power of a currency and its external value, ie its exchange rate, are broadly related and they tend to move over time together. Historically South Africa has had a faster than average inflation rate *and* the rand has had a declining trend against, for example, the US dollar: those two observations are consistent with the view that the internal purchasing power of a currency is related to its external purchasing power.

1.2 Exchange rates and export prices

Generally, better prices for a country's important exports tend to strengthen its currency. This is particularly true of commodity exporters such as Australia, Canada, New Zealand and South Africa. The exchange rates of those countries over time have tended to rise and fall with their major export prices. If the prices go up, there is generally more export value; producers spend more in foreign currency to buy the domestic currency, which tends to push up the currency on a simple supply and demand basis.

1.3 Exchange rates and interest rates

A currency with above average inflation and that tends to depreciate will tend to have higher than average interest rates. From a non-resident perspective, a higher interest rate compensates roughly and over time for capital losses from currency devaluation. Raising interest rates (in South Africa the repo rate in the first instance) tends to support the domestic currency by making it more attractive to hold and more expensive to borrow or short.[1]

1.4 Exchange rates and portfolio shifts

1.4.1 Mr McCauley expounded the proposition, which he said might not be the average view of economists, that if either residents or non-residents decide that they want assets denominated in a given currency, say the rand, then the tendency will be for that wish to be granted by the rand gaining in value or the underlying assets gaining in value or both. A portfolio shift away from the rand can take different forms – an outright sale of equities or bonds; a

[1] §1.1 to 1.3 are based on the evidence of McCauley Record 45

forward sale of the rand to hedge a long position or to establish a short position.[2]

1.4.2 Mr McCauley gave a sobering perspective on the significance, or rather lack of significance, of South Africa for foreign investors. Each country of the world enjoys a share in the world's portfolio of investments. The allocation to South Africa in that portfolio is less than 1%, probably as little as ¼%. By the time a foreign investor decides what amount to invest in South Africa, it has "really made all the important decisions already".[3]

1.5 Leads and lags

Mr McCauley expressed the opinion that while it may not on the face of it appear to be so, a type of portfolio shift occurs in the financing of imports and exports (leads and lags): every month of lead in payment and lag in receipts represents an outflow of a $^{1}/_{12}$ of trade. The leads and lags phenomenon makes the distinction between goods and financial services seem artificial in practice.[4]

1.6 Exchange rates and contagion

Contagion, as Mr McCauley pointed out, is a medical term and if you are going to catch a bug from somebody you need to come

---

2 McCauley Record 45 - 46
3 McCauley Record 47
4 McCauley Record 48

into contact with the bug or someone having the bug. As the term is used in financial markets, however, there need be no contact. One must distinguish between contagion based on (1) trade links, (2) similarity and (3) profit or loss of investors. The *first* is clearly observable; the *second* reflects perceptions of investors; and the *third* suggests that risk arises from the character of the issuer of the financial instrument. Contagion through <u>trade links</u> arises when country A and country B compete in world markets. A depreciation of B's currency can hurt A's competitiveness. A loss of competitiveness can slow exports and economic activity and so lead to pressure for a depreciation in A. Contagion through <u>similarity</u> occurs in at least three circumstances:- <u>economic circumstances</u>: Country A's currency devalues. Investors analyse the economic reasons for the devaluation, identify country B with similar problems, and take their investments out of country B. <u>Asset class</u>: investors may reduce exposure to a whole "asset class" such as emerging markets or a subclass such as EMEA (East Europe, Middle East, Africa). <u>Policy or regime</u>: countries with similar policies or financial regimes are treated similarly. For example, the Argentinean crisis led to higher interest rates in Hong Kong because both had a dollar currency board. Contagion through <u>profit or loss</u>: profits or losses from one exchange rate can permit (force) positioning in (withdrawal from) another exchange rate. For example, in mid-1998, profits from short positions in the Japanese Yen allowed larger short positions in commodity exporters' currencies like the Australian, Canadian and New Zealand dollars and South African rand.[5]

[2] Determinants of the rand exchange rate

2 The exchange rate of the rand is determined by millions of decisions taken daily by

- South African consumers, corporates, foreign exchange dealers, institutional investors and various arms of Government;
- foreign banks, foreign corporates, foreign institutional investors, foreign governments, multi-lateral institutions (such as the International Monetary Fund ("IMF") and the World Bank) and foreign individuals such as tourists and consumers of South African products.[6]

---

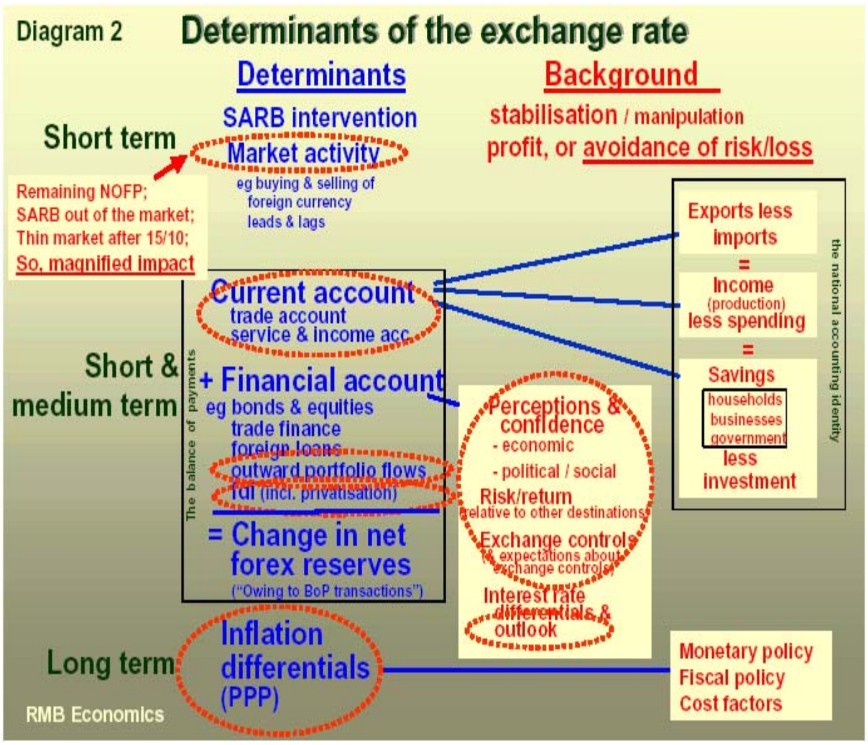
5 McCauley Record 50 - 55

6 Mr R Gouws, Chief Economist, Rand Merchant Bank, Expert Bundle 113

3

3.1 A convenient framework in which to consider the various factors that may have contributed to the depreciation of the rand in 2001 is to have regard to the determinants testified to by Mr Gouws and reflected in this slide:

Slide 2 Expert Bundle 118



3.2 In this report, the order in which the determinants are dealt with are:

(1) Long term: Inflation differentials

(2) Short & medium (a) macro-economic factors;

(b) perceptions/sentiment

(3) Short term: (a) the role of the Reserve Bank;

(b) speculation

(1) Long Term

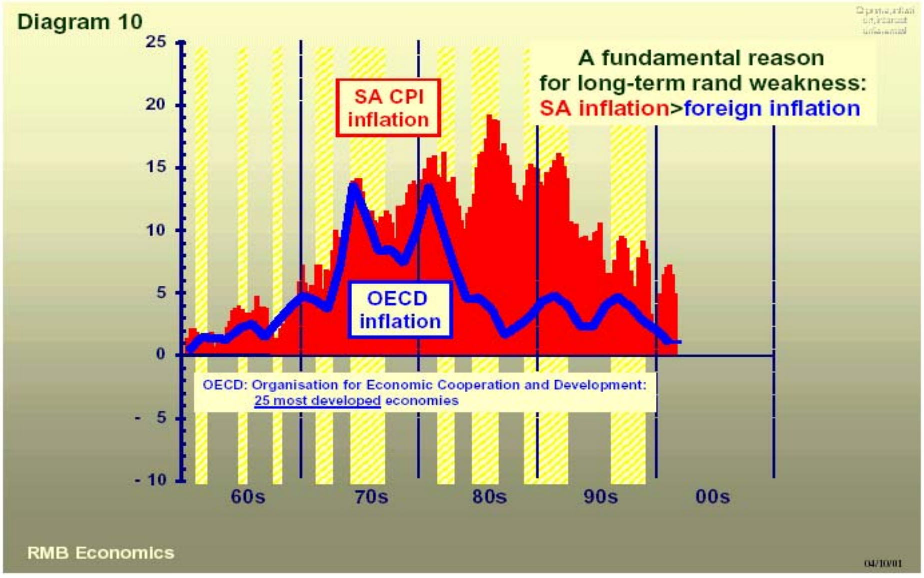
Inflation differentials

4

4.1 A fundamental reason for the long-term decline of the rand was that the South African inflation rate was higher than that of its trading partners. The reason is that if the internal value of any one currency falls faster than the internal value of another, the external value of that currency would, over time, reflect that difference. So, for example, if the rate of inflation in the United States of America is 1% per annum and in South Africa 9% per annum, the depreciation by 8% will maintain the real value of the rand against the US dollar.[7]

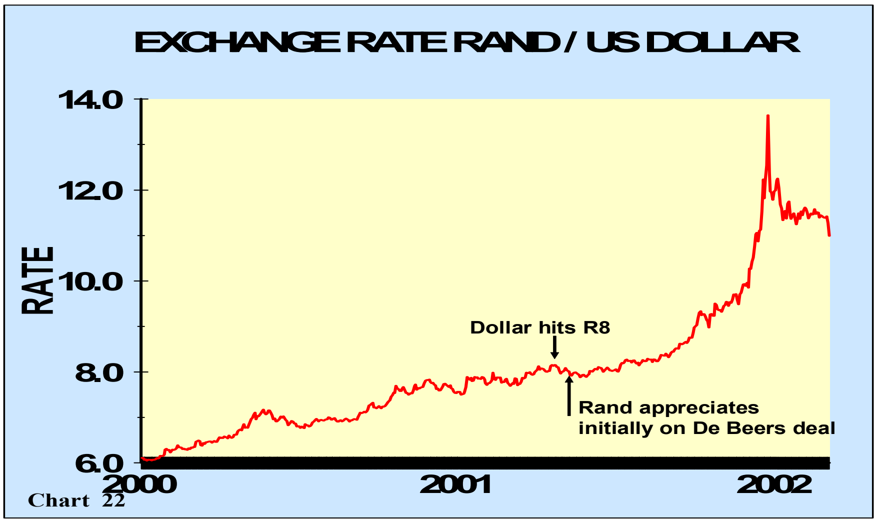
7 Gouws Expert Bundle 115; Stals Expert Bundle 170; Dr A Jammine, Director and Chief Economist, Econometrix (Pty) Ltd, Expert Bundle 301

Diagram 10 <u>Expert Bundle 122</u>



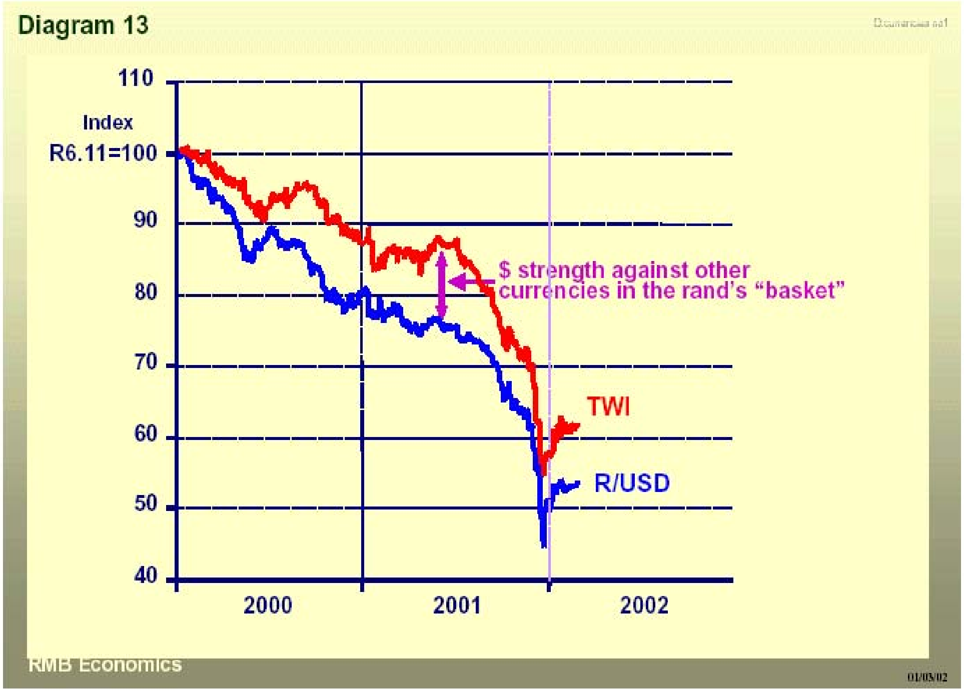
4.2 The slide in the value of the rand, in this phase, began in 2000. During 1999 the rand traded at about R6 to the US dollar, but by the end of 2000 it was trading close to R8 to the dollar, a depreciation of approximately 33%:

Chart 22 Expert Bundle 371



The Commission did not investigate the decline in 2000. One thing seems clear and that is that at least until September 2000 the decline could at least partly be explained by the strength of the US dollar. The strength of the dollar against the trade weighted index (TWI) is shown in this diagram:

Diagram 13 Expert Bundle 124



The TWI is based on weightings determined by the relevant importance of the trade of various countries with South Africa. The percentage weightings in the basket of currencies is shown below:

Diagram 14 Expert Bundle 124

Diagram 14

Rand trade weighted index

%Weightings in the Rand's "basket"	
1. Euro	35,7
2. US	15,2
3. UK	14,9
4. Japan	10,3
5. Switzerland	5,3
6. China Mainland	3,1
7. China Hong Kong	2,6
8. Korea	2,6
9. Zimbabwe	2,3
10. Canada	1,9
11. Sweden	1,8
12. Australia	1,6
13. Singapore	1,6
14. Israel	1,2

RMB Economics

(2) <u>Short to medium term</u>

(a) <u>Macro-economic factors</u>

5

5.1 An imbalance between the total disposable income and total spending of a country is reflected in the net flow of goods and services into or out of the country. These cross-border movements of goods and services, together with a net movement of international capital to and from the country, influences the demand and supply for foreign exchange in the domestic foreign exchange market.[8] In a market where the exchange rate should be

8 Mboweni <u>Bundle SARB (07) 16</u>

free to find its own level, the supply of and demand for foreign exchange are the main factors deciding the eventual level of the exchange rate. An excess supply of foreign exchange should usually be associated with an appreciation in the exchange value of the domestic currency. Conversely, a shortage of foreign exchange can be expected to cause a depreciation of the exchange rate of the domestic currency.[9]

5.2 Demand for, and supply of, the rand are influenced by the state of the global economy. There was a rapid decline in the performance of the international economy commencing in 2000 and continuing in 2001, the upshot of which was a decline in hard currency liquidity in the market, leading to a downward pressure on the rand.[10]

5.3 The effect of the attacks on the World Trade Centre and the Pentagon on 11 September 2001 was the crash in global equity markets which ensued and, in the words of Jammine: "… increased risk aversion towards emerging markets still further and the rand was once again seen to be in the firing line of this sentiment. Commodity prices plunged in expectation of a dramatic deterioration in global economic growth prospects and this affected the rand

---

9 Mboweni Bundle SARB (07) 16

10 Dr I Abedian, Chief Economist, Standard Bank of South Africa, Expert Bundle 276. See, too, for example, Stals, Expert Bundle 173

particularly hard and South Africa was seen as a predominantly commodity based economy. … The rand's depreciation from R8.52 at the time of the terrorist attack to R9.03 at the end of the month, was seen primarily as the function of South Africa's categorisation as an emerging market currency at a time when international investors were bailing out of emerging markets."[11]

5.4 The deterioration in the global economy and the events of September 11, 2001 had a negative effect on the South African economy, and hence on the rand, in two material respects: the flow of capital to emerging markets reduced and after September 11 international fund managers withdrew funds from what they regarded as vulnerable economies in what was described as a "flight to a safe haven".

5.5 In the first half of 2001, despite the global downturn, domestic income grew and gross domestic expenditure was less than national disposable income. Consequently, South Africa had a surplus of exports over imports. At the same time there was an inflow of capital into the economy. Given an ample supply of foreign exchange during this period, the exchange rate of the rand showed limited variation and by the end of June 2001 was

---

[11] Jammine Expert Bundle 321; Mboweni Bundle SARB (7) 16-17

roughly at the same level as at the beginning of the year (R8 to the US dollar).[12]

5.6 In the second half of 2001, domestic spending exceeded total national disposable income: excess spending over income lifted total spending to a level 1.1% higher than national disposable income in the third quarter and 0.3% higher in the fourth quarter. The excess of total domestic spending over total national disposal of income was expressed in a deficit on the current account of the balance of payments. This imbalance created a need in the forex market for an inflow of international capital in order to limit downward pressure on the exchange value of the rand. The deficit on the current account of the balance of payments, however, was not matched by any inflows of international capital into the economy.[13]

5.7 When a deficit on the current account of the balance of payments is not accompanied by an inflow of capital, the deficit is widely perceived as a major source of exchange rate instability. Where the demand for foreign exchange exceeds the supply of foreign

---

12 Mboweni, Bundle SARB (07) 17

13 Mboweni, Bundle SARB (07) 17, 20

exchange, a depreciation in the exchange rate of the rand could be expected as a normal market reaction.[14]

5.8 The following accounts are worthy of detailed analysis:-

<u>The services account in the current account of the balance of payments</u>.[15]

5.8.1 The shortfall on South Africa's services account with the rest of the world widened considerably from the first to the second quarter of 2001. This higher deficit was related to inward movements of foreign direct equity investment giving rise to dividend payments on non-resident shareholdings. Investment income received from offshore equity investments made by South African companies also increased, but to a smaller extent that the increase in dividend payments. The overall deficit on the services and income account widened from a seasonally adjusted and annualised value as follows:

First quarter	R37.2 billion
Second quarter	R47.1 billion
Third quarter	R48.6 billion

---

14 Mboweni <u>Bundle SARB (07) 17;</u> Stals <u>Expert Bundle 173-174</u>.

15 The balance on the current account of the balance of payments is the sum of exports and imports of goods and services out of and into South Africa. The current account consists of two accounts: the trade account and the services account. The services account records income payments and receipts, such as dividends, interest and employee compensation, transportation fees for goods and passengers, travel services and other services.

Fourth quarter R41.7 billion[16]

5.8.2 The financial account of the balance of payments

The financial account summarises the international capital flows and covers all transactions associated with changes of ownership in the foreign assets and liabilities of an economy. Three broad categories of investment are distinguished:

- direct investment;
- portfolio investment; and
- other investment.

5.8.3 The imbalance on the financial account of South Africa's accounts with the rest of the world changed from a surplus (or an inflow of capital) of R4.7 billion in the third quarter of 2001 to a deficit (or outflow of capital) of R1.5 billion in the fourth quarter.

(1) Direct investment

Foreign direct investment ("FDI") flows into South Africa are reflected in an increase in direct foreign liabilities. Direct investment is that category of international investment which reflects the objective of an investor in one country to obtain a lasting interest in another country.

---

16 Mboweni Bundle SARB (7) 23

Non-residents invested direct investment capital into the South African economy during the first three quarters of 2001, but this changed to an outflow of R1.9 billion in the fourth quarter. South African companies increased their holdings of foreign direct investment assets by R5.4 billion during the fourth quarter of 2001, mainly by acquiring a dominant interest in the equity capital of foreign companies.

On a net basis, i.e. offsetting changes in direct foreign assets against changes in direct foreign liabilities, FDI changed from an inflow of R3.6 billion in the third quarter of 2001 to an outflow of R7.3 billion in the fourth quarter, thus contributing to the weakness of the rand.[17]

(2) Portfolio investment

Portfolio investment includes investment in equity and debt securities not classified as direct investment. Non-resident investors increased their holdings of domestic equity securities by R7.9 billion during the fourth quarter of 2001 but simultaneously reduced their holdings of domestic bonds by R10.1 billion. The net outward movement of portfolio capital totalled R3.4 billion in the

17 Mboweni Bundle SARB (7) 23-25

fourth quarter. This raised the total net value of international portfolio capital outflows to R67.6 billion for the calendar year 2001 as a whole, compared with net outflows of R13.8 billion in 2000.[18]

(3) Other investment

Other investment is the category of the international capital that includes all transactions not covered by direct investment and portfolio investment and consists of trade credits, short-term and long-term loans and cross-border bank deposits. On a net basis, other foreign investment amounted to an outflow of R29.3 billion in 2001.[19]

5.9 The Governor summed up the impact of macro- economic factors on the rand in 2001 as follows:

"….the macro-economic scene in South Africa in the fourth quarter of 2001 was characterised by total domestic expenditure exceeding total disposable income. The excess of total domestic expenditure over total disposable income was expressed in a deficit on the current account on the balance of payments which was not matched by an inflow of foreign investment capital into the economy. In fact, capital left the country during the fourth quarter of 2001. This is a very significant factor for the exchange rate's behaviour during that period. Under

---

18 Mboweni Bundle SARB (7) 25

19 Mboweni Bundle SARB (7) 26

circumstances such as these, a depreciation in the exchange value of the rand could be expected as a normal market reaction."[20]

5.10 Dr O'Neill's evidence was that the balance of payments of a country should equal zero. The surplus on the one side should be exactly the same as the deficit on the other side. If one has a surplus in the current account, one should have a deficit in the capital account. The capital account includes net FDI, net portfolio flows (bonds and equities), short-term money flows and the central bank foreign exchange reserve changes. In total, those accounts should equal the current account. Dr O'Neill spoke about a concept known as the "broad basic balance of payments" (BBoP). BBoP is defined as the current account plus net FDI plus net portfolio flows. The general proposition is that a country with a BBoP deficit is likely to have a weak currency and a country with a BBoP surplus is likely to have a strong currency:-

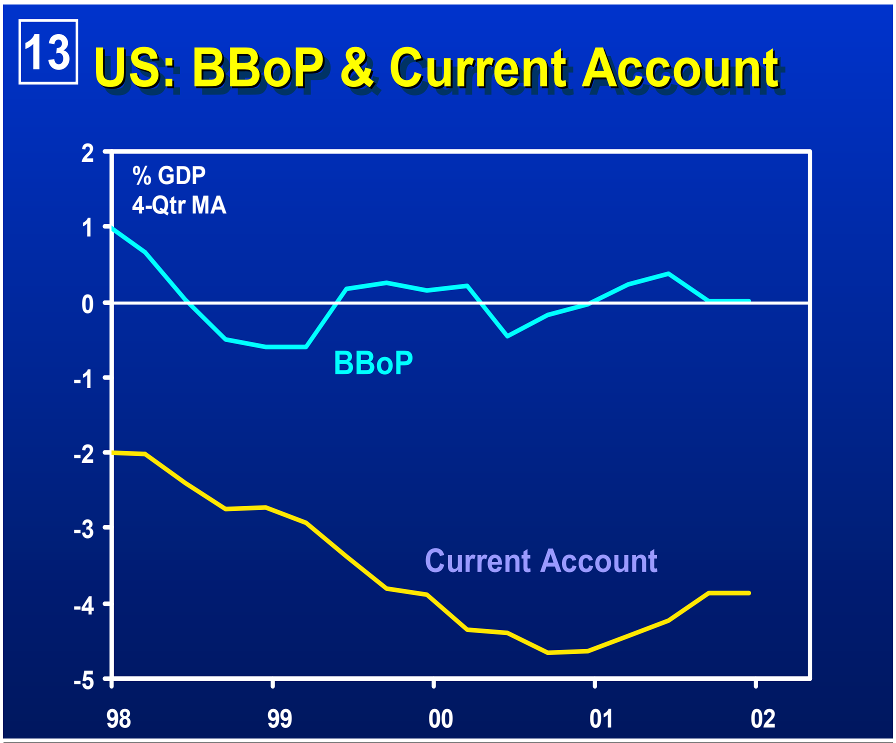
(1) The USA current account balance of payments has deteriorated to such an extent that its deficit is about 4% of GDP, the highest it has been since the early 1970's. Despite that deficit, the US dollar has strengthened against many other currencies because the American BBoP has remained in surplus. The reason for the surplus is that the USA has

---

[20] Mboweni, Bundle SARB (7) 29

attracted large amounts of capital both in terms of portfolio flows and FDI. Those capital flows have more than off-set the US current account deficit.

Slide 13 O'Neill Bundle 14



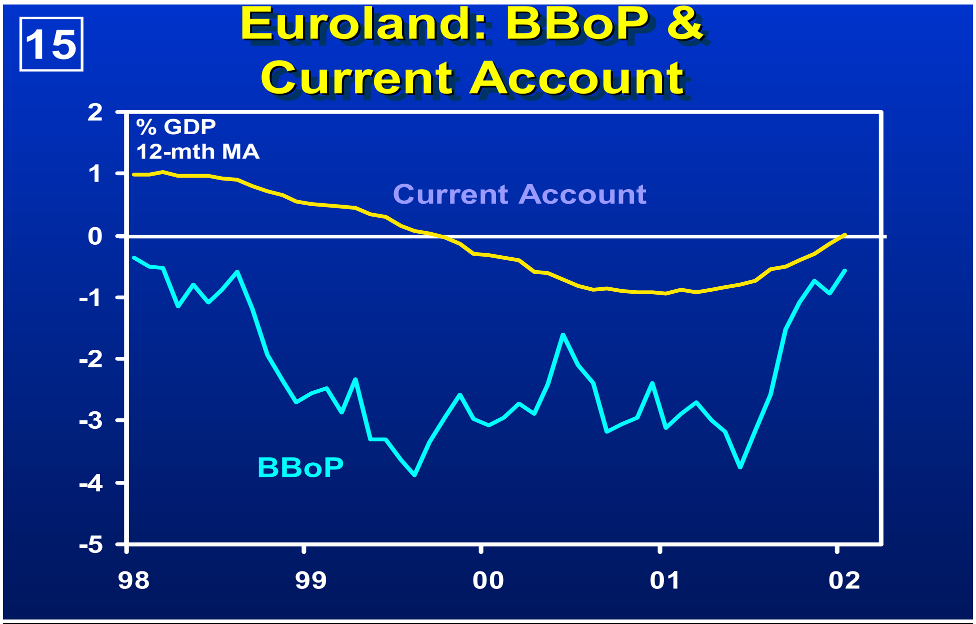
(2) In the early part of the euro's existence, Europe[21] had a small current account surplus. But through 1999 and 2000 Europe ran a large BBoP deficit, at times almost 4% of GDP. Europe failed to attract foreign capital, either FDI or portfolio flows,

---

21 For the purposes of this discussion, Europe is equated with the euro zone.

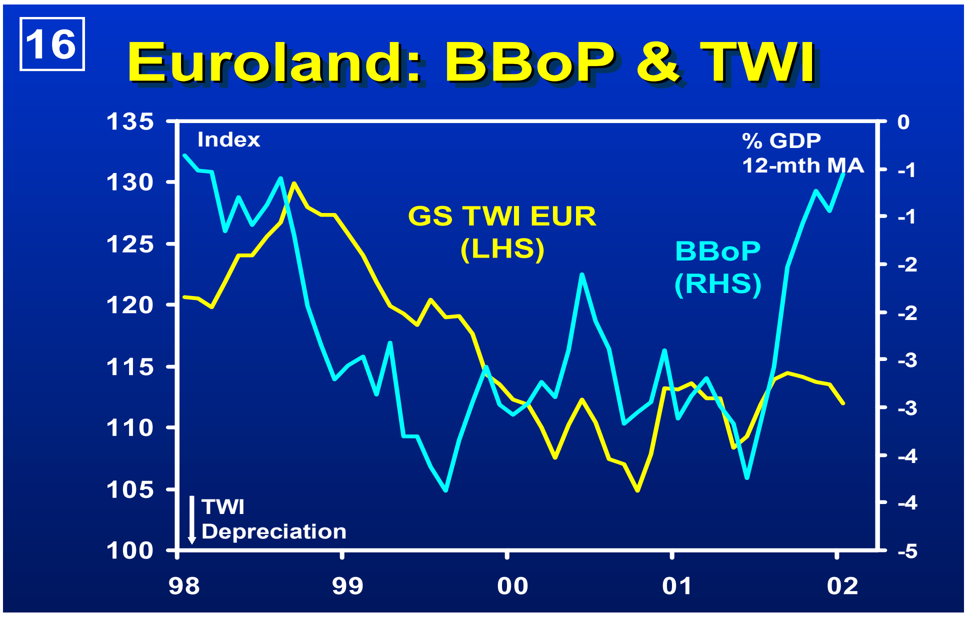
and foreign capital left Europe for the USA and other parts of the world.

Slide 15 O'Neill Bundle 16



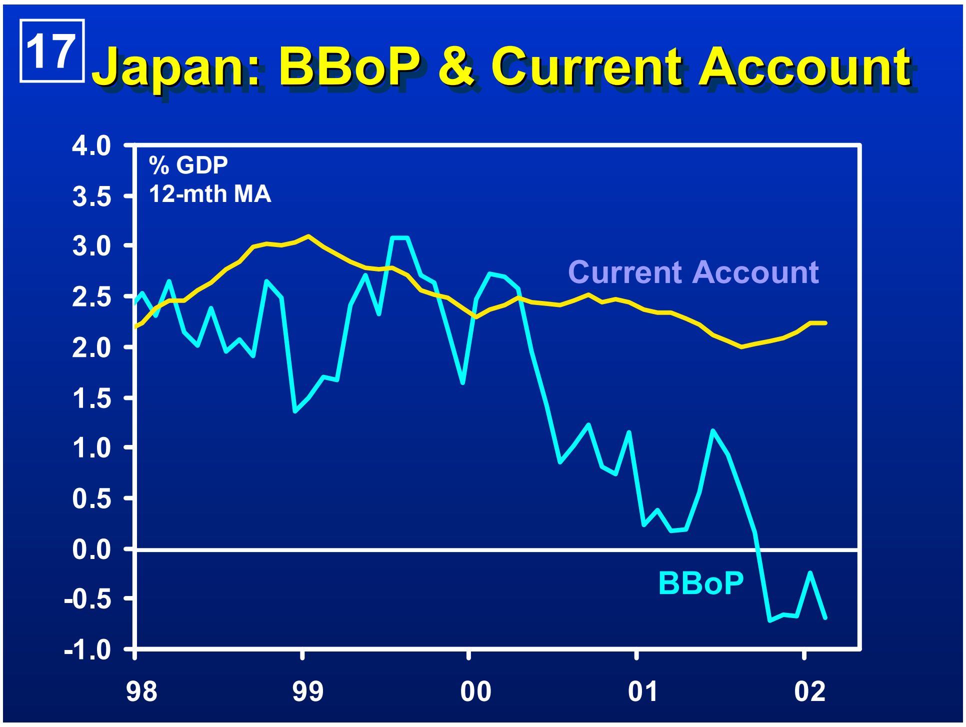
As the BBoP deficit of euro declined, the trade weighted exchange rate of the euro stabilised.

Slide 16 O'Neill Bundle 17



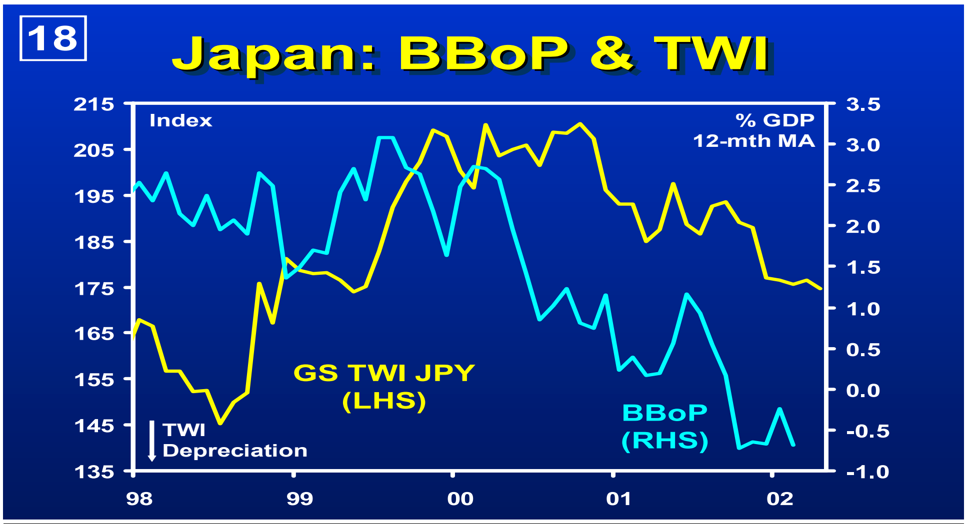
(3) For much of the period 1998 to 2002 Japan had a large current account surplus and a BBoP surplus. (While Japan had a BBoP surplus, the yen strengthened against the US dollar (as shown on slide 1, O'Neill Bundle 2; §1.3 Part C).

Slide 17 O'Neill Bundle 18



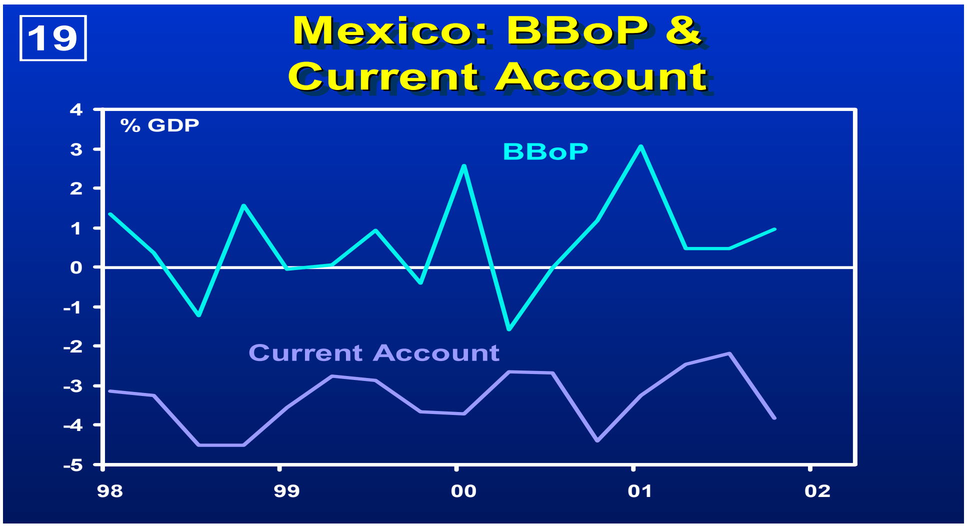
As the Japanese BBoP went into deficit, the value of the yen declined. In short, the strong BBoP surplus is associated with the yen's strengthening, while the BBoP surplus decline is associated with the decline in the value of the yen.

Slide 18 <u>O'Neill Bundle 19</u>



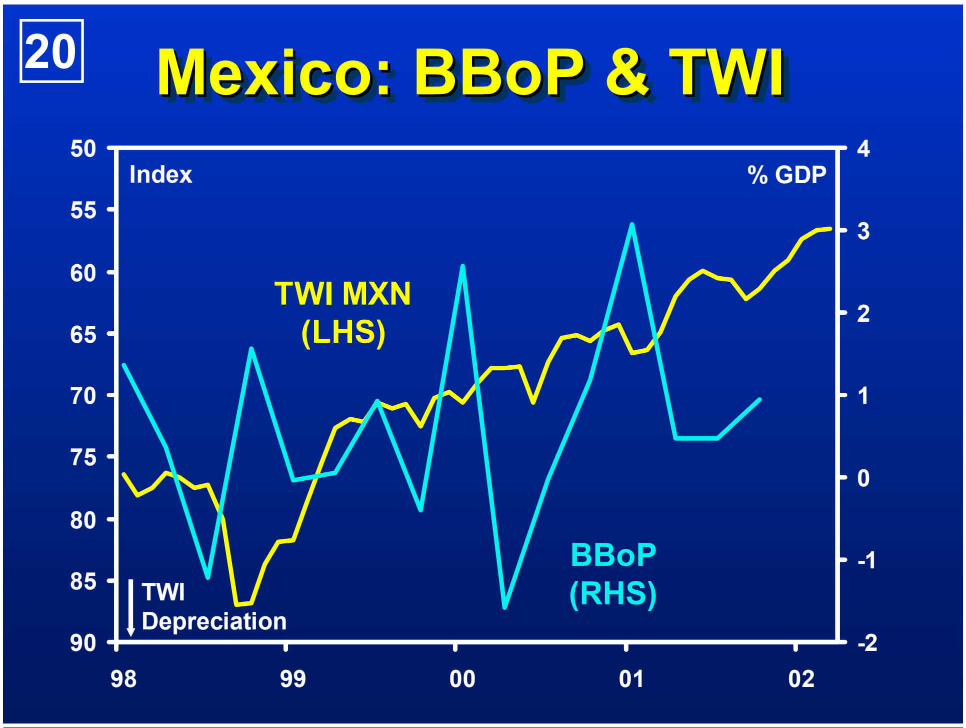
(4) The Mexican peso is one of the few currencies that has strengthened against the US dollar in recent years. The reason is that although Mexico has had a current account deficit, it has had a BBoP surplus, due mainly to large FDI inflows.

Slide 19 O'Neill Bundle 20



The consequence is that the peso has appreciated against the TWI.

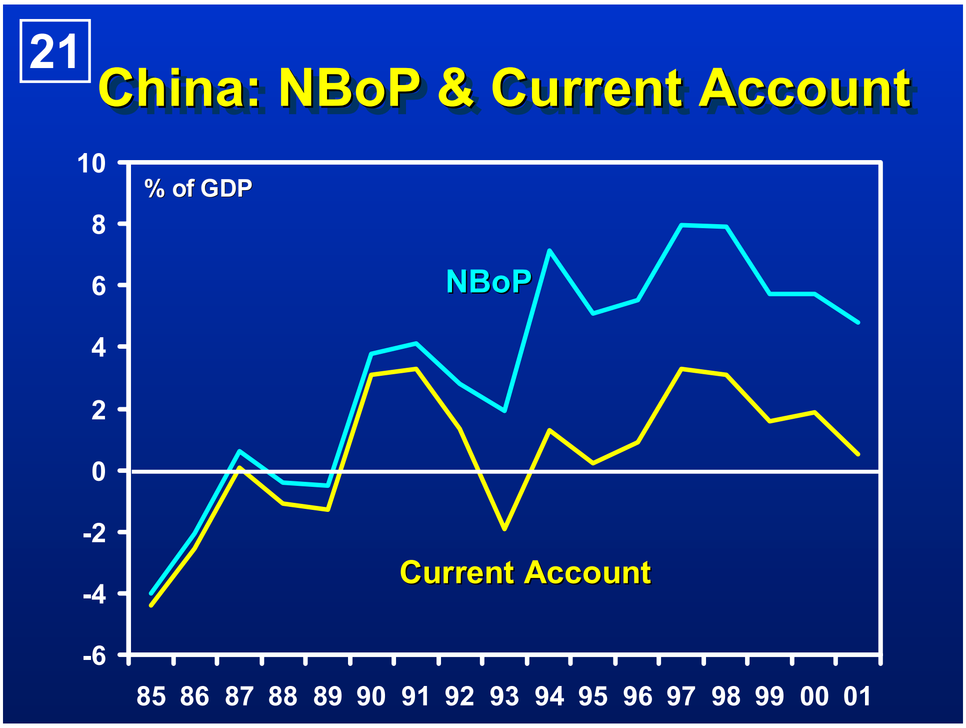
Slide 20 O'Neill Bundle 1



(5) China does not have liberalised financial markets. It is not generally possible for residents of China to buy foreign bonds or foreign equities and it is not possible for foreign residents to buy and sell Chinese equities or bonds. China does not have a completely open capital account. The concept of narrow balance of payments ("NBoP") is thus used. NBoP consists of the current account and FDI (and excludes portfolio flows). China has a large NBoP surplus because it has attracted

massive FDI: in 2002 China may attract FDI in excess of 5% of GDP.

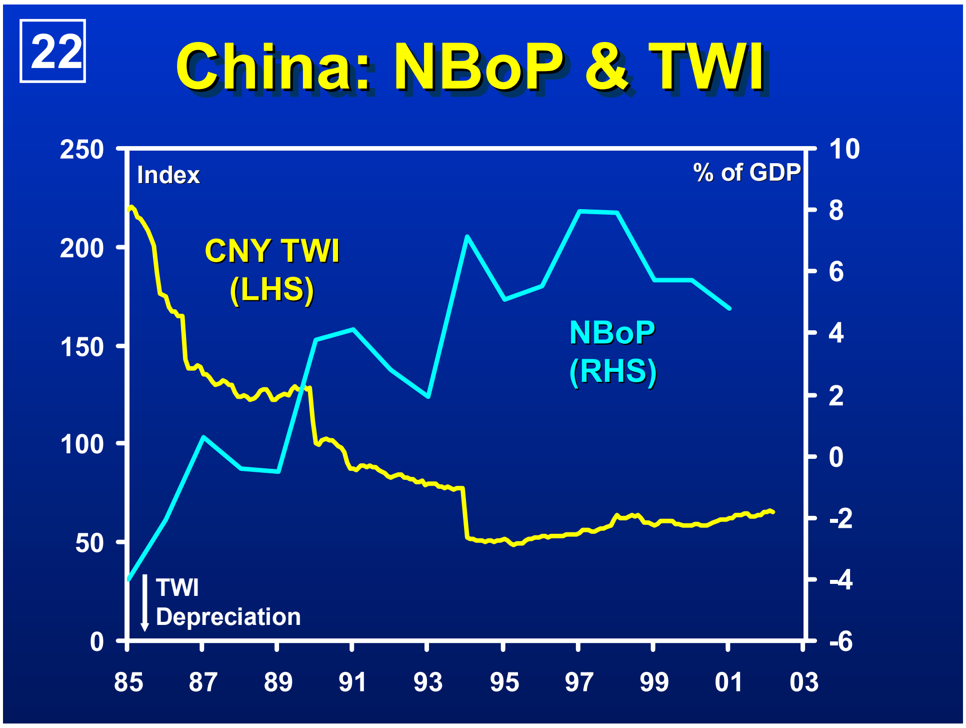
Slide 21 O'Neill Bundle 22



The result is that since about 1995 there has been a slow steady appreciation of the Chinese yuan or oemnimbi. The Chinese currency would probably have strengthened more if it had not been for the large accumulation of foreign exchange reserves by the Chinese authorities.[22]

22 Evidence of O'Neill, Record 1478-1480

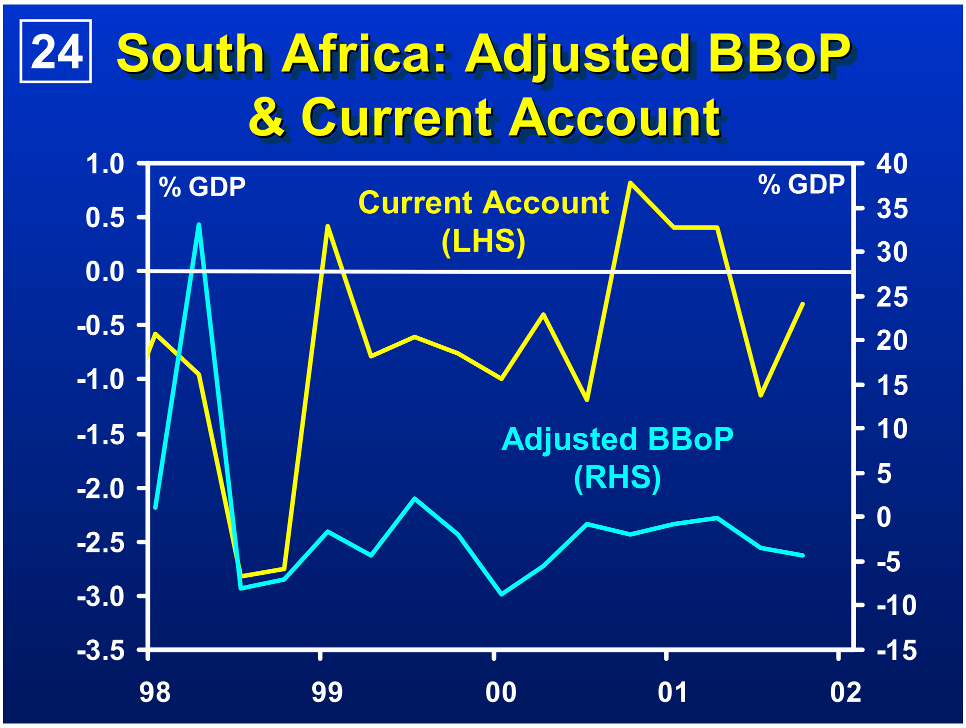
Slide 22 O'Neill Bundle 23



(6) Because of the NOFP, it is very hard to talk about the South African balance of payments in the same way as one does of other countries. Dr O'Neill therefore referred to the adjusted broad basic balance of payment or adjusted BBoP. Adjusted BBoP is the current account plus FDI plus portfolio flows plus the change in the NOFP. (The reduction in the NOFP is in effect the same as a large commercial outflow.) By and large, South Africa's current account balance has been very respectable for the past few years. However, when one takes into account the NOFP,

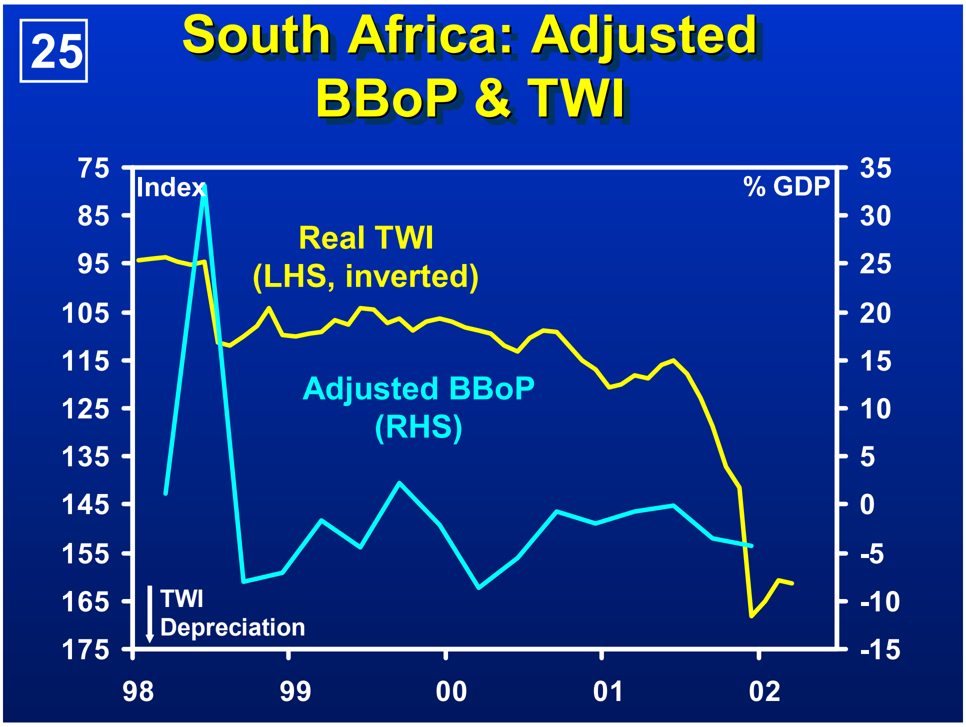
the adjusted BBoP has been significantly in deficit since 1998.

Slide 24 <u>O'Neill Bundle 25</u>



Having regard to the deficit in the adjusted BBoP it is *not* surprising that the rand depreciated in 2000. What *is* surprising is that it did not do so sooner.

Slide 25 O'Neill Bundle 26



An analysis of the accounts making up the adjusted BBoP quarter by quarter in 2001 shows that the adjusted BBoP as a percentage of GDP was:

Q1	Q2	Q3	Q4
-0.7	-0.1	-3.4	-4.3

It is absolutely no surprise, therefore, that the rand fell sharply in quarters three and four. The inference is that there were large capital outflows.[23]

(b) Perceptions/sentiment

6

6.1 During the latter half of 2001 there was a negative perception about South Africa and its currency, the rand. The Governor testified that regional instability, particularly in Zimbabwe, could have played some role in the weakening of the rand from May 2000 and also from June 2001. Other factors which the Governor said were regularly mentioned in the market were perceptions about unemployment, HIV/Aids, crime, the lack of progress with further privatisation, labour reform and investment incentives.[24] In the joint press statement by the Governor and the Minister of Finance of 21 December 2001 it was stated: "Increased risk aversion and growing negative sentiment towards the emerging markets have been further

---

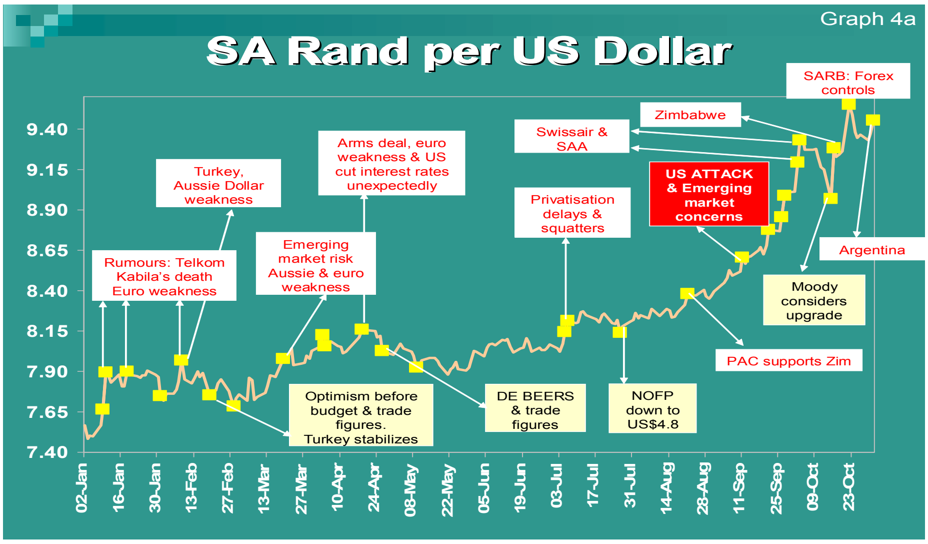
23 Evidence of O'Neill, Record 1480-1484
24 Evidence of Mboweni, Bundle SARB (7) 38

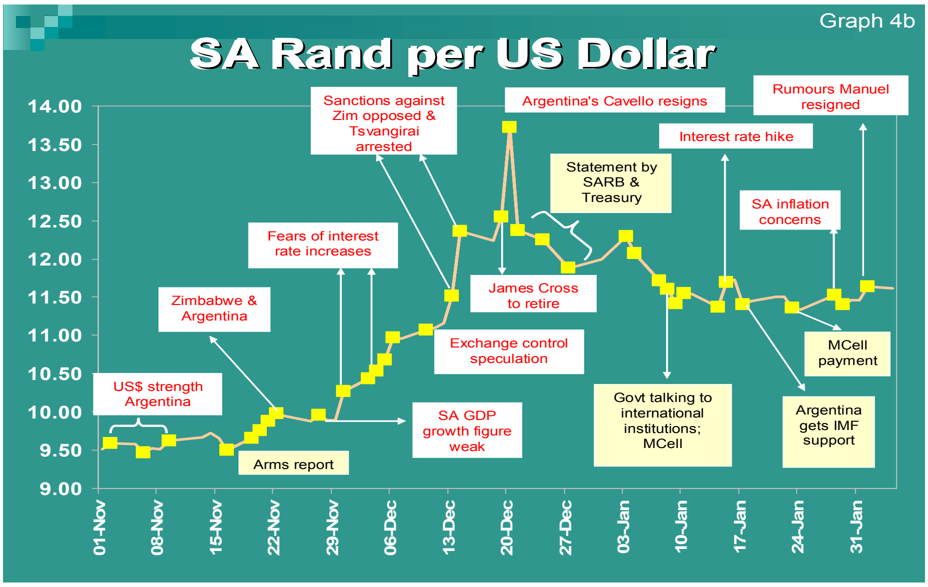
fuelled by the Argentinean crisis. In our region, events in Zimbabwe have also impacted negatively."[25] Mr Luüs, in addition to the factors mentioned by the Governor, added others, some of which were high and rising levels of unemployment, threatening socio-economic stability; a perceived lack of labour market flexibility, compounding the unemployment problem and being detrimental to higher productivity growth; low savings and fixed capital formation levels, constraining the economy's long-term growth potential; dissatisfaction amongst poverty stricken people because of growing economic illiquidity; the civil service was considered to be bloated and inefficient; the country's infrastructure, notably railways and roads, was not being maintained properly[26]. The factors, negative and positive, which might have impacted on the rand are shown graphically:

---

25 Bundle SARB (7) 347
26 Evidence of Mr CW Luüs, Chief Economist, ABSA Group Ltd, Expert Bundle 210, 211

Graphs 4A and 4B <u>Expert Bundle 222-223</u>





6.2 Mr Dykes[27] testified that sentiment played an important role in the rand's weakness in 2001. Negative sentiment towards South Africa was based partly on the Zimbabwe crisis and the emerging

---

27 Chief Economist for the Nedcor Group, <u>Nedcor Bundle 7</u>. See, too, the evidence of Bester, <u>FirstRand Bundle 18</u>; De Villiers, <u>Investec Bundle 36,</u> Woollam, <u>BoE Bundle 9</u>; Morrison, <u>Deutsche Bank Bundle 12</u>; Potgieter, <u>Standard Bank Bundle 47-49; §39 Part D</u>

market woes in the form of Argentina and Turkey. In regard to Zimbabwe, contagion played a significant role in the minds of both foreign and domestic investors. There were, generally unspoken, fears that what had happened in Zimbabwe would be repeated in South Africa at some point in the future. Any hint of a threat to property rights – such as the episode regarding foreign participation in the private security industry – provokes investor fears. The situation in Argentina and problems in Turkey and Indonesia, increased risk aversion during the year. However, the situation was different to that of 1998 when contagion spread from Asia to Russia to South Africa and on to Latin-America.

6.3 In reply to the question posed by Goldman Sachs to 30 of its clients: "What is the biggest change that would be positive for the rand?" 21% said Zimbabwe, 14% said Aids and 10% said crime. It follows that 40% of the responses related to Southern African related concerns. [28]

6.4 The authorised dealers, in their replies to the Questionnaire[29] in describing what factors influenced the rapid depreciation of the rand in 2001, referred, inter alia, to poor emerging market sentiment; emerging market contagion; economic problems in

---

28 See §36 Part D below

29 See §41 Part D below

Argentina; Zimbabwe and South African political factors. There was "generally poor market sentiment". The common factor influencing the rapid depreciation of the rand amongst the representative offices of the foreign banks was the political and economic instability in Zimbabwe.[30]

6.5 Conservative estimates had put the foreign currency inflows from *privatisation* in the 2001/2002 budget at R18 billion. The actual proceeds were only R2.3 billion. In Dr Abedian's words: "This had both perceptual and forex inflow implications. The rand had to be priced accordingly."[31] Dr Jammine emphasised the importance of privatisation from the point of view of foreign investors: they "saw privatisation almost as a litmus test of the government's commitment to investor friendly economic policies".[32]

6.6 A view is that the *exchange controls* which are still in force potentially deter foreign investment because foreigners believe that the gradual or sudden removal of such controls would lead to a gradual or sudden further depreciation of the rand; the partial lifting of exchange controls over the years has probably made the enforcement of the remaining measures much more difficult; and remaining exchange controls are rendering the rand a weak

30 See §42 Part D below

31 Abedian Expert Bundle 275-6

32 Jammine Expert Bundle 315. See, too Luüs, Expert Bundle 211-212

currency because of the fear that comprehensive exchange controls may again be implemented at any time.[33]

(3) <u>Short term</u>

(a) <u>The role of the Reserve Bank</u>

7 <u>Exchange Rate Management</u>

7.1 Mr McCauley testified that few countries are indifferent to the exchange rate. While the objectives of managing an exchange rate differ, there are six established objectives of exchange rate management:

<u>Macro-economic concerns</u>:

- prevent depreciation from raising inflation to unacceptable levels;
- prevent depreciation from undermining competitiveness of exports and thereby undermining incentive to invest in export industry;
- prevent depreciation from ballooning debts denominated in foreign currency, particularly those of government;

---

33 Luüs <u>Expert Bundle 213;</u> see, too, Gouws, <u>Record 94</u>

Micro-economic concerns:

- reduce volatility of exchange rate;
- prevent loss of confidence: fear that decline may lead to expectations of further decline and lead normal players to back away from the market;
- prevent "disorderly" market as reflected in "gapping" of successive bid–ask spreads, widening of bid-ask spreads and an absence of a sense of two way risk.[34]

7.2 The instruments to manage an exchange rate are:

- "open mouth" policy;
- intervention;
- moving interest rates;
- imposing or tightening capital (exchange) controls.

Open mouth policy

This is almost universally used by policy makers. A person in authority, such as the minister of finance or the governor of the central bank, makes a statement about the exchange rate with the object to influence the exchange rate, for example, "I think a strong dollar is in the interest of the US economy". [35]

---

34 McCauley Expert Bundle 60 - 61

35 McCauley gave this example: "… in the Philippines last August, the President….said that she thought that 50 pesos to the dollar was a pretty good exchange rate for the peso. It was then trading at more like 55 and strangely enough by the end of the year it was down to close to 50." Record 68

Intervention to support currency

Intervention can be done quietly or openly. Intervention may take place in different ways, for example, by sending the signal that interest rate hikes are likely to follow or through the portfolio effect by the central bank buying the domestic currency, which has the effect of offsetting the result of somebody selling the currency. This is particularly effective in a smaller country. The constraints of intervention by a central bank supporting the local currency are, for example, the concern that the intervention will be ineffectual and a waste of money, and the size of reserves – the central bank must have the wherewithal (reserves) to be able to support the domestic currency.

7.3 Raise interest rates to defend currency

Until quite recently, it was generally accepted that if a currency was under pressure, an effective way to defend the currency was to raise interest rates. But it may be hard to influence the exchange rate in a particular way: high interest rates can hurt growth and many investors associate growth with a strong currency and high interest rates may lead to a sale of bonds. The limits to the effectiveness of this kind of response were shown in the United Kingdom in 1992 and in the case of Europe in the past

15 months. The market has come to the conclusion, according to McCauley, that "the best thing for a currency is the prospect of growth returning to that economy and so raising interest rate or only slowly lowering them, might actually perversely hurt the currency rather than help it. So that is a pretty radical notion I have to admit, one that goes very much against the text books and everything they teach central bankers but there has been a suspicion out there that that is the way it is working actually."[36]

7.4 Tighten capital (exchange) controls

Exchange controls can take various forms, such as restrictions on borrowing lower yielding foreign currencies, on non-resident borrowing of local currency; and on residents purchasing foreign currency. The tightening of non-resident borrowing of local currency can immediately lift the domestic currency. The downside is that the longer term effects of such a policy are harder to gauge and there is an argument that by tightening exchange controls, you actually curb inflows.[37]

[36] McCauley Record 78
[37] McCauley Record 79 - 80

The Reserve Bank

8 The Reserve Bank was established in 1921 as the central bank of South Africa in terms of the Currency and Banking Act, 31 of 1920. That Act was replaced in 1944 by the South African Reserve Bank Act, 29 of 1944. In 1989 a new Act was introduced, the South African Reserve Bank Act, 90 of 1989 ("the Reserve Bank Act"), which is still in force. In terms of the Constitution of the Republic of South Africa, 108 of 1996, ("the Constitution") and in terms of a 1996 amendment to the Reserve Bank Act, the primary object of the Reserve Bank is to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth in the Republic. The Reserve Bank enjoys an important degree of autonomy for the execution of its responsibilities in respect of domestic monetary policy. As far as exchange rate policy is concerned, however, the Reserve Bank and the Government are jointly responsible for determining the framework of policy. The day-to-day implementation of that policy is the function of the Reserve Bank.[38]

---

[38] Mboweni, Bundle SARB (7) 5-7

Reserve Bank policies

9 In January 1979 the Government accepted this recommendation of the De Kock Commission of Enquiry into the Monetary System and Monetary Policy in South Africa: "The Commission recommends a unitary exchange rate system under which an independent and flexible rand finds its own level in well-developed and competitive spot and forward foreign exchange markets in South Africa, subject to Reserve Bank 'intervention' or 'management' by means of purchases and sales of foreign exchange (mainly US dollars), but with no exchange control over non-residents and limited control over residents". The De Kock Commission further recommended: "…whatever other objectives it (the Reserve Bank) might also have from time to time, intervention (in the foreign exchange market) should ordinarily be a smoothing operation." It was only after 1994 when South Africa could afford to commence phasing out exchange controls that the South African forex market reached the full status envisaged by the De Kock Commission and the "managed floating exchange rate" system for the rand was fully applied.[39]

---

[39] Stals, Expert Bundle 167–9; 179

10 On various occasions in the past the Reserve Bank intervened in defence of the rand. As the Reserve Bank did not have adequate foreign reserves, the obligations to deliver foreign exchange into the market were converted into forward obligations. The Reserve Bank, for example, sold US dollars into the spot foreign exchange market in order to support the exchange rate of the rand and then swapped the US dollars back onto its forward book by buying US dollars spot and simultaneously selling them forward. According to the Reserve Bank Act, all profits and losses in respect of providing forward cover are for the account of Government. Over the years, huge losses were made owing to the existence of the NOFP.

11 In 1998 the Reserve Bank intervened in defence of the rand in two distinct ways: by use of the forward book, increasing the NOFP to USD23 billion and by raising interest rates from 14% in June 1998 to 25.5% in August 1998.[40]

12 By 2001 the Reserve Bank and the National Treasury had changed course.

40 Jammine, Expert Bundle 309,310

13 Inflation targeting

13.1 A new monetary policy – inflation targeting – was introduced on 6 April 2000. Since then, the emphasis, in compliance with the Constitution, has been on domestic price stability, i.e. the reduction of inflation to lower levels in order to contribute towards balanced and sustainable economic growth.

13.2 The evidence of the Governor was that inflation targeting is a monetary policy framework implying the targeting of the inflation rate directly. Other intermediate variables influencing inflation such as money supply, credit extension or the *exchange rate* are not targeted directly, although they still play an important role in the determination of inflation. In the medium to longer term, successful inflation targeting should contribute to a more stable exchange rate for the rand.[41] Dr Stals said in evidence that he supported the concept of inflation targeting but that "… in any central bank the Governor has in his drawer much more than just an inflation target in mind because … in economics everything depends on everything else and the inflation target or the inflation result will be affected by a lot of other things that you just cannot ignore because … the Reserve Bank does not fix prices everyday and therefore it does not

[41] Mboweni, Bundle SARB (7) 9

control inflation directly. It affects inflation through its operations in the money market, in the exchange rate environment, in the interest rate structure, in the liquidity of the banking system. So these are the operational instruments that you have to use and have to apply and have to take account of every day even if you have a fixation on inflation at the end of the day and ….whether that target of yours is the money supply or the level of interest rates or the amount of liquidity in the banking system or the bank credit extension or the exchange rate, they are all very much inter-related in a circular process – the one affects the other." [42]

13.3 In the Monetary Policy Review of the Reserve Bank dated March 2001 it was stated:

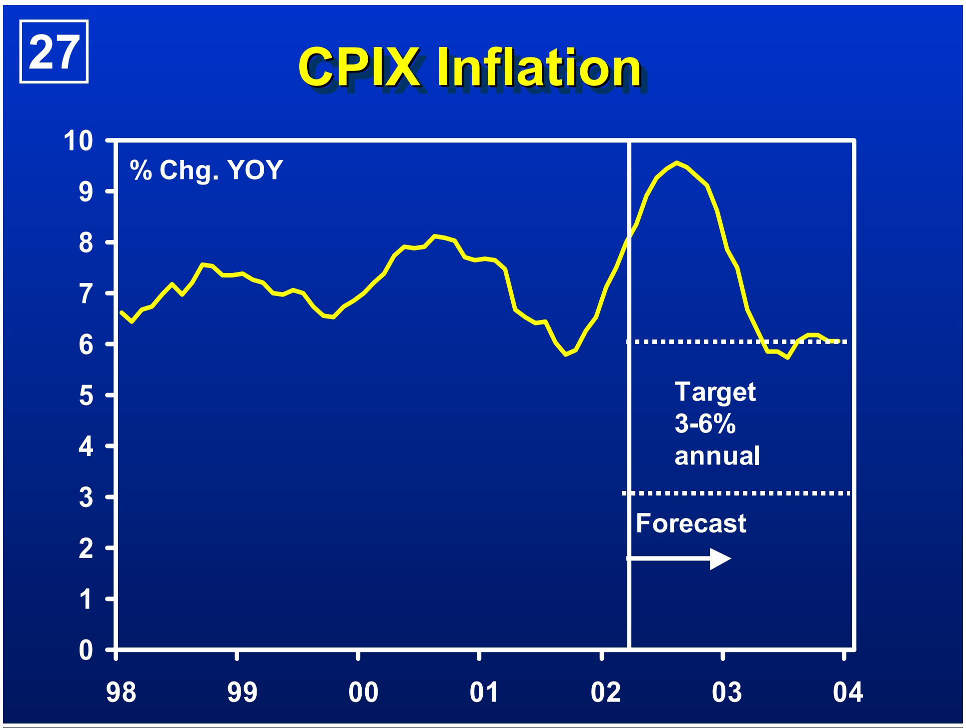
"Inflation targeting requires nominal exchange rate flexibility. In South Africa's case a fully flexible exchange rate regime has been adopted. This means that there is no specific target for the exchange rate. It does not however mean that the Reserve Bank is not concerned about the exchange rate, as exchange rate changes do feed into the inflation process. A depreciation of the currency directly affects the price of imports. Then there are the possible second-round effects where higher import prices feed into wage and other price increases."

13.4 It is the view of Dr O'Neill that inflation targeting is very important for South Africa and the rand has great relevance in the

[42] Stals, Record 286

context of inflation targeting. But the importance of the rand separately from inflation targeting from a global and analytical perspective is somewhat overstated.[43] The slide below shows how CPIX inflation has performed against target. What happened in the operation of the policy of inflation targeting is a lot more important than the topic of the rand. Policy should be focussed on inflation, not the rand. The target of 3-6% annual inflation should be achievable over the next 12 to 18 months.[44]

Slide 27 O'Neill Bundle 28



43 Evidence of O'Neill, Record 1462

44 Evidence of O'Neill, Record 1488

13.5 The price of crude oil is included in the way CPIX is arrived at in South Africa. Different crude oil price scenarios have different outcomes for CPIX. In the opinion of Goldman Sachs, the fair value of the rand is R7 to the US dollar and the price of crude oil should be USD20 to the barrel. If those assumptions are met, South Africa will meet its inflation target.[45] South Africa, however, has no control over the price of crude oil. In most other countries which have inflation targeting, the price of crude oil is not included in the calculation of the target inflation rate for these reasons:

- crude oil prices are not under their control; and
- in the past, large movements in oil prices impacted consumer price inflation but did not have lasting underlying inflation consequences.[46]

13.6 Partly because of the move to inflation targeting and partly because of the Government's exposure to the NOFP, the Reserve Bank did not use the forward book to finance intervention in support of the rand in 2001.[47]

13.7 The <u>policy of non-intervention</u> was made public by the Reserve Bank on a number of occasions in 2001 at a time when the rand

---

45 Evidence of O'Neill, <u>Record 1496</u>

46 Evidence of O'Neill, <u>Record 1490-1493</u>

47 Mboweni, <u>Bundle SARB (7) 15, 247</u>

was in decline. For example, in the Governor's statement of 14 October 2001, it was said that "….with the adoption of an inflation-targeting monetary policy framework, [the Reserve Bank] no longer has any intermediate policy targets or guidelines such as the exchange rate or growth in the monetary aggregates. The authorities are committed to continue allowing the value of the rand to be determined by the market, but are concerned that excessive volatility in the foreign exchange market negatively influences inflation, business decisions and the economy as a whole." Participants in the forex market formed the view that in the absence of support for the rand by the Reserve Bank, the rand would continue to depreciate. The policy of non-intervention became an element of the "one-way bet" view of the rand which infected the forex market in 2001.[48]

[48] Gouws, Expert Bundle 125; Mr M Langley, former Head of Foreign Exchange, Credit Agricole Indosuez, Johannesburg, Expert Bundle 148; Jammine Expert Bundle 339; Mr G Glynos, chief market analyst, Standard & Poor's MMS SA, Expert Bundle 424

14 NOFP

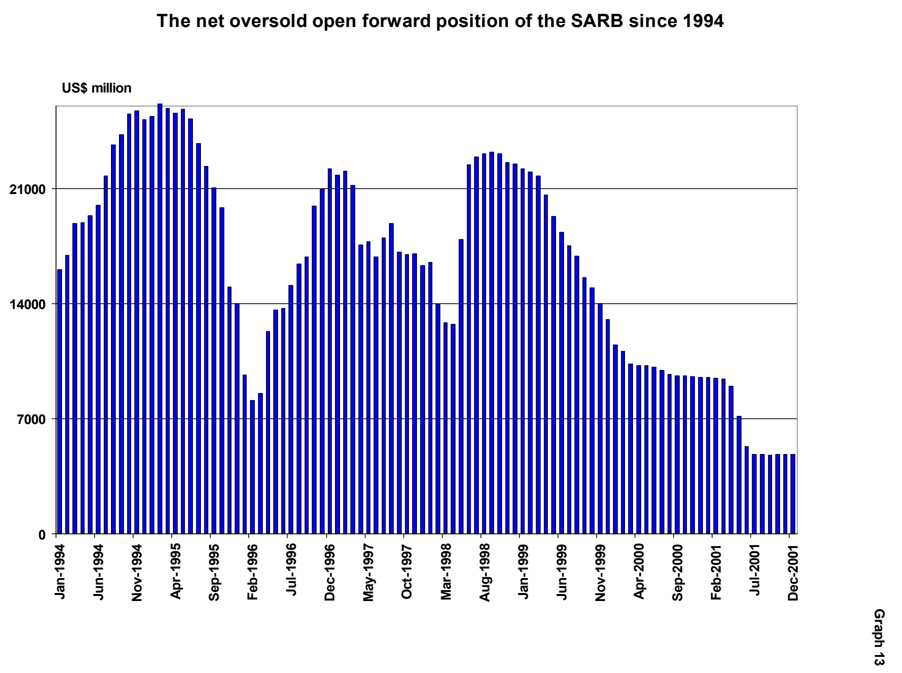
14.1 The Reserve Bank and the National Treasury took a decision to reduce the NOFP. The decision was made public and implemented. By the end of the first quarter of 2001 the NOFP had been reduced from USD23 billion in 1998 to USD9.4 billion.

14.2 The Reserve Bank reduced the NOFP, in its words, by "buying foreign exchange" or, in the words of the rating agency, Standard and Poor, by "mopping up inflows". Total purchases in 2001 amounted to about USD4.4 billion and were related to Government's foreign bond issues and to large corporate transactions. The NOFP, accordingly, declined to USD5.3 billion at the end of quarter two; USD4.7 billion at the end of quarter three and USD4.8 billion as at the end of 2001.[49] The Reserve Bank's success in implementing the policy is shown in this graph:

---

[49] Mboweni, Bundle SARB (7) 33

Graph 13 Bundle SARB (7) 70



14.3 The policy of reducing the NOFP has been praised by the IMF, the rating agencies and the investment banking community. For example, on 9 May 2001 the IMF stated: "Directors [of IMF] commended the authorities for the significant recent progress made in reducing the net open forward position (NOFP) of the Bank. Nevertheless, they noted that the NOFP remains an important source of external vulnerability, and that it needs to be further reduced as market conditions permit".[50]

50 Mboweni, Bundle SARB (7), 31

14.4 The experts from the private sector, whether economists or traders, were not critical of the policy. But all agreed that the Reserve Bank's commitment to reduce the NOFP by buying US dollars contributed significantly to the perception that the rand was a one-way bet.[51] As Dr Abedian said: "… The SARB's single minded focus was on eliminating the NOFP … This of course meant a one-sided intervention in the spot market. The SARB was in principle selling rands and buying hard currency, thereby adding to the net demand for hard currency and putting downward pressure on the rand. Moreover, in pursuit of closing down its NOFP, the SARB seemed to be inclined to fully capture once-off inflows such as the De Beers deal, thereby eliminating any upward pressures on the value of the rand. This proved a consistent policy approach over the period 1999-2001. However, this approach had a significant impact on hardening positions against the currency. Speculative positions against the rand were therefore by and large risk free. In essence, most, if not all, market players believed that even the SARB was neither inclined nor in a position to do anything that would strengthen the currency."[52]

14.5 The apparent correlation between the reduction of the NOFP and the decline in the value of the rand is shown in these two graphs:

---

[51] For example, Gouws Expert Bundle 126; Langley Expert Bundle 148; Luüs Expert Bundle 213.

[52] Abedian; Expert Bundle 273. See, too Jammine, Expert Bundle 337, 338.

Graph 18 <u>Expert Bundle 126</u>

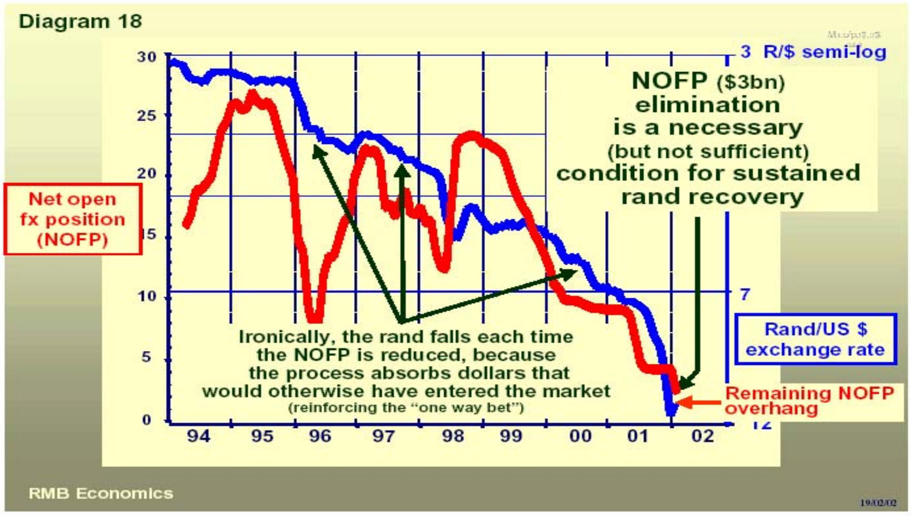
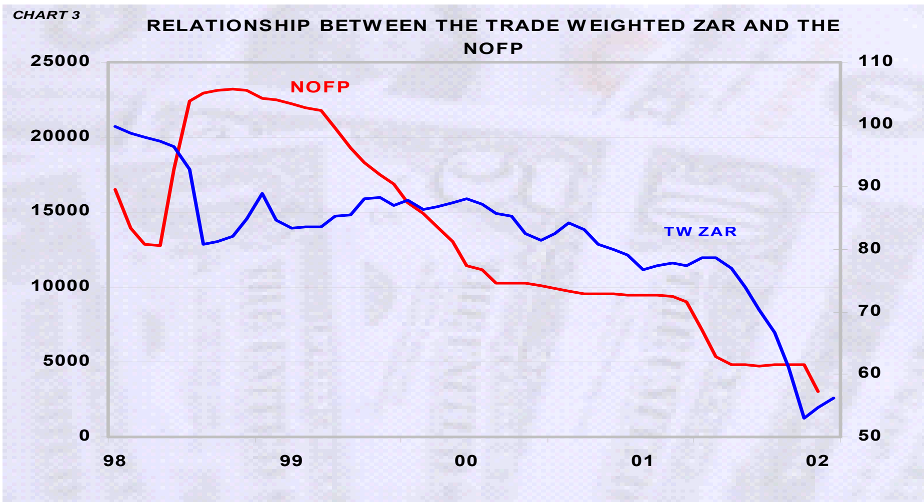


Chart 3 <u>Expert Bundle 455</u>



14.6 The Reserve Bank does not have a different view. The evidence of the Governor was:

"Given the losses on the forward book and negative perceptions from market participants and commentators on the one hand and the potential impact on the currency of reducing the forward book on the other, the Bank had a difficult choice to make. In the long-term interest of South Africa, it was decided to place emphasis on reducing the NOFP. The Bank had to buy foreign exchange as prudently as possible to close out the NOFP.

It is quite possible, however, that this eminently defensible goal of reducing the NOFP could have contributed at times to the sentiment that the rand's value is a one-way bet. To reiterate, the Bank was indeed conscious of this risk in pursuing its goal and strove to manage this risk by buying US dollars selectively. …..

Had the Bank allowed the proceeds of these large corporate transactions to flow through the market, the rand could have appreciated significantly. The market had been expecting a sizeable amount of the foreign exchange proceeds accruing to South African shareholders to be sold off for rand in the market, which expectation initially provided some support for the rand. Upon confirmation that the bulk of such proceeds were to be the subject of a once-off transaction with the Bank, for the purpose of reducing the NOFP, market perceptions of rand weakness could have been reinforced."[53]

14.7 On 14 October 2001 the Governor issued a statement which dealt, inter alia, with the NOFP in these terms: "The net open foreign currency position (NOFP) has declined from USD23.2 billion at the

53 Mboweni, Bundle SARB (7), p 32 – 33

end of September 1998 to USD4.8 billion. Given the negative perceptions resulting from the NOFP, the Reserve Bank reduced this position by purchasing foreign currency in the domestic foreign exchange market, which may have contributed to the depreciation of the rand over this period.

The South African Government's exposure to foreign currency risk, including the NOFP, as a percentage of GDP, is now on par with those prevailing in certain G10 countries. With the NOFP at a more comfortable level, any perceived vulnerability has declined significantly. The Reserve Bank is consequently in a position to alter its approach in dealing with the NOFP.

In future, the Reserve Bank will not intervene by purchasing foreign exchange from the market for purposes of reducing the NOFP. The NOFP will be expunged from cash flows derived from the proceeds of Government's off-shore borrowings and privatisation."[54]

14.8 Had investors and analysts read the statement of 14 October 2001 with the necessary care, they would have realised that as the Reserve Bank would no longer "mop up" US dollars in the forex market to reduce the NOFP, the NOFP should not be considered an element of the one-way bet. The evidence before the Commission leaves one with the impression that the statement was either not read properly or ignored.

---

[54] Mboweni, Bundle SARB (7), 340

14.9 On 21 December 2001 the Governor of the Reserve Bank and the Minister of Finance issued a joint statement. One of the matters addressed in the statement was the NOFP: "The NOFP is down to $4,8 bn from $23,86 [bn] in September 1998. In January 2002, Government will be drawing down the full $1,5 bn syndicated loan, further contributing to reducing the NOFP, which is expected to be expunged entirely during 2002. This will be achieved utilising funds available from Government borrowing and proceeds from privatisation, and not from any purchases of foreign exchange in the market."

14.10 The Government did indeed increase its foreign borrowings in 2001, including a syndicated loan of USD1.5 billion, and the Reserve Bank was able to reduce the NOFP to USD2.9 billion as at the end of January 2002.[55] The NOFP at the end of March 2002 was still USD2.9 billion and "has ceased to be the major concern to the international investment community."[56]

[55] Ramos, National Treasury Bundle 57, 66
[56] Statement of Minister of Finance on 24 May 2002: Record 1759-1760

15 The meeting of 14 October 2001 and the communications that followed

15.1 The evidence of the Governor was that the issue of enforcing existing exchange controls had been extensively discussed in the Reserve Bank and with National Treasury over a long period of time. The Reserve Bank was aware of the various explanations of the rand's weakness in recent years. The explanations included exchange control liberalisation, the Reserve Bank buying spot foreign exchange to reduce the NOFP and the decisions by importers and exporters to lead or lag their foreign exchange payments and sales. The impact of these more fundamental and legitimate factors influencing the exchange rate was acceptable to the authorities. Of more concern were comments from the market that speculative transactions, particularly by non-residents, were adding to volatility and rand weakness. The Reserve Bank was informed that investors and other emerging markets, with less liquid financial markets, were using South African markets as a proxy hedge for weakness in other countries. The Reserve Bank had no choice but to either abolish the remaining exchange controls in total or to apply the existing rules and regulations equitably to all. The Reserve Bank became increasingly concerned that excessive volatility in the forex market during the third quarter of 2001 negatively influenced inflation, business decisions and the economy as a whole. Accordingly, a meeting was called on Sunday, 14 October 2001 between the Reserve Bank and the chief executive officer and head of treasury of major South African and foreign banks registered in South Africa. What was conveyed to the banks, and which is material for present purposes by the Governor, is what is contained in the statement of 14 October in these terms:

"The Reserve Bank stands ready to take appropriate firm steps against trading activities inconsistent with existing rules and regulations. The enforcement of existing rules serves to ensure that only legitimate transactions take place in the foreign exchange market. This does not restrict, for example, the ability of a non-resident investor to either hedge or repatriate the sale proceeds of an investment in South Africa. It does, however, exclude the financing of short rand positions in the domestic markets, which is consistent with the requirement that domestic borrowing by non-resident investors is subject to certain restrictions. This communication should not be construed as an attempt to restrict the activities of banks in the South African markets, provided they adhere to the existing rules and regulations. Normal commercial and financial transactions remain unaffected." On 16

October 2001 the Reserve Bank issued Circular D342, in which it was stated, inter alia:

"To ensure that the provisions of the various sections of exchange control rulings are applied uniformly by all authorised dealers, in particular when dealing with non-residents in the forward and other derivative foreign exchange markets, we deem it necessary to reiterate certain fundamental principles in this regard.

It is incumbent upon authorised dealers to ensure that their overseas counterparties are fully conversant with the rules applicable to dealing in the domestic forward and other derivative foreign exchange markets. It follows, therefore, that when dealing with a non-resident counter-party, other than a correspondent bank, supporting documentary evidence must be obtained confirming that such non-resident counter-party has a legitimate South African exposure resulting from an accrual, investment or asset denominated in rand."[57]

15.2 On about 25 October 2001, an "important notice" was issued to authorised dealers. In terms of the notice, the compliance officer of a non-resident bank was required to sign a compliance letter. The Reserve Bank and a working committee of the ACI, an organisation representing forex dealers, accepted the wording of the compliance letter. In terms of the compliance letter, the

---

57 Mboweni, Bundle SARB (7) 42, 43, 340, 342; Evidence of Mr AM Bruce-Brand, General ManagerExchange Control Department, Bundle SARB (6) 22

compliance officer was called upon to confirm in writing "that all transactions concluded by our clients and our dealers within the preceding 14 business days have been in compliance with the applicable rules and regulations."[58]

15.3 The Reserve Bank believed that applying the existing rules and regulations to exclude speculative trading from the forex markets would reduce volatility in the rand's exchange rate and would be to the benefit of non-resident investors and South Africans alike.[59]

15.4 The exchange controls which the Reserve Bank sought to enforce were these:

"21.5.3 **Forward exchange contracts with South African residents** – Foreign currency may be sold forward to South African residents, provided that the facilities are required to cover a firm and ascertained foreign exchange commitment due to a non-resident. Foreign currency may be purchased forward from South African residents, provided that the facilities are required to cover a firm and ascertained foreign currency accrual due from and payable by a non-resident.

---

58 Evidence of Bruce-Brand, Record 568, Bundle SARB (6) 224-5

59 Mboweni, Bundle SARB (7) 43

21.5.4 **Forward exchange contracts with non-residents –** Foreign currency may be sold forward to non-residents, provided that such non-resident counterparties have legitimate South African exposures resulting from an accrual, investment or asset denominated in Rand."[60]

15.5 The Reserve Bank surmises that while consultation between it and the forex market was taking place following on the statement of 14 October 2001, "… some off-shore banks might have decided, as a precautionary measure, to avoid finding themselves in contravention of exchange control rules, to reduce the level of activity in South Africa's foreign exchange markets. This may well have contributed to a decline in liquidity …".[61]

15.6 The average net daily rand forex market turnover declined from USD8 billion in July 2001 to USD7.4 billion in October 2001 to USD5.5 billion in November 2001 and then increased to USD6.1 billion in December 2001. This is graphically demonstrated as follows:[62]

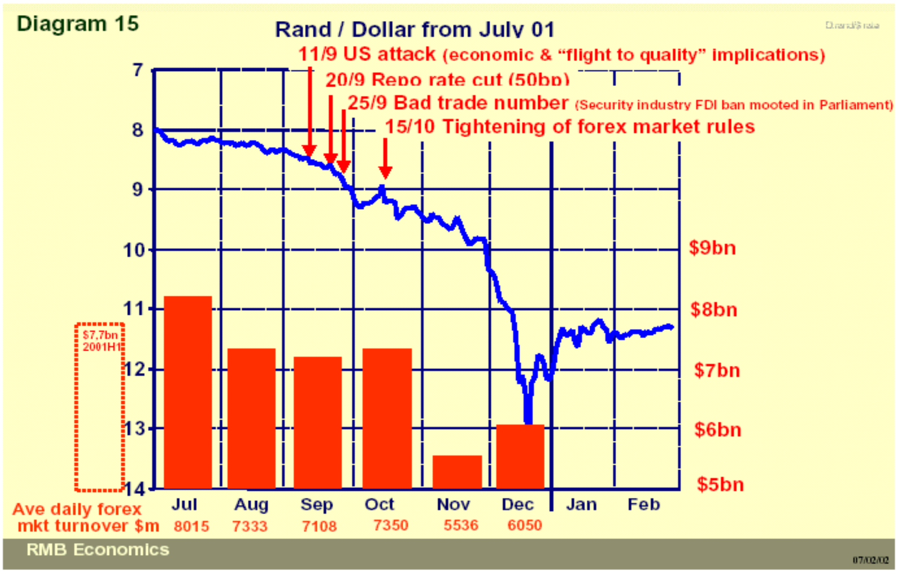
---

60 Bruce Brand, Bundle SARB (6) 18, Record 558-9

61 Mboweni, Bundle SARB (7) 44

62 Mboweni, Bundle SARB (7) 44; Gouws, Expert Bundle 125

Diagram 15 Expert Bundle 125



The most significant decline was in the swap market where the average daily net turnover declined from an average level of USD5.8 billion in the first ten months to an average USD4.3 billion for the last two months. The turnover of non-residents – the most significant participants in the market – declined from USD3.6 billion to USD2.3 billion respectively.[63]

15.7 The Governor expressed the view that liquidity in the forex market could have been affected by the statement of 14 October 2001. He went on to say:

"The issue of liquidity also arises when considering volatility. One-month historical volatility of the rand's exchange rate against the US

63 Mboweni, Bundle SARB (7) 44

dollar increased from a level of 9.1% in the first nine months of 2001 to an average of 20.5% for the last quarter. These volatilities reached a high of 55% at the end of December 2001. It is, however, not possible to attribute changes in these variables to a single reason or event but it is possible that the interpretation of the 14 October 2001 statement could have been a contributory factor."[64]

15.8 A view that was expressed by a number of economists was that the effect of the statement of 14 October 2001 on the rand was negative. For example, Mr Luüs said: "On 14 October 2001 the SARB drained liquidity from the foreign exchange market by a stricter application of foreign exchange regulations. This measure worsened the rand's slide".[65] Dr Abedian testified that the immediate impact of the statement of 14 October 2001 was to "scare away the pure speculators (mainly off-shore) from the market, thereby reducing liquidity in the overall market by another USD200 to USD300 million per day. In an already thin market, this contributed considerable additional pressure on the rand. With these volumes out of the market and no speculators active in the market, the conditions were so much more favourable for a run on the currency."[66]

15.9 During a volatile forex market, such as South Africa experienced in the fourth quarter of 2001, "… many smaller players, that are

---

64 Mboweni, Bundle SARB (7) 45
65 Luüs, Expert Bundle 213
66 Abedian, Expert Bundle 273 See, too, Glynos, Expert Bundle 432

normally active in calmer market conditions, simply withdraw from a volatile market resulting in a sharp decrease in liquidity."[67] Foreign financial institutions, based mainly in London and to a lesser extent in New York, have entered the South African forex market. When volatility is at its highest, however, a number of new entrants leave the market.[68]

15.10 In about the first two days after the meeting of 14 October 2001 the rand appreciated. This was "… a natural consequence of traders sitting on-shore and off-shore that were holding long dollar positions, getting out of their long dollar positions by selling those positions and buying rand until they were confident that they understood what the implications of the circular were …"[69] Once the market understood the import of this statement, the rand continued to depreciate. The volumes dropped because of the reduced number of market markers in the market. The market makers which left the market were the foreign market makers. The probable reason for their withdrawal from the market was that a compliance officer of a foreign bank is in a very responsible position. He would not certify that a forex transaction was not for speculative purposes unless he was satisfied about the truth of the averment.

---

67 Langley Expert Bundle 141

68 Mr P De Villiers, Global Head of Foreign Exchange Trading, Investec Bank, Record 363

69 De Villiers Record 388

Compliance officers of foreign banks probably advised their banks not to trade in the rand until they understood the statement of 14 October 2001 and could satisfy themselves that they were able to comply with the exchange control regulations.[70]

15.11 In the Questionnaire,[71] the authorised dealers were asked the following questions:

"4.6.2.5 The extent to which your organisation's procedures to ensure compliance with Excon differed pre and post 13 October 2001?

4.7 Provide detail on compliance certificates received by your organisation from non-resident banks before and after 13 October 2001. Provide reasons for any changes in the provision of compliance certificates before and after this date." The major authorised dealers canvassed these issues at some length in their evidence before the Commission:-

15.11.1 <u>Absa</u>

Absa's evidence was that the "stricter enforcement of Circular D342 in mid-October [2001]"[72] resulted in an immediate liquidity drain when market

---

70 De Villiers <u>Record 383</u>

71 The Questionnaire is the one sent by the Deloitte & Touche team to authorised dealers referred to in <u>Part K.</u>

72 Evidence of Balt, <u>Absa Bundle 14-15</u>

participants complied with the Circular. The result was an expansion in the second-tier rand market outside South Africa, the widening of bid/offer spreads and a decrease in the pool of market participants. After 14 October 2001, the number of participants dealing directly with the rand market makers decreased, resulting in a decrease in turnover and the widening of bid/offer spreads. The market became imbalanced due to the lower liquidity. As a consequence, the risk of holding rand became unacceptable and caused a severe reduction in foreign exchange supplied to the market.

15.11.2 Nedcor

Nedcor testified that the Circulars dated 15 October 2001, D341, and 16 October 2001, D342, differed in some respects from what had been understood at the meeting with the Governor on 14 October 2001. The perceived differences caused confusion amongst both domestic and international participants and reduced market participation and therefore liquidity. Foreign banks generally were not happy with the measures being taken. Some of them sought legal advice, which was that the banks should not submit the required compliance letters. The Circulars were one of the many factors which contributed to the depreciation of the rand as they drew attention to concerns about the market but did not prevent ongoing speculation against the rand. When the Reserve Bank re-confirmed that non-residents were free to hedge in circumstances where the rand was extremely volatile, the concern was that whereas non-residents had not hedged the underlying exposures in large volumes previously, this might turn out to be the case thereafter. The markets therefore became increasingly nervous. Under the circumstances, some foreign players re-assessed their involvement in the rand market, further exacerbating illiquidity.[73]

15.11.3 FirstRand

In the view of FirstRand Bank, Circular D342 was issued with good intentions, but did not achieve the desired results. The market incorrectly interpreted

[73] Evidence of Parker, Nedcor Bundle, 19-20

the Circular as a re-introduction of exchange controls, despite the Reserve Bank's clear message that it was merely reiterating the current exchange control rules. The Circular contributed to a reduction in liquidity due to the lack of clarity of its interpretation. This was another factor adding to increased volatility in the rand currency markets at the time.[74]

15.11.4 BoE

BoE contended that one of the factors that led to the rapid depreciation of the rand was "the D342 Circular and the uncertainty that it generated concerning Reserve Bank policy".[75]

15.11.5 Investec

The evidence of Investec was that one of the seven most important factors which influenced the depreciation of the rand was "the introduction of SARB Circular D342 on 15 October 2001, which caused a massive decrease in liquidity in the market". The introduction of Circular D342 dated 15

74 Evidence of Bester, FirstRand Bundle, 21-22

75 Evidence of Woollam, BoE Bundle, 8-9

October 2001 and Circular D345 dated 7 November 2001 created substantial negative sentiment in the market. Circular D342 was perceived to involve a tightening of exchange control regulations, while circular D345 was seen as a re-introduction of exchange control as the dispensation allowing authorised dealers to accept US dollars as collateral from foreign borrowers of securities was removed. There was also great confusion and local authorised dealers were uncertain whether they were able to continue making markets to foreign counter parties. This uncertainty and lack of confidence in the currency caused a marked decrease in liquidity as well as a drastic increase in intra-day volatility at a time when the market required liquidity and stability.[76]

15.11.6 JP Morgan

Prior to 14 October 2001, JP Morgan was an active market maker in spot and forward forex transactions. The market was characterised by high levels of activity as a result of the presence of

---

76 Evidence of de Villiers, Investec Bundle, 36, 38

numerous other market makers in Johannesburg, London and New York. This ensured that pricing spreads in the market were kept at a relatively low level. Following the release of Circular D342 on 16 October 2001, market participants, particularly off-shore players, were initially uncertain about its implications and application, resulting in many off-shore institutions ceasing or reducing their market making activities in spot rands. This in turn significantly reduced liquidity in the market and pricing spreads accordingly began to widen considerably. The release of D342 did not, in itself, cause a depreciation of the rand. Initial uncertainty concerning the implications and application of the circular led to illiquidity and a widening of trading spreads. The adverse effect of other factors on the rand was exaggerated by these more illiquid trading conditions.[77]

[77] Evidence of Coulter, JP Morgan Bundle, 16-17

15.11.7 Deutsche Bank

Deutsche Bank is of the view that Circular D342 could have had the effect of changing the market structure and as result the conduct of participants in the markets.[78]

15.11.8 SCMB

On 15 and 16 October 2001 authorised dealers communicated with their overseas counterparties and informed them of the reinforcement of the rule that only counterparties that have confirmed South African exposures, resulting from an accrual investment or asset denominated in rand, could hedge the transaction in the South African forex market and that authorised dealers need to view applicable documentary evidence within 14 days after dealings took place. During this period non-resident banks assessed their positions and foreign bank dealings almost came to a halt.

A debate followed during the next three days between authorised dealers, the ACI and the

[78] Evidence of Morrison, Deutsche Bank Bundle, 13

Reserve Bank in order to establish which transactions were affected and the treatment of transactions originated by South African authorised dealers with non-resident market making banks. By 19 October 2001 it was clear that foreigners could continue trading in the spot market.[79] On 25 October 2001 the bank conveyed to all its correspondent banks the requirements agreed between ACI and the Reserve Bank, which included a reference to the certificate which had to be signed by the compliance officer of a non-resident bank.

In the following weeks, the bank was inundated with calls from non-resident banks seeking further clarity. Banks who had legitimate transactions were concerned about the negative effects of the events being interpreted as a general tightening of exchange control rules.

15.11.9 The bank has contacted all non-resident bank account holders and taken steps to obtain the compliance certificates required. About 55% of

[79] Evidence of Van Zyl, Record 1694

foreign banks have not provided their compliance certificates. Where the compliance certificates have not been forthcoming, the bank has reported the instances to SARB.[80]

Since October 2001, off-shore banks reconsidered their activities in the South African market. Many banks were no longer prepared to risk non-compliance with South African exchange control rules and restricted trades to underlying South African assets, with a result in drop in turnover and market making activities. This caused a shrinkage in turnover, now restricted to trade related and confirmed capital transactions, and a distinct difference between the activities of local authorised dealers and their off-shore counterparties, with a real possibility of a two-tier market developing.[81]

15.12 A summation of the replies received from the authorised dealers by Deloitte & Touche to the Questionnaire is that non-resident banks, unwilling to contract subject to the compliance obligations of D342, ceased their market making activities in spot rand. The

80 Evidence of Potgieter, Standard Bank Bundle 41-43
81 Evidence of Potgieter, Standard Bank Bundle 50

majority of the material authorised dealers were active market makers in the foreign exchange market before 14 October 2001. The majority did not change this role after 14 October 2001. However, some authorised dealers found their market making role increased as non-resident banks withdrew from the market.[82]

15.13 Dr O'Neill's evidence was that he arrived in Johannesburg on the morning of 15 October 2001. It bothered him that in the context of inflation targeting, so much attention was being given to exchange controls. It made him nervous about the commitment to inflation targeting.

Dr O'Neill was further of the view that since 14 October 2001, turnover in the spot market declined and that decline might well have contributed to the size or speed of the depreciation of the rand.[83]

15.14 The Reserve Bank mounted a spirited defence of its decision of 14 October 2002 by calling the advisor to the Governor, Mr L van Zyl, to testify. He made the following points:-

(1) The purported causality between turnover and the value of the rand is not clear to the Reserve Bank at all. The Reserve Bank

---

82 Pages 23-24 of the DT Report referred to in Part K

83 Evidence of O'Neill, Record 1499 -1500

suggests that any causality is an over-simplification and that it should not be accepted by the Commission.

One should look at different periods of rand weakness in an effort to determine what causality, if any, may exist between either an increase or decrease in turnover in the domestic rand forex market and the exchange rate of the rand. For purposes of the following examples, the Reserve Bank has used the total turnover in the domestic rand foreign exchange market. Strictly speaking, it would be more correct to focus on turnover in the spot plus outright forward market as forex swaps do not directly affect the spot exchange rate. This more correct methodology, however, would not materially affect the Reserve Banks conclusion, because the different components of turnover tend to move in the same direction and by roughly the same magnitude. These are the examples:-

(a) In 1996 the rand depreciated from an average of USD1 = R3.6410 in January to USD1 = R4.2057 in April, a depreciation of 15.5%. Over the same period the average daily turnover in the domestic rand forex market increased by almost 42% from USD3.019 billion to USD4.284 billion. Total turnover by non-residents increased by some 79% from USD0.683 billion to USD1.223 billion.

(b) In 1998 the rand depreciated sharply from USD1 = R4.9357 in February to USD1 = R6.2386 in July, a depreciation of 26.4%. Over the same period total average daily turnover increased by some 139% from USD3.093 billion in February to USD7.395 billion in July. Turnover with non-residents increased by 213% from USD1.323 billion in February to USD4.138 billion in July.

(c) In January 1999 average daily turnover was USD6.855 billion. By June the average daily turnover had increased by almost 33% to USD9.089 billion. Over the same period the average daily exchange rate depreciated by a relatively small percentage of 1.7% from USD1 = R5.9835 in January to USD1 = R6.0883 in June.

(d) The rand averaged USD1 = R11.5467 in December 2001, fluctuating significantly and briefly depreciating to USD1 = R13.84, on an average daily turnover of USD6.051 billion. In February 2002 average daily turnover had declined by 19.4% to USD4.876 billion, but the rand was far more stable, trading at an average exchange rate of USD1 = R11.4847.

(2) The Reserve Bank suggests that had it not acted in October 2001 to limit dealing without a firm and ascertainable commitment or

approval in the domestic rand foreign exchange market, the outcome in November and December 2001 might have been much worse. Non-residents would probably not have bought the rand when the currency fell on a surplus demand for foreign exchange. It seems much more likely, based on past experience, that had non-residents' activities not been curtailed, they would also have sold the rand when they perceived the currency to be weak, leading to much more volatility and possibly a greater depreciation. It should be borne in mind that by 14 October 2001 the rand had already started depreciating rapidly (see diagram 15 paragraph 3.1 hereof).

(3) In 2001 non-residents bought South African bonds and equities to an amount of R4.203 billion. From the beginning of January to the end of August 2001, net purchases of equities and bonds by non-residents amounted to R11.914 billion. In the remaining four months of 2001, this turned to net sales of R7.710 billion. The net sales occurred from the very first business day of September 2001. Net sales of South African equities and bonds by non-residents amounted to R5.510 billion. (Since the beginning of 2002 non-resident portfolio investments into South African equities and bonds have again turned positive. From the beginning of January 2002 to the end of April 2002 non-residents

have purchased South African equities and bonds to an amount of R8.712 billion. This inflow has probably contributed to the rand's recent stronger performance, notwithstanding the fact that turnover in the domestic rand forex market in March 2002 was still lower than in the months prior to October 2001.)

The Reserve Bank submits that the statement of 14 October 2001, which had been extensively discussed prior to its issue, was carefully conceived and did not contribute to the rapid depreciation of the exchange rate of the rand.[84]

16 The issue of Circular D346 on 13 November 2001

16.1 Institutional investors, eg pension funds, long-term insurers, unit trusts and fund managers, may make off-shore investments up to a specified portion of their total assets under management, which is limited to a percentage of the inflow into the fund concerned during the previous year. Institutional investors tended to take out their allowances in tranches, beginning after the release of the annual Exchange Control Circular, normally close to the budget speech day, continuing through the second quarter of each year.

16.2 On 13 November 2001, Exchange Control issued Circular D346 which permitted an additional class of institutional investor,

---

84 Evidence of Van Zyl, Bundle SARB (9) 8-12

namely, fund managers, to invest a portion of their funds off-shore. Following on that permission, applications totalling R1.9 billion were received in November 2001 and approved by Exchange Control in December 2001. The approvals expired within 30 days or at the latest 31 December 2001.

16.3 In order to utilise their allowances before expiry, the institutional investors bought foreign currency to buy shares and/or placed the foreign currency on deposit in anticipation of buying shares in 2002. SCMB Securities (Pty) Ltd obtained an extension to use its allowance until 14 December 2002.

16.4 As a consequence, the foreign currency equivalent of R1.7 billion was bought by institutional investors in an illiquid and volatile market. The rand fell from R10.25 on 1 December 2001 to R11.97 on 31 December 2001 and reached a low of R13.81 on 21 September 2001.[85]

(b) Speculation

Introduction

17 The first point is that speculators have a necessary role to play in the forex market. Dr Stals said that in a well developed market there is a

[85] Evidence of Ms Beck referred to in Part J §8.3 below and in Record 1617

need for short, medium and long-term investors and for buyers and sellers of a variety of spot and forward instruments. The speculator has an important part to play in an effective price discovery mechanism, based on the principles of demand and supply operating in an amorphous market.[86] Mr Luüs testified that speculators are usually required for the efficient functioning of markets. He quoted Marc Levinson, who stated in his book, Guide to the Financial Markets: "Although speculation is often derided as an unproductive activity, it is essential to the smooth functioning of the market. By buying and selling contracts with great frequency, speculators vastly increase liquidity, the supply of money in the markets. Without the liquidity that speculators provide, the futures market would be less attractive to hedgers because it would be more difficult to buy and sell contracts at favourable prices."[87] Ms Ramos said in her evidence that not all speculation is bad. Speculators can help in making a healthy market. She added a word of caution by referring to what John Maynard Keynes said in 1939 in his seminal work, The General Theory of Employment, Interest and Money: "Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation." Ms Ramos added that it is a matter of balance: "Speculators can help make a liquid market while there is a healthy demand for and supply of assets or

86 Stals, Expert Bundle 177
87 Luüs, Expert Bundle 214

currency, and where the burden of the spread is tight. The deeper the more liquid the market, the more likely it will be that speculators will be bubbles on a steady stream. However, in thin markets or in one-sided markets, as was the case in the rand market in November [2001] and particularly in December, speculators will have a greater impact, even with very small transactions."[88]

18 The second point is that speculative activity is difficult to define. As pointed out by the Governor, if speculation implies transactions entered into based on a view of the future value of a currency, then most forex transactions would have a speculative element in them. If speculation is defined to include only transactions which are not based on some fixed and ascertained commitment, then a narrower set of transactions would be caught within the definition.[89]

19 Some of the authorised dealers in evidence canvassed the activity of "speculating" in the rand. *Nedcor's* evidence was that it did not regard profits or losses generated or sustained by the bank from trading in the rand to be unethical or improper in any way. In order to provide a service as a market maker, it is important to be correctly positioned for anticipated moves in the currency. This entails assuming risk. The bank permits speculative risk taken on a conservative scale. "Speculative"

---

88 Ramos, Record 718

89 Mboweni, Bundle SARB (7) 38-39

implies assuming a risk position with a view to making a profit, the outcome of which is uncertain. This is not only applicable to currency traders but involves exporters, importers, institutions and individuals.[90] *NIB* testified that it did not believe that profit made from trading to be unethical. The bank has to make profits. NIB would describe speculation as betting on the future price of a defined asset. Speculation per se is not an unethical practice simply because once a trader has made a bet there is every chance that he or she could incur a loss. When there is a risk of making a loss, the speculation cannot be improper. Market makers essentially provide liquidity to a select client base. In order to facilitate this practice market makers will enter into directional positions based upon the assumptions of market needs via the supply and demand. Speculators are defined as "market users" as opposed to "market makers".[91] *FirstRand* defined speculation as the purchase or sale of anything with the objective to profit from a change in market prices or to avoid a loss due to such changes, usually with a short-term view. Speculation by residents in foreign currency against the rand should have had no net effect on currency reserves because the profit remains in rand. It would seem that any large scale speculation against the rand, other than transactions within the ambit of exchange control, would have

---

90 Evidence of Parker, Nedcor Bundle 18-19
91 Evidence of Lane, NIB Bundle 18

to be undertaken by non-resident banks or through non-resident banks and not by residents because of exchange control.[92] *Investec* expressed the opinion that a speculator can be defined as anyone who uses the market to gain from a position with or without there being any other underlying transaction. The decision to hedge or not to hedge an underlying exposure is in itself speculative. Speculators provide the liquidity necessary to ensure that whenever a hedger requires a hedge position, the market is able to absorb his trade without undue disturbance to the current price. Speculators are confined mainly to professional traders.[93] *BoE* testified that ordinarily the expression "market maker" means any person who buys and sells in the relevant financial market. Any trading in forex or related markets from an unmatched position and directed at making a profit based on an anticipated movement in the markets, necessarily involves an assessment on the basis of available information of the direction of such movement. By their nature, one cannot be certain whether any particular assessment of future markets will be correct. In that sense, any such involvement entails an element of speculation. All trading activity in a commodity, whether it be a currency, a financial instrument or otherwise, where that commodity is purchased for re-sale, is ordinarily undertaken with a view

[92] Evidence of Bester, FirstRand Bundle 14-15
[93] Evidence of De Villiers, Investec Bundle 34-35

to re-sell at a profit and would not be undertaken if the assessment was that the commodity could only be resold at a loss. There is therefore no difference between "market-making" and "speculation" in the context of forex and related markets. The word "speculation" is frequently used in a pejorative sense to convey that particular trading activities are in some way improper or unethical, but in that sense it has no clear or defined meaning.[94] It was *JP Morgan's* submission that the concept of "speculation" is not helpful in differentiating accurately between different forms of commercial activity. All commercial activity, including investment and risk management, involves an element of risk. The assumption of risk necessarily connotes an element of uncertainty as to whether a particular result will eventuate. Engrained in the notion of uncertainty is a speculative view been taken by an investor or risk management.[95] *SCMB* does not regard profits made from proprietary trading, market making, or other trading in the rand to be unethical or improper in any way. Those activities are necessary economic activities. If South African banks did not provide those services or activities, the void would be filled by international banks operating in London and other financial centres to the detriment of the South African economy.

---

94 Evidence of Woollam, BoE Bundle 5-6

95 Evidence of Coulter, JP Morgan Bundle 9

SCMB, as a matter of policy, does not condone engaging in the following types of conduct, which it regards as improper:

- the execution of a large client deal in times of high volatility and low liquidity and which the bank has reason to believe will have an exaggerated effect on the exchange rate;
- the practice of front running, which occurs when a bank or trader makes a monetary gain by acting in advance of a known transaction or order, which may influence the exchange rate; and
- the exploitation of electronic dealing or broking systems generating artificial exchange rate behaviour.

For SCMB, it is important to understand the distinction between speculation and market making in the context of foreign exchange and other related markets. Speculation involves adopting the view as to the likely movements in the exchange rate and acting, or not acting, on that view. By contrast, a market maker is a bank that, in all liquidity conditions, commits itself to provide bid and offer prices to both the inter-bank market and to its clients. Market making involves the purchase and sale of foreign currency with the intention of making a margin return, while not holding significant positions for extended periods. By far the majority of SCMB's foreign exchange business in the rand is done on the basis of it being a market maker, in other words as a provider of liquidity. The bank has historically, and for 2001, adopted a conservative approach to the size of its currency positions. It operates well within the internal limits set by the SBCA board, which in turn are significantly lower than those allowed by the Reserve Bank.[96]

20 In their replies to the questions put to them by Deloitte & Touche,[97] most authorised dealers stated that speculation is often used in a pejorative sense, implying that speculative activities are in some way improper or unethical. This they said is unjustified and choose rather to define speculation as adopting a view as to the likely movement in the exchange rate of the currency and acting on that view with the intent of making a profit or preventing a loss. They believe that speculation in fact has a positive effect on the markets as a result of the liquidity that speculators bring to the market. All agreed that according to their definition of speculation they do engage in speculation but that this is in no way unethical, improper or illegal. The consensus among the material authorised dealers was that profiting from proprietary trading and market making was in no way unethical or improper. They asserted that these activities are necessary economic activities that are conducive to a dynamic, liquid and efficient financial market.

---

96 Evidence of Potgieter, Standard Bank Bundle 45-47

97 See Part K for the role played by Deloitte & Touche in the investigation on behalf of the Commission. §20 is based on p 22 of the DT report.

21 Mr McCauley drew a distinction between "hedgers" and what he called "pure short sellers" or "naked shorts". The former class of person would include a multinational company that has a long position in South Africa: it has bought dollars and invested the dollars in a factory in South Africa. If it becomes concerned about the value of the rand, it would hedge that long position by selling the rand forward against the dollar.[98] A "pure short seller" or "naked short", by contrast, is an institution such as an investment fund that has no ongoing business in South Africa and which "could put on the short basically looking to profit if the rand goes down".[99]

22 Mr De Villiers defined speculation as any transaction in which a trader acts as principal. Market-making can be viewed as speculation because the market-maker trades as principal and has to provide a price for a currency to a counter party. The price will be speculative in nature because "you will move it up and down according to what you perceive that the counter party is going to do with you."[100] Day-to-day speculation in the form of market making and technical trading is a necessary function for any market. It helps a market to be efficient and obviously helps people who needs hedges to hedge properly and cheaply. Speculation which has

---

98 McCauley Record 28

99 McCauley Record 29

100 De Villiers Record 367-8

a negative connotation probably refers "… to the long directional trading where traders take the long-term position of shorting the rand against the dollar and they do it for large amounts."[101]

23 The third point is one made by Dr Abedian. He testified that financial markets are neither efficient nor socially optimal. They are structurally prone to short-lived as well as prolonged "bubbles" in which prices and quantities could deviate from private and socially optimal levels. Information plays a vital role in such markets. As such, financial markets are largely vulnerable to information manipulation, rumours and speculation. Given costly and imperfect information, a large number of players in these markets may adopt a "herd mentality", following bigger players who can afford the investment in information gathering or will have the critical mass to obtain information. Institutional arrangements for remuneration are commonly and justifiably "performance-orientated". Despite a variety of checks and balances in the financial markets, such remuneration frameworks tend to exacerbate the vulnerability of these markets to short term bubbles.[102]

24 The fourth point that a number of witnesses made was that it would be extremely difficult to determine the effect of speculative transactions on

---

101 De Villiers Record 376

102 Abedian Expert Bundle §2.8 p 261

the exchange rate.[103] A total of approximately 5.6 million foreign exchange transactions were reported to Exchange Control in 2001.[104] Mr Gouws expressed the view that to attribute the fall in the rand to a number of specific transactions would be very difficult and perhaps pointless in the light of the magnitude and complexity of developments since early September 2001.[105] Dr Stals made a similar point. He said that in a market with a turnover of at times more than USD10 billion per day, it would be extremely difficult to discover and identify individual transactions with malicious intentions.[106]

25 It seems to the Commission that one should distinguish between two classes of transactions, as identified by the Governor:-

- transactions entered into based on a view of the future value of a currency; and
- transactions which are not based on some fixed and ascertained commitment.

In the former class of transactions, would fall the transactions of authorised dealers, non-residents and resident importers and exporters.

---

103 Mboweni Bundle SARB (7) 38
104 Bruce-Brand Bundle SARB (9) 5
105 Gouws Expert Bundle 117
106 Stals Expert Bundle 177

25.1 Authorised dealers

South African authorised dealers are allowed to trade the rand for their own account in the inter-bank market. This form of forex trading is known as "proprietary trading". During 2001 the authorised dealers did not run huge positions against the rand. Their aggregate open positions amounted to less than 1% of their net qualifying capital in 2001. The statutory limit for those positions is 10% of net qualifying capital.[107]

An authorised dealer, being a market maker, can be given a position by virtue of a deal being struck. The position which he is left with holding and which could be sizeable, may take some time to unwind and can even be rolled in to the forward market. Decision-making in this regard will be influenced by regulatory limits, internal limits and the view on the rand.[108]

25.2 Non-residents

The Governor expressed the view that, owing to the relatively free access that non-residents, particularly banks, enjoy in the US dollar/rand forex market, non-residents are in a position to speculate on the rand. South Africa has the mixed blessing of

---

107 Mboweni Bundle SARB (7) 39

108 Memorandum of Reserve Bank Bundle SARB (7) 104

having more liquid financial markets than most other emerging markets. Consequently, in times of international crisis, South Africa's financial markets could be used as a proxy hedge for exposures to other emerging-market countries. Some of the non-residents view the rand as an international hedge currency and, through their established emerging markets trading desks, are prepared to trade the rand on a proprietary basis, that is for their own account. Non-resident banks trade rand very actively and represent some 55% of the total turnover in the rand forex market. It is because of the belief that non-residents were trading contrary to the existing exchange control rules (ie there was no underlying commitment to the transactions) that the statement of 14 October 2001 was issued.[109]

25.3 Importers and Exporters / Leads and lags

25.3.1 To enable the main bankers of major corporates to cope with the flow of foreign currencies, a system was devised whereby the funds were administered by the banks as part of their nostro[110] or vostro account balance pending conversion. To assist in identifying those funds separate sub accounts in the name of the customer were opened in

---

109 Mboweni, Bundle SARB (7) 40-42; McCauley, Expert Bundle 58

110 A nostro or vostro account is the foreign currency account of a local bank with an overseas bank.

the bank's nostro accounts (shadow) administration. Those accounts are known as the Customer Foreign Currency (CFC) accounts. In March 1998 the exchange control requirement to repatriate foreign currency earnings in respect of the export of goods and services within 30 days was extended 180 days from date of shipment or date of service rendered. In September 1998 the CFC account system was amended to allow the retention of foreign currency earnings in respect of the export of goods for 180 days from the date on which such funds were first credited to the CFC account.[111]

25.3.2 An exporter who anticipates a more favourable exchange rate delays converting export proceeds in the foreign currency (eg US dollars) into the domestic currency (eg rands) ("lags" its payment.) An importer who fears a worse exchange rate can accelerate payments for imports by buying the foreign currency forward ("leads").

25.3.3 According to the Reserve Bank, in the second quarter of 2001, the total exports of goods and services from South Africa, at a seasonally adjusted annualised rate, amounted to some R328 billion, with imports of goods and services

---

111 Bruce-Brand Bundle SARB (6) 19-20

amounting to almost the same. Even if a small portion of those amounts was involved in leads and lags, it could have had a noticeable effect on the exchange rate. Importers and exporters are thus in a position where they can legitimately take sizeable positions by virtue of their views on the rand's prospects. They have the same impact on the rand as pure speculative activity.[112]

25.3.4 The Reserve Bank draws the inference that exporters were lagging the repatriation of foreign currency (albeit possibly within the 180 day period) from the fact that there was a gradual increase in the forex balances of South African corporates in their CFC accounts as at:

31 December 1998	USD995m
31 December 2000	USD1 981m
31 December 2001	USD2 625m.[113]

25.3.5 Mr McCauley expressed the opinion that while it may not on the face of it appear to be so, a type of portfolio shift occurs in the financing of imports and exports (leads and lags): every month of lead in payment and lag in receipts

---

[112] Mboweni Bundle SARB (7) 39-40

[113] Mboweni Bundle SARB (7) 40

represents an outflow of $^{1}/_{12}$ of trade. The leads and lags phenomenon makes the distinction between goods and financial services seem artificial in practice.[114]

25.3.6 Dr Abedian expressed the view in his evidence that while there might have been good technical reasons for extending the period of repatriation from 30 days to 180 days, exporters no doubt find it profitable to retain their earnings for as long as possible. With the continuous weakening of the currency in recent years, it has become common knowledge that any delay in repatriation is likely to make currency gains over and above the trade profit. It is important to note that had it not been for the predictable one-way direction of the currency value, exporters would normally choose to "take cover" for their CFC holdings so as to hedge against any potential appreciation of the rand. Expenses involved in such hedging would have forced them to retain their hard currency deposits only on an as-needed-basis and no longer. However, in view of the downward trend of the value of the rand, CFC accounts have become profitable operations for exporters and they

114 McCauley Record 48, Expert bundle 49

have every reason to accumulate deposits in such accounts.[115]

25.3.7 The probability that importers would hedge their purchases of foreign currency (lead) and exporters would delay repatriating their rands from off-shore (lags) is supported by the analysis done by Mr Glynos in this table:

Table 1 Expert Bundle 453

Table 1 **Forward points on the ZAR relative to the spot rate**

	Column 1	Column 2	Column 3	Column 4
	Spot rate on 01/01/2000	Forward rate as of 01/03/2000	Forward rate as of 01/06/2000	Forward rate as of 01/12/2000
Forward points as of 01/01/2000 (Bid)	6.1425			
3 month forward points	795	6.222		
6 month forward points	1480		6.2905	
12 month forward points	2850			6.4275
Actual spot rate on respective dates		6.34	6.975	7.6175
Difference		0.1180	0.6845	1.1900
% terms		1.90%	9.80%	15.60%
	Spot rate on 01/01/2001	Forward rate as of 01/03/2001	Forward rate as of 01/06/2001	Forward rate as of 01/12/2001
Forward points as of 01/01/2001 (Bid)	7.5625			
3 month forward points	790	7.6415		
6 month forward points	1480		7.7105	
12 month forward points	3280			7.8905
Actual spot rate on respective dates		7.715	8.0225	10.255
Difference		0.7350	0.3100	2.3645
% terms		0.90%	3.90%	23.10%
	Spot rate on 01/06/2001	Forward rate as of 01/09/2001	Forward rate as of 01/03/2002	
Forward points as of 01/06/2001 (Bid)	8.0225			
3 month forward points	1370	8.1595		
6 month forward points	2680		8.2905	
12 month forward points	5090			
Actual spot rate on respective dates		8.4526	11.38	
Difference		0.2931	3.0895	
% terms		3.50%	27.10%	

---

115 Abedian Expert Bundle 269

In each case the actual spot rate on the forward date was higher than the forward rate. Take, for example, the twelve month forward points:

For the year 2000:

Spot rate on 01/01/2000	Forward rate on 01/12/2000	Actual spot rate on 01/12/2000	Percentage Difference
6.1425	6.4275	7.6175	15.60%

For the year 2001:

Spot rate on 01/01/2001	Forward rate on 01/12/2001	Actual spot rate on 01/12/2001	Percentage Difference
7.5625	7.8095	10.255	23.10%[116]

26 Another fairly common way of speculating involves "short-selling". This amounts to a market participant selling a currency which he does not own, in anticipation that when delivery needs to take place, the currency can be bought in the market at a lower price, basing his

116 Glynos Expert Bundle 453

judgment on the expected future development of the price of the currency.[117]

27 Another type of speculator is the offshore investor who has bought South African Government bonds and wishes to hedge his currency exposure and so sells rand forward.[118]

28

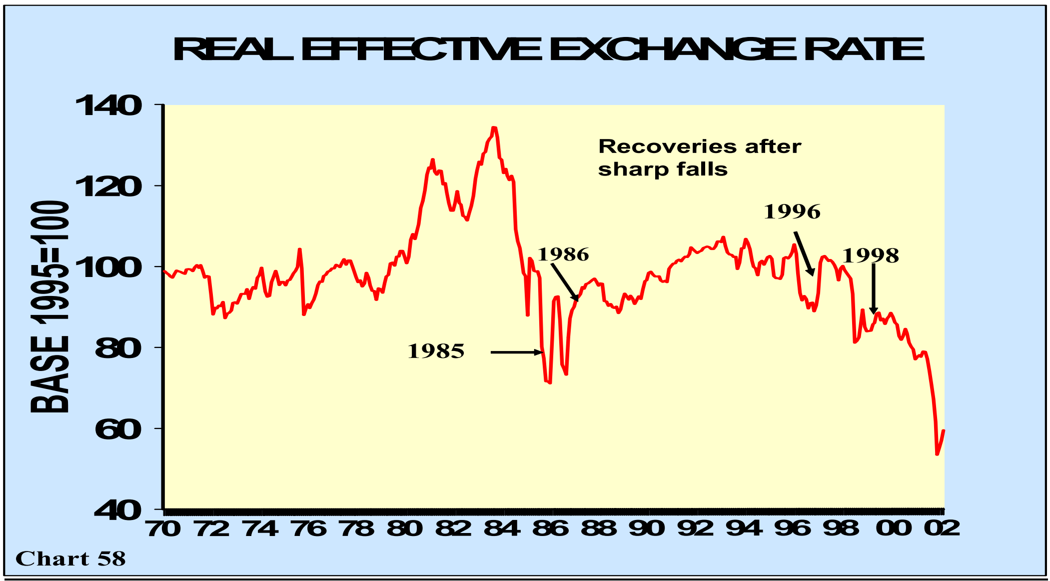
28.1 Dr Jammine is of the view that the leads and lags phenomenon was exacerbated by panic by importers and glee by exporters who deliberately held off repatriating dollars for as long as possible. He sees in an asymmetric trend for a protracted period of time in which the demand for dollars by importers is abnormally low while at the same time the supply of dollars by exporters is abnormally low. That is why the rand has tended to overshoot and then recover in its downward slump during sell offs such as those seen in 1985, 1986, 1996, 1998 and 2001:

---

117 Memorandum of Reserve Bank Bundle SARB (7) 104

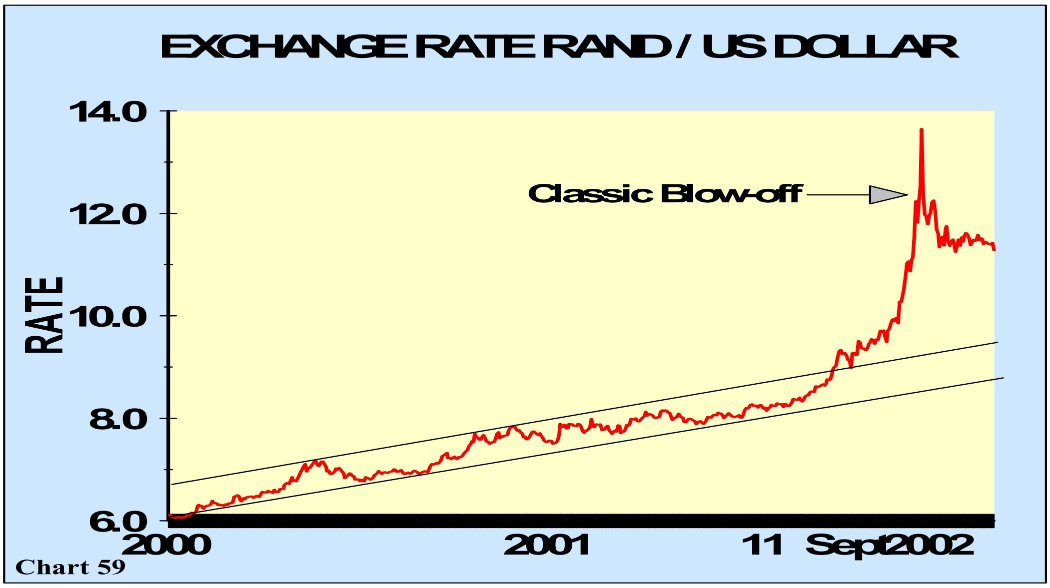
118 Memorandum of Reserve Bank Bundle SARB (7) 104

Chart 58 Expert Bundle 420



28.2 In November, and particularly, December 2001 the rand, according to Dr Jammine, entered a "blow-off" phase. The entire depreciation of the rand against the dollar from the beginning of 2000 until September 2001 saw the depreciation of the rand occurring within a clearly defined upward channel. However, once the dollar had broken the upward channel on the upside, it was apparent that the currency was in unchartered territory and would keep running upwards in an ever dramatic fashion against the dollar until the movement blew itself out. The channel referred to by Jammine is shown in the following chart:

Chart 59 Expert Bundle 421



28.3 Dr Jammine stated that even though the depreciation of the rand until about October 2001 could be justified somehow on economic and political grounds, the move in November and especially December 2001 defied the bounds of normal economic and political analysis and logic. He suggested that some people must have profited enormously at the time and that those speculators were found in the financial services industry both domestically and abroad.[119]

29 Dr Abedian's evidence was that there were "pure currency speculators" in the rand to an estimated volume of USD200 million to USD300

[119] Jammine Expert Bundle 343-345; Abedian, Expert Bundle 260-261

million per day. He said: "I highlight here that there is no way by definition to quantify it, but my discussion with the trade both inside and outside the country is that this volume had grown by September last year to an estimated or guestimated amount of possibly as high as 300 million dollars per day."[120]

[3] The experts' conclusions[121]

(1) Mr Gouws

30 Mr Gouws came to the conclusion that against the background of a steady depreciation of the rand during 2000 and the first half of 2001 most market participants came to the view that the currency was weak and it is likely that they took decisions to help protect themselves against further weakness. There was, therefore, already a weakening bias in the currency by the time the extraordinary confluence of factors and forces started to exert an influence from early September 2001 onwards. Some of those affected the currency via the influence on the current account; most affected the currency via the negative impact on confidence and on expectations about capital flows. The role of these factors became magnified after mid October 2001 by a lower level of market liquidity

120 Abedian Record 422

121 The evidence of the experts is dealt with in the order in which they gave evidence.

following the Reserve Bank's announcement that foreign exchange control rulings were to be policed more rigorously. Some market participants may have taken advantage of the prevailing circumstances, but the sharp decline of the currency was the result of economic, political, policy and confidence factors and forces that had built up over a number of months. To attribute the fall in the rand to a number of specific transactions would be difficult and perhaps pointless in the light of the magnitude and complexity of developments since early September 2001.[122]

(2) Dr Stals

31 Dr Stals summed up his views as follows:-

(1) The South African exchange rate is determined by forces of demand and supply. The system of a managed float is by its nature unstable. Volatile movements in the exchange rate can be expected from time to time.

(2) The nominal exchange rate of the rand against other currencies will over time depreciate more or less by the inflation differential between South Africa and its major trading partners.

[122] Gouws Expert Bundle 117

(3) Globalisation led to an integration of financial markets on a worldwide basis. There has been a big increase in international capital flows. Turnovers in foreign currency markets assumed astronomical dimensions. South Africa participated in those developments and removed or relaxed exchange controls to an important extent. All those developments contributed to a more volatile exchange rate for the rand.

(4) In the second half of 2001 various adverse external and domestic developments led to a deterioration in the South African balance of payments and therefore to a decline in the supply of foreign exchange.

(5) Without any official support, shortages developed in the market for foreign exchange with a strong concurrent pressure on the rand to depreciate.

(6) There was a growing perception in the market that the rand would continue to depreciate. Protective action by importers and expedient conduct by exporters squeezed the market even further. In December 2001 there were signs of panic in the market because of the shortage of liquidity.

(7) The reduction in the NOFP may have contributed to the woes of the rand. The role of the NOFP in the depreciation of the rand has, however, been exaggerated in the media and in the market.

As long as the Reserve Bank enters into forward foreign exchange cover transactions for South African residents in respect of "firm, ascertained and documented" commitments, increased or declines in the NOFP will be neutral as far as supply and demand conditions are concerned in both the markets for foreign exchange and for domestic rand liquidity.[123]

(3) Dr Abedian

32 Dr Abedian summed up the "bottom line impact" of the factors analysed in his report and evidence as follows:

(1) Net demand for the rand had diminished substantially.

(2) Policy uncertainty and an implicit policy re-think influenced the market.

(3) A one-way bet on the currency had taken root.

(4) No obvious defence for the currency was evident.

(5) Liquidity in the market was diminishing from mid-year on and reached low levels during the fourth quarter of the year.

(6) Global and environmental factors continued to weigh adversely on the currency.

(7) The market conditions were ripe for a run on the currency.

[123] Stals Expert Bundle 183

Dr Abedian identified three possible scenarios for the rapid depreciation of the rand in December 2001:-

(1) A perfectly legitimate large transaction by one of the major market players might have led to the emergence of a herd mentality resulting in the run on the rand.

(2) It is technically possible that one may execute a deal fully aware of the full-scale domino effects and one does so in order to benefit via a major deal already in contract. Such a situation was particularly more feasible when the pure speculators were driven out of the market by November 2001.

(3) There were uncoordinated numerous market transactions that culminated in a self-fulfilling prophecy leading to a severe overshooting in valuation of the currency. Deals of this kind might well have had no motive other than well-considered business logic, yet the impact or outcome was identical to either of scenarios 1 and 2.[124]

(4) Mr Bruce-Brand

33 Mr Bruce-Brand testified that he was not able to isolate any transactions which caused, contributed and/or gave rise to the rapid depreciation of the value of the rand. Furthermore the numerous economic and political

---

124 Abedian Expert Bundle 282, 283

factors mentioned by the various witnesses influenced the exchange rate of the rand – which would make the task even more difficult for him.[125]

(5) Mr Mboweni

34

34.1 The conclusion that Mr Mboweni, the Governor, came to was that the exchange rate obviously came under a great deal of pressure in the latter half of 2001. If developments in the balance of payments are taken into account, as well as the other issues mentioned by him, including the fact that market participants would tend to trade according to the view that the rand was vulnerable, thereby adding further pressure to the rand, the depreciation in the value of the rand was not altogether unexpected. Admittedly the severity and the speed of the decline were surprising and of great concern.

34.2 It is the view of the Reserve Bank that the best defence of a currency is prudent macro-economic policies accompanied by structural and micro-economic reforms, where appropriate.

34.3 The Governor defended the Reserve Bank's role in 2001 by stating:

125 Bundle SARB (6) 24

- given the inflation targeting monetary policy framework under which the Reserve Bank operates, it was not considered appropriate to hike interest rates in defence of the currency;
- it was not considered appropriate to intervene in the forex market to support the value of the rand by means of the forward book;
- on 14 October 2001 it was felt appropriate to enforce existing exchange controls on non-residents to ensure that only legitimate transactions took place in the forex market;
- contained in the statement of 14 October 2001 was a very positive announcement regarding future purchases of foreign exchange to reduce the NOFP;
- in a joint statement issued by the Governor and the Minister of Finance on 21 December 2001 the positive economic fundamentals were reiterated.[126]

[126] Mboweni Bundle SARB (7) 46

(6) Ms Ramos

35

35.1 Ms Ramos said that the Government has had to make policy choices in a complex and often unforgiving world. At the centre of the range of policy choices lies the principle that South Africa is an open economy. In that environment it is inevitable that from time to time there will be turbulence. The policy makers must be confident that the policy choices they have made and the good performance experience for the economy of the past five or six years will support the ongoing growth and sustainable development that the South African economy needs.

35.2 The Government has had to ensure that the appropriate macro-economic fundamentals are in place. Far-reaching reforms of the fiscal framework and management of public finances have been undertaken. Monetary policy has been consistent in tackling the distortionary impact of high inflation. Trade reform and financial market development have increased the flow of foreign currency to South Africa. Government's spending has been re-prioritised to increase spending on social services, which promotes re-distribution and provides a safety net against the potential social costs of globalisation.

35.3 In an environment of global integration, it is essential for a sound and well regulated financial system to be in place. Government has achieved this through an ongoing financial market reform aimed at keeping South African financial market standards consistent with international practice.

35.4 Government has chosen to follow a flexible exchange rate to act as a shock absorber against global developments. Exchange rate adjustments helped cushion the economy from external trade and capital flow shocks, and mitigate the impact of economic contraction, especially in respect of the poor.[127]

35.5 There was no single or dominant cause for the depreciation of the rand. Ms Ramos said: "There were a number of variables at play at the same time and certainly in our attempts to try and understand what was going on, we have been unable to say what caused it was A and not B. It was a complex set of issues not least of which is the confidence that South Africans have in their own country and their own economy and so it has been difficult for us to say that there was one set of issues that led to the exchange rate depreciation that we saw last year. There were lots of things happening at the same time."[128] The Minister of Finance spoke of a complex set of factors which

---

127 Ramos, National Treasury Bundle, 58-59

128 Ms Ramos Record 735-6

were at play. [129]

(7) Dr O'Neill

36 In mid-April 2002, Goldman Sachs asked thirty clients four questions. Twenty-nine clients replied. The clients were multi-currency asset managers in London and New York, hedge funds, corporations with commercial exposure in South Africa and one or two individuals. The group is representative of the global financial community. The questions and answers were:

Question	Answer
1. Are you bullish/bearish about rand	31% bullish 69% bearish
2. Do you think the monetary and fiscal policy is good or bad?	59% good 41% bad
3. Do you think the framework has improved/deteriorated in the past year?	52% improved 48% deteriorated
4. What is the biggest change that would be positive for the rand?	[A] More open markets (i.e. remove exchange controls): 21% [B] Open more FDI:

[129] Manuel Bundle National Treasury 87

	14% [C] Zimbabwe: 21% [D] Aids: 14% [E] Crime: 10% [F] NOFP/other: 21%[130]

37 Dr O'Neill came to the following conclusions:-

(1) The foreign exchange markets have been generally very peculiar since 1999 since the introduction of EMU. Lots of currencies, including the most important in the world, the dollar, and the euro specifically, have behaved very differently than the consensus expected.

(2) The US dollar has been and remains peculiarly strong because of lots of capital inflows including foreign direct investments and portfolios [into the USA].

(3) Until late 2001 the rand was not independently weak from the general weakness which other currencies showed against the dollar.

(4) Policy should concentrate on inflation targeting and not on the rand. If policy was supplemented and intensified with its inflation

130 Evidence of O'Neill, O'Neill Bundle 33, Record 1500-1502

targeting, some of the problems surrounding the rand would probably go away.

(5) If South Africa wants a strong rand, South Africa needs to have a BBoP surplus so that it will not be subject to the vagaries of sentiment. The way to achieve that is to attract more foreign direct investments and more portfolio flows.

(6) The events of late 2001 suggest that with foreign exchange controls, one either has no controls or one has complete controls. But, if one has partial controls, it is confusing and very hard for people to understand except those very close to monitoring them and implementing them. It is also often taken as a sign of lack of confidence in other targets and in particular if there is an inflation targeting regime in place. It was not obvious to Dr O'Neill what purpose foreign exchange controls serve. In his view, if the removal of exchange controls was done in the context of specifically targeting more foreign direct investments and enhancing a greater broadening of the understanding of the inflation targeting regime, he believes that the abolition of exchange controls will lead to a significant inflow and strengthening of the rand.[131]

[131] Evidence of O'Neill, O'Neill Bundle 34, Record 1503-1504

(8) Standard Corporate and Merchant Bank ("SCMB")

38 The exchange rate of the rand is determined primarily by the actual and expected level of net demand, which is demand for the currency minus the supply of it.

39 In the view of SCMB, the following factors may have negatively influenced the exchange rate for the rand during 2001:

- the global economy was on a path of gradual slow-down with a possible recessionary outcome even before 11 September 2001;
- the downturn of the global equity market in the telecommunication and aviation sectors contributed to a delay in the Telkom and SAA privatisation plans thereby reducing the prospects for the inflow of foreign currency;
- negative developments in emerging economies such as Turkey and Argentina;
- the possible use by exporters of the full extent of the 180 day period causing additional leads and lags in the foreign exchange market;

- the reinforcement of the rules pertaining to non-resident dealings by the Reserve Bank in October 2001 may have had the effect of further draining liquidity in an already thin market;
- the Reserve Bank's non-interventionist approach appears to have influenced perceptions in the market of a continued decline in the value of the rand;
- political and economical turmoil in neighbouring Zimbabwe;
- the reduction of the NOFP;
- Press comment on the outflow of dividends from South African companies listed off-shore.

40 Participants in the forex market saw the rand hitting all-time lows virtually every day and a certain amount of panic prevailed as relatively small amounts of import demand influenced the exchange rate. Inter-bank spreads between buying and selling rates were quoted as high as 1000 basis points (normally 100 basis points). These conditions had not previously been experienced in the South African market as the Reserve Bank would, under such conditions and in terms of their then existing policies have provided the necessary liquidity.[132]

[132] Evidence of Mr WJ Potgieter, Director and Head, International Banking Division, SCMB, a division of Standard Bank of South Africa Limited ("SBSA"), Standard Bank Bundle 47-49

The views of the authorised dealers

41 In the Questionnaire, the authorised dealers were requested by the DT team to describe inter alia the specific transactions, actions, events, factors or omissions influencing the rapid depreciation of the rand in 2001. Their responses are summarised in the following table:

Table 4, DT Report p 40[133]: Details underlying reasons shown in figure 11	
Cause	Details provided
Zimbabwe	Land invasions in Zimbabwe, lack of South African government criticism of Zimbabwe, fear of Zimbabwe style land invasions in South Africa, fear of influx of refugees from Zimbabwe, indications that Zimbabwe's upcoming presidential election was unlikely to be fairly contested.
Emerging markets/ Argentina	Poor emerging market sentiment, emerging market contagion, economic problems in Argentina, specific events in Argentina (e.g. resignation of president).
September 11	The events of September 11, terrorist attacks in the US, war on terror, flight to quality post September 11.
Privatisation	Speculation regarding delays in privatisation, actual delays in privatisation
trade deficit	Balance of payments concerns
SARB policies	Circular D342, comments by Reserve bank staff (including Governor), closing out of NOFP, resignation of James Cross, use of

133 Pages 40-41 of the DT report referred to in Part K.

Table 4, DT Report p 40[133]: Details underlying reasons shown in figure 11	
Cause	Details provided
	De Beers inflows to offset against NOFP, speculation regarding relaxation of exchange controls, statements regarding defence of the currency.
Withdrawal of market makers/ liquidity	Illiquid market, market makers withdrawing at times of high volatility, foreigners withdrawing, clamp down by SARB on speculation causing lack of liquidity.
leads and lags/ investor panic	Use/abuse of 180-day rule, exporters delaying foreign exchange repatriations, panic setting in exacerbating Rand collapse.
Dividend repatriations	Offshore listed companies repatriating dividends to overseas shareholders in foreign currency.
Political factors	Negative view of South African Government performance, government's Aids policy, government corruption, poor performance of President Mbeki.
General market sentiment	Generally poor market sentiment.

<u>The views of the representative offices</u>

42 The common factor influencing the rapid depreciation of the rand amongst the representative offices was the political and economic instability in Zimbabwe. Other top ranking factors included the listing abroad of large South African corporations and the continued dividend

flows from South Africa which did not inject foreign currency into South Africa in exchange for the dividend flows. The disaster of 11 September 2001 was listed as an influencing factor. It was felt that this led to volatility in global equity and currency markets. Exchange control regulations were also considered to have contributed to the depreciation of the rand.[134]

134 P50 of the DT report referred to in Part K.

Part E: The Wakeford Allegations

Index

Table of annexures to Part E

Table of annexures to Part E (continued)

	Annexure
Settlement agreement between Reserve Bank and Deutsche Bank AG, Johannesburg branch	C
Letter from the Commission to the Governor, Reserve Bank, dated 30 May 2002	D
Letter from the Commission to Deutsche Bank AG, Johannesburg dated 30 May 2002	E
Letter from the Reserve Bank to the Commission dated 6 June 2002	F
Letter from Deutsche Bank AG, Johannesburg to the Commission dated 7 June 2002	G
Letter from Jurgens Bezuidenhout Attorneys to the Commission dated 7 June 2002.	H

E The Wakeford Allegations

The evidence of Mr Wakeford

1 During December 2001 Mr Kevin Wakeford, Chief Executive Officer of the South African Chamber of Business ("SACOB"), formed the view that a formal enquiry was desirable to investigate the causes underlying the rand's decline. He was at a loss for an explanation for the rand's decline. He regarded the decline of the rand as a matter of national importance. On 30 December 2001 Mr Wakeford publicly called for the establishment of a commission of enquiry. On 2 January 2002 he was orally informed by an informant, whom he described in evidence as highly revered and credible, about certain transactions and mechanisms which could have contributed to the rapid depreciation of the rand. The informant told him that the mechanisms and transactions had been reported to the Reserve Bank, but the Reserve Bank had not taken any action. On 4 January 2002 Mr Wakeford publicly repeated his call for the establishment of a commission of enquiry. On 7 January 2002 Mr Wakeford repeated that request to the Presidency. On the following day, 8 January 2002, at the request of a senior official of the Presidency, Mr Wakeford in "great haste and in a great rush" prepared and submitted a "report on dubious financial methods that have impacted the rand" ("the

Report") to the Presidency. A copy of the Report is attached to Part E as Annexure "A". On the same day, 8 January 2002, the Presidency announced the appointment of this Commission. According to Mr Wakeford, in announcing the appointment of the Commission, Mr Bheki Khumalo, a spokesman for the Presidency, stated that "the Presidency had received information from a number of other sources relating to the rand's rapid depreciation."[1]

2 When testifying, Mr Wakeford read onto the record a written submission ("the Submission"). A copy of the Submission is attached to Part E as Annexure "B". Mr Wakeford testified that the Submission was not substantively different to what was communicated to the President; was more carefully thought through[2]; and contained one (or more) deliberate retractions on advice from his attorneys to protect himself[3].

3 Mr Wakeford motivated the call by him for a commission of enquiry. He said that he received numerous enquiries from SACOB members regarding the rapid depreciation of the rand. He detected a degree of panic emerging in the market place. He and those he consulted were at a loss for an explanation. Even without the information he obtained from

---

1 Evidence of Wakeford, Record 773-776

2 Wakeford Record 771-2

3 Wakeford, Record 798

his informant, he would have called for a commission of enquiry. It was an issue of national importance. Mr Wakeford testified that Dr Ebrahim of the IMF indicated to him his concern that South Africa was on the edge of a financial crisis. Mr Wakeford provided these statistics: between February 2001 and February 2002, the producer price of maize rose by 127%; at one time in 2002 the price of maize was R2 200 per ton whereas in 2001 it was R700/800 per ton. The price of wheat rose by 30%, sunflower by 62% and beef by 25%. Assuming that the rand was R11.30 to the US dollar, food prices for the poor would increase on average by 30% and "a 30% increase on a very low income that absorbs your disposable income is something very frightening." Argentina, whose currency depreciated by 75%, experienced food riots.[4]

4 Mr Wakeford refused to disclose the identity of his informant. He admitted that the sole source of information contained in the Report was his informant and that he had taken no steps to verify the information.[5] The mystery surrounding the identity of the informant gave rise to speculation in the media[6] that Mr Wakeford's informant was Mr James Cross, the former Senior Deputy-Governor of the Reserve Bank. Mr Cross in evidence refuted that speculation before the Commission and

4 Wakeford Submission, Record 775, 778-9, 782
5 Wakeford, Record 792-806
6 Bundle SARB (8) 234

emphatically denied that he was the informant.[7] At the request of the Reserve Bank, the chairman of the Commission asked Mr Wakeford to confirm that Mr Cross was not his informant. Mr Wakeford did so. Mr Cross, perhaps unwittingly, gave evidence which might throw some light on the source of the information provided to Mr Wakeford. Mr Cross testified that in late August 2001 he was approached by two representatives of a local branch of a foreign bank. They wished to test a financing mechanism for off-shore acquisitions by South African companies. After details of the proposal were put to Mr Cross and his colleagues, the representatives of the foreign bank were told that the Reserve Bank would not agree to the proposed structure. Some time later in September or early October 2001 Mr Cross received a telephone call from another person working for the same foreign bank. In essence, the complaint was that the Reserve Bank had approved a similar structure (to the one proposed and rejected in late August 2001) and that the result of the structure would be negative for the rand. Mr Cross thereupon requested Mr Grové of the Reserve Bank to review the transaction. Mr Cross' recollection is that the corporate involved in the transaction was said to be Sasol.

[7] Cross, Bundle SARB (8) 231

5 The Commission is left with the strong impression that Mr Wakeford's informant was employed by the local branch of the foreign bank referred to by Mr Cross. One must bear in mind that Mr Wakeford's informant told him that the "dubious transactions and mechanisms had been reported to the Reserve Bank but that the Reserve Bank had, for whatever reason, taken no action" and the informant alleged that the core management of Deutsche Bank, which had dealt with the Reserve Bank in regard to the transactions in question, had "a historically privileged position and relationship with the Department of Finance and the Reserve Bank". If the informant worked for a foreign bank, a rival to Deutsche Bank, the information relayed to the President in the Report was hearsay based on hearsay. Not surprisingly, then, the information turned out on investigation to be inaccurate in a number of material respects.

6 The material allegations in the Report, Annexure "A" hereto, which were investigated by the Commission, in brief, were these:

- a dubious and peculiar share transaction involving Deutsche Bank and Sasol was concluded;
- the foreign capital which Sasol obtained from the share transaction was used to finance the Condea acquisition, potentially under false pretences;

- Deutsche Bank, having become over-exposed to rand denominated Sasol shares, dumped rands in the local, thin, market;
- there was a strong likelihood that Sasol and Deutsche Bank colluded to cause a drop in the value of the rand in order to strengthen their economic position in relation to a fall in oil prices;
- it was rumoured that Nampak, M-Cell and Billiton were in the process of following similar strategies;
- Deutsche Bank's core management had a historically privileged position and relationship with the National Treasury and Reserve Bank.

7 In the Submission and evidence, Mr Wakeford did not persist with the allegation that there was a special, unhealthy or cosy relationship between Deutsche Bank and the Department of Finance or the Reserve Bank. There was also no evidence of such relationship placed before the Commission.

8 The National Treasury led evidence to rebut any such suggestion:-

- The National Treasury did not receive any application from Deutsche Bank in 2001. There were discussions between

National Treasury and Deutsche Bank about a possible Sasol transaction in 2000 but no application in that regard was made to National Treasury. During 2000 the National Treasury received several Reserve Bank requests on behalf of the MTN Group. On 12 March 2001 MTN made a slide presentation to the Minister of Finance and National Treasury. No application, however, was ever submitted to National Treasury. All the MTN applications were dealt with and resolved by the Reserve Bank.[8]

- Deutsche Bank Johannesburg ("DBJ") was appointed a primary dealer in the domestic bond market in April 1998. Eleven other institutions were also appointed after due process was followed. From time to time South Africa has borrowed in the international capital market since 1994. A total of 17 transactions including public bonds, private placements and a syndicated loan were concluded during this period, three of which were lead managed by Deutsche Bank. There are no credit lines or liquidity support that the National Treasury has provided to Deutsche Bank, nor did the National Treasury receive any private credit lines or liquidity support from Deutsche Bank. In July 2001 the Reserve Bank and the National Treasury concluded a syndicated loan of

8 Evidence of Mr C Malan, Chief Director, Financial Regulation, National Treasury, National Treasury 2 Bundle 1; Record 1127

USD1.5 billion as co-borrowers. Deutsche Bank was one of thirty-one institutions that participated in the loan. A former employee of National Treasury, Mr Richard Ketley, left the National Treasury in 2000 and joined Deutsche Bank in its bond market section. Mr Ketley has since left Deutsche Bank and is presently at Stanbic Africa.[9]

9 The evidence for the Reserve Bank was that applications for Exchange Control approval submitted by DBJ or Deutsche Securities are not

- treated differently from applications submitted by other authorised dealers; or
- given any preference.[10]

10 The Presidency furnished the Commission with a copy of the Report. The Commission thereupon appointed a team of assistants to investigate the allegations contained in the Report. The evidence was subsequently led before the Commission of Mr Wakeford; the institutions mentioned by him in the Report, namely, (using his descriptions) Sasol, Billiton, Nampak, M-Cell, Deutsche Bank; the Department of Finance; the

---

9 Evidences of Mr B Molefe, Deputy Director-General, Assets and Liability Management, National Treasury, National Treasury Bundle 2 (9); Record 1132

10 Evidence of Mr CT Grové, Assistant General Manager, Exchange Control, Reserve Bank Record 1188

Reserve Bank and the leader of the team of assistants which had investigated the allegations.

Billiton

11 BHP Billiton SA Ltd ("Billiton") regularly receives proposals from various banks and financial institutions with regard to a wide variety of potential transactions. During November 2000 Billiton was approached by London representatives of Deutsche Bank with a loan structure proposal involving aluminium linked financing. A number of discussions took place between Deutsche Bank and Billiton during 2001. During January 2002 a final decision was taken not to pursue the proposal due to Billiton's concerns in regard to the tax implications of the proposed structure. Billiton did not enter into any structured finance arrangements with or through Deutsche Bank during the period 1 January to 31 December 2001 or thereafter. Deutsche Asset Management's shareholding in BHP Billiton Plc as at 31 December 2001 was 1.65%. BHP Billiton Plc is the ultimate holding company of Billiton.[11]

[11] Evidence of Mr AP Brugman, the Treasurer of Billiton, Record 819

<u>The regulatory framework</u>

12 Before analysing the Sasol, Nampak and M-Cell transactions for which DBJ or Deutsche Securities obtained approval from the Reserve Bank, it is necessary to sketch the regulatory framework in which those applications were made, granted and implemented.

13

13.1 The evidence given on behalf of the Reserve Bank[12] was that authorised dealers are not empowered to grant any South African corporate the authority to make a foreign direct investment. Such corporate is obliged, through an authorised dealer, to submit a written application to Exchange Control for authority to do so. Exchange Control is required to be in possession of sufficient information regarding the transaction, its nature and purpose, before consulting with the National Treasury or exercising the authority delegated to it by the Minister of Finance. In considering any such application submitted by an authorised dealer on behalf of a South African corporate, Exchange Control

---

12 Evidence of Mr CT Grove, Assistant General Manager, Exchange Control Department, Reserve Bank: <u>Bundle SARB (8) 6</u>

takes into account not only the merits of the particular case and the circumstances giving rise thereto, but also equality of treatment of all similar requests. Any such application can only be considered properly if Exchange Control is in possession of sufficient information. It is the duty of the authorised dealer on behalf of its South African corporate client to verify the content of each application and to ensure that all applications are fully detailed and presented in an acceptable form. Any application must state clearly the corporate's reasons for wishing to undertake the transaction; what benefits will accrue to South Africa either in the short or the long term; and whether there might be subsequent or other related transactions.

13.2 Once the application has been approved by Exchange Control, it is incumbent on the authorised dealer concerned to ensure that the transaction or transactions in respect of which authority has been given are finalised on the particular basis on which it was formally approved by exchange control. Exchange Control requires that the authorised dealer must verify, as and when the underlying transactions are implemented, that any conditions laid down by exchange control had been adhered to.

13.3 It is the view of Exchange Control that, in the event of an applicant – a South African corporate – or its authorised dealer implementing a transaction or series of transactions which formed the subject matter of an application to Exchange Control ("the main application") and such implementation of a transaction or those transactions:

- deviates in any manner from the authority granted by Exchange Control; or
- takes place in any manner not disclosed to Exchange Control in the main application; or
- involves further or ancillary transactions not disclosed in the main application, then, and in that event, such implementation would constitute a contravention of the Exchange Control regulations. It is important to emphasise that it is the view of Exchange Control that included in "further or ancillary transactions not disclosed in the main application" would be a hedging transaction entered into as a consequence of the main application.

13.4 Applications by South African corporates to invest overseas are considered by Exchange Control in the light of the national interest. In terms of Exchange Control policy, the purpose of Exchange Control over direct investment abroad is to prevent the loss of foreign currency reserves through the transfer abroad of capital held in South Africa and to help to avoid undue pressures on South Africa's foreign exchange reserves. Such investment, in terms of that policy, must result in a longer term benefit to the country, such as the promotion and/or enhancement of exports of both goods and services, including technology, through the protection of existing markets and the development of new ones and the protection of essential imports of goods and technology.

13.5 South African corporates are also allowed to utilise their local cash holdings in South Africa to partly finance new investments whether cost thereof exceeds the respective amounts of R750 million and R500 million. Such additional foreign currency transfers are restricted to 10% of the cost in excess of those amounts irrespective of the size of the transactions. The balance of the finance required must still be raised abroad by the South African corporate and may be so raised, on application to exchange control by means of certain approved transactions. One of them, and the only one that is relevant for the purposes of this commission, is what is described by Exchange Control as "a share placement". [13]

[13] In their evidence the corporates and Deutsche Bank referred to the transactions in question by various names, including "asset swaps" . The label is irrelevant. In substance all the transactions were "share placements" as defined by the Reserve Bank.

13.6 Exchange Control's definition of a share placement is the placement of a listed South African corporate's own shares with long-term foreign investors on the basis that:

- the listed shares to be placed may consist of a new share issue by the South African corporate or existing shares bought back by the South African corporate, and
- the long-term foreign investors must in consideration of the placement with them of those shares, pay to the South African corporate the foreign currency abroad to finance the approved foreign acquisition, to refinance an existing approved foreign investment or to finance an expansion of an existing approved foreign investment.

13.7 In addition to the requirements set out above, in considering an application for foreign direct investment, Exchange Control, as a matter of policy, imposes the following pre-conditions to any authority granted:

- the transactions when implemented must be reserves neutral, i.e. when the transaction is implemented there must be no negative impact on the country's total foreign exchange reserves;
- all share placements must take place at arms-length and at market related prices or values;

- the South African corporate is required to advise Exchange Control via its authorised dealer on a periodic basis as determined by Exchange Control of the success or otherwise of the share placement and of the flow-back to South Africa of the shares placed. "Flow-back" means those shares of the South African corporate which have been placed with a foreign vendor and which have found their way back to South Africa and have been purchased by and registered in the names of South African residents.

14 We now turn to consider the three share placement transactions by having regard only to the essence of each transaction.

<u>Sasol</u>

15

15.1 Condea was the chemical business of RWE-DEA, a subsidiary of RWE, the largest utility company in Germany. Condea's business was concentrated in the surfactant value chain and in oxygenated solvents. After a competitive bid process for the acquisition of Condea, Sasol was declared the successful bidder and entered into an agreement with RWE-DEA for the acquisition of Condea. The effective date of the acquisition was 1 March 2001. The total purchase consideration was €1.3 billion (in round numbers). The acquisition was financed by a loan, the use of the foreign investment allowance (R500 million plus 10% of the purchase price), a revolving credit facility and a share placement.[14] It is the share placement element of the financing of the Condea deal which is relevant.

15.2 On 25 January 2001 DBJ applied to Exchange Control on behalf of Sasol to raise up to €350 million (R2.6 billion)[15] by means of an off-shore share placement and to utilise the proceeds to re-finance a portion of the foreign loans raised to finance the acquisition of Condea. The terms of the share placement were to be as follows:

- existing Sasol shares held by wholly owned subsidiaries of Sasol would be placed with long-term foreign investors;
- the transaction was to take place at market related prices;
- it was proposed that the placements would be transacted with long-term non-resident institutional clients of Deutsche Securities (Pty) Ltd ("Deutsche Securities") of whom seven specified clients were named;

14 Evidence of Mr A Coetzee of Sasol Ltd, Sasol Bundle 12-17
15 The figures in this section of the report are rounded off

- no South African party would participate in the proposed share placement.

15.3 On 30 January 2001 Exchange Control informed DBJ that the proposed share placement was approved. It was noted that long-term foreign investors would subscribe for the shares and that no South African party would participate in the share placement exercise. The shares were to be placed at market value. DBJ was requested to keep Exchange Control posted on a six monthly basis as to the success or otherwise of the placement which should include full details of any flow-backs that might have occurred.

15.4 On 16 February 2001 Deutsche Securities, in a letter addressed to Exchange Control, confirmed that the share placement would take place as follows:

- Deutsche Securities would purchase shares in Sasol and on-sell/place these with long-term foreign investors;
- Sasol would pay Deutsche Securities the rand value of the shares placed in South Africa;
- Sasol would receive the foreign currency (proceeds from the sale of the shares) directly into their off-shore account for the account of an entity approved by the South African Reserve Bank;

- no conversion from rand to foreign currency would take place on behalf of Sasol.

15.5 Exchange Control responded on 21 February 2001 in which it confirmed that it was agreeable to Deutsche Securities acquiring the shares in Sasol in the secondary market and on-selling those to long-term foreign investors for payments off-shore; all costs towards the purchase of the shares by Deutsche Securities were to be settled locally in rand by Sasol to ensure a reserves neutral position at all times.

15.6 On 25 June 2001 DBJ reported to Exchange Control that:

- a total of 39.7 million Sasol shares had been placed;
- proceeds of €34 million (net of expenses) were raised through the placements and that these were used in part settlement of the purchase price of Condea;
- the euro proceeds were settled directly for the account of Sasol Investment Holdings (Pty) Ltd (“SIH”);
- shares were placed with Deutsche Bank AG, London, (“DBL”) who had undertaken to Sasol that they would not sell the shares for a period of twelve months other than to other suitable long-term foreign investors;

- DBL had subsequently sold a total of 9.6 million shares to foreign investors.[16]

15.7 As of 28 March 2002, DBL had placed 16.8 million of the original number of shares acquired in 84 separate placement transactions.

15.8 On 15 January 2002 Deutsche Securities informed Exchange Control that flow-back from a Sasol share placement had been low and estimated that about 6% (2.3 million shares of the original 39.6 million shares) had flowed back to South Africa.[17]

---

16 Grové, Bundle SARB (8) 19 - 21

17 Grové, SARB Bundle (8) 175

Nampak

16

16.1 In 2000 Nampak Ltd ("Nampak") decided to finance its United Kingdom Expansion through an equity injection into its wholly owned United Kingdom subsidiary, Nampak Holdings (UK) Plc ("Nampak Holdings (UK)"). The proceeds would be used to partly fund the capital expenditure programme planned for Nampak Plc, a subsidiary of Nampak Holdings (UK). The capital expenditure was estimated in November 2000 to be £50 million.[18]

16.2 On 28 November 2000 DBJ made application to Exchange Control for Nampak through Nampak International Ltd ("Nampak International") to raise up to £25 million (about R277 million) by means of a share placement. The application was supplemented on 11 December 2000. The application was initially turned down. On 12 December 2000 the application was renewed and then granted by Exchange Control on 14 December 2000.

16.3 The share placement was to take effect as follows:

[18] Evidence of Mr J Sayers, Nampak Bundle 6; Grové, SARB(8) 40

- Nampak shares to the rand value of £25 million would be placed on the Johannesburg Stock Exchange with long-term foreign investors;
- the sale proceeds would be received by a Nampak subsidiary in rands;
- the rands would be converted into pounds on the day the share placement was transacted.

16.4 Exchange Control authorised the transaction on terms similar to those in the Sasol application (set out in §12.2 hereof), save that, in addition, the proceeds of the share placement were to be received off-shore and capitalised in the books of Nampak Holdings (UK).

16.5 It was Nampak's understanding that the transaction would be "currency neutral" in that no rands would leave South Africa.

16.6 On 21 June 2001 Nampak advised Deutsche Securities that it could proceed with the share placement. On 27 June 2001 Nampak Products bought, through the agency of Deutsche Securities, 13.8 million shares in Nampak for R171 million. On 3 July 2001:

- Nampak paid Deutsche Securities R171 million for the shares (and as the payment should have been made by Nampak Products, a book entry was subsequently made);

- Nampak Products sold the shares to DBL for £15 million;
- DBL paid £15 million to Nampak International on behalf of Nampak Products for the shares (the first tranche).

16.7 On 3 August 2001 the second tranche for £5 million of the £25 million authorised share placement was effected in a similar fashion to the first tranche and the relevant payments were made on 7 August 2001.

16.8 By 28 March 2002, DBL had placed 10 million out of a total of 18.3 million Nampak shares in 27 separate transactions.

<u>M-Cell</u>

17

17.1 In February 2001 Mobile Telephone Networks Holdings (Pty) Ltd ("MTN Holdings") acquired a cellular licence in Nigeria for USD285 million. On 23 August 2001 Mobile Telephone Networks (Pty) Ltd ("MTN") sent a request for proposals to six financial institutions as to how its strong balance sheets and free cash flows could be used to retire the off-shore US dollar debt in an amount of USD250 million. On 30 August 2001 Deutsche Securities responded in a letter addressed to M-Cell Limited ("M-Cell") setting out its proposals:

- the payment by M-Cell of rands to Deutsche Securities;
- the payment of foreign currency by DBL to M-Cell;
- the foreign currency would be generated by the placing of M-Cell shares with long-term foreign investors;
- DBL "would effectively underwrite the placement of shares off-shore". The proposals were acceptable to M-Cell.

17.2 On 25 October 2001 DBJ made application to Exchange Control to raise USD75 million by means of a share placement. In addition to the share placement scheme outlined above, DBJ informed Exchange Control that the share placements would be implemented in a number of transactions over the following six months as market conditions allowed. On 15 October 2001 DBJ informed Exchange Control that the cash flows would be as follows:

- the rand value in respect of the M-Cell shares purchased in the open market would be paid to Deutsche Securities by MTN; and
- the foreign currency proceeds from the sale of the M-Cell shares to foreign investors would be paid directly to Mobile Telephone Networks International (Ltd) (Mauritius), a wholly owned subsidiary of MTN via Mobile Telephone Networks Africa (Pty) Ltd.

17.3 On 15 November 2001 Exchange Control approved the application and pointed out that suitable steps had to be implemented in order to minimise any flow-back to South Africa and that Exchange Control reserved itself the right to call on the applicants to re-finance any flow-backs to the Republic to ensure reserves neutrality.

17.4 On 8 January 2002 M-Cell instructed Deutsche Securities to proceed with the approved transaction up to a value of the rand equivalent of USD20 million. The first tranche of the Deutsche Security proposal, which involved the placement of 15.7 million M-Cell shares with foreign investors was settled on 25 January 2002 as follows:

- an amount of R232 million was paid by MTN Holdings to Deutsche Securities on 25 January 2002 in payment of M-Cell shares purchased from South African residents;
- on the same date DBL paid an amount of USD20 million to MTN International in return for the M-Cell shares to be placed with long-term off-shore investors.[19]

17.5 As of 28 March 2002 DBL had placed 7.2 million of the 15.7 million M-Cell shares.

---

19 The evidence of Mr RD Nisbitt, M-Cell Bundle 8; Grové SARB (8)

Findings

18

18.1 The Sasol, Nampak and M-Cell share placements in themselves:

- were not dubious nor peculiar;
- were legal;
- were in accordance with Exchange Control approvals;
- when implemented did not contribute to the rapid depreciation of the rand;
- were reserves neutral.

18.2 The Condea transaction was not funded by Sasol "potentially under false pretences" nor did Sasol and Deutsche Bank collude to cause a drop in the value of the rand.

The Deutsche Bank hedging, funding and related transactions

19 The controversy, both from an exchange control and rand exchange rate perspective, relates to the hedging, funding and related transactions undertaken by Deutsche Bank in respect of each of the share placements. The evidence given on behalf of Deutsche Bank[20] in regard to those

[20] Evidence of Mr N Smith, Deutsche Bank Bundle Part (2) 9

hedging and other transactions was exhaustive and is available for analysis by any interested party. For our purposes it is sufficient to set out the various transactions in broad terms as described by Deutsche Bank.

<u>Sasol share placement hedging, funding and related transactions</u>

20

20.1 In order to hedge the *market* risk in respect of DBL's holdings of the Sasol shares, DBL and Deutsche Securities entered into a forward sale transaction on 22 February 2001 in terms of which DBL agreed to sell to Deutsche Securities 38.4 million Sasol shares at a price equal to their market value in rands on the date of implementation of the share placement plus interest.

20.2 In order to *hedge* DBL's currency risk in respect of DBL's holdings of DBL's Sasol shares, DBL, as a non-resident, exchanged R2.5 billion for €350 million on 19 and 20 February 2001.

20.3 In order to fund DBL's holdings of unplaced Sasol shares, DBL and DBJ entered into a re-purchase transaction on 26 February 2001 in terms of which DBL sold South African Government bonds to DBJ for which DBJ paid DBL R2.4 billion. This amount was equal to the value of the bonds.

20.4 In order to manage the cost relating to the holdings of bonds purchased under the re-purchase transaction and the Sasol shares purchased by DBL, DBL loaned 38.4 million Sasol shares to DBJ on 23 March 2001.

20.5 Deutsche Bank contends that the effect of the share placement, hedging, funding and other transactions on DBJ and DBL was as follows:

- DBL purchased Sasol shares;
- DBL hedged its market risk relating to the shares;
- DBL hedged its currency risk by selling South African bonds and exchanging the rand proceeds for foreign currency; and
- DBL and DBJ balanced their currency positions.[21]

20.6 Deutsche Bank avers that the exchange of rand for foreign currency pursuant to the currency hedge on 19 and 20 February 2001, which was at least seven months before the start of the rapid depreciation of the rand in October 2001, did not contribute to the depreciation of the rand – on the contrary, the rand/US

---

21 Smith, Deutsche Bank Bundle Part (2) 10

dollar exchange rate strengthened on 19 and 20 February 2001 and over the entire month of February 2001.[22]

Nampak share placement hedging, funding and related transactions

21

21.1 In order to hedge its *currency* risk in respect of tranche 1, DBL, as a non-resident, exchanged R170 million for £15 million. In order to hedge its currency risk in respect of tranche 2, DBL exchanged R59 million for £5 million. The exchanges were executed on 26 June 2001 and 24 July 2001 respectively.

21.2 In order to hedge their *market* risk in respect of tranche 1, DBL and Deutsche Securities entered into a forward sale agreement on 27 June 2001 in terms of which DBL agreed to sell to Deutsche Securities 13.8 million Nampak shares at a price equal to their market value in rands on the date of implementation of tranche 1 of the share placement plus interest. DBL hedged its market risk in respect of Tranche 2 by entering into put-and-call contracts on the South African Futures Exchange ("SAFEX"). The expiry date of the contracts is 19 September 2002 and the strike prices are R13.96.

22 Smith, Deutsche Bank Bundle Part (2) 12

21.3 Deutsche Securities hedged its market risk in respect of tranche 2 by entering into put-and-call contracts on SAFEX. The expiry date of the contracts is 19 September 2002 and the strike prices are R13.96.

21.4 DBL obtained funding of about R170 million and R54 million from DBJ by way of re-purchase transactions. In terms of the re-purchase transactions, DBL sold South African Government bonds with a value approximately equal to its funding requirements to DBJ and DBJ paid DBL an amount in rand equal to the value of the bonds.

21.5 In order to manage the cost relating to the holdings of bonds purchased under the re-purchase transactions and the Nampak shares purchased by DBL, DBL loaned the unplaced Nampak shares to DBJ on 9 October 2001. As security for the obligations under the security loans, DBJ transferred South African Government bonds to DBL. The bonds had a market value similar to the Nampak shares.

21.6 Deutsche Bank contends that the effect of the share placement and the hedging, funding and other transactions on DBJ and DBL was as follows:

- DBL purchased Nampak shares;
- DBL hedged its market risk relating to the shares;

- DBL hedged its currency risk; and
- DBL and DBJ balanced their currency positions.[23]

21.7 Deutsche Bank avers that the exchange of rand for foreign currency occurred on 26 June 2001 (£15 million) and 24 July 2001 (£5 million). The rand strengthened on 26 June 2001 and on 24 July 2001.

M-Cell share placement hedging transactions

22

22.1 In order to hedge its *currency* risk, DBL, as a non-resident, exchanged R231.8 million for USD20 million on 8 January 2002.

22.2 DBL hedged its market risk in respect of the M-Cell shares by entering into put-and-call contracts on SAFEX. The expiry date of the contracts is 21 June 2002 and the strike prices are R15.05, R15.28 and R15.78.

22.3 Deutsche Securities hedged its market risk in respect of the M-Cell shares by entering into put-and-call contracts on SAFEX. The expiry date of the contracts is 21 June 2002 and the strike prices are R15.05, R15.28 and R15.78.

---

23 Smith, Deutsche Bank Bundle Part (3) 146

22.4 Deutsche Bank contends that the only transaction involving the exchange of rand for foreign currency was the currency hedge referred to in §22.1 (the exchange of R231.8 million for USD20 million on 8 January 2002). This occurred after the period during which the rand depreciated.[24]

Exchange Control's Concerns

23

23.1 Following on the request made by Mr Cross referred to in §4 Part E, Exchange Control held discussions and entered into correspondence with Deutsche Securities and DBJ about the *Sasol* share placement. The correspondence ended with two letters from Deutsche Securities dated 18 February 2002 and 26 February 2002. In the evidence given on behalf of Exchange Control on 8 April 2002, Mr Grové expressed the opinion that on the face of it the following discrepancies appeared between the Sasol application which was approved and the letters of 18 February and 26 February 2002:-

24 Smith, Deutsche Bank Bundle Part (4) 362

- the original Sasol application for a share placement transaction did not disclose all the related or subsequent transactions, i.e. the hedging, funding and other transactions;
- the details of those transactions were not immediately disclosed;
- some or all of the hedging, funding and other transactions prejudiced the obligation placed on DBJ to ensure reserves neutrality. On 26 March 2002 Exchange Control gave DBJ the opportunity to respond in writing to its concerns.[25]

23.2 At a meeting between Exchange Control, DBJ, DBL and Deutsche Securities on 12 February 2002 DBJ was requested by Mr Grové to provide Exchange Control with a full report on the *Nampak* share placement. On 26 February 2002 DBJ responded by providing Exchange Control with a written explanation by Deutsche Securities. Exchange Control is of the view that on the face of it, the following discrepancies appear between the Nampak application and the approval granted by Exchange Control in regard thereto and the letter of 21 February 2002:

- the application for a share placement did not disclose all the related or subsequent transactions which were implemented or

---

[25] Grové, Record 1169-1174

were to be implemented, i.e. the hedging, funding and related transactions;

- the currency risk hedging transactions (in terms of which DBL exchange R170 million for £15 million and R59 million for £5 million) did not maintain or ensure reserves neutrality.[26]

23.3 At the meeting of 12 February 2002 Mr Grové requested DBJ to provide Exchange Control with a full report on the *M-Cell* share placements. On 21 February 2002 DBJ responded by providing a written explanation from Deutsche Securities.

23.4 Exchange Control is of the opinion that on the face of it the following discrepancies appear when regard is had to the *M-Cell* applications and the M-Cell approval and the letter of 21 February 2002:

- the original M-Cell application for share placement did not disclose all the related or subsequent transactions, i.e. the hedging transactions;
- the currency risk hedge in terms of which DBL exchanged R231.8 million for USD20 million on 8 January 2002 does not maintain and/or ensure reserves neutrality.[27]

---

26 Grové, Record 1178-1180
27 Grové, Record 1186-1187

23.5 On 26 March 2002 Exchange Control called upon DBJ and Deutsche Securities to address its concerns. The interaction between Exchange Control, DBJ and Deutsche Securities in which Exchange Control reviewed the Sasol and Nampak share placements and the hedging, funding and related transactions was a parallel process to the one conducted by the Commission ("the review process").

24 Under cross-examination by counsel for Deutsche Bank, Mr Grové testified on 8 April 2002:-

- It was not disclosed to Exchange Control at the time the share placements were approved that DBL would "warehouse" the shares. On the contrary, it was stated that DBL would be one of the long-term foreign investors. Nevertheless, had DBJ or Deutsche Securities applied for approval of the share placements on the basis that DBL would warehouse the shares, Exchange Control would have considered the application on that basis.[28]
- Had Exchange Control been made aware, at the time the applications were made, that the hedging, funding and other

---

28 Grové, Record 1193-5

transactions would be concluded, Exchange Control would not have approved the share placements.[29]

- At the time the applications were made, Exchange Control did not know and did not assume that DBL would hedge its risks.[30]

Deutsche Bank's contentions

25 Deutsche Bank contended in evidence that the hedging, funding and related transactions were either specifically approved by the Reserve Bank or fell within general Reserve Bank approvals:-[31]

25.1 DBJ applied to the Reserve Bank by letter dated 9 February 2001 for approval of the forward sale transaction between DBL and Deutsche Securities in respect of DBL's market exposure on the Sasol shares. The Reserve Bank approved the transaction by letter dated 13 February 2001.[32]

25.2 DBJ applied to the Reserve Bank by letter dated 18 October 2001 for approval of the forward sale transaction entered into between DBL and Deutsche Securities in respect of DBL's market

---

29 Grové, Record 1195-1200
30 Grové, Record 1196-1200
31 Smith, Deutsche Bank Bundle (6K)
32 Smith, Deutsche Bank Bundle (6B)

exposure on the part of the Nampak shares. The Reserve Bank approved the transaction by letter dated 18 October 2000.[33]

25.3 The purchase and sale of SAFEX contracts fall within the general Reserve Bank approval that permit non-residents to trade in securities and financial instruments listed on South African exchanges.[34]

25.4 Any non-resident, including DBL, is free to undertake transactions in rands without Reserve Bank approval, and this occurs on a regular basis. Accordingly, DBL, as a non-resident, did not require Reserve Bank approval to transact the currency hedges.[35]

25.5 Re-purchase transactions between residents and non-residents fall within the general Reserve Bank approval set out in section E.5 (E)(i) of the Rulings. Re-purchase agreements between DBL and DBJ are arranged, transacted and reported to the Reserve Bank on an ongoing basis.[36]

25.6 Securities loans by non-residents to residents are common. Such loans fall within the general Reserve Bank approval set out in Section E.5(E)(ii) of the Rulings. The approval permits the

---

33 Smith, Deutsche Bank Bundle (6C)
34 Smith, Deutsche Bank Bundle (6C)
35 Smith, Deutsche Bank Bundle (6C)
36 Smith, Deutsche Bank Bundle (6D)

borrowing of securities listed on the JSE by authorised dealers from non-residents on condition that the loans are secured by the pledge of certain types of assets.[37]

25.7 Subsequent to the transactions being entered into, the re-purchase and securities loan transactions were reported to the Reserve Bank by DBJ. This was done in the normal course of DBJ's business in accordance with normal practice.[38]

26 Deutsche Bank dealt in evidence with the Reserve Bank's concerns that the hedging, funding and other transactions were not "reserves neutral":-

26.1 The term "reserves" means the gold and foreign currency held by a central bank. The term is not generally used in any other context. The Reserve Bank seems to ascribe a wider meaning to the term. The Reserve Bank has not published its understanding of the term. There is also no general consensus amongst experts on what the Reserve Bank means by the term. A number of different meanings have been suggested by economists and experts. The following meanings appear the most likely:

- it is possible that the Reserve Bank understands the term to mean the net foreign currency pool of all South African

---

37 Smith, Deutsche Bank Bundle (6D-6E).

38 Smith, Deutsche Bank Bundle (6E)

residents, i.e. the aggregate of all foreign currency held by South African residents;

- it is also possible that the Reserve Bank means the gross foreign reserves of the South African monetary sector.

26.2 On whatever definition the Reserve Bank might use, the hedging, funding and other transactions were, in aggregate, "reserves neutral" i.e. the transactions did not result in a net outflow of rand from South Africa. In the case of the Sasol and Nampak funding transactions, DBL introduced non-resident owned bonds into South Africa, foreign currency having been introduced in South Africa to acquire the bonds in the first instance.

26.3 Smith was not aware of any provision in the Exchange Control Regulations, the orders and rules made pursuant thereto or the rulings that require share placements to be "reserves neutral".

26.4 In the Reserve Bank approvals and related correspondence with Deutsche Bank, the Reserve Bank refers to the term "reserves neutral" only in limited instances, for example, in relation to the Sasol share placement the Reserve Bank stated: "all cost towards the purchasing of the shares by your institution must be settled locally in rand by the company [Sasol] involved to ensure a reserves neutral position at all times." Deutsche Bank's understanding of the reference to "reserves neutral" is that the payment by Sasol to Deutsche

Securities should be settled in rand and not in foreign currency. The payment was in fact settled in rand.

26.5 There is no condition in any of the share placements to preclude DBL or any other foreign investor in the shares from hedging its currency exposure in respect of the shares by exchanging rand for foreign currency.[39]

The investigation of the Wakeford allegations

27

27.1 The team the Commission appointed to investigate the Wakeford allegations consisted of a forensic auditor, structured finance specialists and an attorney ("the team"). The team interviewed Mr Wakeford. As he was not able to substantiate the allegations made in the Report, the team conducted its own investigation. Consultations were held with DBJ, Sasol, Nampak, M-Cell, Billiton, the Reserve Bank and National Treasury. Having determined that Billiton did not conclude a share placement with Deutsche Securities, the team concentrated on the other transactions. The team prepared a report. The leader of the team,

[39] Smith, Deutsche Bank Bundle (6H) – (6I)

Mr Papadakis, gave evidence before the Commission after evidence had been led by the entities named in the Report.[40]

27.2 The material conclusions of the team in regard to the Sasol share placement and the hedging, funding and related transactions were:-

(1) The effect of the conversion of R1.8 billion for €250 million on 19 and 20 February 2001, if viewed in isolation, would be that the total foreign currency reserves of South Africa were reduced by €250 million.

Mr Papadakis was cross-examined by counsel for DBJ. The contention advanced on behalf of DBJ in essence was that "…there was an inflow of foreign currency into [South Africa] in consequence of an acquisition of bonds by [DBL]."[41] Mr Papadakis disputed that it was a purchase of bonds. He testified that according to the records of DBJ there was a bond *re-purchase* transaction of R2.4 billion, which was "in economic terms a loan" and hence there was no inflow of foreign currency into South Africa.[42]

(2) On the days the currency conversion was effected, 19 and 20 February 2001, the rand appreciated in value. The team

---

40 Evidence of Mr G Papadakis, Gobodo Bundle 1-20; Record 1518-1575
41 Evidence of Papadakis, Record 1540 line 13
42 Evidence of Papadakis, Record 1538-1539, 1544

was not in a position to provide any conclusion as to whether or not that transaction contributed or gave rise to the rapid depreciation of the rand.

27.3 The material conclusions of the team in regard to the *Nampak* share placement and the hedging, funding and related transactions were:-

(1) The effect of the conversion of rands for pound sterling of R170 million for £15 million on 26 and 27 June 2001 and R59 million for £5 million on 2 August 2001 was that the foreign currency reserves of South Africa were depleted to the extent of the conversion.

(2) The rand appreciated in value on 26 June and 2 August 2001 but depreciated on 27 June 2001. The team was not in a position to provide any conclusion as to whether or not those transactions contributed or gave rise to the rapid depreciation of the rand.

(3) The application of the foreign currency proceeds received by Nampak was not applied strictly in accordance with the approval granted by Exchange Control. Any deviation from the basis on which an application is approved needs to be submitted to Exchange Control.

The application was approved by the Reserve Bank on the basis that the pound sterling would be used "…to fund the capital expenditure programme of Plysu PLC". The team discovered, in the words of its report, that the funds "…were initially utilised to reduce the loan raised from the syndicate of banks to settle the purchase price of Plysu." In evidence it became common cause between the team and Nampak that the funds were used to settle the loan and that the team regarded this discrepancy as a side issue. The Reserve Bank then placed on record that this was "a minor deviation in the overall scheme of the transaction as a whole and with the benefit of hind-sight the Exchange Control Department says that they would have agreed to the request."[43]

27.4 In regard to the *M-Cell* transactions, the team concluded that:

- Deutsche Bank utilised its own funds to underwrite the transaction;
- DBL exchanged R231 million for USD20 million on 8 January 2002 as a hedge of its currency risk;
- the M-cell shares which were unsold by DBL were sold subsequent to 31 December 2001;

---

[43] Evidence of Papadakis, Record 1571-2

- the M-Cell share placement was implemented during January 2002 (which falls outside the period of the investigation).

28 <u>The response of the Reserve Bank</u>

28.1 Mr Bruce-Brand returned to the witness box on 7 May 2002 to deal with the evidence which had been given since he had last testified.

28.2 He testified that Exchange Control approved twelve share placements/corporate swaps to the value of approximately R22.9 billion. Seven approvals were not proceeded with. Only transactions totalling approximately R4 billion were implemented.

28.3 Mr Bruce-Brand emphasised that for exchange control purposes the reserves are the total gold and foreign exchange reserves of South Africa. In an exchange control environment "reserves neutrality" cannot reasonably refer to any other reserves. Mr Van Zyl's evidence was that there are three components of South Africa's reserves. Firstly, the Reserve Bank reports on the reserves on page S102 of its Quarterly Bulletin and one month in arrears on the Reserve Bank website. At the moment the reserves are USD7.6 billion of which about USD1.6 billion is gold and the rest is foreign exchange reserves. Secondly, there is a smaller amount, about USD4 billion under control of the authorised dealers. The authorised dealers are aware in what categories they are allowed to invest and what categories are excluded to them. A third category of reserves is one under the control of the Government from time to time.[44] On page S102 of the Quarterly Bulletin the Reserve Bank reports on "gold and other foreign reserves" under these headings:

[44] Evidence of Van Zyl, Record 1694-5

<table>
<tr><td colspan="3">Reserve Bank</td><td>Rest of Monetary Sector</td><td>Central Government</td></tr>
<tr><td>Gold Reserves</td><td colspan="2">Foreign Exchange Reserves</td><td rowspan="2"></td><td rowspan="2"></td></tr>
<tr><td></td><td>SDRs*</td><td>Other</td></tr>
</table>

* “SDRs” means Special Drawing Rights

28.4 The amounts which are allowed to be invested abroad by South African corporates (R750 million or R500 million plus 10% of the cost of the investment in excess of those amounts) negatively impact on the reserves of the country. South Africa is prepared to accept that decrease in the foreign reserves. Where the investment exceeds the allowed amount, the investment cannot be allowed to take place in any manner which may negatively impact on the reserves of the country. When agreeing to a share placement, Exchange Control requires that, save for the allowed amount, reserves neutrality is maintained. Any flow-back that occurs must be rectified.

28.5 It is Exchange Control’s contention, consequently, that no transaction should be engineered, under any guise, to exceed the permissible outflows prescribed by the Minister of Finance.

28.6 In considering the share placements in issue, the question is whether bonds were purchased by DBL and whether DBL paid for the bonds or not. Exchange Control would not take into account the foreign exchange which may or may not have come into South Africa's reserves for the purpose of adjudicating upon the relevant share placement transactions. Acquisitions of South African assets by non-residents built up prior to an application to Exchange Control for a share placement would definitely not be considered by Exchange Control as a motivating factor.[45]

The Settlement Agreement

29

29.1 The review process that commenced in October 2001, in terms of which Exchange Control reviewed the Sasol and Nampak share placements and the hedging, funding and related transactions which Deutsche Bank put in place, culminated on 22 May 2002 with the conclusion of a Settlement Agreement between Exchange Control and Deutsche Bank. On 24 May 2002 the

[45] Evidence of Bruce-Brand Bundle SARB (9) 1-3

Commission was informed that the Settlement Agreement was confidential in terms of s33(2) of the South African Reserve Bank Act, 90 of 1989. Exchange Control and Deutsche Bank brought an application for an in camera hearing, which the Commission granted, in which the terms of the Settlement Agreement were disclosed to the Commission.[46] On 28 May 2002 the Commission acceded to a request by Deutsche Bank that the Settlement Agreement be made public. The Reserve Bank did not object. The Commission thereupon published the Settlement Agreement and Annexure 1 thereto. The Settlement Agreement and Annexure 1 thereto are attached to Part E as Annexure "C".

29.2 The material terms of the Settlement Agreement were that DBJ and Exchange Control agreed that the Deutsche Bank group would implement a set of transactions described in Annexure 1. The intention was to address Exchange Control's concerns regarding reserves neutrality, while at the same time not requiring the unwinding of any of the asset swaps/share placements in related transactions (Clause 2). Once the transactions referred to in Annexure 1 had been implemented, those transactions would gradually be unwound as the share placements continued (Clause 3). As security for the undertaking that DBJ would ensure that the

46 Record 1763-1765

Deutsche Bank group would enter into the transactions, DBJ would deposit R10 million with the Reserve Bank on the business day following signature of the settlement agreement. The deposit would be interest free. The deposit would be repaid to DBJ once DBJ had provided Exchange Control with documentary evidence confirming completion of the transactions set out in Annexure 1 and DBJ had appointed a person who was suitably qualified in exchange control matters to take responsibility for all DBJ's communications with Exchange Control (Clause 4). The Settlement Agreement was concluded without admission of liability or wrongdoing on the part of the Deutsche Bank group (Clause 6). The Settlement Agreement was in full and final settlement of all claims, disputes and proceedings of any nature that either party might have against the other in relation to the asset swaps/share placements and related transactions (Clause 7).

Legal Submissions

30 At the end of the public hearings, the Commission was not clear on what the *legal duties* of DBJ were in relation to disclosure of information and reserves neutrality. Accordingly, on 30 May 2002 the Commission sought clarity from Exchange Control and DBJ in a letter

addressed to each.[47] In short, the questions which were posed to the parties were:

- whether DBJ was under a legal duty to make disclosure and ensure reserves neutrality;
- if so, in terms of which law those duties arose;
- whether the breach of any legal duty relied on by the Reserve Bank in those circumstances constituted prima facie evidence of criminal conduct, such as a contravention of Regulation 22 of the Exchange Control Regulations;
- if the Reserve Bank contended that DBJ was not in breach of a legal duty, whether the Reserve Bank contended, in the words of §1.3.4 of the Commission's Terms of Reference, that those transactions were in breach of the "spirit" of the exchange control regulations, and if so, how?

31 The Reserve Bank's submissions are contained in a letter addressed to the Commission dated 6 June 2002, a copy of which is attached to Part E as Annexure "F". DBJ's submissions are contained in a letter to the Commission dated 7 June 2002, a copy of which is attached to Part E as Annexure "G".

47 The letters are Annexures "D" and "E" to Part E

32 Attorneys acting on behalf of DBJ addressed a letter to the Commission dated 7 June 2002 in which it was submitted that it was not appropriate for the Commission to deal in its final report with the legality and ethics relating to the share placements and related transactions. A copy of the letter is attached to Part E as Annexure "H". A similar submission had been made orally on behalf of the Reserve Bank during the in camera hearing on the final day of the Commission's hearings. In the Reserve Bank letter of 6 June 2002, Annexure "F" to Part E, the Commission was advised by the Reserve Bank that it did not withdraw those oral submissions.

Regulation 12

33

33.1 The Reserve Bank submitted that in terms of regulation 12 of the regulations governing the Commission's proceedings, the Commission should not make a finding or recommendation concerning the disputes between Exchange Control and DBJ, the disputes having been resolved in the Settlement Agreement.

33.2 Regulation 12 provides:

> "Whenever the Commission is satisfied upon evidence or information presented to it that the Commission's inquiry may

adversely affect any existing, instituted or pending legal proceedings or any investigation instituted in terms of any law, evidence which is relevant to such proceedings or investigation shall be dealt with by the Commission in such a manner as not to affect adversely such legal proceedings or investigation."

33.3 The argument advanced on behalf of the Reserve Bank was that in terms of the Settlement Agreement, the disputes between Exchange Control and DBJ have been satisfactorily finalised; that the Settlement Agreement addresses the question on reserves neutrality, which was one of the main issues aired during the Commission; that the parties have resolved that dispute; that the Commission's purpose is to deal with the rapid depreciation and value of the currency and to find any transactions which were either unethical or illegal and which had an effect on the rapid depreciation of the currency; that the share placement transactions and the hedging, funding and related transactions did not affect or lead to or cause the rapid depreciation of the rand. It was pointed out that one of the factors taken into account between the Reserve Bank and DBJ in settling their differences, rather than ventilating them in litigation in the High Court was "… The implications of litigation would have been expensive and time consuming and we do not believe would have given the correct public focus to exchange control and exchange control regulations. What you would have had in the press would have been a focus on a fight between an international bank and the South African Government on exchange control which would have flown in the face of what the Minister of Finance told us about 15 minutes ago, and that is the gradual relaxation of the process. We believe that it would have given the wrong focus."[48]

33.4 The submissions on behalf of DBJ are summarised as follows:

- where it is established during the Commission's enquiry that a particular transaction did not give rise or contribute to the rapid depreciation of the rand in the period under review, it would be outside the scope of the Commission's Terms of Reference to come to any conclusion as to the legality and ethics of the particular transaction;
- the transactions comprising the asset swaps did not give rise or contribute to the rapid depreciation of the rand;
- the disputes between DBJ and the Reserve Bank have now been resolved: by agreeing to the Settlement Agreement, the Reserve Bank "…has approved all the transactions comprising the asset swaps and has with finality resolved the issues raised in the dispute and rendered an alternative resolution of the dispute or a finding by the Commission in

---

48 Record 1768-69; 1781-2

respect thereof irrelevant. In these circumstances, any finding by the Commission as to the legality and ethics of the asset swaps and related transactions could only be interpreted as a repudiation of the Reserve Bank's authority.";

- The Commission should be sensitive to an unfair perception that there is something "dubious" about DBJ's role in the market which could disproportionately affect DBJ's business in South Africa.[49]

Criminal Conduct

34

34.1 Although Exchange Control contends that DBJ breached its administrative law duties, it does not contend that DBJ breached any criminal law duty. Exchange Control submits that, in concluding the Settlement Agreement, it took into account that "DBJ, in failing to adhere to exchange control Regulations, may have:

- not done so wilfully (that is DBJ may have been able to demonstrate an absence of dolus) or negligently (that is DBJ may have been able to show an absence of culpa); and

---

49 The full submissions are contained in Annexure "H" to Part E.

- being able to demonstrate an absence of negligence (culpa) and possibly been able, on the balance of probabilities, to show that it acted in ignorance of the exact position in connection with Disclosure and Reserves Neutrality in the context of the Exchange Control Regulations, the Orders and Rules, the Rulings and all the Conditions, and that in so doing it was not culpable (in the criminal law sense) in its actions or any assumptions which it may have made."[50]

34.2 Put prosaically, Exchange Control concedes, in effect, that a criminal prosecution of DBJ would have failed.

Breach of Administrative Duties

35

35.1 Exchange Control submitted, in regard to DBJ's alleged breach of the duty of disclosure, that:-

- DBJ should have disclosed in the original Sasol and Nampak share placement applications the hedging, funding and related transactions;
- the so-called currency hedges were in truth and in fact spot transactions by DBJ;

50 See pages 13-15 Annexure "F" to Part E

- the forward sales were ostensibly used for a different purpose and were not disclosed at the time of the share placements as forming part of the share placement transactions;
- the non-disclosure on the part of DBJ constituted a breach of the exchange control Regulations and in particular Regulation 10(1)(c) read with Regulation 22, as well as section A of the Rulings.

35.2 Exchange Control submitted, in regard to reserves neutrality:

- there is no exchange control Regulation or Ruling which requires a share placement similar to the Sasol and Nampak share placements to be reserves neutral at the time of the implementation or that a reserves neutral position should be maintained at all times in respect of such transactions;
- nevertheless, it is generally accepted amongst authorised dealers that reserves neutrality is a requirement of share placements;
- the policy of Exchange Control in granting share placement applications is that it will only do so if satisfied that reserves neutrality will be maintained at all times;

- the basis on which Exchange Control granted the share placement applications in question would have ensured reserves neutrality;
- the hedging, funding and related transactions, as implemented, were not reserves neutral (for the reasons set out in §'s 23 and 28 of Part E).[51]

35.3 DBJ's contentions, in regard to disclosure of the hedging, funding and related transactions, were that:

- those transactions were specifically approved by the Reserve Bank or fell within pre-existing general Reserve Bank approvals or were not subject to the exchange control Regulations;
- the disclosure requirement in the Rulings is that "full and precise particulars of the underlying transaction are given in the first instance";
- the "underlying transactions" in respect of the Sasol share placement were the transactions in terms of which Sasol acquired and financed Condea and the underlying transactions in respect of the Nampak share placement were the transactions in terms of which Nampak would

[51] See Annexure "F" to Part E

capitalise Nampak Holdings (UK) plc and the expansion of the business of its subsidiary, Plysu plc;

- the hedging, funding and related transactions were not "underlying transactions" in terms of the Rulings;
- there was consequently no obligation to give "full and precise particulars" of the hedging, funding and related transactions.

35.4 DBJ's contentions, in regard to reserves neutrality, were:

- there is no general or specific requirement on the part of the Reserve Bank for share placements to be reserves neutral;
- the Sasol and Nampak share placements and the related transactions were in fact reserves neutral;
- the Sasol and Nampak share placements and the related transactions will be reserves neutral to positive upon their completion.[52]

Findings

36 The Commission makes the followings findings:-

[52] For the full submission see Annexure "G" to Part E.

36.1 The share placements were not shown to have contributed or given rise to the rapid depreciation of the rand (as Mr Wakeford was led to believe).

36.2 The Sasol, Nampak and M-Cell share placements, which were identified in the Wakeford Report, were not in contravention of exchange controls.

36.3 The disputes between Exchange Control and DBJ in relation to the hedging, funding and related transactions, relate to the administrative law duties of DBJ. There is no question of potential civil or criminal liability on the part of DBJ.

36.4 The currency conversion which was effected in relation to the Sasol hedging, funding and related transactions, can be considered to have contributed to the longer term depreciation of the rand based on the Commission's definition of the impact of a transaction on the currency.

36.5 The currency conversions which were effected in relation to the Nampak hedging, funding and related transactions, can be considered to have contributed to the longer term depreciation of the rand based on the Commission's definition of the impact of a transaction on the currency.

37 The Commission is not able to make a positive finding on whether DBJ was in breach of its administrative law duties in regard to the hedging, funding and related transactions. The legal position is not as clear and unequivocal as the two parties contend. It is presumably for that reason, amongst others, that Exchange Control and DBJ settled their differences by concluding the Settlement Agreement.

38 The hedging, funding and related transactions cannot be regarded as unethical in terms of the conduct characterised as unethical in §9 of the Executive Summary.

Clearly, the intention of approving "share placements" is to allow the financing of off-shore investments using local funds in a controlled manner to protect the reserves of the country.

Therefore, based on the Commission's definition of what constitutes a breach of the "spirit of exchange controls", the transactions ran contrary to the "spirit of exchange controls" in that there was a lack of up front and complete disclosure with regard to the transactions and the foreign reserves were depleted to the extent that rand was exchanged for foreign currency in the local forex market.

In a sophisticated and dynamic market place, it is accepted that a financial services provider will be pro-actively looking for new products and services to meet the needs of their clients and, at the same time, maximise revenues. However, through a process like this Commission, all market participants are reminded of their responsibilities towards a sustainable economy and the commitment towards business practices which support the regulatory and other structures implemented by the Government.

39 There are, nevertheless, a few general observations which the Commission wishes to make about an application by an authorised dealer to Exchange Control to make a foreign direct investment.

40 The <u>first</u> is that an authorised dealer is not an uninformed layman. An authorised dealer is assumed to have a working knowledge of the purposes and policies of Exchange Control. An authorised dealer must use its knowledge, experience and common sense in applying exchange controls.

41 The <u>second</u> is that the relationship between the regulator, Exchange Control, and authorised dealer is based on trust. In applications of the kind in question, an authorised dealer must trust Exchange Control to exercise its discretion properly. And, Exchange Control is entitled to trust an authorised dealer to make full disclosure to it of all material

information on which it is required to exercise its discretion to grant an application to make a foreign direct investment.

42 The <u>third</u> is that there should be no doubt in the mind of any authorised dealer what Exchange Control means by South Africa's reserves. For exchange control purposes, the reserves are the total gold and foreign exchange reserves of South Africa. That much is known to anyone who reads the Reserve Bank's Quarterly Bulletin, which one assume authorised dealers do as a matter of course.

43 The <u>fourth</u> is that an authorised dealer who makes application for a foreign direct investment must take into account that:

- one of the purposes of exchange controls is to prevent the loss of foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa;
- one of the pre-conditions to the grant of an application to make a foreign direct investment is that the transaction, such as a share placement, when implemented, must not have a negative impact on South Africa's total foreign exchange reserves;
- any related transaction which is concluded consequent to the share placement transaction, such as a hedging or funding transaction, must share one of the characteristics of a share

placement, ie the transaction must be reserves neutral, otherwise – and this is a statement of the obvious – one of the purposes of exchange controls would be frustrated.

44 The fifth is that, by their nature, applications to make foreign direct investments will vary. There is no standard formula for the application or the approval by Exchange Control. If an authorised dealer has any doubt about the requirements of Exchange Control or the extent of its duty to make disclosure, it should consult Exchange Control. It is to the benefit of the authorised dealer, its client and the Reserve Bank that any doubts, ambiguities or concerns are addressed at the time of the application rather than in a protracted review process. (What exacerbated this matter was that the differences between the Reserve Bank and DBJ were aired before the Commission under the intense scrutiny of the media.)

45 The Commission's findings and recommendations in regard to exchange controls look to the future. Exchange Control and authorised dealers should take heed of the lessons learnt from the Exchange Control/DBJ controversy. The Commission hopes that its findings and recommendations will assist the parties in the application of exchange controls during their limited lifespan in their present form.

Part F: Forex dealing

Index

F Forex dealing

1 Participants in the forex market

Several foreign banks in New York, London and Europe actively trade in the rand on their emerging market desks in order to service the needs of customers that have an interest in South Africa and to generate income for the bank. International fund managers actively trade in the rand to manage exposures to investments in South Africa and to generate income for the funds. All the major banks are authorised dealers and have large treasury operations to offer their corporate customers access to financial markets, to manage the financial exposures arising from their banking business and to generate income for the banks. Smaller banks which are authorised dealers operate on a similar but smaller basis. Local operations of foreign banks, registered in South Africa, which are authorised dealers, offer treasury and corporate banking services in the local market. Most of the larger corporates runs treasury functions in order to serve the needs of their various operations. The Reserve Bank is an integral part of the financial markets and its trading room activities will mirror those offered in the major trading rooms, domestically and internationally.

2 A typical treasury

2.1 A typical treasury will be divided into different departments performing different functions: the front office, the back office and risk management. The treasurer is responsible for the entire treasury operation and often reports directly to the chief executive officer.

2.2 For the purposes of this Commission, the focus is on the *front office*. The front office is divided into several different desks each focussing on a specific market. A chief dealer who reports to the treasurer will head each desk. The front office desks are the following: forex desk, domestic money market desk, fixed income desk, commodities desk and equities desk. The focus in the Commission is on the *forex desk*. The forex desk transacts all forex products in the rand and in other currencies to service corporate customers and to generate income for the bank. The forex desk is a major source of income to the treasury.

2.3 The forex desk is further divided into functional units under the leadership of a chief trader. The forex desk functional units are the spot desk, forward desk, corporate desk and currency options desk. The *spot rand desk* and the *spot rand trader* are usually the focal point of rand activity in the trading room. The rand's spot trader will make use of several specialised tools to perform his duties: information feeds, technical analysis tools, automated trading terminals, voice broker boxes and sophisticated telephone systems. What is important for the Commission's purposes is the information feeds. Reuters and Bloombergs are two of the main suppliers of live feeds of financial information to traders. The Reuters and Bloomberg information feeds also provide pricing models for various forex products as part of their service.

2.4 Treasuries are required to be profitable. The set-up costs and running costs of a treasury are very high and require a substantial amount of income just to break even. The activities of a treasury involve high risk and therefore a high return is required. Banking regulation requires that capital be set aside to underpin the risks arising from the treasury. For an active treasury this capital requirement can be substantial and a satisfactory return is required on the capital. All traders are remunerated through incentive structures. These are based on performance exceeding budget and can be very substantial for successful traders.

3 Trading activities are managed by setting various limits and monitoring compliance with those limits very closely. Non-compliance is not tolerated and repeated non-compliance is a dismissible offence. The

types of limits are counter party limits, which represent the maximum exposure to a particular counter party or group of related counter parties; exposure limits, which represent maximum exposure to particular market rates (exchange rates, interest rates, etc); and stock loss limits, which represent a maximum loss that a particular deal or strategy may incur before it must be closed out. These are normally set per trader and per day and per month.

4 The factors which affect a trader's views will be the results of market research conducted by the bank at which the trader works or an independent research institute, global and domestic events, political and social conditions, fiscal and monetary policy and rumours. Traders consider all those factors and sources of information and form a view on the very short, and medium term direction of the rand. A trader will then translate this view into a trading strategy designed to generate income and will implement the strategy within the limits available.

5 Mr Langley described in evidence how quickly and on what sparce information a trader will deal in the rand. He testified that a spot trader will react to a headline on the Reuters screen first before he actually reads the story. "He is not interested in the story, he is interested in the headline, because he has not got time to read the story." He took the example of the (incorrect) headline "Trevor Manuel resigns" and said that "…

again it would be a negative connotation for South Africa, therefore the trader would go automatically into the spot market and buy dollars [and] when you buy dollars you will automatically sell rand." He testified that all the banks are subscribed to Reuters. In the life of a trader, it is all a question of getting the information first. "…A trader wants that news, because that is his lifeline … and he wants it first, because he does not want to be second." If a trader is second he loses. "From a trader's point of view you want to be the first one, you want to be the first one to react, you want to be the first one to be out of the blocks there to actually take advantage of that news …" Mr Langley said that the trader must make a decision and he has to make the decision as the news comes out. He has seconds to make the decision. Five minutes would be too long to make a decision.[1]

[1] Part F is based on the evidence of Mr M Langley, former Head of Foreign Exchange, Credit Agricole Indosuez, Johannesburg, Expert Bundle 131-143; Record 188-206

G Ethics of forex dealers

1 The forex market is a decentralised market which is not regulated per se as a market. The market place has nevertheless developed its own norms of behaviour. The Association Cambiste Internationale ("ACI") was founded in Paris in 1955. It has 25 000 members in 83 countries. The ACI is an association of forex dealers which has adopted an international code of conduct and practice for the financial markets known as the Model Code. The Model Code should be adopted by each forex community in each centre where forex is traded. The ACI has no power of enforcement. The crisis of 1998 (referred to by some witnesses as the "Asian contagion" crisis) led to calls for a "new international financial architecture". The response of the G7 nations was to create the Financial Stability Forum ("FSF"). The FSF took up three themes, one of which was highly leveraged institutions (HLI's), including hedge funds, and created three working groups to consider the themes.

2 The FSF working group on HLI's commissioned a study on the effect of HLI's on small and medium sized economies in 1998. Mr McCauley was the BIS representative on the study group. The study group visited Australia, Hong Kong, Malaysia, New York, New Zealand, Singapore

and South Africa. The study group heard reports of aggressive trading practices such as trading at quiet hours in order to affect an exchange rate; the practice of the "double play" in Hong Kong involving both an attack on the exchange rate (leading to higher interest rates) in conjunction with taking a short position in equities; and there was evidence of "talking your book": the practice of a large financial institution which takes up a position and then instructs its economist to write an analysis that supports the position. Following on its research, the study group, in collaboration with major commercial and investment banks, drew up a set of guidelines. The guidelines were discussed and endorsed by the bodies responsible for forex market standards in the main financial centres such as London, New York, Singapore and Hong Kong. The guidelines are known as the Trading Principles. The principles which are of a particular interest to the Commission are the following:

"2 Foreign exchange managers have a particular responsibility in the execution of orders at volatile times. Intermediaries should take care to discuss with customers the risks of operating in these environments and the possible scrutiny of actions. Market makers may reserve the right to refuse customer transactions that they feel may further disrupt or have the intent to disrupt the market.

4 The handling of customer orders require standards that strive for best execution for the customer in accordance with such order subject to market conditions. In particular, caution should be taken so that customers' interests are not exploited when financial intermediaries trade for their own accounts (eg "front running").

5 Institutions and other trading organisations should be attentive at all times to ensure the independence and integrity of any market related research that they publish.

6 Financial intermediaries are encouraged to implement rigorous internal guidelines concerning the handling of rumours and possible false information. We strongly endorse the Model Code that dealers should not relay information they know is false or they suspect may be inaccurate.

7 Manipulative practices by banks with each other or with clients constitute unacceptable trading behaviour."

Included in the financial institutions which accept the Trading Principles are JP Morgan Chase, Goldman Sachs, Barclays, Citibank, Deutsche Bank, HSBC and Standard Bank of South Africa.

3 The Model Code makes recommendations, for example, in regard to:

- gifts: management should monitor gifts given or received by forex dealers and set a clear policy;
- gambling: gambling or betting among market participants should be strongly discouraged;
- managers must set clear written rules governing personal account trading;
- confidentiality: "dealers and brokers share responsibility for maintaining confidentiality and without explicit permission from the parties involved should not disclose or discuss any information relating to deals transacted or in the process of being transacted";
- misinformation and rumours: "dealers and brokers should not relay any information which they know to be false and should take great care when discussing unsubstantiated information which they suspect to be inaccurate and which could be damaging to a third party".[1]

4 ACI South Africa has members in thirty organisations, mainly authorised dealers and licenced broking houses. Those thirty organisations employ about four hundred and fifty forex dealers, three

[1] Paragraphs 1 – 3 are based on the evidence of McCauley: Record 30-40

hundred of whom are ACI South Africa members. The Model Code is endorsed by ACI South Africa and forms part of the examination programme that ACI SA provides. Since 1988 more than five hundred trade dealers, brokers and support staff have attended ACI SA workshops. Procedures for breaches of the Model Code are:

- consultations with transgressors before the ACI SA Executive Committee;
- if the dispute is not resolved there, the transgressor's employer is consulted;
- the Reserve Bank is informed of the breach. The forex market in South Africa is nevertheless unregulated. Market participants impose a form of self-regulation by holding themselves bound to the Model Code. During the past eight years only one member has been reported to ACI SA for breaching the Model Code. The trader concerned was dismissed by his employer.

5 Mr Langley[2] testified that unethical behaviour occurs amongst forex traders in South Africa in these respects:-

2 The evidence of Mr M Langley, former Head of Foreign Exchange, Credit Agricole Indosuez, Johannesburg, Expert Bundle 143, Record 209-215

- If the forex market is quiet, a trader wishing to generate volatility starts a rumour to elicit a reaction. The trader does so by "making a story or re-hashing something".
- Two traders at different banks collude in an attempt to manipulate the rand in one direction or another.
- Trades can be done and then cancelled between two traders at different banks in order to create the perception of actual trade at a particular rate.

- Banks that are known to be very large or act as transactors attempt to disguise their activity by asking another bank to execute parts of the trade on their behalf. In reply to a question by a Commissioner about the extent of unethical behaviour, Mr Langley said that: "It usually happens when it is quiet….When it is volatile, you don't even have time to get involved in this nonsense…when it is extremely volatile, you don't have time for this nonsense. [In times of volatility] …you actually want the phone to stop ringing. You actually want the thing to stop. You actually pray for a quiet day." He further gave evidence that it is "very, very difficult to actually prove that somebody has been unethical unless it is blatantly obvious"; unethical behaviour is limited; there are a number of banks that do not tolerate any unprofessional behaviour at all; and forex traders "are supposed to trade in an ethical and professional manner at all times".

6 The president of ACI South Africa, Mr Gibbs, testified that, to the extent that Mr Langley's evidence slanted the forex industry as a whole, he wished to defend the integrity of the industry. In the experience of ACI South Africa, breaches of the Model Code are "few and far between" and its members are generally "outstanding citizens".[3]

7 Mr De Villiers[4] gave evidence that the ACI of South Africa has accepted the Model Code and that the "governing authorities and regulators, are in the process of considering whether to do so." In his view, forex traders "should adhere to things that are lawful, honest, that [do] not breach any client confidentiality and that you do not lead your client astray". Starting unsubstantiated rumours in the forex market would be highly unprofessional. Collusion between dealers, of the kind described by Mr Langley, in order to have an impact on a currency would need to take place consistently throughout the day. Collusion of that magnitude would leave an audit trail, which should be picked up and queried.

---

3 §s 4 & 6 are based on the evidence of Mr R Gibbs, the President of ACI South Africa, ACI Bundle 1-7; Record 1402-1407

4 Evidence of Mr P de Villiers, Global Head of Foreign Exchange Trading, Investec Group, Record 374-378

8 Mr Balt[5] said that he considered that the following transactions could be considered to be unethical:

- any transaction that runs contrary to the spirit of exchange control rules, ie one that unduly and negatively affects the foreign reserves of the country;
- front running, ie the placement of personal orders by a member of an exchange in advance of client or institutional orders, with the foreknowledge that a movement in price may occur from a large trade;
- breaches of confidentiality falling short of insider trading;
- price manipulation through rumour mongering;
- spreading rumours deliberately to trigger market "stock losses";[6] and
- "position parking".[7]

[5] Statement of Balt, Group Treasurer, Absa Bank, Absa Bundle 15.1-15.2

[6] "Stock losses" may be described as an order where a trade is to be executed if the instrument price hits a specified limit. In the case of a long position, the instrument is to be sold if the price falls below a stipulated level, and conversely, in the case of a short position, the instrument is to be bought if the price rises above a stipulated level. Stop-loss orders are put in place to limit losses to a pre-determined amount.

[7] "Position parking" may be described as the practice whereby two contract parties agree a deal, usually on the understanding that the contract will be reversed at a specified later date, at or near the original contract rate irrespective of the interim market rate change. The consequence of such an agreement is that for a period of time the obligations of an institution are excluded from its books of account and from management or regulatory oversight.

9 In the Questionnaire,[8] the authorised dealers were posed the following questions:-

"4.5.1 What ethical standards are applied in the conduct of your foreign exchange activities? Are these documented? By whom were they drafted? Do they differ in any significant manner from the ACI Financial Markets Associations Code of Conduct?

4.5.2 What policies and procedures are followed in order to ensure compliance with these ethical standards?

4.5.3 During the period under investigation, were there any breaches of these ethical standards that you are aware of? Please supply details if applicable."

10 The response of the major authorised dealers to those questions was in short the following:-

10.1 <u>Absa</u>

Absa staff members are required to sign a declaration to the effect that they subscribe and adhere to the Model Code, together with

---

8 The questionnaire submitted by Deloitte & Touche to the authorised dealers: see <u>Part K</u> and <u>DT report p23</u>

Absa's Personal Account Trading policy and that they have familiarised themselves with the contents thereof.

The corporate finance department maintains a list of companies for whom deals have been executed which may have an influence on those companies' share prices. During regular departmental meetings those names are communicated to all staff members who are involved or have knowledge of the relevant deals. Staff members are prohibited from trading in those companies' securities for their personal account.

Absa employees are required to maintain a register of their personal account portfolios. The registers are provided to the decentralised compliance officer on a monthly basis. The compliance officer provides the Absa Group Compliance Officer with the information quarterly. Trends are reported to the Absa Group Audit and Compliance Committee.

Breaches, being a deviation from Absa policy, are regarded as misconduct. Absa's disciplinary process will be instituted against any employee guilty of such misconduct. Based on the monthly returns received for the period under review, there were no breaches of those ethical standards.[9]

9 Evidence of Ms R Potgieter, Head: Compliance and Operational Risk of Absa Corporate and Merchant Bank, a division of Absa Bank Limited, Absa Bundle 67-68

10.2 Nedcor

The ethical standard applied in the conduct of the bank's foreign exchange activities is the Model Code, which forms an integral part of the policies and procedures documented by the risk management area. One of the policies provides: "All dealers must be conversant with the Code of Conduct of the ACI and must at all times conduct themselves in accordance with this Code of Conduct." In addition to the ethical standards contained in the Model Code, the bank has formulated additional and more detailed ethical standards contained in more than eighty policy documents.

There are many specific policies and procedures in place to ensure compliance. Examples are:

- an internal induction process;
- annual competency tests;
- there is limited access to the dealing room via security cards;
- no mobile telephones are permitted in the dealing room;
- all telephone calls to and from the dealing room are recorded;
- security videos monitor the dealing room;

- there are procedures in place to prevent the destruction of video and telephone recordings;
- there is daily monitoring of the dealers by controllers and managers.

Any known contraventions of policies and procedures will lead to disciplinary action in accordance with the bank's disciplinary procedure. The bank has a policy of zero tolerance towards crime. It is the policy of the bank to identify and properly investigate any possibility of irregularities against and within the bank and, when appropriate, to pursue disciplinary action, as well as employ civil and criminal legal remedies available under the law to ensure that the bank maintains a culture of "zero tolerance" towards crime.

There were no material breaches of policies and procedures relevant to the terms of reference of the Commission for the period under investigation.[10]

10.3 NIB

The Model Code has been accepted as the ethical standard for NIB treasury. All forex dealers are ACI members and have

10 Evidence of Parker, Nedcor Bundle 14-17

formally accepted the Model Code. The Model Code and certain additional internal requirements have been incorporated into the NIB policies and procedures manual.

The policies and procedures in the manual are monitored on a regular basis by chief dealers, heads of departments and the treasurer. The independent risk and compliance function monitors compliance on an ongoing basis. The bank is subject to regular internal and external audits as well as regulatory inspection. All complaints of unethical behaviour by personnel are investigated promptly and in depth. Similar measures as those implemented by Nedcor (see §10.2 above) have been implemented at NIB.

As far as the bank is aware there were no breaches of ethical standards relevant to the terms of reference of the Commission of the period under investigation.[11]

10.4 FirstRand Bank

All the bank's trading activities are housed within Rand Merchant Bank ("RMB"), a division of the bank. RMB's Code of Conduct does not differ in any significant way from the Model Code. RMB's code of conduct applies to all employees of RMB, and where adherence to the Code is required in terms of their

---

[11] Evidence of Lane, NIB Bundle 17-19

employment, to employees of other members of the Group. In addition, the market risk management framework of the bank applies to all trading activities. The framework prohibits unethical or illegal practices.

Every employee is bound by RMB's Code of Conduct insofar as it forms part of his or her employment contract. Each employee is required to sign an employee declaration pertaining to the Code of Conduct. Compliance officers in each division of the bank are required to monitor adherence to all compliance-related issues and procedures and to report any non-compliance to the RMB Compliance Officer. A data base to record events of non-compliance has been established and a compliance training programme is in the process of being rolled out.

A member of staff was reported to the Reserve Bank for a contravention of exchange controls. Save for that one incident, there were no other breaches of RMB's ethical standards that it is aware of during the period under investigation.[12]

10.5 Investec

Investec applies general standards of integrity, honesty, lawfulness and client confidentiality in its forex activities.

[12] Evidence of Bester, FirstRand Bundle 8-9

Investec has a published Code of Conduct, which is not specific to forex activities. Investec's application of the standards of conduct in the Code of Conduct is not in conflict with the Model Code.

Processes and controls to ensure compliance with ethical standards were documented some time ago by external auditors. Reliance is primarily placed on ensuring proper segregation of duties. The bank's board audit committee will ensure compliance with ethical standards, processes and procedures.

The bank is not aware of any breach of ethical standards during the period under investigation.[13]

10.6 BoE

All business activities of the BoE Group, including the bank's foreign exchange activities, are governed by the Group's Code of Ethics ("the Code"). In terms of that Code all staff are required to "conduct themselves in a professional manner and according to the highest standard of conduct and ethics". The Group's philosophy is stated to be "to conduct our affairs with uncompromising honesty, integrity, diligence and professionalism."

---

13 Evidence of De Villiers, Investec Bundle 33

All of the Group's staff, including staff involved in forex transactions, are obliged to sign a copy of the Code acknowledging that they have read and understood it upon obtaining employment with any division of the Group.

The Code and all other ethical standards that the staff of BoE are required to follow are enforced through the Group risk management and Group compliance frameworks.

To the knowledge of the bank there were no breaches of the Code by any staff involved in forex dealing during the period January 2001 to December 2001.[14]

10.7 Citibank

Citibank subscribes to the Model Code and its forex dealers adopt the Model Code. The bank complies with its own internal standards and procedures described in two documents, the Statement and the Handbook.

All new bank employees undergo induction training, which covers the Citi Group ethical standards of personal and professional integrity on all aspects of the employment relationship with Citibank. New employees acknowledge receipt in writing of the Statement.

---

14 Evidence of Little, BoE Bundle 5, 29

The following measures are also employed:

- compliance grids are signed off on a regular basis to ensure awareness of and compliance with ethical standards;
- all deals done during the day are reviewed by comparing the rate at which transactions were dealt against rates prevailing in the market at the time of transacting;
- deals are flagged if they do not fall within market rates and are reviewed independently;
- all telephone conversations held within the dealing room are recorded;
- all Reuters conversations are printed and all conversations resulting in a transaction are retained;
- the bank is a signatory to the Financial Stability Forum's Trading Principles, which have been incorporated into the bank's guidelines and Codes of Conduct.[15]

10.8 JP Morgan

15 Evidence of Scott, Citibank Bundle 25-26

The ethical and general standards required to be followed by the bank's employees during 2001 were set out in Chase's Code of Conduct, which incorporates trading and investment guidelines, Chase and Morgan's Worldwide Rules and their respective compliance manuals (collectively called the "Chase Code"). The Chase Code sets out broadly similar standards of conduct to those contained in the Model Code.

Every employee is obliged to comply with the Chase Code and with all relevant laws, regulations and internal policies. Regular compliance training is conducted by the compliance function of the bank. All the bank's traders are subject to the Chase Code which is rigorously enforced. Employees who breach the Chase Code are disciplined.

The bank is unaware of any breaches of the Chase Code at the bank during 2001.[16]

10.9 <u>Deutsche Bank ("DBJ")</u>

DBJ has a procedures manual for forex dealing which was drawn up by the compliance department. The procedures manual aims to ensure ethical standards and provides for all other aspects of forex trading on behalf of DBJ. DBJ subscribes to the Model Code.

---

16 Evidence of Coulter <u>JP Morgan Bundle 18-19</u>

DBJ is not aware of any breaches of those ethical standards during the period under investigation.[17]

10.10 SCMB

In addition to the regulatory framework, SCMB subscribes to the Model Code. SCMB also adheres to more general principles of good banking practice, such as customer confidentiality and avoidance of conflict of interest, some of which are documented in the Standard Bank Code of Business Ethics. SBSA's internal audit and compliance functions monitor adherence to law, regulations and internal policies. The procedures implemented by SCMB in order to ensure compliance with policy, include the following:

- upon entering the service of SCMB, each employee is required to sign an agreement, which includes an undertaking to maintain confidentiality in respect of customer information. In terms of SCMB's disciplinary code, disclosure of confidential customer information may result in dismissal;
- nominated employees who have access to confidential information or who may be in a position of conflict of

[17] Evidence of Mr NG Morrison, Managing Director of DBJ, Deutsche Bank Bundle 8-9

interest are required to sign a policy document dealing with personal account trading.

70% of SCMB's foreign exchange dealers are members of the ACI and have been involved in many workshops and discussions on the subject. Senior staff members of SCMB lecture the subject to junior dealers internally and externally at the invitation of ACI. SBCA has a policy of training its own dealers and junior staff members are given on-the-job training and are regularly subjected to internal exams. There is also a mentor/mentee programme in terms of which all junior and middle management staff participate.

Back office payments, confirmations and reporting procedures are segregated operations with a different reporting structure, as is the case with the general risk management principles operating in SBSA.

SCMB is not aware of any breaches of the Model Code or the principles contained in its Code of Business Ethics during 2001.

11 In the replies to Deloitte & Touche, most of the authorised dealers said that they do subscribe to the Model Code. Those that do not, have internal codes of conduct that do not differ significantly from the Model Code. Authorised dealers indicated that they have internal control

frameworks designed to identify, inter alia, breaches in ethical conduct. Breaches of the codes of conduct to which they subscribe are infrequent and are met with disciplinary action and possible dismissal. There were no breaches of any codes of conduct material to the Terms of Reference of the Commission during 2001.[18]

[18] Report of the DT team p 23

H The impact of the depreciation of the rand on the South African banking industry

1 Mr Tucker, the chief executive officer of the Banking Council of South Africa, gave evidence on behalf of the Banking Council. The council represents 43 of the 56 banks and branches of foreign banks registered in South Africa:-[1]

1.1 The rapid decline in the value of the rand would have had both positive and negative consequences for each of the banks. While it is possible that some banks derived a net benefit from the depreciation of the rand during the last quarter of 2001, the depreciation of the rand had a severe negative impact on the banking industry as a whole.

1.2 The six major South African banks' figures were aggregated for the purposes of this analysis:-

1.2.1 The higher volatility and wider spreads of the last quarter of 2001, and especially in December 2001, gave rise to higher revenues on foreign exchange dealings than for the remainder of the year. As a result, the average monthly gross revenues of the foreign exchange trading operations were R148 million per month for the first nine months and R288 million per month for the last three months of 2001.

[1] Evidence of Mr RSR Tucker, Record 744-761

The actual forex revenues for the last quarter were R212 million for October, R189 million for November and R461 million for December. Those gross revenues exclude all costs such as IT costs, telecommunication costs, staff costs and the cost of capital.

1.2.2 The same factors that led to higher foreign exchange revenues during the last quarter also led to losses on the fixed income trading desk, that is the desk which trades in interest derivatives of instruments and in bonds. Downward pressure on the value of a currency almost invariably leads to high interest rates and lower bond values. So as the rand depreciated, the margins spread and there was higher volatility. Those very factors gave rise to pressure on the interest derivatives and bond markets, which led to losses.

1.2.3 The average monthly revenue of the six banks from forex and fixed income trading, if the two desks are aggregated, for the first nine months of 2001 was R253 million and for the last quarter of 2001 was R261 million. In other words, during the last quarter of 2001 the six largest banks earned an average of only R8 million more revenue per month from trading in foreign exchange, interest derivatives and bonds than they did in the first nine months of the year. That amounts to an R3.3% increase on the average revenues for the first nine months.

1.2.4 Those revenues must be measured as a percentage or against a US dollar/rand turnover of approximately USD8 billion a day or USD160 billion a month. If one takes the revenue of R148 million a month, which was the average revenue for the first nine months, that represents less than 0.01% of that turnover. If one takes the average for the last quarter of R288 million per month, that represents 0.016 of a percent of the actual turnover in the market.

1.2.5 Another comparison is that between revenues on foreign exchange trading and the banks' total revenues. The revenue earned by the six major banks on forex trading compared with the total revenue of the banks, net of interest expenses, represents 4.2% for the first nine months, 4.8% for October, 4.5% for November and 8.3% for December 2001.

1.2.6 Another way of looking at the impact of the depreciation of the rand is on the share price of the major banks. If it had appeared to the market that banks would be able to generate higher returns from a rapid decline in the rand their share prices would have increased in the last quarter of 2001 to reflect the increased earnings potential. The share prices of the six major banks, however, tended to move lower. For example, Stanbic's share price was just under R35 at the end of the second quarter of 2001 and by the end of the fourth quarter, the price was down to R31. Investec's share price was R250 in the second quarter and down to R160 in the fourth quarter. The share prices of the six major banks were below that of the all share index. For example, in the fourth quarter the all share index ran up significantly from an index of just on 100 to an index of just below 130. The bulk of the banks' index was between 63 and 88.

1.2.7 In July 2001, The Banker, a leading financial services publication, surveyed leading banks internationally and produced a list of the top 1000 institutions. The Banker produced a table showing the comparative of the major South African banks in July 2001 and the same again in January 2002. Stanbic started of at 146 and is down to 199; Nedcor started off at 158 and is down to 219; and BoE started at 455 and is down to 565. The South African banks were probably ranked lower because the effect of the weaker rand was felt in two ways: they would enjoy reduced access to and higher cost of credit internationally and lower trading volumes and smaller positions in dealings with off-shore counter parties.

1.2.8 Capital requirements. One of the requirements imposed upon banks around the world is that they are obliged to hold capital in a certain ratio to the value of their risk assets. In South Africa the minimum capital requirement is 10%. Between January 2001 and January 2002 the aggregate trading book capital requirement of the four major banks had increased by R2.7 billion principally as result of increased amounts owing by counter parties following the rand depreciation. The cost of the additional capital to the banking industry amounts to about R51.3 million per annum.

1.2.9 Certain expenses incurred by the banks, most notably IT costs, are set in US dollars. Banks are heavily reliant on technology and IT costs comprise a significant portion of expenditure. According to data provided by the six major banks, the banks anticipate an increase of R160 million that is 9% of budgeted expenditure, for every R1 increase in the price of the US dollar. The movement from R9 to

R11.15 to the dollar therefore means an additional cost to the banks of R480 million per annum.

1.2.10 <u>Capital held by foreign banks</u>

Foreign banks doing business in South Africa are required to hold capital in South Africa to support their domestic operations. The current capital requirement is R250 million or 10% of the adjusted risk assets, whichever is the greater. In January 2001 the rand value of the capital was R2.3 billion. In January 2002 the rand value was R3.1 billion. Accounting standards may under certain circumstances require the foreign banks to reflect their translation losses in their domestic financial statements. If all of the R2.9 billion held by foreign banks in June 2001 were unhedged, the foreign banks collectively would have reflected a translation loss for that period of about R928 billion in their reporting currencies. If they had hedged, the banks would have incurred hedging costs. On an index of 100 in June 2001, by January 2002, the dollar index was down to 69, the pound was down to 68 and the Euro was down to 67. Depending on the domestic currency of the bank which is holding capital in South Africa, that is the level of depreciation that it would have suffered on the rand capital that it has to hold.

1.2.11 Share prices and foreign investment

At present about 6% of the share capital in South Africa's major banks is held by foreign investors. The depreciation of the rand has not been good for those foreign shareholders or for the prospects of attracting additional foreign investors. On an index of 100 in the fourth quarter of 2000 compared with the fourth quarter of 2001, five of the six major banks are on a range somewhere between 38 and 64. That is an indication of the sort of loss in their domestic currency that foreign shareholders would suffer if they realised their share in South African banks.

1.2.12 Bad debts and provisioning

There are two ways in which depreciation of the rand leads to an increase in bad debts for South African banks:-

- imported products may no longer be affordable in the South African economy. The importers of those products will face difficulties or go out of business and the South African banks face a credit risk exposure to those importers which they have financed;

- the increase in the interest rate by the Reserve Bank of 1% in January 2002 results in an increase in all interest rates; that placed additional pressures on borrowers and is likely to result in an increase in bad debts within the banks.

1.2.13 Increased cost of international expansion

In order to better serve their local and international clients, South African banks have been expanding their operations in Africa and other major financial centres. This has now become less viable and more costly as such acquisitions are normally paid for in hard currency.

2 The major banks gave oral evidence before the Commission about the impact of the depreciation of the rand in 2001 on their operations:-

2.1 Absa Bank Ltd ("Absa")

The rapid depreciation of the rand mainly had a negative affect on Absa's treasury operations. The impact on profitability was mixed. Gains were made on the foreign exchange and gold and currency options desks. By contrast, the interest rate derivatives and local and off-shore funding desks were negatively affected by sharp decline in liquidity.

As a whole, the treasury was adversely affected by the risk to credit lines, as these lines are set within institutional and country risk parameters. Although dollar denominated, these are set with reference to Absa's rand based balance sheet. The capacity of these lines was exceeded in rand terms despite the fact that there was still dollar denominated capacity available. This limited the ability of Absa to service normal client needs over the relevant period. Foreign credit lines with Absa were also at risk of being reduced due to the relatively smaller balance sheet in dollar terms.

The value at risk parameters were also exceeded and operational stability was compromised. During December 2001 the capital market yields became unstable, which had a direct impact on liquidity in the market. Absa's ability to issue longer term instruments was accordingly curtailed.

Capital adequacy ratios decreased due to the negative impact of the rand on Absa's balance sheet.[2]

2.2 <u>Nedcor Bank Ltd ("Nedcor Bank")</u>

The material impact the depreciation of the rand had on Nedcor Bank was:

- profitability: unexpected gains on foreign assets and earnings, plus trading opportunities in a volatile market;

[2] Evidence of Mr PJB Balt, Group Treasurer, Absa Bank Ltd, <u>Absa Bundle 11</u>

- shareholder value: the value of foreign assets and profits increased in rand terms;
- capital adequacy improved due to the higher value of off-shore assets;
- Nedcor Ltd will experience difficulty in attracting or maintaining foreign investors because of a drop in the value of the shares when converted to foreign currency.[3]

2.3 Nedcor Investment Bank Ltd ("NIB")

The broad impact of the depreciation of the rand on NIB was:

- the weakening currency resulted in a reduction in the value of NIB's balance sheet relative to the US dollar based off-shore balance sheets of international banks;
- NIB needs to protect the US dollar equivalent of its balance sheet in relative and absolute terms given the increasing demand of accessing international capital markets by South African banks: this has now become more difficult for NIB as result of the weakening rand;
- NIB generated profits from the declining rand, although the profits were not excessive;

[3] Evidence of Mr M S Parker, Executive General Manager, Treasury, Nedcor Bank, Nedcor Bundle 22

- NIB also benefited in rand-terms due to the translation gains made on its foreign currency earnings.[4]

2.4 FirstRand Bank Ltd ("FirstRand")

The bank earned high income from trading margins in foreign currency transactions with customers as a result of increased customer activity and increased volatility in the foreign exchange markets. This increase in profitability will most likely be countered at a later stage by lower income because overall customer volumes would still be constrained over time by what is allowed within Exchange Control Rulings.

Foreign currency liabilities on the balance sheet will be re-valued at higher rand values, thus resulting in an increased requirement for the bank to hold liquid assets and cash reserves in terms of the Banks Act. Liabilities are increased by the increase in counter-party exposures due to mark-to-market revaluation. This would increase costs and lead to lower profits because of higher costs of maintaining a higher level of cash reserves in respect of which the bank earns no interest. It is also likely that the bank will incur higher cost to hold a higher level of liquid assets.

4 Evidence of Mr P Lane, Executive Director of NIB with responsibility for the NIB Treasury Division, NIB Bundle 22

The bank's net asset value in rand terms has increased by the extent to which it has capital held in foreign currency to support its offshore activities.

The rapid depreciation in the rand has reduced the net open position that the bank may hold in foreign currency. This will impact negatively on its business as a market maker thus affecting its ability to service its customers, as well as potential profits.

Existing foreign currency exposures to its customers will have a higher rand value following the rapid depreciation of the rand without a concomitant increase in income. In future, the bank might be forced to reduce foreign currency exposures as measured in foreign currency on its customers whose balance sheets are denominated in rand.

Most of the bank's systems technology and software expenditure is effectively priced in foreign currencies. The depreciation of the rand will increase those costs substantially over time, resulting in higher banking charges in a developing market, which can hardly afford it.

All assets in foreign currency where the bank is exposed to potential losses, should counterparties not honour their obligations, have been re-valued at the depreciated levels because of the depreciation of the rand, resulting in higher asset or exposure values in rand terms. As a result, the bank has to hold higher capital in terms of the Banks Act against its assets, which have been re-valued upwards in rand terms. Higher capital requirements result in a lower return on capital, because the same income relates to a greater amount of capital.

The rapid depreciation of the rand has resulted in a reduction of the Group's net asset value, as expressed in dollars, by about 30% compared to its international competitors.[5]

2.5 <u>Investec Bank Ltd ("Investec")</u>

The rapid depreciation of the rand had an overall negative impact on Investec and was the cause of great concern to management and staff.

Given the broad spread of businesses within Investec Group Limited in a variety of different jurisdictions, overall profitability was little impacted by the exchange rate movement.

The impact of the depreciation of a currency on rand liquidity was limited, although adverse interest rate perceptions caused depositors to tend to place funds at the short end of the market. There was an additional detrimental impact on Investec, given that the unanticipated deterioration in the value of its positions

[5] Evidence of Mr JJH Bester, Head of Risk and Audit Services for FirstRand, <u>FirstRand Bundle 9-12</u>

caused an increase in the funding of US dollar margins given as collateral to a number of counterparties with whom the bank had entered into ISDA credit support annexes.

The bank's operational stability was not affected in any material way by the rand's rapid fall.

The Group's capital adequacy was not materially affected, although there was a sharp increase in trading capital required to conduct its foreign currency operations.

In the short term, shareholders' value may have been enhanced by the increase in Investec's reserves due to the revaluation of the Group's off-shore assets, but in the longer term shareholder value may well be impaired in that a volatile and generally weakening currency deters foreign investors from direct investment and from investing in its equities and bonds. This in turn reduced liquidity in South Africa's various financial markets.[6]

2.6 Citibank N.A. ("Citibank")

The impact on the Johannesburg branch of Citibank ("Citibank SA") and Citibank was negative. The depreciation of the rand is in future expected to reduce US dollars equivalent revenues in particular from Citibank SA's account services, payments and

6 Evidence of Mr RPMA Forlee, Head of the South African Treasury and Financial Markets Operations at Investec, Investec Bundle 10-11

collections and asset-based finance business. Since Citibank SA consolidates its financials in the United States of America, the depreciation of the rand has served to diminish the value in US dollars on rand-based revenues. Citibank SA's capital adequacy was negatively affected by the rand's depreciation. Its capital is received in US dollars and converted to rand and is therefore now worth less than it would have been had the rand not depreciated. Any diminution of Citibank SA's capital base impact negatively upon its parent company, Citibank. The depreciation of the rand affected the administration of Citibank SA in that it set-off pre-existing internal protocols and procedures, provoking reviews of portfolios, thereby increasing the administrative burden on the organisation. Citibank SA did generate profits due to the depreciation of the rand. However, those profits were not excessive as profitability for the forex desk for the year was approximately 6.7% above budget. Gains in respect of forex trading were set-off by losses relating to the depreciation of the rand, such as losses in respect of interest rate products.[7]

[7] Evidence of Mr I Scott, Head of Foreign Exchange Trading, Citibank SA, Citibank Bundle 27

2.7 JP Morgan Chase Bank ("JP Morgan")

The consequences of the depreciation of the rand for the Johannesburg Branch of JP Morgan were that the rand denominated revenue declined in real terms when reported in US dollars and thereby negatively affected shareholder value. This was off-set to some extent by the fact that about 65% of the Johannesburg offices' cost were denominated in rand. The notional value of trades by the Johannesburg Branch in rand terms required to generate US dollar returns similar to those obtained prior to the depreciation increased. In the ordinary course this would have required further endowment capital to be injected into the bank from off-shore for capital adequacy purposes. However, this was off-set by the lower trading volumes occasioned by the illiquidity in the market. [8]

2.8 Deutsche Bank ("DBJ")

The rapid depreciation of the rand did not benefit DBJ. For 2001, nearly all its revenues were in rands whereas 19% of its expenses were incurred in euros and GBP. The weakening of the rand therefore negatively impacted DBJ's profits generated in South Africa. In euro terms, with the rapid depreciation of the rand, the

[8] Evidence of Mr JJ Coulter, Managing Director, Head of Investment Banking and CEO of JP Morgan, JP Morgan Bundle 20

capital which the Deutsche Group has invested in South Africa has been significantly reduced in value. The capital adequacy ratio of DBJ has also reduced because the weakening rand increased exposure on certain transactions, therefore requiring that additional capital be placed against those positions.[9]

2.9 Standard Bank group

The impact on the Standard Bank group of the depreciation of the rand in 2001 was the following:-

(1) Overall profitability

A weaker rand impacts negatively on general consumer and business confidence and consequently on expenditure. This has a negative impact on the lending growth and hence profitability of Standard Bank of South Africa Limited ("SBSA").

The weakening of the rand increases the cost of imports for most business customers of SBSA; this impacts negatively on profitability and in certain cases on the solvency of customers. This will undoubtedly increase bad debts during the next twelve months.

9 Evidence of Morrison, Deutsche Bank Bundle 11

The increased expenditure on information technology and communication due to the depreciation of the rand will reduce the overall profitability of SBSA.

The factors mentioned above will, over time, far outweigh any short term increase in foreign exchange trading profits caused by the volatility of the rand.

(2) Growth strategy

The decline in the rand significantly increases the cost of expansion of the Standard Bank group's activities in Africa and other emerging markets such as Brazil and Russia. The consideration payable for acquisitions and expansion of infrastructure, which is largely US dollar denominated, will significantly increase.

(3) Capital adequacy

The trading book capital requirement increased from about R1.5 billion at the end of November 2001 to peak just below R3 billion in December 2001. SBSA's board of directors was asked in late December 2001 to approve an increase in allocation to R4 billion for the trading book. This reduced the availability of capital in other areas of the bank and caused strains in meeting prudential requirements for capital adequacy for the bank as a whole at that time.

(4) Capital raising and shareholder value

Foreign shareholders currently account for about 10% of the Standard Bank Investment Corporation Limited ("SBIC") shareholder base by value. The returns which those foreign investors received from investing in SBIC shares declined substantially in 2001 as result of the weaker rand. The SBIC share price fell from 421 US cents per share in January 2001 to 263 US cents per share in December 2001, amounting to a reduction of 38% in US dollar terms.

(5) Sentiment

The decline in the rand had a negative impact on staff morale, particularly in the bank's international operations. The sentiment of foreign investors remain generally negative towards the South African banking sector as a whole, although sentiment has recently improved.

The Banker Survey of July 2001 ranked SBIC as 146 out of the top 1000 commercial banks worldwide. Based on the decline in the rand from July 2001 to December 2001, SBIC's ranking is estimated to have dropped to 203. This reduces the international standing of the Standard Bank Group and could impact on the future cost and ability of SBIC to raise foreign loans.[10]

3 The Deloitte & Touche team[11] investigated the forex profits of authorised dealers to determine whether the profits were disproportionate either with the industry as a whole or with historic profit performance as this could have indicated speculative activity outside the norm. The weighted average of the material authorised dealers indexed monthly profits was plotted against the monthly average of the daily-bid-offer spread. Spreads were fairly consistent until September 2001. Thereafter volatility increased with the spread peaking in December 2001. Profits were volatile over the year and peaked in December 2001. No individual material authorised dealer made profits that were out of line with either the average or all material authorised dealers or their own historic profit performance.

---

10 Evidence of Mr SP Ridley, Director: Finance and Operations of Standard Corporate and Merchant Bank ("SCMB"), Standard Bank Bundle 58-61

11 Evidence of Immelman, Part K, and Report of DT team 31-33

4

4.1 The authorised dealers were asked in the Questionnaire[12] to describe the broad impact that the rapid depreciation of the rand in 2001 had on their organisations. The responses of local banks and local branches of foreign banks were divergent. Whereas local banks were primarily concerned with the possible impact on interest rates and other domestic factors, local branches of foreign banks stressed the negative impact on their profitability when measured in the foreign currency in which they report. Local banks that report their earnings in a foreign currency were similarly affected.

4.2 The authorised dealers reported that there were some short-term positive effects, the most material of which were:

- many banks made large profits on their forex desks in the final quarter of 2001, which they attributed to their market making activities through a combination of wide spreads and high volumes;

[12] The Questionnaire prepared by Deloitte & Touche. See Part K and the evidence of Immelman DT Report 42-45

- many banks reported large foreign currency translation gains over that period that resulted from converting foreign assets into rand.

4.3 There were short-term negative effects as well. As result of rising bond yields – falling bond prices – banks with long bond trading books incurred losses. As the rand weakened, fears of interest rate increases reinforced the trend to sell bonds.

4.4 The consensus between the authorised dealers was that the overall effect of the depreciation of the rand was negative:-

- foreign currency denominated liabilities, restated in rand at the weaker exchange rate, resulted in the authorised dealers being required to hold larger cash and liquid asset reserves in terms of exchange control rules;
- the rapid depreciation of the rand reduced the net open position that authorised dealers are obliged to hold in terms of the Banks Act in equivalent foreign currency terms;
- the cost of imported infrastructure including IT systems increased;
- a depreciating rand resulted in a reduction in the capital and balance sheet structures of South African

authorised dealers as expressed in foreign currency terms;

- the cost of employing foreign experts increased;
- there was negative sentiment towards South Africa, which discouraged off-shore interest in investment opportunities;
- the view that the weakening of the rand was likely to prompt interest rate increases resulted in customers preferring to keep their funds in short-term deposits;
- increasing interest rates had an adverse effect on sentiment towards equities of companies in the banking sector;
- the decline in the value of the rand caused an increase in the margin collateral required where banks had entered into ISDA credit support annexures;
- additional risk management and administration costs were incurred;
- there was a negative effect on the morale of staff, who saw their purchasing power eroded in global terms and who might leave South Africa in order to earn valuable foreign currency, thus contributing to the critical skills shortage in the financial sector.

Part I: Exchange Control

Index

Table of annexures to Part I

I Exchange controls

[1] Introduction

1 A concise, but comprehensive, review of exchange controls in South Africa is contained in the statement (confirmed in evidence)[1] of Mr Bruce-Brand, general manager, the exchange control department ("Exchange Control") of the Reserve Bank. A copy is attached as Annexure "A" to Part I. Only matters of material interest to the Commission are dealt with below.

2 South Africa has had exchange controls since 1939. The applicable legislation at present is the Currency and Exchanges Act, 9 of 1933. Section 9(1) of that Act provides that "the [President] may make regulations in regard to any matter directly or indirectly relating to or affecting or having any bearing upon currency, banking or exchanges". The Exchange Control Regulations ("the Regulations") were promulgated in 1961 and are amended from time to time. The Minister of Finance issues Orders and Rules under the Regulations.

---

1 Bruce Brand, Bundle SARB (06) 3, Record 534

3 Exchange control policy is determined by the Minister of Finance. The application of the policy is refined in consultation with the Governors of the Reserve Bank. The Minister of Finance has delegated to the Governor, a Deputy-Governor, the general manager and various officials of Exchange Control the powers, functions and duties assigned to and imposed on the National Treasury under the Regulations. Exchange Control is responsible for the day-to-day administration of exchange control.

4 The Minister of Finance has appointed banks to act as authorised dealers in foreign exchange subject to conditions and within limits prescribed by Exchange Control. Authorised dealers are not the agents of Exchange Control but act on behalf of their customers.

5 Exchange Control has issued Exchange Control Rulings ("the Rulings") which contain administrative measures as well as the permissions, conditions and limits applicable to transactions in foreign exchange which may be taken by authorised dealers. The Rulings are amended from time to time by way of exchange control circulars ("the Circulars"). In 1990 the Exchange Control Manual ("the Manual") was issued by the Reserve Bank to assist authorised dealers. The Manual

serves as a general guideline and does not supersede the Regulations, Rulings, Circulars and so on.[2]

6 Applications for foreign exchange received by authorised dealers from their customers are dealt with by them if the applications fall within the parameters outlined in the Rulings without reference to Exchange Control. Applications by customers of the authorised dealers in foreign exchange which fall outside the scope of the Rulings must be referred to Exchange Control for adjudication.

7 The purpose of exchange control is:

- to ensure the repatriation into the South African banking system of all foreign currency acquired by residents of South Africa;
- to prevent the loss of such foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa;
- to effectively control the movement into and out of South Africa of financial and real assets while at the same time not interfering with the efficient operation of the commercial, industrial and financial systems of the country.

[2] The Regulations, Rulings and Circulars are collectively referred to in this report as "exchange control rules."

8 After 1994, the South African Government decided on a gradual approach to the elimination of exchange controls rather than a "big-bang" approach. A phased approached allowed Government more time to implement other policy changes in order to achieve the pre-conditions necessary for a successful abolition of exchange control.

9 Government decided that the logical sequencing for the liberalisation of exchange controls would be:-

(1) the abolition of exchange control on all current account transactions (ie import and export of goods and services);

(2) the abolition of exchange control on non-residents;

(3) gradually becoming more lenient in the approval of applications for direct foreign investment by South African corporates;

(4) allowing institutional investors to acquire foreign assets to diversify their total portfolio investment;

(5) a progressive relaxation of all other controls on resident individuals; and

(6) to release emigrants' blocked funds.

Steps (1) and (2) have been implemented, steps (3), (4) and (5) are in the process of implementation and step (6) has not yet "been looked at". [3] Dr Stals estimated that about 70% of the exchange controls that existed in 1979 have been removed.[4]

10 The exchange controls which still exist are analysed in the statement of Mr Bruce Brand. For the purposes of the Commission, these are the pertinent remaining exchange controls:-

(1) Corporates

Corporates are allowed, on application, to transfer up to R750 million from South Africa for each new and approved investment in Africa, provided a longer term benefit to South Africa can be demonstrated. In respect of investments elsewhere in the world, corporates are limited to the transfer from South Africa of up to R500 million per new approved investment subject to the same criteria.

Corporates, on application to the Department, are also allowed to utilise their local cash holdings in South Africa to partly finance new investments where the cost thereof exceeds the respective amounts of R750 million and R500 million. Such additional

3 Bruce Brand, Record 550
4 Evidence of Stals, Record 266

foreign currency transfers are restricted to 10% of the cost of the investment in excess of those amounts irrespective of the size of the transaction. The balance of the finance required must still be raised abroad on the basis outlined above.

Corporates wishing to invest in countries outside the CMA[5] may also apply for permission to enter into corporate asset/share swap and share placement transactions to acquire foreign investments.

(2) Institutional Investors

Long term insurers and pension funds may under application acquire foreign portfolio assets of up to 15% of their total assets and registered fund managers up to 15% of their total assets under management, subject to the regulatory framework within which they operate. Unit trusts through unit trust management companies may under application acquire foreign portfolio assets of up to 20% of their total assets under management, subject to the regulatory framework within which they operate. The foreign portfolio assets may be acquired by transferring foreign currency from South Africa abroad. Such transfers are limited to 10% of the previous calendar year's net cash flow.

(3) Individuals

5 Common Monetary Area which includes South Africa, Lesotho, Namibia and Swaziland

Individuals may invest up to R750 000 per individual for any purpose outside the CMA provided the party is over eighteen years old and a registered taxpayer in good standing.

11 Cross-border (onshore/off-shore) foreign exchange transactions executed by authorised dealers on behalf of their customers are reported to the Reserve Bank on a daily basis. These are called "reportable transactions". On-shore/on-shore and off-shore/off-shore transactions are not reportable. On-shore/on-shore transactions comprise inter-bank transactions. Off-shore/off-shore transactions take place outside of South Africa. The Reserve Bank is therefore not able to report on them as it has no source of information or jurisdiction over non-residents.

[2] <u>Recommendations by authorised dealers</u>

12 The authorised dealers were asked the following question in the Questionnaire:[6] "7.9 What recommendations do you have regarding the administration of exchange control?" The evidence of the material authorised dealers in response to that question was as follows:-

12.1 <u>Absa</u>

[6] The Questionnaire prepared by the Deloitte & Touche team. See <u>Part K</u>.

The exchange controls are open to conflicting interpretations and therefore have at times resulted in an "uneven playing field" and in the extreme, a marketing tool for some of the more aggressive authorised dealers. As an example, an authorised dealer will often accuse another authorised dealer of allowing a particular transaction that should, in its opinion, have been refused. Issues relating to the interpretation of payment which could be categorised as payment of "fees in respect of services rendered" (a new category) often result in differences of opinion between authorised dealers.[7]

12.2 Nedcor

In Nedcor's opinion, the problems with complying with exchange controls are the following:-

- Divergent interpretations of authorised dealers in respect of certain aspects of the Rulings. The competitive nature of the market places an authorised dealer at the risk of losing client business in the event of strict interpretations of certain Rulings.

[7] Evidence of Mr RL Rabuzzi, General Manager, Operations and Technology, International Banking SA, Absa Corporate and Merchant Bank, Absa Bundle 42

- Lack of transparency of exchange control related information between the Reserve Bank and authorised dealers pertaining to specific approvals granted to multi-banked clients.
- The current requirement for the presentation of paper-based documentation to support cross-border payment transactions is not necessarily effective and is open to abuse. The documentation is easily replicated.
- Initiatives to improve processing efficiencies through automation in the relevant back office environments are restricted by the current high cost, manual, paper-based exchange control requirements.
- The difficulty of enforcing compliance with South African exchange controls against foreign banks.
- The accurate matching of multiple debit transactions against credit transactions against CFC accounts can be problematic. This is further complicated where clients maintain multiple CFC accounts at more than one authorised dealer.

Nedcor's recommendations are the following:-

- Compliance with Exchange Control Regulations should be based on the electronic monitoring of trade and payment transactions wherever possible. This would require the alignment/integration of databases of the relevant parties involved in trade transactions, i.e. SARS, Reserve Bank and authorised dealers.

- The level of compliance could be improved by placing more emphasis on the accountability of customers who hold CFC accounts. A process similar to the current "letter of undertaking" for import and export clients could be used for these account holders.
- Restrictions could be placed on the movement of funds between CFC accounts held by persons at different authorised dealers.
- A representative forum should be established to review existing and planned future exchange controls, agreeing on procedures which will ensure high levels of compliance and ultimately improve the effectiveness of such controls.[8]

12.3 NIB

In most cases, the provisions contained in the Circulars are incorporated as clear and precise amendments in the Rulings themselves. There are, however, some instances where the provisions of the Circulars are not incorporated in the Rulings.

[8] Evidence of Mr MS Parker, Executive General Manager, Treasury, Nedcor, Nedcor Bundle 27-28

This gives rise to confusion. For example, sections B(17) and C(10) of the Rulings, which govern forward cover transactions, have not been updated to reflect the provisions of the circular dealing with the post 14 October 2001 amendments applicable to non-residents' local dealings in these transactions. Any fundamental changes incorporated in the circulars must be reflected as amendments to the Rulings. [9]

12.4 Investec

The two main problems are:

- section G, in addition to other rules, is ambiguous and leads to different interpretations as to what is permissible; and
- the difficulty in enforcing compliance by non-resident banks of Circular D342 dated 15 October 2001.[10]

Recommendations made by Investec were:

- re-introducing Circular D226, thereby alleviating the administrative burden currently placed on the authorised dealers by Circular D342;
- making all corporates "document exact" but ensure real time monitoring of balance of payments;

[9] Evidence of Mr P Lane, Executive Director of NIB with responsibility for the Treasury Division, NIB Bundle 26

[10] Evidence of Ms PF Trollip, Global Head of Treasury Compliance, Investec, Investec Bundle 24

- the removal of remaining exchange controls in an orderly and controlled fashion in an attempt to improve off-shore investor sentiment, thereby improving economic growth.[11]

12.5 FirstRand Bank

The problems that FirstRand Bank have with the administration of exchange controls are:-

- There is insufficient certainty with regard to the interpretation of Exchange Control with specific emphasis about what non-resident banks and non-residents are allowed to transact.
- There is insufficient consultation by Exchange Control with authorised dealers before Rulings are made. Invariably, there is consultation, debate and amendments between Exchange Control and authorised dealers after Rulings have been issued, which results in uncertainty and ultimately in negative sentiment towards the country, putting pressure on the rand.
- The bank has added functionality to a number of systems where practical and economically viable but exchange control still requires significant manual intervention. Exchange control administration limits the bank's ability

11 Evidence of De Villiers, Investec Bundle 38-39

to achieve straight through processing since it requires human intervention and decision making and adds to the cost of doing foreign exchange business.

- Non-residents are allowed to trade with any authorised dealer in South Africa and may have accounts at more than one authorised dealer. It is thus impossible to ensure that non-residents comply with exchange control. Which means that non-residents are required to self-regulate.

The recommendations made by FirstRand Bank are:-

- Exchange control is an artificial mechanism that creates an inefficient allocation of resources and invariably has unintended side-effects which require further regulation. This process detracts from confidence in South Africa and ultimately in the rand. In FirstRand's view, it is a question of process, procedure and timing but one view is that "… one would tend towards and orderly [abolition] of exchange control."
- Failing the abolition of the exchange controls, FirstRand recommends that the Reserve Bank ensures that the

Rulings and Circulars are clear and well-defined and that they apply equally to all players within the market.[12]

12.6 JP Morgan

The events of the fourth quarter of 2001 demonstrate the real difficulties of enforcing and managing exchange control, particularly in relation to off-shore participants in the rand market. JP Morgan endorses the stated position of the National Treasury and Exchange Control in favour of the expeditious but phased relaxation of exchange controls. In the interim, JP Morgan favours the continuation of consultation and the interaction between Exchange Control and authorised dealers in order to effectively enforce and administer existing exchange control requirements.[13]

12.7 Deutsche Bank ("DBJ")

It is important that South Africa strives for a fully convertible currency. Convertibility risk is a major concern among all investors and is a significant reason why foreign capital inflows into South Africa have been modest for several decades.[14]

---

12 Evidence of Mr JJH Bester, Head of Risk and Audit Services, FirstRand Bank, FirstRand Bundle 19-21; Record 1377-8

13 Evidence of Mr JJ Coulter, JP Morgan Bundle 18

14 Evidence of Morrison, Deutsche Bank Bundle 13

12.8 Standard Corporate and Merchant Bank ("SCMB")

The following specific areas of concern have been encountered by SCMB and demonstrate some of the difficulties in administering the exchange control regulations and rulings:

- the requirements that clients present documentation and evidence of a firm and ascertainable commitment is not effective considering that clients are entitled to hedge or unhedge foreign exchange commitments during the life of the transactions with different authorised dealers;
- the administration of CFC accounts in order to control the 180-day rule is cumbersome;
- the issue of compliance certificates by foreign banks has been introduced but SCMB has found a large number of counter-parties not willing to co-operate.[15]

[3] Recommendations of the Reserve Bank regarding the administration of exchange control

13 During the hearing, the Commission asked the Reserve Bank for its recommendations. The Reserve Bank responded by giving evidence that the effectiveness of the current administrative system of enforcing exchange control is interlinked with and dependent upon the fullest

15 Evidence of Potgieter, Standard Bank Bundle 44-45

cooperation from all the authorised dealers and the clients for whom they act in matters of exchange control. The relationship between the authorised dealers, their clients and Exchange Control has as its underlying rationale a duty of utmost good faith, transparency and trust. Without this the system cannot function effectively. In light of everything that was said by the Reserve Bank to the Commission, Mr Bruce-Brand was of the opinion that exchange controls are effective provided that all role players fulfil their obligations in both the spirit and the letter of the existing rules and regulations. By and large the experience of Exchange Control is that it is the norm. The effectiveness of the primary objective, i.e. the protection of South Africa's foreign reserves, is borne out by growth in the reserves from about two weeks of import cover in 1994 to the prevailing level of about twenty-four weeks of import cover. This objective has been achieved against the background of extensive exchange control liberalisation and a significant reduction in Government's foreign exchange liabilities.[16]

[4] Compliance by the authorised dealers

14 The authorised dealers were requested in the Questionnaire to furnish the following information:-

---

16 Bruce-Brand Bundle SARB (8) 236-7

"4.6

4.6.1 What procedures does your organisation use to monitor Excon compliance?

4.6.2 In your response, please specifically address, inter alia:

4.6.2.1 at what stage of conducting a foreign exchange transaction compliance with exchange control is verified and how this is managed and controlled;

4.6.2.2 procedures in place to ensure that exporters comply with the 180 day rule to repatriate foreign exchange proceeds;

4.6.2.3 procedures employed to monitor CFC accounts and to monitor overdrawn vostro accounts;

4.6.2.4 the extent to which your Excon procedures provide you with assurance that trades with corporates and non-resident banks are backed by firm and ascertainable commitments; …"

15 Detailed evidence was given by the large authorised dealers (who account for about 95% of all forex dealing in South Africa) in response to those questions. What follows is a summary of their evidence.

Absa

15.1 Foreign exchange transactions are concluded in two ways: clients may either request an authorised branch or one of Absa's five international banking centres ("the centres") to book foreign deals on their behalf, or, if they are appropriately mandated by Absa International Banking Department in this regard, clients may elect to book deals directly with Absa's treasury dealing room ("the dealing room"). Where a client has approached a branch or centre to book a deal on its behalf, the branch or centre will, without exception, ensure, before proceeding, that the underlying transaction is permissible in terms of exchange control rules. If a current client has concluded a forex deal directly with the dealing room, the details of the deal are communicated to the relevant branch or centre, and it is the branch or centre's responsibility, in all instances, to ensure that the transaction is permissible in terms of Excon rules. The internal audit department monitors adherence to certain exchange control limits by means of Computer Assistant Auditing Techniques (CAATS). Excesses are reflected on a report and are investigated. Contraventions and any corrective actions are reported to the Reserve Bank. Monitoring of limits is for all intents and purposes done manually.

15.2 Whenever a Form F.178 (the form that is completed in relation to the requirement to repatriate foreign exchange export proceeds within 180 days) is attested to by an Absa branch or centre, the details are recorded and diarised for follow up of receipt of the export proceeds. If the notification is not timeously received, the client or the receiving authorised dealer is followed up by means of a letter. If a satisfactory response remains outstanding after three requests, the matter is reported to the Reserve Bank, as required by the exchange control rules.

15.3 All CFC accounts are managed and maintained within Absa's middle office and five centres, in that way enhancing the effectiveness of the monitoring and control process. A system-generated report, listing particulars of all CFC account credits which are within seven days of expiry of the required one hundred and eighty day period, is drawn up by each centre. It is that centre's responsibility to inform clients of the impending expiry of the stipulated one hundred and eighty day period and to ensure that the funds are converted accordingly within the period as required by exchange control rules. If the funds are not converted within the period, Absa will follow up with a client in order to expedite the conversion. If the client's co-operation is not forthcoming, Absa reports the matter to the Reserve Bank as required by the exchange control rules.

15.4 In all instances where a corporate client books a deal directly with the dealing room, the underlying transaction is not finalised until it has been vetted and found to be permissible in terms of exchange control rules or has been authorised in terms of a specific approval granted by Exchange Control. All branches and centres are subject to regular internal and external (Reserve Bank) audits and inspections, one of the main focus areas of which is to ensure that all transactions concluded by the branches and centres comply fully with the requirements and conditions prescribed in the exchange control rules.[17]

<u>Nedcor</u>

15.5 A centralised exchange control department is in place. Each quarter, all business units are required to complete and submit a compliance report to the group compliance unit. Internal audit conducts reviews of all business units on a regular basis, preferably annually. The reviews include the evaluation of compliance of exchange control rules. Dedicated risk managers are located in the major processing centres handling customer-initiated transactions. One of their functions involves the

[17] Evidence of Rebuzzi, <u>Absa Bundle 36-41</u>

evaluation of the effectiveness of Reserve Bank related controls and compliance on an ongoing basis.

15.6 Cross-border pay-away of funds is verified prior to processing of the pay-away. In respect of other transactions, a risk/compliance management process has been implemented, which includes procedures such as independent sampling and regular internal audit reviews. The bank is also subject to periodic inspections by the Reserve Bank.

15.7 The F178 form is sent from a branch to a dedicated F178 section within a department of Global Business Operations ("GBO") within the bank. The F178 section will capture the relevant data on its system. The system gives the exporters seven days grace after the expected payment date to provide the bank with evidence of export proceeds received. Should no such evidence be lodged with the bank, the F178 system generates a schedule/report on the exporters and amounts not received as per F178. The system will automatically generate a letter to remind the exporter that it must forward evidence of export proceeds received to the bank. Regular follow-up procedures are executed in case the exporter does not respond to the letter. Should no proceeds be received within 180 days from shipment date, a report of the exporters and their outstanding proceeds is forwarded to the bank's exchange control department, which in turn, will report the matter to Exchange Control.

15.8 CFC accounts are marketed, sold and opened by forex and trade marketing officials in the bank. GBO will process the transaction. GBO will also confirm that Exchange Control approval has been granted to purchase or sell foreign exchange and execute the CFC transaction. Incorrect transactions are investigated by GBO and rectified. The reports which are generated in terms of the system generate data which is used for the 180 day exchange control process described earlier.

15.9 Exchange Control requires that "when transferring funds between CFC accounts, the authorised dealer effecting the transfer must make use of a free format MT100 and quote the date on which the funds were originally credited to a CFC account…" The bank is trying to comply with this requirement. The difficulty arises from the fact that when funds are transferred between CFC accounts at different authorised dealers, the total amount transferred may be made up of smaller amounts that were originally credited on various dates over an extended period not exceeding 180 days.[18]

NIB

18 Evidence of Parker, Nedcor Bundle 11-12; 36-39

15.10 Each NIB entity involved in transactions affected by the Reserve Bank is guided by separate and dedicated internal operational and administrative procedures. Reserve Bank compliance reports are generated by affected business units at intervals stipulated by the Reserve Bank and then submitted to the Reserve Bank if required. From this data and information a summarised report is presented to the NIB Operational Risk Committee on a monthly basis by the NIB Group Compliance officer.

15.11 Spot transactions: if required in terms of exchange control rules, the prescribed documentation is called for from the client to substantiate that the underlying transaction exists and that it is permitted in terms of exchange control rules. The underlying documents are then stamped "exchange provided". The back office will call for a copy of the Reserve Bank approval from the NIB exchange control department in cases which require prior Reserve Bank approval. The Reserve Bank may, in certain circumstances, exempt importers and exporters from providing the prescribed substantiating documents. The transaction is then confirmed with the client and settlement takes place at the end of two working days calculated from the time when the client concluded the trade with the dealing room. At this point, the transaction is also reported to the Reserve Bank.

15.12 Forward transactions: procedures followed are basically the same as for spot transactions, save that the prescribed underlying documentation, where required by exchange control rules, only need to be viewed and stamped "forward cover granted" by NIB's back office within fourteen days from the date of concluding the transaction.

15.13 NIB does not offer CFC accounts.

15.14 Where NIB is requested to attest to a form F178 for clients on short-term exports, the transaction is diarised for follow-up with a client at the end of the 180 day period.[19]

<u>FirstRand Bank</u>

15.15 The bank strictly adheres to a Deal Conclusion Forum process in respect of structured transactions. The Deal Conclusion Forum consists of senior management representing each of the functional areas and includes independent exchange control sign-off by the bank's in-house exchange control specialist. Every non-standard deal is presented to the Deal Conclusion Forum by the transactor or transacting team. An in-depth analysis and term sign-off are integral to the sign-off process.

19 Evidence of Lane, <u>NIB Bundle 15-17</u>

Direct dealing customer

15.16 A number of the bank's clients, typically large corporates, have direct access to its foreign exchange trading desk. On the deal being entered, an electronic deal device is sent to the bank's foreign exchange operation centre responsible for that client. The foreign exchange operations centres are responsible for all the administrative functions related to the transaction. The centres send out a confirmation of the deal and request the client to bring in the relevant documentation in order for the bank to verify that the transaction is in compliance with exchange control rules. No settlement takes place until the process is completed. The documentation is checked and stamped "exchange provided" and handed back to the customer, whereafter it is settled. Compliance is therefore verified prior to settlement.

Branch dealing

15.17 The bank has seventeen foreign exchange operations centres in the main metropolitan areas. Before any deal is struck the operations centre ensures that the deal complies with exchange control rules, checks the customer's credit limit and stamps the documentation "exchange provided" (if required) for the transaction. Only then is the deal booked into the branch dealing system. If documentation cannot be provided at the time that the client was to take out forward cover, the bank will book the deal on condition that the client provides the bank with documentation within a maximum period of fourteen days, but in any event before settlement. Settlement does not take place unless the bank has verified compliance with exchange control rules.

e-Forex

15.18 This is the bank's electronic dealing and payment system that is available for installation at the client's offices. The procedures are similar to those of the direct dealing clients in that compliance with exchange control rules is verified at an operation centre and no settlements take place before the process is completed.

15.19 The bank has various procedures in place to ensure compliance with the 180-day rule. The operation centres have a specific exchange control department that is responsible for the administration and follow-up on all the attested F178s. A diary system is kept to ensure that funds are received within the prescribed period. When no funds are forthcoming, the client is contacted and it has to provide satisfactory reasons or rectify the situation. Where export proceeds are not received within the 180-

day period, the bank is obliged to report non-receipt to the Reserve Bank. [20]

Investec

15.20 Investec has various ways in which it monitors exchange control compliance. It has two important risk management forums, a New Business Committee, known as the Deal Forum, which is responsible for approving new deal structures and the Credit Committee, which is responsible for approving credit limits. Either of those forums will identify transactions that require exchange control approval and the committees' approval is subject to exchange control approval.

15.21 The bank employs exchange control officers who advise and monitor areas within the bank which have exchange control responsibilities. These officers provide the liaison between the bank and Exchange Control. In addition, the relevant business divisions have dedicated personnel responsible for exchange control compliance within their areas on a day-to-day basis.

15.22 The bank's internal audit division performs regular audits in addition to those undertaken by Exchange Control

[20] Evidence of Mr AS Ribbens, Head of the First National Bank Foreign Exchange Product House, a division of FirstRand Bank, FirstRand Bundle 42-47

15.23 Within the treasury division of the bank, foreign exchange trading falls into two main categories, "vanilla" transactions (i.e. straight forward transactions) and structured transactions. With regard to vanilla transactions, the responsibility for exchange control compliance lies within two areas: treasury compliance for non-resident banks and the corporate treasury administration area for corporate transactions. All structured transactions are discussed with the treasury compliance team and are either approved as complying with section G of the Rulings or specific exchange control approval is sought via the exchange control officers.[21]

<u>BoE</u>

15.24 The bank has procedures in place to monitor exchange control compliance. These procedures are applied to non-bank transactions and focus on three areas:-

- <u>Payments to non-residents in rand and foreign currency</u>

  The branches of the bank are obliged to ensure that clients provide them with documentary evidence of the commitment to the non-resident and/or a respective Reserve Bank authority. Where the outward payments are in respect of allowances, such as travel allowances,

[21] Evidence of Ms Trollip, <u>Investec Bundle 18-20</u>

the allowance limits and supporting documents are required before making payment;

- <u>Transfer of assets to non-residents</u>

  The bank has procedures in place to ensure that transactions are concluded at fair market value and at arms-length in that the non-resident pays for assets being acquired before a non-resident endorsement is placed on any document of title;

- <u>Control over goods exported</u>

  The branches of the bank are obliged to ensure that the stipulated follow-up procedures are adhered to, to ensure that either goods or the sale proceeds thereof are returned to South Africa.

15.25 During the conduct of a foreign exchange transaction, the branches of the bank are not permitted to authorise payments to non-residents without viewing the required documentation and verifying the authenticity of the documents. The treasury prints and reviews CFC account statements daily and the balances are monitored to ensure compliance by exporters with the 180-day rule to repatriate foreign exchange proceeds. The bank's internal control and compliance procedures are well documented and monitored on a continual basis.[22]

<u>Citibank</u>

15.26 Citibank has an "excon department". In *manual* applications to buy or sell foreign currency, all the relevant documents are forwarded to the excon department for approval. If the documents are in compliance with the exchange control rules, the department approves the transaction and the documents are stamped accordingly. If the documents are not in order, the excon department issues an instruction to that effect. Until the defects are remedied, the transaction is not processed. Once the excon department has approved the transaction and the customer has confirmed it, the excon department reviews the application electronically from the process centre. In *electronic* applications, a similar process is followed, save that the excon department records its approval by electronic notes. The original documents are received manually and suitably endorsed by the excon department. The excon department plays a similar role in respect of *branch* transactions, which may also be manual or electronic in form.

22 Evidence of Mr G Little, Head of Treasury Operations at BoE, <u>BoE Bundle 6-8</u>

15.27 In regard to 180 day transactions, on the due date the customer account is checked by the trade department for the credit amount reflected on the F.178 form. In the absence of a corresponding credit, the customer is contacted by the trade department and requested to supply the bank with proof of incoming funds. If the customer does not respond within a month, a second query is automatically raised. In most instances the customer is contacted by telephone before the queries are raised. If the customer advises the bank that funds will not be received in respect of the export, it is requested to provide its advices in this regard in writing and to furnish reasons. The matter is then reported to Exchange Control. After contacting the customer directly, Exchange Control advises Citibank of any action it might have taken. Should the customer not revert to Citibank within the given time, it again refers the matter to Exchange Control.

15.28 CFC accounts are monitored on a daily basis. A report is generated indicating all accounts that will reflect a movement on them the previous business day. In the case of a credit reflected on a customer's account, a copy will be made of the deposit. The date, 180 days from the date reflected on the account, is diarised for follow-up purposes. On the due date, a print-out of the customer's account is obtained by the excon department for a period of 180 days prior to the due date, to determine whether the value of the debits on the account are equal to the value of the credits on the account. If any exceptions are identified, these are reported by the excon department to the Exchange Control.[23]

JP Morgan

15.29 JP Morgan does not provide CFC or vostro settlement accounts. In respect of transactions with other authorised dealers, JP Morgan has very limited exchange control compliance requirements. In respect of transactions with other local institutions, such as pension funds and fund managers, JP Morgan determines whether there is a forex element to the transaction. If so, the bank either obtains evidence of separate exchange control approval from the institution or requests the institution to provide approval from its authorised dealer, which in most cases is a party other than JP Morgan. In respect of transactions with local corporates, the bank does not conduct any retail activities such as issuing letters of credit or travellers cheques and does not offer CFC or vostro accounts. [24]

---

[23] Evidence of Mr A Ayeyemi, Senior Country Operations Officer, Citibank, Citibank Bundle 2-5, 9-17

[24] Evidence of Coulter, JP Morgan Bundle 13-15

Deutsche Bank ("DBJ")

15.30 DBJ does not participate in retail banking. It does not have any vostro accounts and does not maintain CFC accounts.

15.31 The monitoring of exchange control compliance commences at the outset of the DBJ/client relationship when DBJ adopts a new client. The client adoption procedure encompasses the "know your client" rule. When DBJ sets up a foreign exchange trading account with a specific client, it establishes the precise nature of a client's business activities. The traders verify the exchange control requirements with a counter-party at the time of entering into a forward exchange contract in order to ensure that the trades are backed by firm and ascertainable commitments.[25]

15.32 Deutsche Bank is not aware of any transactions that contravened exchange controls during 2001.

SCMB

15.33 The monitoring of exchange control compliance in the bank is a formidable task, which is undertaken at 57 retail branches countrywide and at 14 International Business Centres ("IBC's"). Bank employees ensure exchange control compliance by viewing, stamping and endorsing documents as required by the exchange control rules. On-going staff training is conducted to ensure that

---

[25] Evidence of Morrison, Deutsche Bank Bundle 10

staff are fully conversant with the requirements of exchange control. In addition to internal training, external training is provided to customers of the bank. All areas of the bank dealing with foreign exchange have an updated copy of the Rulings on hand. To ensure that the interpretation of the Rulings remains up to date, a representative from SCMB attends the bi-monthly Reserve Bank Rulings Committee meetings. The Reserve Bank conducts regular exchange control inspections at the various IBC's. Monthly *internal* inspections are performed to ensure continuing compliance with exchange control rules.

15.34 Where errors are discovered during the inspection process, a from 10951 application is submitted to the Reserve Bank in terms of which the Reserve Bank is notified of any contraventions of its Regulations and Rulings. During 2001, twelve such applications were submitted for a combined total of R5.3 million.

15.35 The bank requires its clients to sign a declaration in appropriate cases that the contract is in respect of either a firm and ascertained underlying commitment to or accrual from a non-resident and that there is no existing foreign exchange cover in respect of the transaction.

15.36 The bank fulfils its role in ensuring compliance with the 180 day rule by keeping a copy of the F178 form and capturing it on its system. The form is filed by the bank under its due date and it is later matched with the foreign currency receipt. On the maturity date any F178 form which has not been matched with the payment is reported by the system. In those cases clients are contacted to provide proof of receipt of funds or reasons for non-receipt. Any irregularities are reported to the Reserve Bank.

15.37 The average days weighted by amount on attested F178 forms for 2001 ranged from 60 days, eg in October, to 120 days, eg in November, 2001.

15.38 The bank has detailed processes in place for monitoring CFC accounts and vostro accounts.[26]

[5] <u>The Reserve Bank's response to the comments of the authorised dealers</u>

16 On 7 May 2002 Mr Bruce-Brand dealt with the various criticisms and suggestions of the authorised dealers as follows:-

16.1 The authorised dealers report to Exchange Control when they do not receive the compliance letters from non-resident banks. The Reserve Bank is reviewing the current position with regard to

[26] Evidence of Potgieter, <u>Standard Bank Bundle 26-39</u>

such non-compliance, but it is in the interim allowing transactions to proceed in order not to interfere unduly with the smooth operation of the forex market in South Africa. Compliance letters continue to be called for and non-receipt must still be reported to Exchange Control.

16.2 It is a fact that there is a cost to administering exchange controls for the authorised dealers. In a post exchange control environment, however, there are still likely to be costs in order to ensure compliance with prudential requirements, money laundering and the collection of balance of payments data.

16.3 There were relatively few difficulties reported with the approximately 5.6 million foreign exchange transactions which were reported to Exchange Control during 2001. Difficulties, in the main, are limited to share placements. The number of transactions successfully implemented in 2001 bears testimony to the fact that exchange controls operate efficiently and effectively within the policy parameters set by the Minister of Finance.

16.4 A minor inconsistency or an unclear point in exchange control rules does not render the administration of exchange controls in their totality ineffective.

16.5 Authorised dealers have the opportunity to air their views on any issue relating to exchange controls at the Liaison Committee, which meets quarterly under the chairmanship of Mr Bruce-Brand. Unfortunately, authorised dealers have been sending more junior delegates of late.

16.6 Every effort is made by the Reserve Bank to implement exchange controls in order to facilitate the commercial transactions of the South African economy. A degree of flexibility is applied in the implementation of exchange control rules. If, in some instances, flexibility leads to uncertainty, it is a price worth paying.

16.7 Any application to Exchange Control has a certain motive and intent. If that intent is not disclosed or exposed willingly, then the applicant is not being transparent in its ultimate aim or objective. An approval by Exchange Control, which has been achieved under those circumstances, may eventually result in consequences not acceptable to Exchange Control. Exchange Control cannot be expected to anticipate undisclosed transactions having a bearing on the application on which it must make a decision.[27]

[27] Evidence of Bruce-Brand, Bundle SARB (9) 1-7

[6] The KPMG investigation into exchange control administration

17

17.1 An investigation team of four members, all employed by KPMG, was appointed by the Commission to investigate the effectiveness of the current administrative system of ensuring adherence to exchange controls in guarding against hot transactions and to advise the Commission on measures to improve such system. ("the KPMG team"). The members of the team included exchange control and financial experts. The team prepared a report which was handed in in evidence by the team leader, Mrs Beck. In view of the report's importance for Exchange Control, the report is attached to Part I marked "B" ("the KPMG report").[28] What follows is a brief analysis.

17.2 The KPMG team conducted its investigation in three stages:

(1) Discussions were held with Exchange Control, covering the following topics:

- the structure and operation of Exchange Control and its relationship with authorised dealers;

[28] Evidence of Mrs A Beck, Report on Exchange Control Administration; Record 1614 - 1658

- the processing of exchange control applications by Exchange Control, including the systems used and the internal processes;
- the mechanics of import and export undertaking; and
- Exchange Control's areas of concern;

(2) An evaluation of Exchange Control was done by assessing its systems and procedures for the approval of capital transactions exceeding R100 million submitted to Exchange Control from 1 January to 31 December 2001.

(3) Views were obtained in regard to Exchange Control administration of the authorised dealers, the external auditors who are parties to import/export undertakings and large corporates active in the foreign exchange market.

17.3 The KPMG team came to the conclusion that the *strengths* of the Exchange Control administration were the following:-

(1) Exchange Control has effective controls for ensuring the validity of applications and for ensuring that it has received all the applications submitted by authorised dealers.

(2) A response to an application requires dual control before it is given to the authorised dealer to enhance control over and consistency of approvals.

(3) The electronic feeding of cross-border foreign exchange data from authorised dealers should help to provide timeous and complete information for balance of payment statistics.

(4) Import/export undertakings have removed a substantial amount of the paperwork that used to be the responsibility of authorised dealers. As import/export undertakings are only given to clients that have a good system of control and are deemed low risk, this improves the overall efficiency of Exchange Control administration. Inspections by Exchange Control and the corporates' external auditors help to ensure compliance with exchange control.

(5) Authorised dealers have implemented processes to ensure compliance with exchange control rules and are responsible for about 99.5% of forex transactions. The transactions are audited by the authorised dealers' internal auditors and by Exchange Control inspections to ensure compliance with exchange control.

17.4 The *drawbacks* of exchange control administration, according to the KPMG team, and the team's recommendations were as follows:-

(1) Export proceeds and CFC accounts

An exporter can illegally exceed the 180 days retention limit in a CFC account by opening CFC accounts with more than one authorised dealer and by then moving the foreign currency between the different CFC accounts. Some authorised dealers receive funds and MT100[29] forms without dates and assume that those are new funds as it is too onerous to follow up manually.

If full use were made of the permitted time periods, an exporter could retain its proceeds in foreign currency for 210 days: the permissible off-shore retention of 30 days and the retention in a CFC account for 180 days. Exporters may grant credit terms of 180 days, which authorised dealers are permitted to extend for 180 days, which could result in the conversion of the export proceeds to 570 days

[29] To ensure an audit trail of the source and timing of the receipt of export proceeds, authorised dealers are prohibited from accepting any foreign currency from other authorised dealers without a form MT100. A form MT100 is an electronic message that shows the amount of foreign currency and the date it was credited to a CFC account.

from date of export. This is only likely to occur between related parties.

The repatriation of export proceeds can never be completely controlled. Exchange Control has no direct control over export proceeds until they are deposited in a CFC account or sold to an authorised dealer. Exchange Control will not know when an exporter's off-shore client pays for the goods. Neither will Exchange Control know whether the exporter has complied with the 30 day time limit within which such export proceeds have to be credited to a CFC account or sold at spot. It is not practical for Exchange Control or the authorised dealers to monitor this and reliance has to be placed on exporters.

Exchange Control uses the F178 form to control the repatriation of proceeds of *goods* exported. There is no equivalent for the export of *services* and therefore Exchange Control relies on the corporate to repatriate fees earned off-shore.

(2) <u>Double counting</u>

In terms of exchange control regulation 3(1)(f), non-residents and domestic entities that are more than 75% or more foreign owned or controlled (called affected persons) are restricted in the amount of local financial assistance that they may use. Authorised dealers may grant or authorise local financial assistance to non-residents or affected persons, provided that such financial assistance will not cause the borrower to exceed 100% of the unencumbered rand value of funds that he has introduced from abroad or realised profits accumulated to invest locally.

The regulation can be contravened when a non-resident or an affected person borrows security or funds from a local bank and presents the proceeds as a capital base to borrow against from another bank. This is called double counting. With those funds the non-resident could take a larger position in the rand.

Non-residents are permitted to trade with any authorised dealer and may have accounts with more than one authorised dealer. It is therefore impossible for the lender to ensure compliance with exchange control.

(3) Shorting the rand

An authorised dealer is required to ascertain whether a non-resident has a legitimate exposure resulting from an accrual, investment or asset denominated in rand, before it concludes a forward exchange contract ("FEC") with such non-resident. If a non-resident buys an FEC to hedge an underlying rand asset, for example, shares and then later sells the shares and buys foreign currency at spot to remit the proceeds of the sale off-shore, he could retain the FEC without the authorised dealer knowing this. This could enable the non-resident to short the rand and take a position in the rand. This is illegal.

This form of shorting the rand cannot be controlled or identified. The extent is unknown. It could negatively affect South Africa's foreign reserves and contribute to pressure on the rand.

(4) Staff competence

A proper level of training and competence of staff dealing with exchange control and exchange control applications is difficult to maintain. This applies to all parties responsible for implementing exchange control, i.e.

Exchange Control, authorised dealers, external auditors and corporates.

(5) Transfer pricing

Profit can be transferred overseas through over-invoicing to a South African importer or under-invoicing by a South African exporter. Foreign companies may over-invoice their South African subsidiaries to gain preferential tax benefits overseas or, in the expectation that the rand will depreciate, to remove profit from South Africa throughout the year rather than only on the declaration of the dividend. The extent of the problem cannot be assessed. It could negatively affect South Africa's foreign reserves and contribute to pressure on the rand.

(6) Import and Export undertakings

There are eight identifiable weaknesses in the audit by external auditors of compliance by corporates with exchange control rules. The audit process is one developed by the South African Institute of Chartered Accountants ("SAICA") in conjunction with Exchange Control.

(7) Submission of applications

Exchange Control requires authorised dealers to ensure that the applicant complies with all the conditions stated in the approval. This can be difficult when the currency is bought or sold through an authorised dealer other than the one with which the application was made or where the application was submitted directly to Exchange Control and not through an authorised dealer. Furthermore, it is possible to transfer more than the amount approved when foreign currency is bought from more than one authorised dealer and none from the authorised dealer who submitted the application.

Exchange Control cannot identify from the cross-border foreign exchange system whether the approved transaction has been concluded as the insertion of the Exchange Control approval number on a transaction is not mandatory. Mandatory insertion of the approval number would enable Exchange Control to monitor and ensure that approved limits are not exceeded.

Limits which are exceeded could negatively effect South Africa's foreign reserves and contribute to the depreciation of the rand.

(8) Compliance with approval conditions

In terms of all approvals given by Exchange Control to corporates to invest off-shore, it is a requirement for the resident investor to submit annual financial statements of the off-shore entity to Exchange Control and to remit profits to South Africa annually. Authorised dealers do not always effectively monitor, and the corporates do not always comply, with those requirements.

This could negatively affect South Africa's foreign reserves.

(9) Data in applications

It is not feasible for Exchange Control to verify all the data submitted in an application. Exchange Control therefore relies on the integrity of the applicant (both the corporate and the authorised dealer) to submit complete and accurate information.

(10) Inconsistency of approvals

It is perceived by some of the corporates that:-

- exchange control, especially with regard to off-shore investment, is not applied consistently across all legal entities and transactions;
- Exchange Control assumes that listed and large companies have better controls and corporate governance than privately owned smaller companies;
- approval can be obtained if Exchange Control deems there to be a longer term benefit to South Africa and the concepts "longer term benefit" is open to interpretation since it is subject to the discretion of Exchange Control.

(11) <u>Accuracy of Reserve Bank cross-border foreign exchange data</u>

The team identified several transactions with large input errors. The team also identified a transaction where a corporate or authorised dealer incorrectly recorded a deposit of USD60 million as a freight payment instead of a money market transaction.

(12) Authorised dealer systems

Most authorised dealers use sophisticated treasury systems developed overseas, which do not cater for exchange control. Consequently, additional systems have to be developed by the authorised dealers for exchange control at significant cost. Alternatively, manual systems have to be used. The systems are costly to develop and maintain.

(13) Communication by Exchange Control

(a) Although there is a rulings committee that acts as a forum for the authorised dealers, several authorised dealers commented that there is insufficient consultation by Exchange Control with them before rulings are made. The team's recommendation is that Exchange Control should be more consultative in deciding policy and strategies to monitor policies.

(b) Where an application is turned down by Exchange Control, it does not usually give reasons for its refusal to grant the application. The recommendation is that reasons should be given where an application is rejected.

(c) Some of the Rulings are outdated. The team recommends that, to avoid confusion, the Rulings which are out of date, should be completely re-written with the assistance of authorised dealers.

(d) The Manual is the only access the public has to the implementation of exchange control policy. While the Manual is apparently up to date at the moment, it has not always been so in the past.

(e) Changes to the Rulings are not adequately communicated to corporates, especially those who are involved in import and export undertakings. The recommendation is that all changes to exchange control rules should be communicated to both the corporates and the media.

(14) <u>Small transactions</u>

Exchange control is onerous and focuses on detail rather than on substance. For the authorised dealers, exchange control is expensive and time consuming. In the current exchange control approval system, the value of a transaction is irrelevant, often resulting in costs out of proportion to the value of the transaction being incurred. It is recommended that routine and smaller transactions should be excluded from scrutiny with materiality levels being put in place. This would reduce the unproductive scrutiny of immaterial transactions.

(15) Foreign direct investment ("FDI")

Exchange control is a deterrent to FDI and should be reviewed. When foreign investors decide to invest in South Africa, it is often the first time that they have experienced exchange control. They usually regard exchange control as a bureaucracy that will hinder the efficient management of their investments.

Although it is claimed that all exchange controls on foreign investments have been removed, this is not correct. The KPMG report lists 10 examples (§134.1 – 134.10 of the KPMG report, annexure "B" to Part I).

(16) Emigration

With the depreciation of the rand the tendency is for someone leaving South Africa to use the investment allowance (R750 000 per person or R1.5 m for a family unit) rather than the emigration allowance (of R400 000). Consequently there is no notification to the authorities of the emigration.

17.5 Abolition of exchange control

17.5.1 There are (at least) four good reasons to abolish exchange control:

- off-shore investors see exchange control as a major deterrent for foreign direct investment;
- in terms of their mandate, certain off-shore fund managers are not allowed to invest in countries having exchange control;
- domestic corporates are often charged higher fees and rates to raise funds off-shore than would have been the case without exchange control;
- off-shore listings by South African companies are often a consequence of the limitations on off-shore investments.

17.5.2 There are three major sources of funds that could be exported if exchange control were abolished:

- institutional investors;
- blocked funds relating to emigrants;

- domestic corporates who wish to invest abroad or obtain off-shore listings.

17.5.3 The negative consequences of a gradual abolition of exchange control could be off-set by inter alia the following:

- by means of a gradual increase in the percentage of funds that institutional investors may invest off-shore, Exchange Control could control the outflow of currency from South Africa;
- a portion of the blocked funds could be released over a period of four to five years to minimise the strain on domestic foreign reserves;
- in the case of South African companies listing off-shore, the off-shore transfer of the shares could be treated as a disposal of those shares on which capital gains tax or a similar tax could be applied.

[7] <u>Liberalisation of exchange controls</u>

18 The Minister of Finance testified that, as has been broadly recognised internationally, a gradual approach to capital account liberalisation is

advisable and should occur late in the process of economic reform. The Government has chosen a policy of gradual liberalisation of exchange controls based on a set of key policy and structural requirements:-

(1) It is imperative that the appropriate macro-economic fundamentals be put in place. These include credible and sustainable fiscal and monetary policies; pro-growth trade and investment policies and a Government spending programme that promotes redistribution and provides a safety net for the poor against the potential social costs of globalisation.

(2) In an environment of global integration with large and rapid shifts in capital flows, it is essential for a sound and well-regulated financial system to be in place.

(3) The Government has chosen to follow a flexible exchange rate to act as a shock absorber against global developments.[30]

19 The Director-General, National Treasury, gave evidence on the extent to which key policy and structural requirements have been met.

(1) Macro-economic stability

A pre-condition for capital account liberalisation is credible and supportive fiscal and monetary policy. This reduces the scope for domestically generated instability and capital flight. The

[30] Evidence of Manuel, National Treasury Bundle (1) 83-84

objective of macro-economic stability has now been achieved: the fiscal deficit has come down from approximately 5% in 1994/1995 to 1.9% in 2000/01 and is expected to be 1.4% for 2001/2 and the Government has implemented an inflation target of 3-6%, compared with consumer price inflation of about 9% in 1994/1995.

(2) Tax policy reform

The relaxation of exchange controls has been accompanied by key income tax reforms to protect the tax base and minimise tax biases that could encourage the export of capital. This has primarily taken the form of a shift from a source-based to a residence-based system of income tax.

(3) Social safety nets

An important component of the sequencing of exchange control reform is to have a social safety net in place. This mitigates the possible negative impact on the poor of potential financial instability which could result from an ill-considered pace of capital account liberalisation. South Africa has one of the most extensive systems of social safety nets amongst emerging market economies.

(4) Domestic financial market reform

Complete liberalisation and large capital flows increase the danger of bank failures if not properly managed. In these circumstances competent bank management, realistic valuation of bank assets, increased public disclosure and prudential reporting become important characteristics of a sound banking system. The objective of bank supervision and regulation under these circumstances should be to avoid any systemic risks to the banking system.

(5) Capital account liberalisation has been accompanied by significant reforms to a robust financial market infrastructure. Despite repeated episodes of exchange rate pressure and sharp depreciation, South Africa has been protected by a regulatory system that is well established and sophisticated in comparison with other emerging markets.

(6) A further reform signalled in 2001 in the form of a shift to prudential regulation, will see exchange controls on life insurers and pension funds replaced by prudential limits on foreign investments.

(7) The relaxation of exchange controls has to be managed to be in line with the country's balance of payments. Capital inflows and

trade proceeds provide a source of foreign exchange within which the capital account should be managed if a major impact on the exchange rate is to be avoided.

20 The evidence of the experts and authorised dealers was generally supportive of the Government's policy of gradual liberalisation of exchange controls. What was nevertheless emphasised was the negative sentiment towards exchange controls and the disadvantages of exchange controls. *Mr Luüs* said that the exchange controls which are still in place potentially deter foreign investment because foreigners believe that the gradual or sudden removal of such controls would lead to a gradual or sudden further depreciation of the rand and because of a fear that comprehensive exchange controls may again be implemented at any time.[31] It was recommended by *Investec* that remaining exchange controls should be removed in an orderly and controlled fashion in an attempt to improve off-shore investors' sentiment, thereby improving economic growth.[32] The evidence for *FirstRand Bank* was that exchange control is an artificial mechanism that creates an inefficient allocation of resources and invariably has unintended side effects which require further regulation. This process detracts from confidence in South Africa

[31] See Evidence of Luüs in Part D §6.3
[32] Evidence of De Villiers, Part I §12.4

and ultimately in the rand.[33] The events of the fourth quarter of 2001 demonstrated to *JP Morgan* the real difficulties of enforcing and managing exchange control, particularly in relation to off-shore participants in the rand market. JP Morgan endorses the policy in favour of the expeditious but phased relaxation of exchange controls.[34] For *Deutsche Bank Johannesburg* it is important that South Africa strives for a fully convertible currency. Convertibility risk is major concern among all investors and is a significant reason why foreign capital inflows into South Africa have been modest for several decades.[35] The *KPMG team* was of the view that there were at least four good reasons to abolish exchange control:

- off-shore investors see exchange control as a major deterrent for foreign direct investment;
- in terms of their mandate, certain off-shore fund managers are not allowed to invest in countries having exchange controls;
- domestic corporates are often charged higher fees and rates to raise funds off-shore than would have been the case without exchange control;
- off-shore listings by South African companies are often a consequence of the limitations on off-shore investments.

33 Evidence of Bester, Part I §12.5
34 Evidence of Coulter, Part I §12.6
35 Evidence of Morrison, Part I §12.7

21 In reply to the question posed by Goldman Sachs to 30 of its clients: "what is the biggest change that would be positive for the rand?", 21% said: "more open markets", ie remove exchange controls.[36]

22 In Dr O Neill's opinion, the events of late 2001 suggest that with foreign exchange controls, one either has no controls or one has complete controls. But, if one has partial controls, it is confusing and very hard for people to understand except those very close to monitoring them and implementing them. It is also often taken as a sign of lack of confidence in other targets and in particular if there is an inflation targeting regime in place. It was not obvious to Dr O'Neill what purpose foreign exchange controls serve. In his view, if the removal of exchange controls was done in the context of specifically targeting more foreign direct investments and enhancing a greater broadening of the understanding of the inflation targeting regime, he believes that the abolition of exchange controls will lead to a significant inflow and strengthening of the rand.[37]

---

36 See §36 Part D

37 See §37(6) Part D

23 In his closing remarks to the Commission on 24 May 2002, the Minister of Finance[38] re-affirmed the Government's commitment to a gradual process of exchange control liberalisation that takes into account critical sequencing considerations. Timing and sequencing are critical. It has been broadly recognised internationally that a gradual approach to liberalisation is advisable and should occur late in the process of economic reform. The IMF has stated that it considers the present pace of exchange control liberalisation in South Africa to be appropriate. Prudent liberalisation must consider factors such as the sequencing of economic reform and the strengthening of the balance of payments. As such, it is not possible to set a time table for the gradual relaxation of exchange controls, rather such a policy will be monitored and reviewed continuously. There is another benefit to a gradual approach to liberalisation and that is that gradualism may produce internal and external criticism about the slow pace of reform, but it has also avoided policy reversals in the face of currency crises. A gradual approach to exchange control liberalisation has enabled the Government to deliver a policy message which is consistent and certain.

[38] See Record 1754-1761

Part J: The investigation by the KPMG team into transactions that gave rise to the rapid depreciation of the rand during 2001

Index

Table of graphs, charts, diagrams and tables contained in Part J

J The investigation by the KPMG team into transactions that gave rise or contributed to the rapid depreciation of the rand during 2001

1 The Commission appointed KPMG to identify transactions that gave rise or contributed to the rapid depreciation of the rand during 2001. The team consisted of six members, amongst whom were computer and exchange control experts and financial consultants ("the KPMG team").[1]

2 The sources of information were inter alia the following:

- statistical data provided to the Reserve Bank by authorised dealers, which data the team obtained from the Reserve Bank;
- statistics on the US dollar/rand exchange rate obtained from Bloombergs;
- applications by residents to Exchange Control for off-shore investments exceeding R100 million;
- the September to December 2001 JSE monthly bulletins;
- the 2001 and 2002 Reserve Bank Quarterly Bulletin;
- McGregor's bureau for financial analysis;
- information supplied by the Bond Exchange of South Africa ("BESA") on bond values;

1 The KPMG team prepared a report on the "Investigation into statistical and other data" and Ms A Beck gave evidence at Record 1614-1639

- the responses of corporates to questionnaires sent to them by the team;
- information supplied by authorised dealers and corporates on specific enquiries by the team;
- information supplied via the tip-off lines operated by KPMG and Deloitte & Touche.

3 The scope of the investigation was limited to transactions between:

- South African legal entities and natural persons, on the one hand, and authorised dealers, on the other hand; and
- non-resident banks and authorised dealers.

The investigation excluded transactions between:

- authorised dealers (the Deloitte & Touche team focussed on those transactions);
- non-resident banks, the so-called off-shore/off-shore transactions (Exchange Control does not keep information on those transactions); and
- non-residents, other than banks (Exchange Control does not keep information on those transactions).

4 KPMG identified, analysed and investigated the following:

- days of large movements in US dollars/rand exchange rates;

- categories of largest inflow, outflow and net flow of foreign currency in rand terms;
- days when there were large net sales of rand by non-residents to authorised dealers in the spot and forward markets;
- applications exceeding R100 million by residents to invest off-shore;
- resident corporates who were most active in the foreign currency market;
- the after-hours US dollar/rand exchange rate.

5 <u>Large movements in US dollar/rand exchange rate</u>

The team identified the days in 2001 on which there were large movements in the US dollar/rand exchange rate. The days in 2001 that the team identified were 10 January, 8 March; 12 and 13 September; 3, 15, 16 and 22 October; 5, 21, 29 and 30 November; and all trading days in December except 31 December. The result of the analysis is set out in this table:

Table 1 : Days of large USD / Rand movements, §36 p 13 of the Report

Days of large USD / rand movement	*Rand strengthen / (weaken) SA cents*
12/09/2001	(3.86)
13/09/2001	(.27)
03/10/2001	(19.75)
15/10/2001	(7.50)
16/10/2001	(22.40)
22/10/2001	(22.76)
05/11/2001	4.32 *[2]
21/11/2001	(16.05)
29/11/2001	(41.86)
30/11/2001	2.53*
03/12/2001	(14)
04/12/2001	(18.50)
05/12/2001	(59)
06/12/2001	(30.50)
07/12/2001	(5.00)
10/12/2001	(4.00)
11/12/2001	(19)
12/12/2001	(1.00)
13/12/2001	(37)
14/12/2001	(71.50)
17/12/2001	15*
18/12/2001	(16)
19/12/2001	(27)

2 In the case of all figures marked with an asterisk (*) the following applies: Although the rand appreciated on these days, there was a high level of volatility and a significant weakening of the currency during such days.

Days of large USD / rand movement	*Rand strengthen / (weaken) SA cents*
20/12/2001	(100)
21/12/2001	145,50*
24/12/2001	11*
27/12/2001	8*
28/12/2001	(19.50)

6 Selected categories of large net flows of foreign currency in rand-terms

6.1 The basis of this investigation was the Reserve Bank's balance of payments categories. The team identified, during the period 1 April to 31 December 2001, the categories of the largest inflow, outflow and net flow of foreign currency in rand terms ("the selected categories").[3] The team then identified the days, if any, in each selected category when there were unusually large net outflows of foreign currency. The team drilled down to identify unusually large transactions on those days. The team thereafter established whether unusually large transactions coincided with days on which there were large movements in the US dollar/rand exchange rate. Where days of unusually large transactions coincided with days on which there were large movements in the

3 On 1 April 2001 Exchange Control introduced a new system of returns by means of which authorised dealers have to submit balance of payment information to it. Prior to this date, balance of payments information was not available in the same format.

US dollar/rand exchange rate, the transactions were investigated further.

6.2 Having established the transaction dates and the inflow, outflow and net flow of foreign currency in all the South African balance of payment category codes, the team selected categories with large outflows for further analysis. Outflows were considered as those with the flows that could have caused or contributed to the rapid depreciation of the rand:

Table 2 : Large categories of foreign currency outflows in rand terms (the selected categories), p 17 of the Report

Balance of payments category code	*Description of category*	*Outflow : Rand billion during period 01/04/01 – 31/12/01*	*Percentage of total rand outflows during period 01/04/01 – 31/12/01*
102/103	Imports of goods	171,7	12.36
401	Dividends paid by resident companies to non-resident shareholders	16,9	1.22
701	Sales by non-residents of shares issued in SA	204,0	14.69
702	Sale of domestic bonds by non-residents	796,0	57.32
703	Money market instruments[4]	18,2	1.31
901	Payments not classified	44,2	3.18
999	Repayments by residents of loans made to them by non-residents	29,8	2.14
Sub-Total		1280.8	92.22
Categories not selected by the team		107.8	7.78
Total		1388.6	100.00

[4] e.g. Short term deposits.

6.3 The team analysed each of the selected categories set out in Table 2 as follows:

Table 3 : Analysis, per selected category, of large foreign currency outflows in rand terms: Report page 19

Item	*Balance of payments category code*	*Balance of payment category description*	*Graph annexure Number*	*Average daily net outflow during the period 1/4/01 - 31/12/01 R million*	*Days considered for further analysis*	
					Date	*Outflow R million on relevant day*
1.	102/103	Imports of goods	5.1 and 5.2	(166.4)	30/04/2001 19/11/2001	(5 960.40) (1 911.80)
2.	401	Dividends paid by resident companies to non-resident shareholders	5.3	(47.5)		
3.	701	Sales by non-residents of shares issued in South Africa	5.4	(23.2)	10/04/2001 30/04/2001 08/06/2001 07/12/2001 14/12/2001	(4 361.22) (1 220.59) (1 240.43) (1 207.93) (811.84)
4.	702	Sale of domestic bonds by non-residents	5.5	(29.5)	12/04/2001 11/09/2001 11/10/2001 22/10/2001 06/12/2001 20/12/2001	(21 236.66) (2 403.79) (1 499.42) (1 664.80) (1 090.76) (1 897.89)
5.	703	Money Market Instruments	5.6	(1.4)		
6.	901	Payments not classified	5.7	(1.5)	04/10/2001	(690.26)
7.	999	Repayments by residents of loans made to them by non-residents	5.8	(466.4)	04/05/2001 21/05/2001 21/09/2001 14/11/2001 21/11/2001	(1 415.64) (1 422.17) (2 436.35) (1 208.22) (4 327.69)

6.4 The outflows, per item number in Table 3, on further analysis were the following:-

6.4.1 Item 1: Table 3: imports of goods

Included in the outflow of R5.9 billion was apparently a transaction of R5.8 billion. An authorised dealer, however, had made a mistake: the transaction was for only R58 million. The error had no effect on the exchange rate.

Included in the outflow of R1.9 billion was a transaction for R690 million. The team established that the R690 million outflow by BMW South Africa (Pty) Ltd ("BMW") was matched by an equal export inflow by BMW and could not have caused or contributed to the rapid depreciation of the rand.

6.4.2 Item 2: Table 3: dividends paid by resident companies to non-resident shareholders

The team obtained from the Reserve Bank Quarterly Bulletins the total dividend inflows and outflows of the whole South African market:

Table 4 : Total dividend inflows and outflows per quarter in 2001 and the total for 2000, Report p 23

2001	Q1 Rand million	Q2 Rand million	Q3 Rand million	Q4 Rand million	Total 2001 Rand million	Total 2000 Rand million
Inflow	1 198	5 441	2 230	1 810	10 679	8 787
Outflow	4 436	11 593	7 873	7 013	30 915	17 650
Net	(3 238)	(6 152)	(5 643)	(5 203)	(20 236)	(8 863)

Exchange Control provided the team with the transaction dates and values of all dividend flows during 2001 for the off-shore listed companies:

Table 5 : Total dividend outflows compared to the dividend net outflows[5] of offshore listed companies per quarter in 2001, Report p 23

2001	Q1 Rand million	Q2 Rand million	Q3 Rand million	Q4 Rand million	Total Rand million
Total Outflow	4 436	11 593	7 873	7 013	30 915
Listings Net Outflow	3 165	1 959	278	1 284	6 686
%	71.4	16.9	3.5	18.3	21.6

Based on an analysis of that information, the conclusions the KPMG team came to were these:

5 Net outflow was used to ensure comparability across all the offshore listed companies. The net inflow was not significant.

- the off-shore listed companies' net outflow of dividends is significant and might have contributed to the rapid depreciation of the rand in 2001;
- however, the off-shore listed companies did not contribute significantly to the rapid depreciation of the rand in the fourth quarter of 2001: the off-shore listed companies purchased foreign currency to pay the R1 284 million dividends in small amounts over the last quarter, with minimal purchases in December 2001.

6.4.3 <u>Item 3: Table 3: sales by non-residents of shares issued in South Africa</u>

As appears in Item 3 of Table 3 in most instances where there were rapid depreciations of the rand, there were also major outflows of proceeds of the sale of South African shares by non-residents. On each of the days identified in Item 3 in Table 3 there were several hundred transactions in terms of which non-residents sold shares issued in South Africa. Those transactions might have contributed to the depreciation of the rand on the days concerned.

The team then decided to identify any unusual share trading volumes during November and December 2001 with the intention to drill down further should unusual trading volumes be found. The team established that there were unusually high trading volumes in South African Breweries ("SAB") shares on the JSE for the week ending 30 November 2001. The team established from SAB that:

- there was an unauthorised leakage in the United Kingdom media overnight on 27 December 2001 of a document allegedly falsified and attributable to Interbrew's investment bankers, which included an apparent intention to acquire or merge with South African Breweries;
- on 30 November 2001 Interbrew announced that the leaked document had been falsified and that it had no intention of making an offer for SAB;
- the Financial Services Authority is conducting an investigation into the falsely leaked information.

The unusually high trading volumes in SAB shares on the JSE during the week ending 30 November 2001 may have resulted in the following:

- the sale of SAB shares on the JSE by non-residents; and

- the purchase and large outflow of foreign currency after settlement in the week ending 7 December 2001.

  Included in the amount of R4.3 billion in item 3 in table 3 there was apparently a transaction for R3.7 billion. This was a further system error by an authorised dealer: the correct figure was R37 million.

6.4.4 Item 4 Table 3: Sale of domestic bonds by non-residents

In most instances when there were rapid depreciations of the rand, there were major outflows of proceeds from the sale of bonds by non-residents.

The team concluded that the bond market is very liquid and that non-residents trade extensively in the market. Non-residents invest in the South African bond market for several reasons, including the high yield that is offered compared to bonds in other countries. However, when the US dollar/rand exchange rate drops, there is a point when the currency loss matches the additional yield obtained. When that happens, non-residents sell the bonds and take their funds off-shore, usually in US dollars. The increased demand for foreign currency leads to a drop in the US dollar/rand exchange rate, which in turn leads to more selling of bonds, causing a spiral effect.

It was unclear to the KPMG team whether the sale of bonds triggered the fall in rand or vice versa.

Included in the R21.3 billion sales of bonds outflow on 12 April 2001 there was apparently a transaction for R20.6 billion. This was due to another system error by an authorised dealer: the correct figure was R206 million. The error would not have had an effect on the exchange rate of the rand.

6.4.5 Item 7: Table 3: Repayments by residents of loans made to them by non-residents

The repayments by residents of loans made to them by non-residents would be currency neutral and would have had a minimal effect on the rand.

7 Identification of days when there were large net sales of rand by non-residents to authorised dealers in the spot and forward markets

7.1 During the period 1 September to 31 December 2001 the team identified:

- days on which there were large net sales of rand by non-residents to authorised dealers in the spot and forward markets;

- the days on which large non-resident/authorised dealer sales coincided with days on which there were large movements in the US dollar/rand exchange rate;
- days of large net sales of rands by non-residents to authorised dealers. The days identified were 19 and 30 November and 5 December 2001. An analysis of those days reveals:

<u>Table 6 : Large net sales of rands by non-residents, Report p35</u>

Date	*Net sale of rands by non-residents to authorised dealers USD million*	*Large non-resident sellers of rand to authorised dealers*		*Large buyers of rand from non-residents by authorised dealers*	
		Name	*US$ million*	*Name*	*US$ million*
19/11/01	121	Standard Bank Ldn ABN Amro Royal Bank of Scotland	134.6 17.8 9.0	SCMB	130.7
30/11/01	77.9	Deutsche AG Barclays Bank of America Goldman Sachs	14.3 24.0 17.5 19.0	SCMB Deutsche RMB Nedbank	21.2 22.9 23.1 9.9
05/12/01	78.3	Deutsche AG UBS First Int'n Bank of Israel	12.9 32.8 16.3	Deutsche Bank BOE Morgan Guaranty NIB SCMB	17.0 9.0 12.0 8.7 10.1

7.2 The following appears from Table 6:

- the entries on 30 November and 5 December 2001 are insignificant as the amounts are total net volumes of smaller transactions concluded on those dates;
- the first entry on 19 November 2001, a sale or sales by Standard Bank London of the rand equivalent of USD134.6 million, turned out, on investigation, to be an option deal between SCMB and Standard Bank London that resulted in the transactions being spot neutral and therefore would have had no effect on the rand.

7.3 The team established that non-resident banks were net sellers of rands to authorised dealers on 10 out of 23 business days in November 2001 and on 4 out of 19 business days in December 2001. Non-resident banks were therefore buying rand and selling US dollars to the authorised dealers for most of the time (28 out of 42 business days) during November and December 2001. That would have supported the rand. There is no indication that non-resident banks were responsible for the depreciation of the rand during November and December 2001. However, the volume of US dollars sold by non-resident banks decreased over this period, while the demand for US dollars did not reduce, and that fact -

and not a large scale selling of rands by non-resident banks – put pressure on the rand.

8 <u>Applications exceeding R100 million made by residents to invest off-shore</u>

8.1 Exchange Control supplied the KPMG team with 69 applications which exceeded R100 million made by residents during 2001 to invest off-shore. Exchange Control provided the team with the application dates and the team established the transaction dates from the authorised dealers or corporates. When transaction dates coincided with days on which there were large movements in the US dollar/rand exchange rate, the transactions were investigated further.

8.2 Off-shore investments by resident corporates are normally done in one or more of the following ways:-

(a) transfer of cash to buy shares or assets off-shore;

(b) share placements or asset swaps.

(a) <u>Cash transfers</u>

The team identified transactions where the transaction dates coincided with days of large movements of the US dollar/rand exchange rate:

Table 7 : Investment offshore by corporates on days where there were a rapid depreciation of the rand. Report p 39

Item	*Transaction date*	*Resident Corporate*	*Offshore Investment companies*	*Amount approved by Excon*	*Currency outflow*
1	13/12/01 14/12/01	Harmony Gold Mining Co	Bendigo Mining	AUD 50 m	AUD 22 m R 127 AUD 28 m R 164
2	04/12/01	Standard Bank	Standard Bank Mauritius	USD 20 m	USD 20 m
3	3/12/01	Vodacom	Vodacom Congo	USD 39 m	USD 39 m
4	31/12/31	ABSA	Banco Austral	R 110 m	USD 4 m
5	12/09/01	BOE	BOE International	GBP 22 m	GBP 22 m

Item 1 Table 7:

Harmony invested AUD 50 million (= USD26 million) on 13 December 2001. Harmony simultaneously sold export proceeds of USD11.4 million to fund part of the investment and effectively purchased only USD14.6 million on that day in the forex market. That amount would have been large enough to have moved the market at the time. The rand fell from R11.11 to R11.48 on 13 December 2001.

Item 2 Table 7:

On 4 December 2001 SBSA invested USD20 million off-shore. The transaction was concluded in USD2 million and USD3 million tranches with different counterparties to avoid moving the market. The size of the tranches makes it unlikely that they would have had a significant effect.

Item 3 Table 7:

On 3 December 2001 Vodacom (Pty) Ltd invested USD39 million off-shore. The forward contract had been taken out on 2 November 2001, which was not a day of rapid depreciation of the rand.

Item 4 Table 7:

On 31 December 2001 Absa invested USD4 million off-shore. The rand depreciated only 1 cent on that day.

Item 5 Table 7:

On 12 September 2001 BoE invested £22 million off-shore. Although the rand depreciated on that day, it was the events of 11 September 2001 that moved the rand rather than transactions in South Africa.

(b) Share placements and corporate asset swaps

There is no cash flow in share placements and corporate asset swaps and therefore the rand is not affected. A disposal or hedging of the shares of assets could affect the rand exchange rate. The team could not verify whether the non-resident corporate investors concerned had done any hedging.

8.3 Institutional investors, eg pension funds, long-term insurers, unit trusts and fund managers, may make off-shore investments up to a specified portion of their total assets under management, which is limited to a percentage of the inflow into the fund concerned during the previous year. The team's enquiries indicated that institutional investors tended to take out their allowances in tranches, beginning after the release of the annual Exchange Control Circular, normally close to the budget speech day, continuing through the second quarter of each year. However, on 13 November 2001, Exchange Control issued Circular D346 which permitted an additional class of institutional investor, fund managers, to invest a portion of their funds off-shore. Following on that permission, applications totalling R1.9 billion were received in November 2001 and approved by Exchange Control in December 2001. The approvals expired within 30 days or at the latest 31 December 2001. In order to utilise their allowances before expiry, the institutional investors bought foreign currency to buy shares and/or placed the foreign currency on deposit in anticipation of buying shares in 2002. SCMB Securities (Pty) Ltd obtained an extension to use its allowance until 14 December 2002.

As a consequence, the foreign currency equivalent of R1.765 billion was bought by institutional investors in an illiquid and volatile market. The rand fell from R10.25 on 1 December 2001 to R11.97 on 31 December 2001 and reached a low of R13.81 on 21 September 2001.

9 Resident corporates most active in the forex market

From information obtained from Exchange Control and supplied to the KPMG team at its request, the team identified large or unusual transactions and came to the following conclusions:

9.1 Anglo American Corporation of South Africa Ltd ("Anglo American")

Anglo American has Exchange Control approval to invest up to USD150 million of its surplus funds off-shore. Those investments do not affect the rand because dollars are bought at spot and covered forward to maturity date. To ensure that dividend remittance occurs in an orderly fashion, Exchange Control has given approval to Anglo American to remit amounts in a manner that causes minimal disruption to the forex market. Anglo American transacted in accordance with that approval.

9.2 AngloGold Ltd ("AngloGold")

As a result of the change in its hedging policy in early 2001, AngloGold sold a smaller amount of US dollars in the spot and forward markets in 2001 than it had done in previous years. This may have had a negative effect on the rand exchange rate. (In its "Conclusions" §24.3 of the Report, however, the team stated, in regard to both the De Beers and AngloGold changes in hedging policy: "The impact hereof on the USD/rand exchange rate is impossible to assess as it would have been spread over the year.") The change in policy and its effect were not illegal or unethical.

9.3 Anglo American Platinum Corporation Ltd ("Angloplat")

In terms of exchange control, dividends are required to be remitted immediately. Angloplat was given permission by Exchange Control to retain for a maximum period of six months a dividend of USD36 million off-shore that it might have required for a potential off-shore investment. The dividend was remitted in September 2001 within the six month period. This transaction would not have led to the rapid depreciation of the rand.

9.4 BP Southern Africa (Pty) Ltd ("BP")

BP had problems in obtaining payment from businesses in Africa within agreed credit terms. This was due to a shortage of foreign exchange and cash flow problems of debtors, especially government and quasi-government debtors. As at 31 December 2001 BP had overdue foreign debtors of USD12 million that exceeded 180 days (that had been reported to their bankers). The value of the transactions is unlikely to have affected the rand.

9.5 <u>De Beers Consolidated Mines Ltd ("De Beers")</u>

Previously the proceeds from the sale of exports were remitted by De Beers to South Africa immediately upon receipt. From July 2001 De Beers granted credit terms of 180 days to the purchaser of its diamonds, DTC London. The change in policy delayed the flow of dollars in the US dollar/rand exchange market and may have negatively affected the rand exchange rate. The change in policy was not illegal or unethical.

9.6 <u>Dow AgroSciences Southern Africa (Pty) Ltd ("Dow Agro")</u>

Dow Agro wound up an off-shore insurance company which was anticipated would have USD26 million reserves that would be repatriated to South Africa. Dow Agro sold US dollars forward in July 2001 for settlement on 28 December 2001. The anticipated reserves did not materialise and Dow Agro had to purchase the dollars on 21 December 2001 for settlement on 28 December 2001. (Dow Agro did transfer the balance of the reserves of R205 million in accordance with exchange control rules.) This transaction might have contributed to the depreciation of the rand. On 21 December 2001 the rand rallied for a time but then hit a low of R13.81 during the day.

9.7 <u>Engen Petroleum Ltd ("Engen")</u>

Although all its debtors are within exchange control requirements, Engen does have debtors exceeding their credit limits. These relate to exports to African countries where there is a shortage of foreign currency and cash flow problems, eg Zimbabwe. The value of those transactions is unlikely to have affected the rand.

9.8 <u>Eskom</u>

South African companies may take forward cover when they have a firm commitment in foreign currency. If the invoice is in rand, no forward cover may be bought without Exchange Control approval. Eskom has Exchange Control approval to take forward cover for the foreign content of contracts between Eskom and contractors, despite the fact that the contractors invoice in rand and that Eskom pays in rand. Eskom requires such forward cover because in the invoice the foreign content of the contract (eg machinery imported by the contractor) is converted by the contractor to rand at the current exchange rate on the date of the invoice. On the date when Eskom pays the contractor, Eskom sells the forward cover, effectively cancelling the original forward cover. The purchase by Eskom of forward cover might have contributed to the rapid *depreciation* of the rand. However, the cancellation by Eskom might have contributed to the *appreciation* of the rand and Eskom did have significant cancellations in both November and December 2001.

9.9 Ethos Private Equity Ltd (“Ethos”)

Ethos concluded significant forex transactions in the first two weeks of December 2001 when it was hedging an underlying transaction. On 5 December 2001 Ethos bought net USD10 million. The rand fell from R10.57 to R11.16 on that day. The Ethos transaction might have contributed to the depreciation of the rand on that day.

9.10 Equity Diamond Cutting Works (Pty) Ltd (“Equity Diamonds”)

Equity Diamonds exports diamonds worth about USD5 million per month and is has some imports payable in US dollars. In the week ending 7 December 2001, Equity Diamonds bought USD65 million spot and sold USD50 million spot and USD10 million forward. The transactions were done in USD10 million, USD5 million and USD3 million tranches. Equity Diamonds made a loss of R7.9 million on those transactions. All the transactions were done through Nedbank. Nedbank identified the excessive trading in December 2001 and suspended the direct dealing facility that Equity Diamonds had with the dealing room.

Equity Diamonds had underlying commitments of a maximum of USD10 million. Accordingly, to the extent to which its dealing exceeded normal hedging activities, the dealing would be speculative in nature. At one point on 7 December 2001, Equity Diamonds had sold USD39 million with an underlying exposure of USD10 million. Prima facie, the transactions in excess of underlying commitments were a contravention of exchange control rules. The possible contraventions of exchange control rules were reported to Exchange Control.

During the week ending 7 December 2001, the rand depreciated against the US dollar from R10.25 to R11.19. The Equity Diamond transactions might have contributed to rapid depreciation of the rand during that week.

9.11 Sasol Limited ("Sasol")

Sasol made the following purchases in the forex market relating to the Mozambique pipeline and oxygen plant:

- 27 September – 18 December 2001: USD123 million;
- 1 October – 11 December 2001: €72.5 million.

Sasol purchased the following in the forex market in relation to the off-shore investment in Sasol Chevron:

- 13 December – 21 December 2001: USD80 million.

Those transactions might have contributed to the rapid depreciation of the rand during late November to December 2001.

10 <u>After-hours trading</u>

The team analysed after-hours USD/rand exchange rates, which were affected mainly by non-residents, to assess whether after-hours trading by non-residents caused or contributed to the rapid depreciation of the rand during 2001. A graph prepared by the team reflects that overnight movements in the USD/rand exchange rate were considerably less significant than those during the normal trading day, even in periods when the rand was moving rapidly. Consequently, no further investigation of after-hours trading was considered necessary.

11 <u>Conclusions of the KPMG team</u>

11.1 Without suggesting any illegality, collusion, unethical conduct, improper gain or improper avoidance of loss, the following transactions or series of transactions might have contributed to the rapid depreciation of the rand in 2001:

(a) the issue of Circular D346 by Exchange Control and the investments off-shore which followed (see § 8.3);

(b) the high level of trading in SAB shares (see §6.4.3);

(c) the Dow Agro transaction on 21 December 2001 (see §9.6);

(d) the Sasol transactions in late 2001 (see §.9.11);

(e) the Ethos transaction on 5 December 2001 (see §9.9);

(f) the Harmony transaction on 13 December 2001 (see §8.2 item 1 Table 7);

(g) the off-shore listed companies' (Anglo American plc; South African Breweries plc; Old Mutual plc and Billiton plc) net outflow of dividends during 2001 was significant and might have contributed to the rapid depreciation of the rand, save that the off-shore listed companies did not contribute significantly to the rapid depreciation of the rand in the fourth quarter of 2001 (see §6.4.2).

11.2 The team found it impossible to assess the impact on the USD/rand exchange rate of the change in hedging policies of AngloGold and De Beers (see §'s 9.2 and 9.5).

11.3 The Equity Diamonds transactions during the week ending 7 December 2001 might have contributed to the rapid depreciation of the rand. Prima facie, those transactions were in contravention of exchange control rules (see §9.10).

11.4 The team's analysis of net sales of rand by non-residents gave no indication that the non-resident banks were responsible for the rapid depreciation of the rand during November and December 2001.

11.5 From the team's analysis there is no indication that after-hours trading by non-residents caused or contributed to the rapid depreciation of the rand during 2001.

Part K: The Deloitte & Touche Investigation into the activities of the financial market participants

Index

Table of annexures to Part K

Table of graphs, charts, diagrams and tables contained in Part K

K The Deloitte & Touche Investigation into the activities of the financial market participants

[1] Introduction

1 The Commission appointed Deloitte & Touche ("DT") to conduct an investigation into the activities of the financial market participants. The investigation was performed by a team of six persons, including treasury, banking, structured finance and auditing experts ("the DT team").[1]

2 In terms of the Commission's Terms of Reference, the entire rand market required investigation: all institutions involved in transacting, or making markets, in foreign currency in 2001 had to be investigated.

3 Each one of the millions of transactions in the global rand market has the potential to impact on the value of the rand. Foreign exchange transactions arise, inter alia, from investment, hedging, trade, financing or capital transactions, including dividend payments. A forex transaction therefore commonly represents only a part of a related series of financial commitments and structures, all of which require identification, analysis

---

[1] The DT team prepared a "Report on the Activities of South African Financial Markets Participants" and Mr A J Immelman gave evidence at Record 1574-1612

and understanding in order to assess the likely impact of an individual forex transaction on the rapid depreciation of the rand. Given the size and complexities of the market, the time, cost and effort required to perform a detailed analysis on a transactional basis was considered impractical given the reporting deadlines imposed.

4 Given those limitations, the DT team followed a two-phased approach:

<u>Phase 1</u>

- design, test and implement a methodology for investigating the activities of the market participants;
- which focuses on key periods which should be investigated;
- to lay the basis for forming an opinion on the activities of the institutions concerned;
- to ascertain whether those activities should be further investigated to identify the underlying transactions requiring further investigation;

<u>Phase 2</u>

- and if required, conduct a further detailed investigation to identify and report on the specific transactions and their effect on the value of the rand in accordance with the Terms of Reference.

5 The team focussed on the following criteria to identify areas of activity that were unusual or out-of-line and required further investigation:

- limits, trading ethics and the extent and composition of transactions;
- the size of the bid-offer spread;
- the level of forex related profits;
- the magnitude of client transactions;
- the extent of securities lending activities;
- the degree of corporate and structured finance foreign exchange related activities; and
- unusual activities on hot days.

6 The financial market participants dealt with by the team included authorised dealers; representative offices of foreign banks ("rep offices"); the Reserve Bank; BESA; the JSE; and South African Futures Exchange ("SAFEX"), a division of the JSE.

7 Due to the strategic, competitively-sensitive and authorised dealer-client confidential nature of certain of the information supplied by authorised dealers, the information was treated as confidential and was reported by the team at total authorised dealer level only. Where necessary, the

figures of individual authorised dealers were weighted by their share in terms of US dollar/rand turnover of the foreign exchange market to make average numbers meaningful at total authorised dealer level.

8 The team concentrated on the period September to December 2001 although the first eight months of 2001 were not excluded. The reason for the focus on the last four months of the year is that over the period 1 January to 31 August 2001 the rand depreciated by 10.7% or an average of 1.3% per month, while from 1 September to 31 December 2001, the rand weakened by 42% - an average of 10.5% per month.

[2] Approach

9

9.1 The major data source for the investigation into market participants' activities on-shore/on-shore and on-shore/off-shore were quantitative and qualitative responses to a questionnaire ("the Questionnaire")[2] sent to the following market participants: authorised dealers; Reserve Bank; rep offices; BESA; JSE and SAFEX.

---

2 A copy of the Questionnaire is attached to Park K as Annexure "A"

9.2 Given the time restraints, the information supplied in response to the Questionnaires was accepted as correct and reliable and no audit was performed on the responses to verify their accuracy and completeness. Certain data supplied by the authorised dealers were corroborated by data supplied by the Reserve Bank. Mr Immelman explained in evidence the DT team considered very seriously the extent to which reliance could be placed on the responses to the Questionnaires and the time and cost required to perform a detailed audit to verify those responses. The team believed it could rely on the information supplied by the authorised dealers as they are obliged to comply stringently with the requirements of the Reserve Bank. The authorised dealers are subject to regular inspections by the Reserve Bank which are conducted both on-site and off-site. Furthermore, the authorised dealers were aware of the powers of the Commission which included phase 2 of the DT investigations. Accordingly, there was a very real possibility that a team of investigators would perform detailed investigations into detailed transactions.[3]

9.3 In addition to concentrating on the period 1 September to 31 December 2001, the team imposed special data requirements for those days identified as hot – where the most rapid depreciation

---

[3] Evidence of Immelman, Record 1588-9

occurred – during 2001. Hot days were defined as those days with significant points move in the value of the rand as well as certain notable days. The notable days were identified by economists and financial market participants, such as 12 September 2001, the day after the attack on the World Trade Centre, and 15 and 16 October 2001, the days after the Reserve Bank announced the stricter enforcement of certain exchange control rules. The days regarded as hot in 2001 were 10 January; 8 March; 12, 13 September; 3, 15, 16, 22 October; 5, 21, 29, 30 November; 3-7, 10-14, 17-21, 24, 27 and 28 December.

9.4 A materiality test designed to retain at least 95% of transactions in the rand market was applied. If the daily turnover in foreign exchange/rand of an authorised dealer was less than or equal to USD350 million on any hot day, the authorised dealer was considered non-material. Subsequently, the same test was applied to all days in the period 1 September to 31 December 2001, with the same result. The submissions of non-material authorised dealers were scrutinised and since no irregularities were found, they were excluded from further investigation. The material authorised dealers were Absa, BoE, Citibank, DBJ, FirstRand, Investec, JP Morgan, Nedcor, NIB and SBSA.

[3] Results – material authorised dealers

10

10.1 The results to the responses to the Questionnaires were analysed under the following headings: trading and foreign exchange markets; foreign exchange trading profits; client transactions; securities lending; structured finance; and other.

10.2 Trading in foreign exchange markets

10.2.1 Market making and proprietary trading

The material part of the report is to be found in §20 Part D.

10.2.2 Ethical standards applied in the conduct of foreign exchange trading

The material part of the report is to be found in §10 Part G.

10.2.3 Market making activities of banks before and after 14 October 2001

The material part of the report is to be found in §15.2 Part D.

10.2.4 Foreign exchange limits

10.2.4.1 The DT team set out to determine if the foreign exchange limits of authorised dealers were exceeded or increased during 2001 as this might have indicated speculative position taking. Foreign exchange limits define thresholds that open or unhedged trading positions in foreign exchange may not exceed. They form part of a bank's risk management framework. Limits set by banks include overnight net open positions and intraday limits. All the authorised dealers reported to DT (and gave evidence before the Commission) that their risk management frameworks include comprehensive controls designed and tested to detect and prevent unauthorised activities. Limit structures and monitoring of limits is a key component of a bank's control environment.

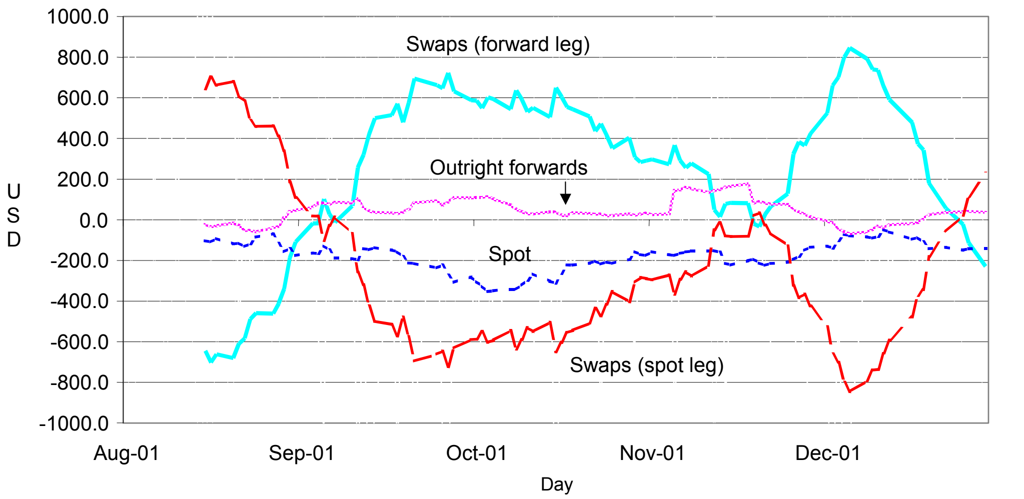
10.2.4.2 The utilisation of the overnight net open position limits during 2001 did not exceed 52%. As a group, and individually, authorised dealers did not increase their risk by holding uncovered positions against the rand overnight during the last quarter of the year at a level greater than prior periods. The average overnight net open position limits decreased over the period 1 September to 31 December 2001. Many authorised dealers indicated that, given the volatility of the rand during this period, it was deemed prudent to cut limits to reduce their exposure and potential for loss. All authorised dealers were obliged to, and in fact did, comply with the limit set by the Reserve Bank. (The Reserve Bank imposes a limit on the overnight position authorised dealers are permitted to carry. The limit is determined by applying a percentage to the capitals of the authorised dealer, or in the case of a local branch of a foreign bank, to the capital of the off-shore parent company.)

10.2.4.3 Intraday positions are permitted to exceed overnight net open position limits as long as they are brought down to within overnight limits by the end of the day.

10.2.5 Spot, outright forward and swap transactions

10.2.5.1 The spot transactions of authorised dealers were investigated to establish if there were any inconsistent trading activities that might have resulted in transactions that impacted on the value of the rand. To assess the impact of spot transactions over the last quarter of 2001, the spot transactions were analysed relative to outright forward and swap transactions. The ten-day moving average of net spot, outright forward and swap transactions of authorised dealers is shown in figure 4:

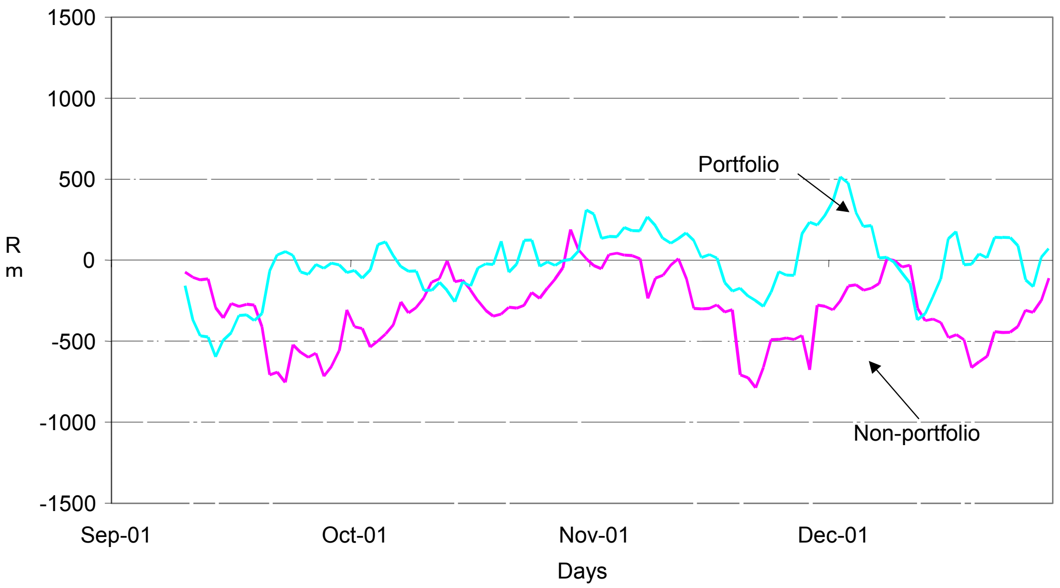
Figure 4, p 28 of report: Net spot, outright forward and swap transactions - average
(net = USD sales - USD purchases)



"Net" is defined as sales less purchases of foreign currency. The ten-day moving average of net spot transactions shows a consistent trend over the period – net *purchases* of foreign currency, which implies rand *weakness*.

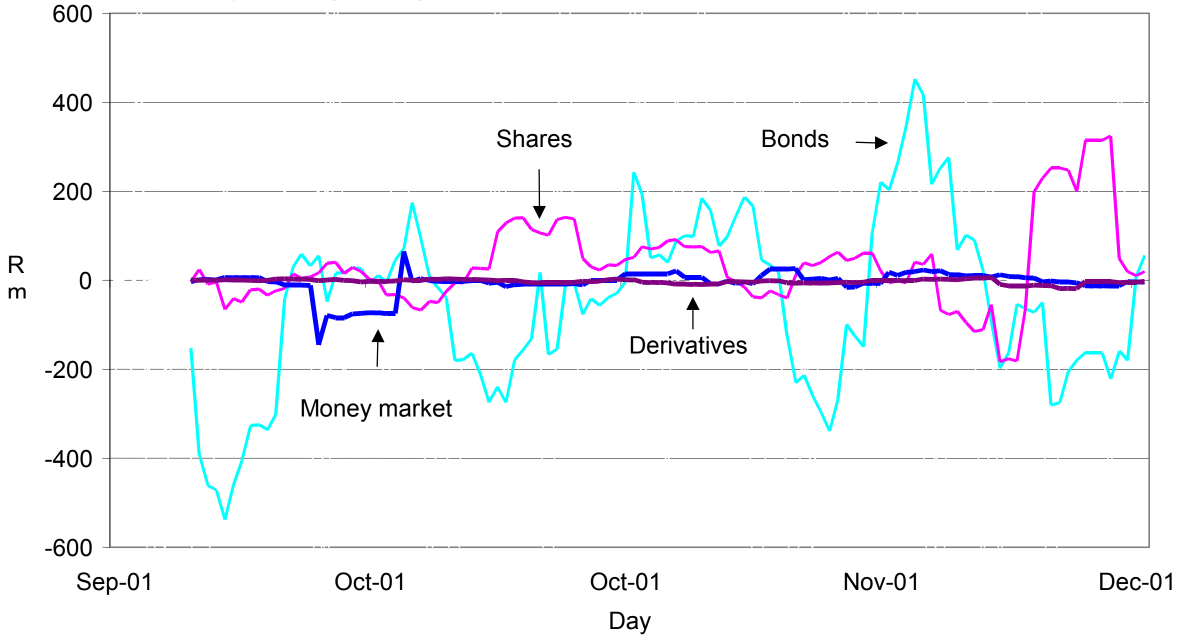
10.2.5.2 To understand the composition of spot transactions, spot transactions should be seen against the backdrop of portfolio and non-portfolio related forex transactions. As will be seen from Figure 6, portfolio related transactions dominated non-portfolio transactions:

Figure 6 p30 of the report: Net portfolio and non-portfolio related flows -10-day moving average



10.2.5.3 As shown in figure 7, flows as a result of bond transactions dominated portfolio transactions:

Figure 7, p 30 of report: Constituents of net portfolio transactions - 10-day moving average



Non-residents would have concluded the bond transactions. It follows that foreign investors were significant net sellers of bonds during the period putting downward pressure on the rand.

In the latter half of December 2001, they were also net sellers of equity. This would have reinforced the negative impact on the rand.

10.2.5.4 No inconsistent trading activities that might have resulted in transactions that impacted on the value of the rand were identified by the DT team.

10.3 Foreign exchange profits

The material part of the report is to be found in §3 Part H.

10.4 Client transactions

Client transactions were investigated to establish their potential impact on the value of the rand and the extent to which the activity of authorised dealers could be ascribed to client transactions. The average balance on the ten largest vostro accounts decreased from November to December 2001. The implication is that foreign banks withdrew their funds from their vostro accounts. The average balance on the ten largest CFC accounts increased over the period October to December 2001. The inference is that the clients of banks tended to hold more foreign currency. An analysis of the client transactions of authorised dealers shows that the clients were reluctant to hold rand. The movement by clients of their funds from rand into a foreign currency would have negatively impacted the value of the rand.

10.5 Securities lending

The extent of securities lending was investigated in an attempt to determine the degree of short selling in the equity market and whether it was disproportionate with historic trends. Short selling could be seen as a forerunner to rand speculation. The volume of shares traded on the JSE increased over the period September to December 2001 peaking on 20 December 2001 at 152.3 million shares. The average security lending transaction value over the period 1 January to 31 December 2001, while fairly volatile, showed a decreasing trend in the latter half of 2001. The DT team came to the conclusion that there was little evidence of short selling – both at total and individual authorised dealer level – that required further investigation.

10.6 Corporate finance

The corporate finance departments of the authorised dealers reported that they did not have any specific products involving foreign exchange transactions during 2001.

10.7 Structured finance

The majority of structured finance transactions entered into by authorised dealers were rand based and therefore could not have contributed to the rapid depreciation of the rand. Cross-border structured finance transactions were mainly trade finance transactions and did not have any impact on the depreciation of the rand.

10.8 The perspective of the authorised dealers of the reasons for the rapid depreciation of the rand

The material part of the report is analysed in §41 Part D.

10.9 Broad impact on the material authorised dealers of the depreciation of the rand

The material part of the report is analysed in §4 Part H.

[4] Results – the international banking division of the Reserve Bank

11 The International Banking Division of the Reserve Bank indicated in the information supplied by it to the DT team:-

- that it was not aware of any illegal or unethical transactions directly or indirectly entered into or concluded by any person or entity during 2001 which contributed or gave rise to the rapid depreciation of the rand; and

- that it was not aware of any person or entity who was involved in collusion, made an improper gain or improperly avoided loss through a transaction concluded during 2001 that contributed or gave rise to the rapid depreciation of the rand.

[5] Results – rep offices

12

12.1 Questionnaires were sent to 52 South African rep offices. Replies were received from 49 offices. The rep offices are representative of banks in Austria, Belgium, Canada, China, Cyprus, Denmark, Egypt, France, Finland, Germany, Greece, Italy, Israel, Luxemburg, Malawi, Norway, Nigeria, Portugal, Russia, Sweden, Switzerland, United Kingdom and the USA. All the rep offices reported that their local office was very small. Since all the rep offices indicated that their country limit was not exceeded during 2001 and all transactions were booked off-shore, no further investigation by the DT team was considered necessary.

12.2 All of the rep offices reported that:

- they were not involved in any transactions, nor had they assisted in any transactions, that might have contributed to the depreciation of the rand;
- they were not aware of any illegal or unethical transactions or actions by any person or entity during 2001 that might have contributed or given rise to the rapid depreciation of the rand;
- they were not aware of any person who might have made an improper gain or improperly avoided a loss from the rapid depreciation of the rand.

[6] Results - exchanges

13

13.1 The data provided by the exchanges were included where applicable in the hot day analysis.

13.2 The BSEA and the JSE were not aware of:

- any illegal or unethical transaction, directly or indirectly entered into or concluded by any person or entity during 2001 which contributed or gave rise to the rapid depreciation of the rand;

- any person or entity who was involved in collusion, made an improper gain or improperly avoided loss through a transaction concluded during 2001 that contributed or gave rise to the rapid depreciation of the rand.

[7] Financial market activities on hot days

14

14.1 This section, by showing the magnitude and source of foreign currency activities on hot days, overviews the nature, extent and complexity of the interaction between financial markets and financial market participants and illustrates the myriad of influences at play when attempting to isolate any one transaction that might have impacted on the value of the rand.

14.2 The foreign currency activity on hot days is summarised in Table 5. Table 5 shows, for every hot day, the points move in the rand; any notable economic, political or regulatory event on the day; the net foreign currency activity in each financial market; and the net spot foreign currency flow for the day. Foreign currency data are denoted in millions of US dollars. Negative numbers represent the net purchase of foreign currency:

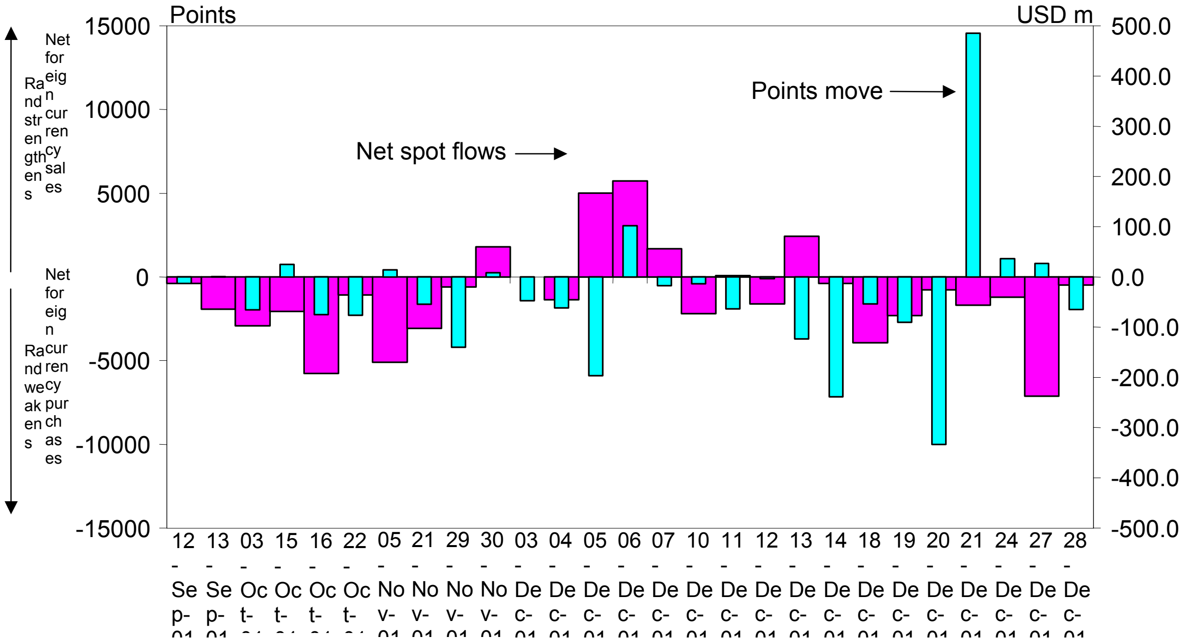
Table 5, p54 of report: Summary of hot days activity

Date	Intraday point move	USD m						Economic and other events
		Portfolio flows				Authorised dealers	Net spot	
		Bonds	Equity	Money Market	Derivatives			
12-Sep-01	-386	-80.7	-38.1	0.2	0.0	106.1	-12.5	September 11 aftermath
13-Sep-01	27	-34.5	11.7	0.1	0.0	-41.2	-63.9	September 11 aftermath
03-Oct-01	-1975	-15.7	-7.8	-1.8	0.0	-71.6	-96.9	Various remarks by SA politicians
15-Oct-01	750	-13.7	0.8	-0.6	0.1	-54.8	-68.3	SARB enforces existing excon rules
16-Oct-01	-2240	37.8	92.3	2.3	-0.1	-324.1	-191.9	Zimbabwe, AIDS, excon rules aftermath
22-Oct-01	-2276	-177.5	-9.1	0.1	0.0	151.5	-35.0	SARB: possible inflationary pressures
05-Nov-01	432	-55.6	11.0	0.1	0.7	-125.9	-169.8	Argentina
21-Nov-01	-1605	16.9	27.5	-25.2	-0.9	-120.9	-102.6	Transnet buys back 20% SAA
29-Nov-01	-4186	205.9	-7.2	0.0	0.1	-218.5	-19.8	SARB: possible interest rate increase
30-Nov-01	253	8.0	10.8	0.8	-0.5	40.8	59.9	3rd Quarter current account deficit
03-Dec-01	-1400	86.8	-6.9	3.7	-1.0	-82.4	0.1	SARB: NOPF and value of Rand
04-Dec-01	-1850	100.3	44.6	1.9	0.3	-192.1	-45.0	Zimbabwe high court ruling
05-Dec-01	-5900	-32.3	-5.5	3.2	3.3	198.5	167.3	Argentina
06-Dec-01	3050	-98.5	3.9	0.4	-0.3	286.1	191.5	Zimbabwe
07-Dec-01	-500	9.3	-110.7	2.3	0.1	155.1	56.1	Zimbabwe
10-Dec-01	-400	37.3	-13.3	-0.3	1.0	-97.9	-73.1	Speculation on exchange control
11-Dec-01	-1900	-9.9	-18.0	0.9	1.0	28.8	2.9	Inflation
12-Dec-01	-100	-62.2	4.2	0.1	0.0	4.7	-53.2	Zimbabwe
13-Dec-01	-3700	-22.6	43.0	-0.2	0.4	60.2	80.7	Zimbabwe
14-Dec-01	-7150	0.8	-68.6	5.8	-13.4	63.2	-12.2	Zimbabwe and Argentina
18-Dec-01	-1600	-6.2	216.3	-0.5	1.6	-342.1	-130.9	Higher November inflation figures
19-Dec-01	-2700	17.4	24.1	-7.2	0.0	-111.2	-76.8	James Cross resigns
20-Dec-01	-10000	-146.6	-5.2	0.3	0.0	126.0	-25.4	Argentina
21-Dec-01	14550	-3.9	-15.0	-1.1	-3.5	-32.1	-55.7	Joint Mboweni / Manuel statement
24-Dec-01	1100	15.5	28.2	0.1	0.0	-84.0	-40.2	Government announces Rand support
27-Dec-01	800	-50.1	8.0	0.0	0.0	-194.8	-236.8	Thin trade
28-Dec-01	-1950	46.6	-11.4	0.0	0.1	-50.8	-15.5	Thin trade

14.3 The analysis indicates that there is no clear and consistent correlation between movement in terms of direction and magnitude in the exchange rate of the rand and foreign currency flows in individual markets. On days when there were net sales of foreign currency, ie net purchases of rand, the exchange rate weakened and vice versa.

14.4 Figure 13 plots the net foreign currency flows against the point moves in the rand. On the majority of days when there was demand for foreign currency, as evidenced by net spot foreign currency purchases, the rand weakened. However, there was no correlation in terms of magnitude: see 16 October and 14, 20 December 2001. The rand weakened on three of the five days when there was a net supply of foreign currency as indicated by net spot foreign currency sales.

Figure 13 p 55 of the report: Intraday points move in Rand and net foreign currency spot flows



14.5 The team came to the conclusion that there were a myriad of factors influencing the behaviour of participants, all of which collectively impacted on the value of the rand.

[8] <u>Overall conclusions</u>

15

15.1 The investigation by the DT team provided no indication that further investigation of the financial market participants was required. Phase 2 of the investigation was therefore not performed.

15.2 The information provided by the financial markets participants indicates that their activities reflect a uni-directional response to market factors, primarily regulatory, economic and political, and that the depreciation of the rand and the extent of the exchange rate spread was a reflection of uncertainty, reduced liquidity, a pervasive negative sentiment and a reversal of demand for the rand by foreign institutions.

15.3 It is not unreasonable to assume that the off-shore/off-shore market activities experienced very similar influences and reacted the same way, placing significantly more pressure on the rand.

15.4 The millions of transactions that make up the market, the combined impact of which reflected a demand for foreign currency and an aversion to holding rand, contributed to the rapid depreciation of the exchange rate of the rand.

15.5 Any person or juristic entity who, directly or indirectly, entered into, concluded or caused any transactions which contributed or gave rise to the rapid depreciation of the rand relative to other currencies during 2001, did so in response to factors influencing the market and in a manner that is consistent with standard practice in international financial currency markets.

FINAL REPORT OF THE COMMISSION OF INQUIRY INTO THE RAPID DEPRECIATION OF THE EXCHANGE RATE OF THE RAND AND RELATED MATTERS

Report released: 01 August 2002

THE SUPPLEMENTARY FINAL REPORT

I Background

1 At the request of the Minister of Justice, the two majority members of the Commission ("the Commission") who signed the Final Report, this Supplementary Final Report has been prepared in response to the report of the other Commissioner ("the Minority").

2 Throughout the Minority Report reference is made to findings and recommendations of "the Commission" (for example, in §'s 137, 138, 223, 274, 276, 283, 284, 326, 357 and 369). These references are incorrect. The Minority Report is not the report of the Commission. It is the report of one member of the Commission. To avoid confusion, the Minority Report should be amended in this regard before it is published.

3 Contrary to well established practice, which the Commission followed, the Minority did not afford her fellow Commissioners an opportunity to comment on her Report before she submitted it to the Minister of Justice.

4 The Minority declined to enter into any discussions on the content of the Commission's Draft Report, other than to reject it out of hand and instead indicated her intention to file a Minority Report. In doing so, she kept her report a secret from her fellow commissioners.

5 Had the Commission been given the opportunity to consider and comment on the Minority Report, the comments contained in this Supplementary Final Report would have been conveyed to the Minority in private. By keeping the Minority Report a secret, the Minority was also deprived of the benefit of the views of her fellow commissioners. Likewise, her refusal to comment on the drafts of the Commission's Final Report deprived it of the benefit of her views.

6 All efforts to avert or minimise the embarrassment caused by the disparate reports by the Commissioners were frustrated by the Minority's refusal to co-operate and to oblige when the secretary to the Commission requested a copy of her Minority Report.

II Comment

<u>Public hearing as an appropriate forum</u>

7 The Minority contends (in §11) that "In hindsight, a public hearing was probably not the most appropriate forum for conducting such investigations". In her "General Recommendation" (§432) she calls for a further investigation, which she says, "should not be a public one."

8 When the President appointed the Commission, he declared in Proclamation R.7, 2002, that the provisions of the Commissions Act, 8 of 1947, were applicable to the Commission. In terms of s4 of that Act "all the evidence and addresses heard by a Commission shall be heard in public".

9 In any event, it was in the public interest that a matter of great concern to all South Africans should be enquired into in public, rather than secretly behind closed doors.

10 The issues of confidentiality, which arose in the Commission, were carefully managed to the satisfaction of all concerned. The public nature of the investigations did not inhibit the Commission or the assistants to the Commission from conducting a thorough investigation. The Commission is in the dark as to the source and content of any other information which the Minority contends should be obtained during a secret inquiry.

11 Not only did some hearings take place in camera, as allowed for in the Commission Act, but also procedures were put in place to protect competitive information.

General recommendation

12 The Minority Report contains a recommendation that "the reasons for the collapse of the currency be investigated in more detail" and that "a further investigation takes place which will investigate the crisis that occurred in 2001" (§'s 431 and 432).

13 The Commission contends that sufficient evidence was canvassed, under the time and budget constraints, to probe the rapid depreciation of the exchange rate of the rand in 2001. Both in the Executive Summary and Part D of the Commission's Final Report, factors which might have contributed to the rapid depreciation of the rand in 2001, are comprehensively analysed. It is not apparent what the additional benefit of another investigation would be given the time and costs thereof, as well as the relevance of the outcome thereof given the time lapsed since the events of 2001.

Institutional investors

14 The Minority Report recommends that outflows of capital of institutional investors warrant "a very detailed investigation" (§427). Such a recommendation overlooks the fact that all outflows of capital of institutional investors passed through the hands of the authorised dealers or the Reserve Bank or the National Treasury, and thus the Commission did in fact investigate such capital outflows. Further investigation is thus not warranted.

The swap market

15 There has not been sufficient evidence before the Commission to support the statements in § 430 of the Minority Report about the impact of swaps on the exchange rate of the rand. Inter alia, the Minority Report comments that the "extraordinary high volume of swap transactions deserved proper investigation to establish the reasons for this." There was overwhelming evidence before the Commission that swap transactions do not affect the exchange rate of a currency.[1] Paying for an investigation into millions of transactions [2] which did not have, on the evidence presented to the Commission, any impact on the value of the rand, would constitute 'fruitless and wasteful expenditure'.

Experiences of other countries

16 The Minority Report bemoans the fact that "the experiences of other countries" were not sufficiently looked at by the Commission (§13). The reality is that the Commission sought the assistance of, inter alia, National Treasury, the Reserve Bank and the Banking Council to elicit the evidence of foreign experts. A great deal of time and effort was spent in identifying potential witnesses, contacting them, and trying to persuade them to give evidence.

17 The reward for all that endeavour was the evidence of the three foreign witnesses who did give evidence (one in camera). These witnesses were Mr RN McCauley, Deputy Chief Representative of the Bank for International Settlements; Dr TJ O'Neill, Managing Director & Head of Global Economics, Goldman Sachs; and Mr. BI Bakarudin (in camera) of the Bank Negara Malaysia.

Briefing note from Dr Jammine

18 The Minority Report refers extensively in §'s 146 - 154 to the views of Dr Jammine, apparently expressed in "a briefing note". Dr Jammine gave evidence before the Commission in the first week of March 2002. The "briefing note", however, was prepared by him at the request of the Minority in June 2002, after the Commission had concluded hearing evidence.

19 A commission of inquiry is obliged to hear evidence in public. It is precluded from eliciting evidence clandestinely from a witness. Dr Jammine was asked by the Minority to prepare the briefing note, without consulting with or without sharing those views with her fellow commissioners. Dr Jammine's views as contained in the Minority Report were therefore not subjected to the public hearing process as provided for in the Commission's Act nor were they analysed by the Commission, and should therefore be viewed in

that light.

Evidence from Malaysia

20 The Minority Report deals with "evidence from Malaysia" (§430). The evidence was given by a witness called, Mr Bakarudin. At his request, he gave evidence in camera. He was not willing to give evidence in public, and he expressly asked for his evidence not to be published. Accordingly, the Minority Report should have mentioned this. Whilst the Commission does not consider the Malaysian evidence to be controversial, it should however not be published and the President is hereby advised accordingly.

The Deloitte & Touche investigation

21 The Minority Report is critical of the investigation conducted by Deloitte & Touche into the activities of the financial market participants (§'s 16 - 36). It is stated, for example, that the approach adopted by the Deloitte & Touche team was "not designed to identify specific transactions as provided for in the Terms of Reference" (§23). That is not correct.

22 As the Minority Report itself points out (§17), the Deloitte & Touche team adopted a two-phase approach. The second phase, if required, would have been to conduct a detailed investigation to identify and report on the specific transactions and their effect on the value of the rand in accordance with the Terms of Reference.

23 In an environment where the transactions population is as vast as the forex market, any investigation would have required some kind of analytical review process to identify areas which may require further investigation based on some predetermined criteria. Such an approach relies heavily on subjective professional judgement.

24 Despite various indications that some areas considered by the team should have prompted further investigation, these were not investigated further. However, the Commission is comfortable with the extent to which the Final Report has dealt with the conclusions of the team, which are not inconsistent with other evidence presented to the Commission.[3]

The sale of USD 200 million by a South African authorised dealer

25 The Minority Report refers to information which "the Commission" received that a South African authorised dealer was the seller of USD 200 million in February 2001 (§'s 325 and 326). The Commission was not made aware of this information for it to investigate. The Commission regards reference to unsubstantiated speculative information as dangerous to say the least. The Commission contends that such reference is misleading.

The Sasol share placement/asset swap transactions

26 The Minority Report is contradictory. In one breath, the finding is made "that the Sasol share placement in all probability contributed to the rapid depreciation of the exchange rate of the rand in the course of 2001" (§326) while in the other, it states that the Minority "is not able to make a firm finding that the Sasol share placement gave rise to or contributed to the rapid depreciation of the rand..." (§329).

Contravention of exchange controls

27 The Minority Report contains a section with the heading "Contravention of Exchange Control Regulations" (§'s327-368). The discussion begins with the averment that the Reserve Bank stated in its evidence that Sasol contravened exchange control regulations (§327).

28 The statement is incorrect with respect to the share placement/asset swap. It is not the contention of the Commission nor is it that of the Reserve Bank that Sasol contravened the exchange control regulations. The discussion continues with the statement that the Reserve Bank in a letter of 6 June 2002 advised the Commission that Deutsche Bank Johannesburg had contravened exchange control regulations (§327). The letter, which is Annexure "E" to Part E of the Commission's Final Report, draws a distinction between the breach by DBJ of its administrative law duties and its criminal liability. In regard to

the latter, the Reserve Bank advised the Commission that in its view DBJ "was not culpable (in the criminal law sense) in its actions or any assumptions which it may have made."

29 The Minority Report concludes with the recommendation that "…the contraventions of exchange control committed by Nampak and Deutsche Bank be referred to the Director of Public Prosecutions for appropriate action". Save for the Minority, no one else is calling for the prosecution of Nampak and DBJ: not the team of assistants (the Gobodo team) which investigated these transactions, not the regulating authority, i.e. the Reserve Bank, and not the Commission.

30 The Commission does not wish to repeat its contentions in this regard, save to point out that nowhere in the Minority Report is the crucial distinction drawn between the share placement transactions (which the Reserve Bank conceded were in accordance with exchange control rules) and the hedging, funding and other transactions (in regard to which the Reserve Bank contended that Deutsche Bank - and only Deutsche Bank - was in breach of its administrative law duties). It is clear that the Minority does not understand the distinction between 'share placement'/asset swap transactions and the related hedging/funding transactions. In law they have different implications as the former were specifically approved by the South African Reserve Bank, and the latter were controversial [4].

31 It is instructive to note that it is by no means clear that the regulations relied on by the Reserve Bank in referring to "a transaction" or "a related transaction", on a proper interpretation, refer to hedging, funding and related transactions. And as the Reserve Bank itself concedes in its letter of 6 June 2002, DBJ, in failing to adhere to the exchange control regulations, did not do so wilfully or negligently.

32 The recommendation that Nampak should be prosecuted is absurd. The criminal conduct complained of by the Minority is that, whereas Nampak received approval to utilise the proceeds of the share placement "to fund the capital expenditure programme of Plysu plc", the proceeds were initially utilised to reduce the loan raised from the syndicate of banks to settle the purchase price of Plysu. During hearing evidence, the Reserve Bank placed on record that it was not concerned about this "minor deviation" and would have given approval to Nampak to deviate from the original terms of the approval had it known how the proceeds were actually used. Notwithstanding the Reserve Bank's views in this regard, the Commission contends that Nampak committed a minor deviation from what it was authorised to do and a warning would at most be an appropriate sanction and not criminal prosecution.

The 14 October 2001 statements and Circular D342

33 The Minority Report analyses the statement of 14 October 2001 of the Reserve Bank and its consequences (§'s 254-277) and comes to the conclusion, inter alia, that there is no basis for linking the issuing of the 14 October statement and Circular D342 on the one hand and the depreciation of the rand in 2001 on the other (§274).

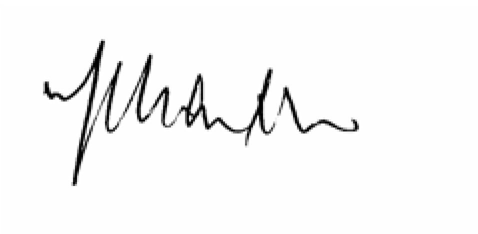
34 In considering the impact of the meeting of 14 October 2001 and the communications that followed, the Commission is obliged to have regard to all the evidence placed before it and not merely the evidence of the Reserve Bank and Mr McCauley. Such evidence must be weighed against the evidence of the other experts and authorised dealers. The overwhelming evidence was that the effect of the statement of 14 October 2001 and the requirement for compliance certificates contained in Circular D342 drained liquidity from the forex market and thus might well have contributed to the size or speed of the depreciation of the rand. It was said that with reduced turnover and with no speculators active in the market, the conditions were so much more favourable for a "run on the currency".[5]

35 It is on the basis of a conspectus of all the evidence, that the Commission finds that the 14 October 2001 statement and Circular D342 changed the behaviour of market participants and were amongst many factors which contributed to the decline in liquidity and increase in volatility in the forex markets, thereby contributing to the depreciation of the rand.[6] The Minority's interpretation and conclusions differ from those of the Commission and the President's attention is drawn to this difference of opinion.

36 The Minority observes that had the Reserve Bank not taken the steps it did in October 2001, the volatility would have continued and possibly increased and the currency may have depreciated further (§276) and that the action of the Governor of the Reserve Bank more than likely contributed to halting the slide of the rand (§277). The Commission places on records that the volatility and the rapid depreciation of the currency continued and in fact, accelerated during the last quarter of 2001, especially after the 14

October 2001 statement. The Minority views in § 276 and 277 are therefore factually inaccurate.

J F MYBURGH SC



M GANTSHO

---

[1] § 19 Commission's Final Report, Executive Summary

[2] The evidence was that in 2001 about 70% of forex transactions were swap transactions; the minimum number of forex transactions was 5.6 million; it follows that there were approximately 3.9 million swap transactions in 2001.

[3] § 77 - 79 Commission's Final Report Executive Summary

[4] § 69 - 72 Commission's Final Report Executive Summary

[5] See a detailed analysis of all the evidence in this regard in §15 pp 55-76 of Part D of the Final Report.

[6] See §'s 105- 118, pp 48-153 of the Executive Summary of the Final Report.

MINORITY REPORT

THE COMMISSION OF INQUIRY INTO THE RAPID DEPRECIATION OF THE EXCHANGE RATE OF THE RAND AND RELATED MATTERS

30 JUNE 2002

Christine Qunta

TABLE OF CONTENTS

PART

A. BACKGROUND

1 The President appointed the Commission of Inquiry into the rapid depreciation of the Rand and related matter, in January 2002.

B. TERMS OF REFERENCE

2. The Commission, in accordance with its Terms of Reference[1], was to enquire into and report on whether between 1 January and 31 December 2001:

2.1 any person or any other juristic entity entered into, concluded or caused any transactions which contributed or gave rise to the rapid depreciation of the Rand;

2.2 any of the transactions in question involved collusion and resulted in any improper gain or avoided loss;

2.3 in respect of any of the transactions in question, any authorized dealer in foreign exchange deviated from the terms and conditions of its appointment;

2.4 in respect of any of the transactions in question, existing regulations and/or restrictions on the export of capital from South Africa were contravened;

in respect of any of the transactions in question, regulations and/or restrictions on the maximum period within which exports proceeds must be repatriated to South Africa were contravened;

---

1 See Annexure 2

2.6 in respect of any of the transactions in question, transactions were entered into that were in contravention of the letter or spirit of the exchange control regulations.

3. The Commission is also required to advise the President on any relevant recommendations, including:

the effectiveness of the current administrative system of ensuring adherence to exchange controls and other regulatory measures in guarding against the occurrence of such transactions; and

possible action that could be taken against any person or juristic entity identified as having participated in any such transactions.

4. An Interim Report was submitted on 30 April 2002 to the President pursuant to paragraph 3 of the Terms of Reference. The Interim Report was a summary of evidence of witnesses who gave evidence to the Commission in March and part of April 2002. It did not make any findings or recommendations. Except to the extent that information from the Interim Report is contained in this Final Report, the Interim Report does not form part of this Final Report.

5. The Terms of Reference require the Commission to investigate specific transactions and the impact of such transactions on the rapid depreciation of the exchange rate of the Rand in the course of 2001.

C. APPROACH OF THE COMMISSION

Macro Economic Factors

6. The Commission's hearings were held in public.

7 In the first week of the sitting of the Commission various experts dealt with the macro economic factors that can influence the exchange rate of a currency in general, and specifically that which in the course of 2001 could have contributed to the depreciation of the exchange rate of the Rand.

7.1 the 11 September 2001 attack in the United States of America;

7.2 emerging market contagion;

7.3 privatisation delays;

7.4 political crises in Zimbabwe;

7.5 sentiment.

8. The evidence of the expert witnesses was extremely valuable as background information for both the Commission and the public. There is no doubt that macro-economic factors do have an impact on the exchange rate of a currency. The Commission was mandated to investigate one factor that also has an impact on the currency, namely foreign exchange transactions.

9. It was not asked to investigate which factors had an impact on the exchange rate during the course of 2001. This report therefore deals with foreign exchange transactions that fall within the Terms of Reference and related matters.

Constraints on the Commission

10. There were several constraints that the Commission faced in executing its task. The major one being insufficient time to complete the various investigations to the extent that would have been desirable.

11 The areas of investigations inevitably dealt with information that was of a very sensitive nature and if such information fell in the hands of competitors or even the general public, it could harm the interest of these corporates or institutions. In hindsight, a public hearing was probably not the most appropriate forum for conducting such investigations.

12. Another problem faced by the Commission was the issue of conflict of interest of both witnesses and assistants of the Commission. The South African foreign exchange market is small and invariably there is affiliation with institutions. In the case of assistants, the assistants sometime had rendered services or were still rendering services to particular institutions and had to recuse themselves. The Commission tried its best to manage such conflicts of interest. For example from among the local experts that gave evidence during the first week of hearings, only two economists, Jammine and Glynos, were not affiliated to a financial institution that fell within the Terms of Reference of the Commission. It is important to point out though that the experts from various financial institutions indicated that they were making statements as independent witnesses.

13. An investigation such as the one the Commission was involved with is a complex exercise which should ideally take into account the experiences of other countries especially given the fact that financial markets are globalised. While three international experts were called, all of whom gave excellent evidence, it would have been valuable to look at the experiences of other countries which have similar problems to that of South Africa in much more detail.

14. The following witnesses gave evidence to the Commission in the public hearing

Economists who gave evidence as expert witnesses[2]

Mr Kevin Wakeford

14.3 Sasol, Nampak and M-Cell

National Treasury and the Reserve Bank

Authorised Dealers

ABSA, Standard Bank, BoE, CitiBank, J P Morgan, FirstRand, NIB, Investec and Deutsche Bank

ACI

International expert witness Mr McCauley, Deputy Chief Representative, representative office for Asian Pacific in Hong Kong of Bank for International Settlement, Dr O'Neill, from Goldman Sachs and Mr B Bakarudin, of Bank Negara Malaysia

The Minister of Finance, Mr Trevor Manual and the Director General of National Treasurer, Miss Maria Ramos

14.10 From the Reserve Bank Governor Tito Mboweni, Mr Cross, former senior Deputy Governor of the Reserve Bank, Van Zyl, advisor to the Governor, Mr Bruce-Band the general manager exchange control and Mr Grove, assistant general manager, exchange control

14.11 Mark Langley

---

2 See Annexure 4

Dr C L Stals

Approach of the Investigating Teams

15. The Commission appointed assistants who investigated various aspects. Three teams of assistants to the Commission were assigned as follows:

Gobodo led a team that investigated the allegations made by Mr Kevin Wakeford;

Deloitte & Touche was appointed to investigate the trading activities of market participants including Authorised Dealers;

KPMG investigated corporates using data supplied by the SARB and corporates. KPMG also investigated exchange control administration and the effectiveness thereof. A team from KPMG was appointed to identify transactions that gave rise or contributed to the rapid depreciation of the Rand relating to corporates.

The Commission also arranged for two tip-off lines on which whistles blowers who wish to remain anonymous could furnish information to the Commission.

A list of assistants to the Commission is contained in Annexure 3;

Team appointed to investigate the trading activities of market participants

16. Deloitte & Touche conducted this exercise. Given the size and complexities of the foreign exchange market, the time, cost and effort required to perform a detailed analysis on a transactional basis was considered impractical given the reporting deadlines imposed.

17. Given these limitations, the following two-phased approach was developed by this team:

Phase 1

Design, test and implement a methodology for investigating the activities of the market participants;

17.2 which focuses on key periods which should be investigated;

17.3 to lay the basis for forming an opinion on the activities of the institutions concerned;

to ascertain whether these activities should be further investigated to identify the underlying transactions requiring further investigation.

Phase 2

If required, conduct a further detailed investigation to identify and report on the specific transactions and their effect on the value of the Rand in accordance with the Terms of Reference.

18. The team looked to establish a trend and an understanding of activities on which to form an opinion and then to ascertain whether those activities themselves require further investigation. The team took the approach that any foreign exchange transaction is a part of and is a reflection of a series of other financial commitments and transactions and those need to be understood and then it would be decided on whether they require further investigation.

Scope

Period covered

19. The Terms of Reference provided for the period 1 January 2001 to 31 December 2001 to be investigated.

20. The investigation into the activities of the market participants and the data supplied by SARB, while not ignoring the entire period, focused on the period September to December 2001. This is evidenced by the fact that the days selected for investigation fell primarily into this period.

Relevant persons and entities

21. For the purpose of the first phase of the investigation, financial market participants included authorised foreign exchange dealers; representative offices of foreign banks; the International Banking Department of the South African Reserve Bank (SARB) and the financial exchanges – Bond Exchange of South Africa (BESA), JSE Securities Exchange (JSE) and South African Futures Exchange (SAFEX) - a division of JSE.

22. In respect of authorised foreign exchange dealers, the activities of the following entities were analysed as their trading activities were determined to be material:

ABSA Bank Limited;

BOE Bank Limited;

22.3 Citibank, N.A., South Africa;

Deutsche Bank AG, Johannesburg Branch;

FirstRand;

Investec Bank Limited;

J P Morgan Chase Bank (Johannesburg Branch);

Nedcor Bank Limited;

Nedcor Investment Bank Limited; and

Standard Bank of South Africa Limited.

23. The approach adopted by this team was accordingly not designed to identify specific transactions as provided for in the Terms of Reference. This was confirmed by the findings of the team. The approach focused on identifying areas of activity that may have led to transactions that contributed or gave rise to the rapid depreciation of the Rand.

24. There were other flaws in the approach of the team which to some extent had an impact on the outcome of the review.

25. The information gathered by the team relied entirely on the responses by the Authorised Dealers to a questionnaire drafted by the team and sent to Authorised Dealers. No independent verification of data took place.

26. All information was aggregated. The team could for example have selected a few transactions and investigated them in detail.

27. The team gathered very valuable information about transactions and did observe some trends that should have prompted further investigation but did not. For example, the data collected showed that the average balances on the ten largest clients foreign currency accounts (CFC)

increased over the period October to December 2001 which is an indication that clients of banks tended to hold more foreign currency and were reluctant to hold Rand[3]. Yet nothing was done to investigate this phenomenon and by way of sample investigate some of the transactions. No attempt was made to investigate the profits made by the Authorised Dealers and the fact that there was a correlation between such profits, the bid-offer spread and the depreciation of the Rand.[4]

28. The team also found that an analysis of Authorised Dealers' client transactions showed that the clients of Authorised Dealers were reluctant to hold Rand. The moving of client's funds from Rand into foreign currency resulted in a negative impact on the exchange rate of the Rand[5]. No further investigation was done.

Scope limitations

29. Testimony provided to the Commission by Mr Robert N McCauley, Deputy Chief Representative of the Bank of International Settlements on 4 March 2002 indicated that in April 2001 trade in the South African Rand occurred approximately as follows:

33% on-onshore (e.g. trade between two banks in Johannesburg);

38% on-offshore (e.g., trade between a bank in Johannesburg and a bank in London); and

29% off-offshore (e.g., trade between two banks in London).

Local economists have indicated to the Commission that the

3 Teams report, p 34 – 35
4 See Annexure 5
5 See Annexure 6

quantum of off-offshore transactions could be closer to 40% of the total volume of the Rand foreign exchange market.

Consequently any analysis performed is limited to a maximum of 71% of the market, and possibly closer to only 60% of the market.

30. For the purposes of the investigation it was assumed that the trading patterns of off-offshore would in essence be the same as those of the on-onshore as well as on-offshore, and as such would not detract from any conclusions reached.

31 The approach of the team culminated in the reporting of findings applicable to market participants on a cumulative and not on an individual basis.

32. The information from the market participants was collated from individual responses received based on a questionnaire distributed to the participants. Consequently respondents did not provide information, including data, strictly according to the request and often applied their own interpretation to certain questions, which while meaningful at individual-authorised-dealer level, made the consolidated and comparative analysis of responses difficult.

33 Given the time constraints, the information supplied in response to the questionnaires was accepted as correct and reliable and the representations made by the market participants were not tested to verify the accuracy and completeness thereof. Certain data supplied by the market participants were corroborated by data supplied by the SARB.

34. In selecting market participants, the activities of whom were to be subjected to analysis, a materiality test of daily turnover in foreign exchange/ZAR of an Authorised Dealer was determined. If the daily

turnover of an authorised dealer was less than or equal to USD350 million on any "hot day", the Authorised Dealer was considered non-material. This test was applied in order to identify those market participants whose activities would be subjected to analysis. The materiality test set did not take into account levels of liquidity in the foreign exchange market on any particular day. The trading activities of market participants not considered material was not subjected to analysis.

35. The team made the overall conclusion that their investigation of the activities of market participants provided no indication that further investigation of these institutions was required.

36. The outcome of the process followed by the team failed to address the issue of whether in respect of market participants any transactions were entered into which contributed or gave rise to the rapid depreciation of the value of the Rand.

Team appointed to investigate data supplied by SARB

37. In respect of the team appointed to investigate data supplied by SARB, the scope of the investigation was limited to transactions between:

South African legal entities and natural persons on the one hand and Authorised Dealers on the other; and

Non-resident banks and authorised dealers.

38. The approach of this team was designed with *reference* to SARB's balance of payment categories, in which categories of individual transactions were identified for investigation.

39. During the period 1 April 2001 to 31 December 2001, the categories of the largest inflow, outflow and net flow of foreign currency in Rand terms ("the selected categories") were identified.

40. The days (if any) in each selected category when there were unusually large net outflows of foreign currency were then selected.

41 Unusually large transactions on such days were identified. In the case of other selected categories, no transactions warranting further investigation were identified.

42. It was established whether unusually large transactions coincided with days on which there were large movements in the USD / Rand exchange rate. Where unusually large transactions fell on days where there were no significant movements in the USD / Rand exchange rate, such transactions were not further investigated, except where a transaction was of such a size that the absence of an effect on the Rand exchange rate called for an explanation.

43. Where, however, days of unusually large transactions coincided with days on which there were large movements in the USD / Rand exchange rate, such transactions were further investigated.

Team appointed to investigate the Wakeford Allegations

44. This team commenced its investigation by reviewing Mr Kevin Wakeford's letter to the President dated 8 January 2002. They interviewed Wakeford and the entities referred to in the letter. As Wakeford was unable to substantiate the allegations contained in the letter of 8 January 2002, an independent investigation into the allegations contained in the letter was conducted. Pursuant to the evidence given by Wakeford, the investigation

was restricted to an analysis of the Sasol, Nampak and M-Cell share placement transactions.

45. The investigation is based on documents and statements made available to the team during the course of its investigation, as well as evidence tendered to the Commission.

46. Consultations were conducted with:

Sasol, Nampak, M-Cell and Billiton. Having determined that Billiton did not conclude an "asset swap" with Deutsche Securities (Pty) Ltd ("DS"), the investigation concentrated on the Sasol, Nampak and M-Cell transactions;

Deutsche Bank Johannesburg Branch ("DBJ") and DS;

The Department of Finance and National Treasury; and

The South African Reserve Bank ("SARB").

47. Once the team compiled its report it provided the corporates and Deutsche Bank with the report before submitting it to the Commission.

PART II

D. THE FOREIGN EXCHANGE AND RAND MARKETS GLOBALLY LOCALLY

Global Financial Markets

48. The daily turnover of global foreign exchange transactions in all currencies increased from about USD600 billion in 1998 to about USD1.4 trillion (1 400 billion) in 1998 and then decreased to about USD1.2 trillion in 2001. The primary reason for the decline was the consolidation of players in the foreign exchange market. Unlike globally, in South Africa there was no overall concentration of foreign exchange dealers.[6]

49. The transaction categories that are concluded globally are spot, forward, swap and option transactions.[7] The swap category is the most frequently used in all currencies globally. The global counterparties who trade in currencies are reporting dealers, banks, securities dealers, most insurance companies, pension funds, asset managers, multinational companies, importers, exporters and retail customers.[8] The dealers account for most of the volume of global currency trading.[9]

50. In the opinion of Dr O'Neill, the global foreign exchange market has been very peculiar since the commencement of the European Monetary Union ("EMU"). Many historical norms appear to have changed:-

50.1 the US Dollar has strengthened against three major currencies,

---

Evidence of Mr Robert McCauley, the Deputy Chief Representative, the Representative Office for Asia and the Pacific, Hong Kong, of the Bank for International Settlements ("BIS"): Record 9 – 11.

7 See Definitions in Annexure 1

8 McCauley Record 14

9 McCauley Record 15

the Japanese Yen, Pound Sterling and Euro, despite the existence and deterioration of the US current account balance of payments - the Dollar should have weakened, not strengthened;

from mid-1999 until late 2000 the Japanese Yen strengthened against the Dollar at a time when there was effectively no growth in the Japanese economy;

the Euro has been weak.[10]

The Rand market

51 Unlike trading in major currencies, trading in the Rand grew over the period 1998 to 2001, especially in Rand terms. Forex trading in South Africa increased from 0.3% of global trading in all currencies in 1992 to 1995, to 0.5% in 1998 and to 0.6% in 2001. The daily turnover in South Africa grew from USD2 billion in 1992 to USD8 billion in April 2001. [11]

52. The global daily trading in the Rand, for which the off-shore trading component was specifically measured for the first time in April 2001, was USD11.3 billion, about 75% of which were swap transactions[12]. Reporting dealers do more than half the trading, other financial institutions such as insurers and pension funds do over a third and other companies such as mining companies, multinationals and local importers, do about a sixth.[13]

53. The Rand is an internationalised currency with the bulk of offshore trading taking place in London and to a lesser extent in New York. In April 2001 USD3.3 billion was traded between two offshore parties (offshore-offshore); USD3.5 billion was traded onshore-onshore and USD4.5 billion

10 See Annexure 6
11 McCauley Record 17
12 McCauley Record 20
13 McCauley Record 20

was traded onshore-offshore, i.e. between institutions in South Africa and those outside South Africa or offshore.[14]

54. During 2001 one authorised dealer, Standard Bank of South Africa Ltd ("SBSA"), through its international banking division, Standard Corporate and Merchant Bank ("SCMB"), alone, in its forex dealing room, transacted approximately 5 000 transactions per day, with an approximate value of USD2 billion in about 40 currencies. Rand-based transactions with a potential influence on the spot exchange rate accounted for about 15% of those transactions.[15]

55. It is important to note that, for the USD3.3 billion traded offshore-offshore:

there is no record of those transactions in South Africa;

the Commission has no power offshore to investigate those transactions; and

55.3 the offshore-offshore trading could have affected the value of the Rand.[16]

56. The Commission asked the Reserve Bank to request the Bank of England to supply it with information on off-shore/off-shore transactions. Information was sought on the local gross average daily turnover (purchases and sales) in US Dollars of spot, outright forwards and swaps in the foreign exchange market in the Rand. The Bank of England was also requested to state, in its opinion, what specific transactions, actions, events, factors or omissions played a part in the rapid depreciation of the Rand in 2001. The Bank of England was unable to furnish the information requested, save for the profile of the Rand trading month by month

---

14 McCauley Record 21
Evidence of WJ Potgieter, Standard Bank Bundle 18
16 McCauley Record 23-24

through 2001, benchmarked to total BIS-reported Rand turnover for April 2001

South African Foreign Exchange Market

57. The foreign exchange market is the single biggest market, in terms of turnover, of the South African financial markets. Given the openness of the South African economy, this market is an extremely important one.

58. The foreign exchange market is essentially an over-the-counter ("OTC") market. The primary aim of the foreign exchange market is to facilitate international trade and international money and capital movements by providing a market where different currencies can be exchanged for one another.

59. In the South African foreign exchange market there are mainly two types of participants: banks authorised by the Reserve Bank to deal in foreign exchange, known as Authorised Dealers, and brokers. It is the activities of the Authorised Dealers that are particularly relevant.

60. Authorised dealers are authorised to act as principals in the foreign exchange market which means that they can act in their own names and may also run positions in foreign currency. Probably the most important reason for allowing them to run positions and to trade in their own name is to provide liquidity in the market. Liquidity is an important factor underpinning the smooth functioning of the market.

61 Market makers in the foreign exchange market attempt to make profits by buying foreign currency at a lower price and selling it at a higher price. The difference, or the spread, is the bank's trading profit. The Authorised Dealers protect themselves during times of excessive volatility in the foreign exchange market. Since high volatility is normally associated with

uncertain and sharp price movements, Authorised Dealers will tend to increase the gap or spread between the buying and selling rates.

62. The banks are reluctant to trade during such times by virtue of the fact that the exchange rate could very quickly turn against them, possibly resulting in losses. Authorised Dealers, however, are limited to the extent to which they may run open positions and are currently limited to 10% of net qualifying capital and reserve funds.

63. During the past decade turnover in the Rand market in foreign exchange in South Africa has increased significantly. Increases were particularly noticeable in 1995/6 and in 1998. Both those periods were characterised by crises in emerging markets. The 1998 emerging market crisis was very negative for South Africa from an economic point of view but nevertheless resulted in increased turnover in the foreign exchange market. Since turnover provides a measure of market activity, and also provides a rough proxy for market liquidity, the conclusion is that liquidity in the Rand market in South Africa increased significantly over time by virtue of the increase in turnover.

64. Liquidity in the foreign exchange market has declined. Not only did the turnover decline to lower levels in the last quarter of 2001 compared to the trend of the last few years, but anecdotal and statistical evidence indicate that the market has become less tight in the sense of widening bid-ask spreads, less resilient, and has lost some of its depth with some transactions being difficult to execute because of the occasional reluctance by market participants to make prices.[17]

Information is derived from the memorandum prepared by the Reserve Bank Bundle SARB(7) 91-108

The environment within which the South African foreign exchange market operates

65. A number of developments in recent years contributed to a more market-orientated exchange rate system and increased volatility in the Rand exchange rate:-

65.1 Globalisation and the integration of world financial markets had a major impact on the process of exchange rate determination. The South African exchange rate became more exposed and subjected to international developments. In the period about 1995-1999, international investors grouped about thirty emerging market countries together and developments in one or more of those countries affected others. For example, the 1998 crisis was initiated by a financial crisis in the foreign exchange market of Thailand, which spread to other East-Asian countries and eventually to countries as far apart as Russia, Brazil and South Africa. In 2001, however, international investors began differentiating between different countries within the group of emerging market economies.

Dramatic increases occurred in private sector international capital flows. Volumes in the foreign exchange markets of the world assumed astronomical dimensions and the ability of central banks to influence market conditions through intervention diminished.

The gradual abolition of exchange controls in South Africa introduced an element of greater volatility in the local foreign exchange market.[18]

[18] Evidence of Dr CL Stals, former Governor of the Reserve Bank, Expert Bundle 171-2

The impact of globalisation and the liberalisation of exchange controls

66. The overall thrust of the Government's economic policy since 1994 has been the pursuit of growth, job creation and redistribution, supported by reintegration with the global economy. While there are risks associated with it, globalisation offers the potential for sustained and broad-based improvement in living standards. Globalisation is characterised by rising trade and capital flows between countries. The Government has chosen a policy of gradual liberalisation of exchange controls based on a set of key-policy and structural requirements:-

the appropriate macro-economic fundamentals must be put in place;

a sound and well regulated financial system must be in place

a flexible exchange rate has been chosen to act as a shock absorber against global developments.[19]

67. Increased capital flows have the potential:

to help fuel faster growth and narrow the gap in living standards;

to raise investment by supplementing domestic earnings;

to deepen domestic capital markets and raise growth with a more efficient allocation of resources among competing projects. But increased capital mobility and integration of financial markets have also led to increased volatility, particularly in portfolio flows. For example, private portfolio flows to emerging economies almost

---

Evidence of Mr TA Manuel, Minister of Finance, National Treasury Bundle 83-85 halved as a result of the Asian crisis, falling from about USD135 billion in 1997 to about USD70 billion in 1998.[20]

68. A gradual approach to the liberalisation of exchange controls has to a large extent enabled the Government to manage the volume of capital outflows and allowed it to adapt the pace and strategy of liberalisation in response to changing circumstance. The pace of liberalisation has taken into account factors such as expected capital inflows, the net open forward position (NOFP), foreign reserve levels and a desired path for the real exchange rate.

69. The process of exchange control liberalisation, however, is complex due to the size of the capital flows, the number of players in the market and the number of financial instruments available. Capital inflows to South Africa have proven to be volatile. Imbalances in the foreign exchange market are more often than not a consequence of the drying up of capital inflows due to mainly external factors rather than changes in capital outflows due to the effectiveness or ineffectiveness of domestic policies.[21]

70. Following on the liberalisation of exchange control, the capital outflows over the period 22 February to 31 December 2001 were as follows:

Private individuals in terms of their investment allowances transferred	R 7 billion
Corporates by way of foreign direct investment transferred about	R13.5 billion
Institutional investors acquired foreign portfolio investments of	R 3.88 billion[22]

20 Evidence of Ms M Ramos, Director-General, National Treasury, National Treasury Bundle 25-26
21 Ramos National Treasury Bundle 34-36
22 Evidence of Mr TT Mboweni, Governor of the Reserve Bank, Bundle SARB (7) 34-35

71. In the opinion of Mr Mboweni, the Governor of the SARB, it is virtually impossible to estimate the exact extent to which exchange control liberalisation has contributed to Rand weakness but there can be no doubt, as the figures above show, that it could at times have been an important structural factor.[23]

72 The re-entry of South Africa into the globalised financial markets and the opening-up to international competition led to a sharp increase in the participation by non-residents in the domestic financial markets. Non-residents are now responsible for about ⅓ of the turnover of the JSE Securities Exchange SA and about ⅛ of the volumes on the South African Bond Exchange. This has caused share and bond prices, as well as the exchange rate of the Rand, to be increasingly influenced by developments in the rest of the world, particularly in emerging markets.[24]

73. Transactions by non-residents contributed materially to substantial increases in financial sector activity in the period 1995 to 2001:

annual turnover on the South African bond exchange increased from R2.0 trillion to R12.4 trillion;

the total value of shares traded on the stock exchange rose from R63 billion to R606 billion;

in the Rand foreign exchange market volumes increased from a net average daily turnover of USD2.7 billion to USD7.3 billion.

74. Transactions of non-residents resulted in greater volatility in capital flows

74.1 Non-resident net purchases of shares on the JSE Securities

23 Mboweni Bundle SARB (7) 35
24 Mboweni Bundle SARB (7) 35; Ramos National Treasury Bundle 40

Exchange SA (measured in billions of Rand) were:

1995	1996	1999	2000	2001
5.3	26.2	40.6	17.4	29.8

74.2 Net purchases by non-residents on the South African bond exchange were even more volatile. Net purchases increased from R3.4 billion in 1996 to R14.8 billion in 1997. Non-residents then sold bonds to the value of R9.8 billion in 1998 and bought back R14.3 billion in 1999 on a net basis. In 2001 non-residents again became net sellers of bonds in the amount of R20.2 billion in 2000 and R25.9 billion in 2001. The sharp fluctuations in portfolio investments of non-residents contributed materially to greater volatility in the external value of the Rand.[25]

International Capital Flows

75. Joseph Yam, chief executive of the Hong Kong Monetary Authority in 1999, stated that international capital flows are essential to effective financial intermediation and play a vital role in economic development. But he noted that as the Asian financial crisis had demonstrated, the increasing volume, velocity and volatility of capital flows have the potential to distort, disrupt or even destabilise domestic financial markets[26]. Speaking after the currency crisis in Hong Kong in 1998 he urged that countries need to grasp the opportunities produced by globalisation but must also manage the risks that they bring with them in ways that strengthen, rather than undermine economic fundamentals. Commenting on the Asian financial crisis in 1998 he had the following to say:

25 Mboweni Bundle SARB (7) 36

26 Speech delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority,at the Credit Suisse First Boston Asian Investment Conference on 26 March 1999

"the Asian financial crisis is a cumulative result of many complex causes coming together at roughly the same time. But if we were to find a single factor that has brought the crisis to a head and magnified its damaging effects, we should be looking not to 'cronie capitalism' or 'Asian values', but to a more specific and more universal phenomenon; the swift flow of large amounts of heavily leveraged capital into and out of the region through an international financial system that is globalised, liberalised, technologically advanced, but from an international point of view, largely unmanaged and unregulated"[27].

76. There are common features between Asian countries as emerging markets and South African markets which, like the Asian countries, are small and open and fluctuation in the currency and the sort of risks associated with globalisation are therefore a feature of the South African foreign exchange market.

77. Dr Abedian has argued that financial markets including capital and foreign exchange markets display two key characteristics: they are imperfect and incomplete[28].The outcome of imperfect and incomplete markets are as follows:

financial markets are neither efficient nor socially optimal;

markets are structurally prone to short-lived as well as prolonged "bubbles" in which prices and quantities could deviate from private and socially optimal levels;

information plays a vital role in such markets. Such financial

---

27 Joseph Yam,supra
28 Aberdian Witness Bundle p 260

markets are largely vulnerable to information manipulation, rumours and speculations[29].

78. The foreign exchange markets are both incomplete and imperfect and are commonly subject to overshooting and undershooting which in small open economies entail a high degree of volatility with resultant financial and social costs. The bulk of these costs refer to structural damages to the economy and shorter macro economic imbalances in the form of higher interest rates, inflation rates, and welfare losses.

79. As the integration of global markets increase and in the absence of an international regulatory and prudential framework, the frequency of financial market crises will occur[30]. To illustrate this point Abedian has shown how a financial crisis has affected the currency in various cases[31]. The reason for each of these crises differ but Abedian argues that specific factors and financial market operations interact to give rise to a particular crises and he broadly identified the following factors as possible root causes of these events:

Macro economic policy imbalances;

"Herding", spawned for no other reason than trend;

self –fulfilling crisis (stemming from internal policy) despite no worsening in trend fundamental;

contagion via trade links;

banking confidence / crises;

29 Abedian, Witness Bundle p 261
30 Abedian, Witness Bundle 262
31 See Annexure 7

79.6 large agents advancing the dates of crises.

80. Referring to the Tai crisis of July 1997 which started locally but then engulfed the whole Asian region in 1998, Yam likened the crisis to a stampede and said that it took very little account of the economic fundamentals behind the market. He argued that there were ongoing problems in many Asian economies but there was no microeconomic reason why there should have been such a sudden and wholesale withdrawal of funds and quoted the US Deputy Treasury Secretary, Lawrence Summers, who had said and, I quote;

> *"If a financial crisis has elements of a self-fulfilling prophecy, like bank grants. Everyone expects failure or everyone expects everyone else to expect failure, leading to a rush to be a first one out in that causing failure.*[32]"

81 This appears to be what happened to the foreign exchange market in South Africa in 2001.

E. PERFORMANCE OF THE RAND 2001

The History of the Rand

82. Dr Jammine argues that a historical review of the Rand should be seen in four distinct phases[33]. The first phase incorporates the Rand movement until 10 March 1995 and covers the period during which there was a dual exchange rate system in place. The financial Rand acted as a shock absorber for the commercial Rand. It is therefore not accurate to compare the movement of the currency prior to 1995 with that which prevailed after such date

---

32 Lawrence Summers, quoted in Yam's address
33 See Annexure 8

83. The second phase is from March 1995 to the end of 1999 which is characterised by two sell-offs in the currency in the first half of 1996 and in the middle of 1999. On both occasions the Rand recovered and stabilised for a period of over a year in 1997 and 1999 respectively.

84. The third phase covers 21 months from the beginning of January 2000 to 11 September 2001.

85. During this period the Rand on an almost consistent basis declined against the US Dollar.

86. It is significant that in the second half of this 20 month period the Rand depreciated against other currency's besides the Dollar as well, but the currencies movements against these other currencies were not as consistently downward as against the Dollar specifically.

87. The fourth phase covers the period 11 September to 20 December 2001 which was characterised by an increase in the depreciation of the Rand.

Highlights of the Performance of the Rand before 2001 were:-

88. Most of the Rand's history incorporated a dual exchange rate system. The financial Rand acted as a shock absorber for the commercial Rand and traded at a significant discount of between 15% and 55% to the commercial Rand over the thirty years that this mechanism was in place.

89. On different occasions during the 1970's the commercial Rand was fixed to the US dollar or to the British pound and fluctuated in line with the value of these currencies. In September 1975, specifically, Government devalued the Rand against the Pound by 18%.

90. In the late 1970's the commercial Rand was allowed to float freely against all currencies and in 1980 hit its highest level ever of USD1.35 to the Rand.

91. During the debt standstill crisis in the 1980's both the commercial and financial Rand plummeted, with the Rand losing over 30% of its real trade weighted value in a matter of months. The only comparable decline of such magnitude in the real effective exchange rate of the Rand was witnessed in November and December 2001.

92. For a period of 11 months after the abolition of the dual exchange rate system on 10 March 1995 the unified Rand was stable at around R 3.60 to the US Dollar.

93. The year 1996 marked a "sell-off" of the Rand with the Rand losing 20% of its value, reaching R 4.50 against the US dollar by June 1996.

94. Around September/October 1997, the world witnessed the start of the so-called Asian crisis. The contagion arising from this crisis hit all emerging markets in May 1998 and the Rand was materially affected, as with currencies of many other developing countries.

95. Having declined by over 20% in real terms in 1998, the Rand regained some of its composure through 1999, trading in a broad band between R 5.50 and R 6.40 to the US Dollar during that year.

96. The long slide in the Rand began with the Rand trading at R 6.12 at the turn of the new millennium.[34]

---

34 Jammine Expert bundle 297 – 300, 303, 304, 307- 312

The Rand Foreign Exchange Market in 2001

97. Most of the experts testifying to the Commission as well as some of the Commission's assistants took into account only the last three months of 2001 as that is the period during which the depreciation of the exchange rate of the Rand accelerated.

98 During the year 2001, the Rand recorded the following exchange rates against the US dollar during the year:

moving from around R 7.60[35] to the US dollar at the beginning of the year, the Rand depreciated to over R 8.00 for the first time ever during the second quarter;[36]

the pace of depreciation increased with the Rand at R 8.52 to the US dollar on 11 September, R 9.03 at the end of September and R 9.44 at the end of October;

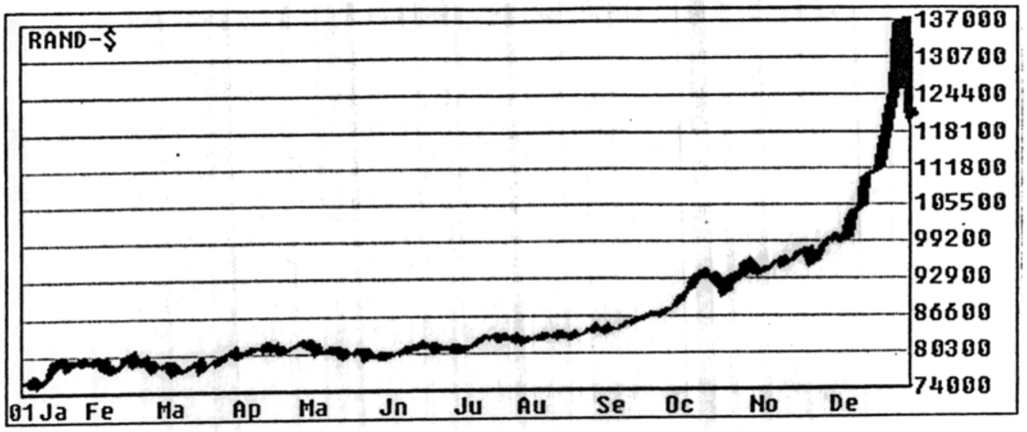
by the end of November 2001 the Rand had fallen to R10.27 to the US Dollar;[37]

the rapid depreciation reached its crescendo with the Rand hitting a new all-time low of R 13.84 to the US dollar on 21 December 2001;[38]

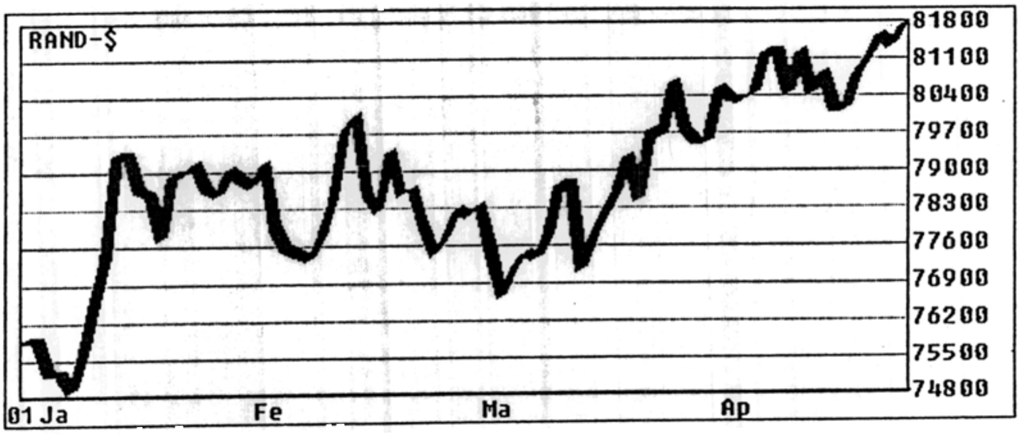
98.5 for the period 1 January to 31 August 2001 the Rand depreciated by 10.7% or an average of 1.3% per month, while from 1 September to 31 December 2001, the Rand weakened by 42% - an average of 10.5% per month.

35 Mboweni Bundle SARB (07) 283
36 Jammine Expert bundle 317
37 Jammine Expert bundle 336
38 Mboweni Bundle SARB (07) 30

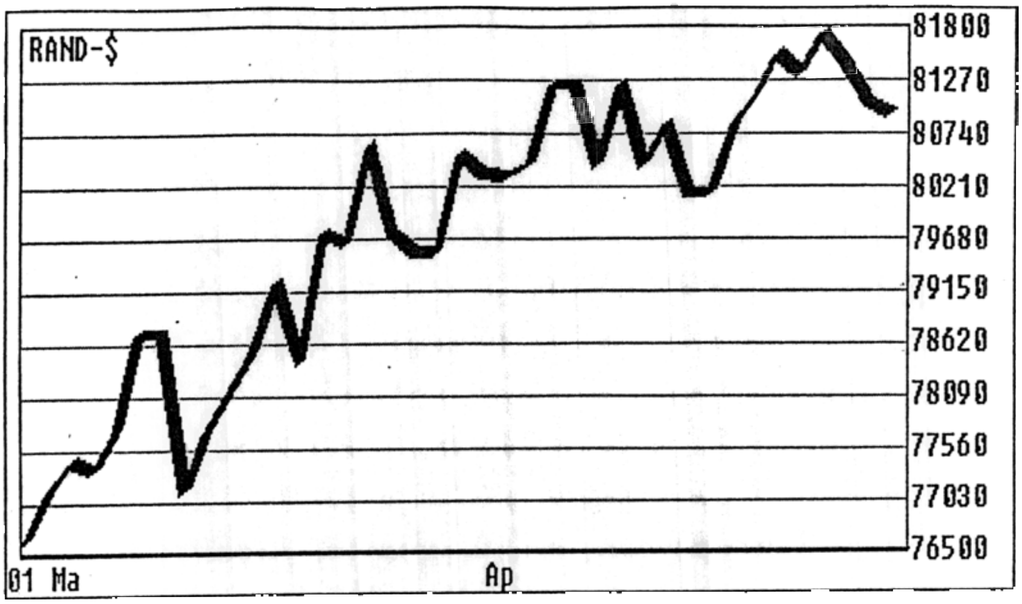
99. Below are three graphs showing the movement of the Rand during the year 2001. The first graph below shows the full 12 months.



100 It can be seen on the graph above that the Rand seems to be relatively flat from January to end of August. The rapid depreciation appears to start in September. From September to December, the Rand depreciated 42%, which is "super" extraordinary. What is not clear in the graph above is that, the Rand lost 10% since the beginning of the year, as shown in the graph below:



101 If we focus on the months May and April, the picture becomes clearer. The graph below shows that the Rand lost 8% (effective 59% annualized) over the two months.



102 What occurred in the last four months of the year was therefore not simply a rapid depreciation (this having commenced in the first six months) but something much more extraordinary given the rate of depreciation.

103 Dr Jammine indicated that in November and December technically the Rand had entered a so-called blow-off phase which means that the currency was in unchartered territory and would keep running upwards in an ever dramatic fashion against the US Dollar until the movement blew itself out which occurred on 20 December. The extent of the depreciation was not simply rapid but abnormal. Gouws also indicates that compared to other currencies towards the end of 2001 South Africa become somewhat of a special case[39].

The Rand against the Dollar compared to other currencies

104 The weakness of the Rand against the US dollar during 2001 compared to other comparable countries is illustrated in Annexures 9 and 10, indicating

39 Gouws Expert Bundle 114

that South Africa had become, towards the end of 2001, somewhat of a special case[40].

105. The graphs in annexures 9 and 10 graphs below show the Rand's performance relative to the exchange rates of similarly rated countries and against those of other emerging-market economies. The thick red line indicating the South African Rand:

If one measures the Rand against four other emerging market currencies: the Brazilian real, the Korean won, the Polish zloty and the Mexican peso, one finds that from 1999 until late 2001 there was not much difference in the value of the Rand and those currencies, save that the Brazilian real was weaker[41].

In 2001 the Rand held its own against the Korean won, the Polish zloty and the Mexican peso until September/October 2001 but then plunged in value. In December 2001 the Rand became even weaker than the Brazilian real.[42]

108 Similarly, until about September/October 2001, the Rand performed as well as other commodity currencies, such as the Australian Dollar, the Canadian dollar, the New Zealand Dollar, the Norwegian Krone and the Swedish Krone. O'Neill commented:

> *"...that it was October of last year something seemed to happen...which caused the Rand to actually under-perform against those commodity majors...relative to the [US] dollar."*[43]

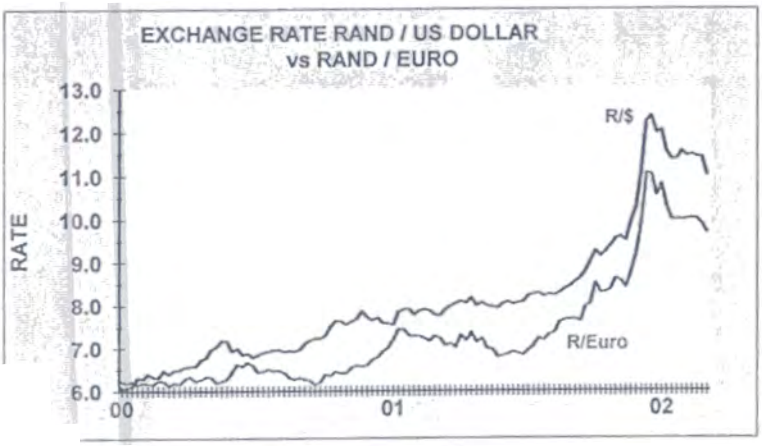
40 Gouws Expert Bundle 114

41 See Annexure 11

42 Evidence of Dr TJ O'Neill, Global Head of Economic Research, Goldman Sachs, Record 1464.

43 Evidence of O'Neill, Record 1468

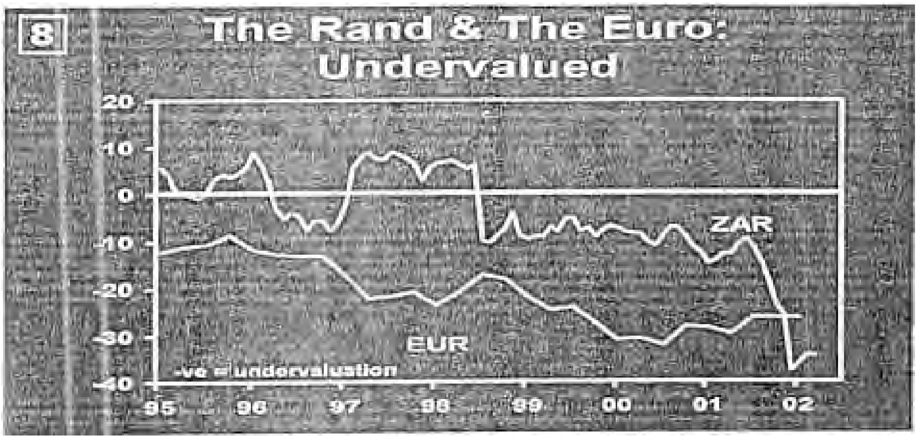
109. The performance of the Rand is usually illustrated against the US dollar. Although the Rand/Euro exchange rate was not worse in early September 2000 than it had been when the Euro was introduced, between September 2000 and November 2000, the Rand suddenly began declining against all currencies, especially the Euro. This was at a time when the Euro began strengthening against the US Dollar.[44] This is illustrated in the graph below[45]:



Goldman Sachs adopts a methodology to estimate the fair value of an exchange rate. Fair value is defined as the inflation adjusted exchange rate (often called purchasing power parity (PPP)) which is then adjusted for relative productivity. Conceptually, a country with stronger productivity should see its real currency appreciate relative to other currencies and a country with weak productivity should see its currency depreciate. Until

44 Jammine Expert bundle 316
45 Chart 20 Expert bundle 369

late 2001, according to the fair value model, the Euro was more undervalued than the Rand[46].



111 It may be that as Europe is a major trading partner of South Africa, the Euro's persistent weakness relative to fair value has contributed to the Rand's weakness. [47]

The role of speculations in the depreciation of the exchange rate of the Rand

112 Experts giving evidence before the Commission disagreed about the reasons for the collapse of the Rand. O'Neill testified that in his opinion one should not spend too much time blaming one specific currency for its decline against the US dollar. In the past three years many currencies weakened against the US dollar, some of which have had weak growth, some had very strong growth, some had current account surpluses, some had current account deficits, and so on. Generally speaking, until late 2001 there was nothing particularly interesting from an international perspective about the Rand's weakness. Given that other important currencies also weakened against the US dollar, there was not much that

---

46 Slide 8, O'Neill Bundle 9

Evidence of O'Neill, Record 1470-1

South Africa could do about it because it had nothing to do with South Africa.[48]

113. There was much debate in the Commission regarding the meaning of the word speculation. Authorised Dealers and expert witnesses were particularly concerned that the term should not be interpreted in a negative sense as speculation is allowed in the South African foreign exchange market provided Exchange Control Regulations are not contravened.

Based on the evidence placed before the Commission, speculation can be defined as entering into a transaction based on a view of the future value of a currency. This is a wide definition and would in effect mean that most foreign currency transactions would have a speculative element in them. It seems that speculative activity can fall into 2 categories: that which can be done legally as in Authorised Dealer's proprietary trading provided they stay within limits set by the SARB and speculation that is illegal or unethical. An example of illegal speculation is trading in the Rand without a firm and underlying transaction. Such speculation is sometimes referred to as pure speculation.

Speculation can also include the operation of leads and lags but more often than when authorities refer to speculation against the Rand, they mostly refer to speculators with an open foreign exchange position, and more particular a short position in Rand.[49]

117. While South African experts agreed on what they perceive to be the macro economic reasons for the weakness in the Rand, they disagreed with what has been referred to as the blow-out period from September to December 2001.

48 Evidence of O'Neill, Record 1466-1469. See also Annexure 12

49 Luüs, Expert Witness Bundle, p 214

18. While some argue that the weakness of the currency in the latter part of 2001 was as a result of an extraordinary confluence of factors and forces which started to exert an influence from early September onwards. They blame much on negative sentiment towards the currency and the 14 October statement by the Reserve Bank. Even where they admit that some market participants may have taken advantage of prevailing circumstances they believe that "the sharp decline" in the currency was the result of economic, political, policy and confidence factors and forces that had built up over a number of months. These factors impacted on the currency via thousands of decisions by market participants.[50]

119. Others have stated that given the sound economic fundamentals even if one could take into account the macro economic reasons a problem arises

> *"when the weakness exceeds all fundamental explanations resulting to some extent, in a situation of relative panic as shown by the extreme movement in the later part of 2001".* [51]

120. Jammine has argued that the fall of the Rand from October onwards relative to other emerging market currencies seemed inexplicable".[52] This was especially so since the economic situation in South Africa seemed a lot better than that of other emerging markets. For example, he mentioned that South Africa's budget deficit was declining as a percentage of GDP to below 2%, whilst that of several other emerging markets, especially in Latin America, were large. [53]

121 At the time Argentina's government was struggling to get its public service to agree to a wage cut as a means of reigning in its public sector deficit that was getting out of control and pushing the country's public debt to

---

[50] Gouws Record, p 161
[51] Glynos, Expert Witness Bundle, p 423
[52] Jammine, Expert Bundle, p 324
[53] Jammine, Expert Bundle, p 326. See also Annexure 13

unacceptably dangerous levels. In contrast the reduction in South Africa's public debt is a consequence of successive years of declining budget deficits which were starting to yield benefits in terms of the reduction in interest government was obliged to pay on its borrowing.[54]

Dr Jammine argued that most of the factors which would explain why in the midst of a positive economic situation some depreciation of the currency would occur, had been around for many months if not years prior to the collapse of the currency. He suggested that it would be difficult to attribute the collapse in the Rand late last year even to a combination of these factors. What the combination of these factors did do is to render the Rand an excellent vehicle for speculation against emerging market currencies.

It is such speculation, he argues, which is the only explanation for the depreciation of the Rand in the latter part of 2001. Like all the other experts he was of the view that there was a perception that the Rand is a one way bet. What contributed even more to this sense was the fact that the Reserve Bank Governor, frequently made it clear that the Reserve Bank would not intervene on the foreign exchange market to support the Rand.[55]

124. Abedian stated that as the foreign exchange market was deepening there were signs of speculative transactions as compared to trade based activities in the foreign exchange market. He indicated that this was largely healthy as it provided additional liquidity in the market and helped to smooth out the leads and lags in hard currency volumes. By the fourth quarter of 2001, the volume of speculative hard currency deals amounted to as much as USD 300 million.[56] He noted however that these were soft estimates and inherently difficult to quantify.

54 Jammine, Expert Bundle, p 326. See also Annexure 14
55 Jammine, Expert Bundle, p 335 – 337
56 Abedian Witness Bundle, p 271

125. It appears that it is not only non-resident banks' participation that was reduced but also local Authorised Dealer activity. According to data available from the SARB and cited by Glynos, volumes traded by local banks reached a peak in October 2001 but then dropped off considerably in November and more so in December. [57]

126. According to Glynos the extent of the decline of trading volumes by non-residents in the forward and spot market in December confirms that there was speculation in those markets.[58]

127. The sharp drop off in local bank trading coupled with lack of speculation from non-resident participants coincided with the Rand exchange rate depreciating at its fastest. [59]

128. The Rand is the second most highly traded emerging market currency. According to a study conducted by the Bank for International Settlements (BIS) covering the month of April 2001, trading in the Rand accounted for 0,5% of all foreign currency trades in the world. This made it the twelfth most traded currency in the world for that month and the second most traded currency amongst emerging market currencies, after the Singapore dollar. In contrast with the 0,5% of total global currency trade in April 2001 the Rand had accounted for only 0,1% of total global currency trade in 1995 and 0,3% in 1998. This meant that the currency's liquidity had increased dramatically over the preceding six years. [60]

57 Glynos Witness Bundle, p 433 See Annexure 22
58 Glynos Witness Bundle, p 433
59 See Annexure 22
60 Jammine, Expert Bundle, p 341

The Dollar/Rand foreign exchange market is dominated by financial institutions in London and Johannesburg. London based financial institutions are the largest traders in volatility products eg. Options.[61]

This increase in liquidity was totally out of proportion to the increase in foreign trade with the country which suggests that the currency had been increasingly associated with financial rather than trade flows. The probability that trades in the Rand had become speculative in nature was therefore quite high and on the rising trend.[62]

131 Trading in the Rand increased further in the third quarter of 2001 and it would seem as if trading in the Rand increased three fold in the six months following April 2001.[63] If it is correct, then Jammine argues that it suggest that by September / October 2001 the Rand may have been accounting for 1,5% of international trading currencies, moving into the eighth position in trading ranks of all currencies in the world, just behind the Australian Dollar. Given that the South African economy and its foreign trade account for less than 0.5% of the world's GDP and international trade respectively it is surprising.

132 Abedian argued that the macro economic factors and the reduction of the NOFP concurred to weaken the currency, but argued that the overall position of the institutional investors in the country did not favour the currency. By the end of the third quarter of 2001, it was abundantly clear that foreign investments of nearly all the fund managers in South Africa would not have a positive return in hard currency terms.[64] Depending on the timing of the foreign investment, such investments could have earned

De Villiers, Record, p 363 and Expert Bundle, p 248

62 Jammine, Witness Bundle page 341
63 See Annexure 16
64 See Annexure 17

negative returns of between 20 to 40% during the preceding year or even the preceding two years.

Against a back drop of poor performances of equities, the saving grace of such investments lay in the dramatic depreciation of the currency. While institutional fund managers do not have any direct and operational mechanisms to influence the value of the currency, pessimism against the currency was helpful for their portfolio results in Rand terms.[65]

It is not only institutional investors with investments abroad but also a number of other market players that found short term gains in the depreciation of the currency. They included exporters in general and commodity exporters whose prices are quoted in US terms, South African corporations and individuals with accumulated foreign investments.
With the exception of importers of non-essential goods nearly all market players had positioned themselves for a fall in the value of the currency. He argued that *"parallel with market sentiments is the material interest of key market players with regard to the currency depreciation"*.[66] Taking this into account he stated that no one had much interest in taking a position in favour of the Rand.

136. It seems experts who pointed a finger at speculators whom they blamed for the rapid depreciation of the exchange rate of the Rand in 2001 were referring to illegal or unethical speculation.

FINDING

137. The Commission is of the view in light of evidence placed before it, that speculative activity both legal and illegal and both by non-residents and residents, contributed to the rapid depreciation of the Rand especially in

65 Abedian, Expert Bundle, p 274
66 Abedian Witness Bundle, p 275

the second half of 2001. On account of the lack of investigation of certain crucial areas of speculative activities such as proprietary trading of Authorised Dealers and CFC accounts, the Commission is not able to establish the exact percentage of such speculative activity.

The Commission however does not view legal speculation undesirable. It is important however that some form of regulation should be introduced to minimise opportunistic or pure speculation.

Collapse of the Rand in 2001 a major financial crisis

The rapid depreciation of the exchange rate of the Rand in 2001 months is an unprecedented financial crisis. A comparable crisis of the Rand occurred in 1985 during which the Rand depreciated by losing approximately 30% of its real trade weighted value in a matter of months. During this period both the commercial and financial Rand collapsed.[67]

140. The circumstances in 1985 were different in that the South African economy suffered a severe down turn in early 1985 when the authorities tried to grapple with escalating inflationary pressure caused by capital outflows and a falling currency by raising interest rates to 25%. The Reserve Bank sharply increased borrowings from abroad which made the country vulnerable to a debt crisis. Chase Manhattan Bank demanded that South Africa repay short term credits and the South African government was unable to oblige. Many other banks began demanding repayment and a debt moratorium was declared by government.[68] Jammine argues that the debt standstill crisis in 1985 with South Africa's creditors fearing that their loans to the country may not be repaid, no such

67 See Annexure 18
68 Jammine, Witness Bundle, p 302 and 303

fundamental crisis existed in late 2001 to justify a similar crash in the currency.[69]

141 The volatility of the Rand, in 2001 and the panic that set in the market created what McCauley referred to as *"a disorderly market"*. In a normal market the success of bids and offers are related in that they fall within a certain range. One notion of a disorderly market is a pattern where the bid offer spread begin to move in big jumps. Whereas normally the bid offer would be a tiny fraction of a percent, when the market gets disorderly, dealers are scared of taking on the risk of taking a clients orders and they secure that risk by widening their bid asks spread, essentially charging more for the service of providing liquidity to the market.[70]

142. Disorderly market *"can be this combination of gapping in the bid asks spread, providing of the bid asks spread and finally a sense that the market is only going one way"*. [71]

The Effects of Currency Crisis in 2001

143. Depreciation in a country's currency can be beneficial. The competitiveness of domestic produces in international markets as measured by the inflation-adjusted effective exchange rate of the Rand improved significantly from December 2000 to September 2001. The monthly average inflation adjusted effective exchange rate of the Rand declined by 11,9% over this period.[72]

144. Another benefit of the depreciation of the Rand is the increase in the country's total international reserve. While the value of South Africa's gross gold and other foreign exchange reserves declined in Dollar terms

---

69 Jammine Expert Bundle, p 303
70 McCauley, Witness Bundle, p 6 Record p 66
71 McCauley, Record p 66
72 Mboweni, Witness Bundle, p29

from USD 13,3 billion at the end of September 2001 to USD 12,4 billion at the end of December 2001, the country's total international reserves in Rand terms rose from R118,9 billion to R150,7 billion over the same period. The result was an improvement in the import cover (i.e. the value of gross gold and other foreign exchange reserves relative to the value of imported goods and serves).[73]

145. Mboweni in his statement to the Commission referred to one of the main benefits being competitiveness of exports. The effective exchange rate of the Rand improved significantly from December 2000 to September to 2001. The monthly average inflation adjusted effective exchange rate of the Rand declined by 11.9% over this period.

146. Jammine has argued that it is difficult to draw conclusions regarding the impact of the depreciation of the exchange rate of the Rand in the course of the last six months.[74] The most obvious outcome has been a steep increase in the inflation rate. The most dramatic rise has been in the producer price inflation rate which has risen from 7.8% in September 2001 to 14.8 % in April 2002. At the consumer level the increase in inflation has been much more modest so far, rising from the low point of 4% in October 2001 to 8.4% in May 2002.

147. The CPI inflation rate, excluding the impact of changes in interest rate, i.e. CPIX inflation around which the government has set its inflation targets, has increased from 5.9% in October 2001 to 9.2% in May 2002. It is still too early to assess the full impact on inflation because there may be a lag between the rate of increase in prices at the producer wholesale level and the passing on of such cost increased to consumers as reflected in the CPI and CPIX inflation rate. A general expectation exists that the CPIX

---

73 Mboweni, Witness Bundle, p 24

74 A briefing note prepared by Jammine

inflation rate will increase more before starting to decline from the 4th quarter of 2002 onwards.

148. There are two important contributors to the sharp increase in inflation stemming from the depreciation of the Rand. These are food prices and fuel prices. As a result of the abolition of agricultural marketing boards in the mid 1990's, food prices in recent times have come to reflect the depreciation of the Rand for more readily and quickly since farmers have the option of exporting their produce at Rand prices well in excess of those previously obtainable in South Africa. As a result, South African food prices have had to rise quite speedily to come into line with the international Rand price of food. There is the fact that the producer price of food at the agricultural level has increased dramatically from 2.0% in April 2001 and 15.1% in September 2001 to a peak of 29.0% in March 2002 and a slightly lower level of 25.4% in April 2002.[75]

149. The food products which appear to have been most vulnerable to export parity pricing (that is the fall in the value of the Rand) is maize, fat and oil. In September 2001 the producer inflation rate at the agricultural level for grain and oil seeds had already risen to 32.1% and 66.8% respectively, partly as a result of the depreciation of the exchange rate of the Rand and partly as a result of shortage of such products internationally which pushed international grain and oil seed prices even in dollar terms. [76]

150. Fuel prices increased by 19% over the past nine months and this can be directly linked to the depreciation of the exchange rate of the Rand against the dollar rather than a general rise in oil prices.

---

75 Jammine, Briefing note
76 Jammine, Briefing note

The more obvious effect has been the 3% increase in the short-term interest rate since the beginning of the year. At the beginning of 2002 the prime overdraft rate was 13%. At the end of June it is 16%.

The effects of inflation have a bigger impact on poor people on account of food and fuel forming a far bigger share of total personal consumption as compared to their middle class counter parts.

153. Jammine has indicated that despite a sharp increase in inflation and interest rate, the real economy performed much better than expected after the collapse of the Rand. Economic growth in GDP for 2002 now looks as if it may come to 2.7% compared with early expectations of 2% or less. Retail sales in the 1st quarter increased by 5.9% year on year in volume terms. Furthermore in the first 4 months in 2002 manufacturing production has increased by 6.8% compared with the same 4 months of 2001. It is not clear whether this resilience in the domestic economic activity will continue or whether the impact of higher prices and interest rates will emerge in the second part of 2002.

154. What is not clear is to what extent the volatility of the exchange rate of Rand has created the impression among foreign investors that the Rand is an unstable currency which could depreciate massively at a moment's notice again in the future. There have been significant inflows of portfolio investment into the South African bond market in recent months. Jammine argues that this would seem to belie the perception of undue risk being associated with investment in South African.

155. Drummond indicates that in casual discussions with potential foreign investors there is evidence of a perception of an unstable financial environment based on what happened to the currency especially in the second half of 2001.

PART III

F. EXCHANGE CONTROL IN SOUTH AFRICA

The South African Reserve Bank

The SARB was established as the central bank of South Africa in 1921 in terms of the Currency and Banking Act No. 31 of 1920. This Act was replaced in 1944 by the South African Reserve Bank Act No. 29 of 1944. In 1989 the South African Reserve Bank Act No. 90 of 1989 (the SARB Act) was promulgated and is currently still in force as amended from time to time.

The bank has been privately owned since its establishment and presently has in excess of 650 shareholders.

The SARB Act provides that no individual shareholder may hold more than 10 000 shares of the total number of 2 000 000 issued shares. After the payment of certain amounts, amongst others, company tax, transfers to reserve and annual dividend payments which may not exceed ten cents per share, the surplus of SARB earnings is paid to Government.

The SARB Act provides for a Board of Directors with 14 members. The Governor and 3 Deputy Governors are appointed by the President for 5 year terms and are members of the Board. The President also appoints 3 other directors for a period of 3 years. The remaining 7 directors are representatives from various sectors of the economy and are elected by the SARB shareholders for a period of 3 years.

160. The Governor and Deputy Governors manage the day-to day affairs of the SARB.

Historical background to Exchange Control

Exchange controls have been in place in South Africa since 1939. The current governing legislation is set out in the Exchange Control Regulations promulgated in 1961 in terms of the Currency and Exchanges Act No. 9 of 1933.

162. Exchange controls in South Africa were applied more stringently during the apartheid era especially in 1985 when international sanctions, trade boycotts, disinvestment campaigns and the withdrawal of loan funding to South Africa exerted severe pressure on the balance of payments and the domestic economy as a whole.

163. The introduction of a dual currency system was meant to address some of the problems. The Financial Rand system was used for capital account transactions. Any outward transfer of funds other than normal trade related transactions, was subject to prior approval by the exchange control authorities.

After the first democratic elections in 1994 the new Government initiated the process of liberalisation of exchange controls. The first major step in this direction was the abolition of the Financial Rand in March 1995.

Role and Functions of the SARB

The Minister of Finance is responsible for exchange control policy. The SARB implements and administers such policy on behalf of the Government and also acts in an advisory capacity. The SARB and the Government are jointly responsible for determining exchange rate framework policy.

The Gov he A of eg wi the Mi ter
nance cco with he rovi th C tu ion nd further
rud to mic po cy
rn pe od h mem rtf
Com te nance arl m

224 the C pulate SARB' primary ob cti to be
the protection

*'th the rrency in th rest of bala ced
sta bl mi rowth th Rep blic'*

A Act mp th m wor describing th
pri ry ob ti AR

he AR m perf
ful ties rried mm ci
m nd impl m tary ol cy m
th corne SA cti

ru ry 00 ffi ta
op y ti
te to AR m ta

T' AR he m
ity th ion to
tribute to ta bl th

Oth te uencing fla ch m
ed xt io or exch ng te ctl rg te houg
do rol te of in tion.

Inflation targeting does require nominal exchange rate flexibility because South Africa has adopted a fully flexible exchange rate regime. There is no specific target for the exchange rate.

The SARB does however concern itself with the exchange rate but only to the extent that it has an impact on the inflation process.

The depreciation of the currency directly affects the price of imports in addition to possible secondary effects where high import prices have impacted on wage and other price increases.

The SARB is responsible for achieving the inflation target through the formulation and implementation of monetary policies.

The Monetary Policy Committee (MPC) of the SARB decides monetary policies.

178. The primary instrument of monetary policy available to the SARB is its influence on the level of short term interest rates through its refinancing system, which is called the repo rate.

179. The change in repo rate influences short term market interest rates in two ways: firstly it directly influences the marginal cost of funding of banks and secondly it reflects the SARB's monetary policy stance. Consequently it impacts on other interest rates in the market and can affect the exchange rate through its impact on domestic demand and capital movements.

180. The interest rate is not adjusted to influence the exchange rate but rather to influence in a pre-emptive manner, future inflation.

In the medium to longer term, successful inflation targeting should also contribute to a more stable exchange rate of the Rand.

The independence of the SARB and its autonomy is enshrined in the Constitution though regular consultation between the Bank and the Minister of Finance does take place.

G. LEGAL FRAMEWORK OF EXCHANGE CONTROL

The Currency and Exchanges Act

The Currency and Exchanges Act is the foundation of exchange control in South Africa. Section 9 (1) of the Act provides that:

> *"the Governor-General (the President) may make regulations in regard to any matter directly or indirectly relating to or affecting or having any bearing upon currency, banking or exchanges."*

Exchange Control Regulations

The Exchange Control Regulations are promulgated in terms of the Currency and Exchanges Act. The Regulations were promulgated on 1 December 1961 and amended from time to time.

The control over South Africa's foreign currency reserves as well as the accruals and spending thereof is vested in the Treasury. The Treasury is defined as the Minister of Finance or an officer in the Department of Finance who by virtue of the division of work in that Department, deals with any matter on the authority of the Minister.

Orders and Rules

From time to time the Minister of Finance issues Orders and Rules under the Exchange Control Regulations. The Orders and Rules contain various orders, Rules, Exemptions, Forms and Procedural Arrangements.

The Exchange Control Rulings

The Exchange Control Rulings are issued by the Exchange Control Department of the SARB and contain certain administrative measures as well as permissions, conditions and limits applicable to transactions in the foreign exchange market which may be undertaken by Authorised Dealers.

188. The Rulings are amended from time to time by way of Exchange Control Circulars.

189. Authorised Dealers may deal with applications for foreign exchange received by them if the applications fall within the parameters outlined in the Rulings without reference to the Exchange Control Department.

The Exchange Control Manual

190. The Exchange Control Manual was first issued by the SARB in October 1990 to assist Authorised Dealers, their customers and other interested parties, by providing a general understanding of the purpose, scope and operation of the exchange control system in South Africa and in the CMA.

191 The Manual serves only as a general guideline and does not replace or supersede the Exchange Control Regulations, Orders and Rules or the norms and policies as applied by the Exchange Control Department.

Authorised Dealers

Certain banks have been appointed by the Minister of Finance to act as Authorised Dealers in the foreign exchange market. Such appointment gives them the right to buy and sell foreign exchange subject to conditions and within the limits prescribed by the Exchange Control Department of the SARB. Authorised Dealers are not the agents of the Exchange Control Department but act on behalf of their customers.

Applications to the Exchange Control Department

193. Applications by customers of Authorised Dealers in forex which fall outside the scope of the Rulings must be referred to the Exchange Control Department for adjudication. The Exchange Control Department deals with each application on its own merit taking into account the information on record with the Exchange Control Department and within the parameters of detailed policy and norms. The records kept by the Exchange Control Department date back to 1939.

194 The decision of the Exchange Control Department including any conditions, if imposed, is furnished in writing to the Authorised Dealer and conveyed by it to the applicant.

195. The responsibility for ensuring that the execution of the transaction complies with any terms and conditions laid down by the Exchange Control Department lies with the applicant, though the application is made through the Authorised Dealer.

196. In certain circumstances, as for instance market sensitive transactions, the Exchange Control Department will entertain applications directly from the applicant.

197. Where approval is refused, resubmission is possible when a more senior official will review the application. In certain instances the department will grant an interview with the applicant and the Authorised Dealer during which the policy and norms are explained.

H. PURPOSE OF EXCHANGE CONTROL

The reason for the exchange control exist in order:

198.1 to ensure the repatriation into the South African banking system of all foreign currency acquired by residents of South Africa whether of a current or of a capital nature;

198.2 to prevent the loss of such foreign currency resources through the transfer abroad of real or financial capital assets held in South Africa;

198.3 to effectively control the movement into and out of South Africa of financial and real assets (money and/or goods) while at the same time not interfering with the efficient operation of the commercial, industrial and financial systems of the country.

198.4 to avoid undue pressures on the country's gold and foreign exchange reserves, which in turn would result in serious domestic inflation, a weakening of the country's terms of trade with the rest of the world, the impoverishment of the domestic population, the retardation of the domestic economic growth rate and the distortion of the Rand equivalent of the South African foreign debt.

The Removal of Exchange Control in South Africa

The first democratic government ushered in by the elections of 1994 has paid particular attention to exchange controls in South Africa.

The South African Government decided on a gradual approach to the elimination of exchange control as opposed to what is termed a "big-bang" approach. A phased approach allowed Government more time to implement other policy changes in order to achieve the preconditions necessary for a successful abolition of exchange control.

It had been decided by Government to proceed with the liberalisation of exchange control in the following sequence :

201.1 firstly, the abolition of exchange control on all current account transactions (import and export of goods and services) which has been done;

201.2 secondly, the abolition of exchange control on non-residents which has also been done;

201.3 thirdly, gradually becoming more lenient in the approval of applications for direct foreign investment by South African corporates. This is an ongoing process;

201.4 fourthly, allowing institutional investors to acquire foreign assets to diversify their total portfolio investments. This is also ongoing;

201.5 fifthly, to release immigrants' blocked funds which are funds or assets of an immigrant that are not transferable from South Africa and are physically controlled by an Authorised Dealer.

Remaining Exchange Controls in South Africa

Certain exchange controls remain. For the purpose of this report the relevant controls are the following:

202.1 foreign investments by South African corporates;

202.2 share placements by South African corporates;

202.3 foreign loans from outside the CMA;

202.4 import and export transactions by Authorised Dealers on behalf of South African importers;

202.5 forward exchange contracts with South African residents and non-residents;

202.6 customer foreign currency accounts.

Net Open Forward Position

The NOFP arose at a time in the history of this country when sanctions were in place against apartheid and the economy was marked by isolation from the rest of the world, low domestic savings and low foreign reserves.

In this environment the SARB had a mandate to intervene in the foreign market and was for many years responsible for providing cover against exchange rate fluctuations on behalf of the Government.

As early as the 1980's, attempts were made to extricate the SARB from the forward market but due to the prevailing political conditions this was not possible.

After the debt standstill in 1985, residents were increasingly reluctant to hold offshore debt because of the losses suffered on revaluation of foreign debts when the exchange rate depreciated by about 30% in 1985.

The strict exchange control requirements at the time prevented any resident from holding foreign currency and banks were permitted to do so within strict limits. In these circumstances the SARB provided forward cover to residents in respect of their offshore exposure.

208. The forward cover mechanism was used to encourage long term borrowing offshore as well as access to short term offshore finance. It was thus used to enable corporate South Africa to access international credit lines. These credit lines were to a large extent related to trade.

209 As a result of this, during the 1980's and the 1990's, the SARB was an active participant in the foreign exchange market firstly and initially by virtue of the responsibility to assist with the development of a foreign exchange market in South Africa but later to assist in achieving a relatively stable exchange rate. The SARB has on various occasions over the years intervened in defence of the Rand. As the SARB did not have adequate foreign reserves, the obligations to deliver forex into the market were converted into forward obligations. Such interventions took place in 1996 and also in 1998.

210 The forward book of the SARB reflects all unsettled future foreign exchange commitments of the SARB. Since the forward book was used among others to provide cover to residents in respect of the offshore loans, this resulted in an oversold or negative balance on the forward book. This oversold balance implies that the SARB's commitment to deliver foreign currency at future dates, is greater than its future commitments to buy or receive foreign currency.

211 The second reason for using the forward book is that it is also used as a way to underwrite intervention. The bank for example, sold US dollars into the spot foreign exchange market in order to support the exchange rate of the Rand and then swapped the US dollars back onto its forward book by buying US dollars spot and simultaneously selling them forward. Profit

and losses in respect of providing forward cover are for the account of the Government.

Huge losses were incurred by the Government due to the existence of the NOFP. The NOFP is the difference between the forward book and the net results of the SARB which is for the Government's account.

It is on account of the exposure of Government in this regard and the consequent losses as well as inflation targeting that the SARB did not intervene in support of the Rand in 2001.

Both the National Treasury and the Bank have expressed a determination to reduce the NOFP as it has been perceived negatively by market participants and commentators, including the International Monetary Fund, the rating agencies and the investment banking community.

Given the losses on the forward book and negative perceptions from market participants and commentators on the one hand and the potential impact on the currency of reducing the forward book on the other, the Bank had a difficult choice to make. In the long term interest of the country, it was decided to place emphasis on reducing the NOFP. The Bank has had to buy foreign exchange as prudently as possible to close out the NOFP.

The Bank has stated that it has been conscious of the risk of doing this and has tried to manage this risk by buying US dollars selectively. When market conditions deemed it not to be conducive, the pace of the reduction of the NOFP was slowed down or the process of reduction was even suspended. This is shown by the wide fluctuation in the NOFP since 1994. [77]

[77] See Annexure 19

Impact of the NOFP on the Exchange Rate

Expert witnesses / economists from the various Authorised Dealers who gave evidence before the Commission as well as the Authorised Dealers themselves (check if Authorised Dealers are also mentioned in NOFP) submitted that the NOFP contributed to the depreciation of the Rand during 2001.

218. The SARB admitted that during the course of 2001, the Bank purchased foreign exchange proceeds which emanated from a number of large transactions. Their total purchases during the period covered by the Terms of Reference amounted to approximately USD 4.4 billion and were generated by Government's foreign bond issues and two large corporate transactions.

These purchases contributed to the decline in the NOFP to USD 4.8 billion at the end of 2001.

If the proceeds of these large transactions had been allowed to flow through the market the Rand could have appreciated significantly.

The SARB has argued that any negative impact on the exchange rate of the Rand is offset by the positive perceptions in the market in that a major negative influence on the currency is being actively addressed.

The specific reductions for 2001 are in the first quarter, USD 9.4 billion, second quarter, USD 5.3 billion, third quarter, USD 4.7 billion and fourth quarter, USD 4.8 billion. As at 12 March 2002, the NOFP stood at USD 2.9 billion.

THE 14 OCTOBER STATEMENT BY THE GOVERNOR OF THE SARB

Consideration of the impact of the statement issued by the Governor of the Reserve Bank on 14 October 2001 falls outside the Terms of Reference of this Commission. However, in view of the fact that it had been repeatedly mentioned by expert witnesses and Authorised Dealers as a factor that they believed contributed to the depreciation of the Rand, the Commission is of the view that it is necessary to deal with it in some detail.

In the course of 2001 and on account of the volatility of the exchange rate of the Rand, the SARB was informed by players in the foreign exchange market that speculative transactions, particularly by non-residents were adding to volatility and Rand weakness. It was informed that investors and other emerging markets with less liquid financial markets were using the South African market as a hedge for the weakness in other countries.[78]

The SARB either had a choice of abolishing the remaining exchange controls or to apply the existing rules and regulations equitably to all.

The Bank became increasingly concerned that excessive volatility in the foreign exchange market during the 3rd quarter of 2001, exacerbated by the tragic events of 11 September 2001, negatively influenced inflation, business decisions and the economy as a whole and therefore issued a statement on 14 October 2001.[79]

227. Part of the statement read:

78 See Annexure 20
79 Mboweni, Record, p 661

"The Reserve Bank stands ready to take appropriate firm steps against trading activities inconsistent with existing rules and regulations. The enforcement of existing rules serve to ensure that only legitimate transactions take place in the foreign exchange market. This does not restrict, for example, the ability of a non-resident investor to either hedge or repatriate the sale proceeds of an investment in South Africa. It does, however, exclude the financing of short Rand positions in the domestic markets, which is consistent with the requirement that domestic borrowing by non-resident investors is subject to certain restrictions. This communication should not be construed as an attempt to restrict the activities of banks in the South African market, provided they adhere to the existing rules and regulations. Normal commercial and financial transactions remain unaffected. "[80]

228. The statement mentioned the NOFP as follows:

"The net open foreign currency position (NOFP) declined from USD 23,2 billion at the end of September 1998 to USD 4,8 billion. Given the negative perceptions resulting from the NOFP, the Reserve Bank reduced its position by purchasing foreign currency in a domestic foreign exchange market, which may have contributed to the depreciation of the Rand over this period."[81]

229. The statement further advised that Government would not intervene in the foreign exchange market.

"In future, the Reserve Bank will not intervene by purchasing foreign exchange from the market for purposes of reducing the NOFP. The NOFP will be expunged from cash-flows derived from

80 Statement is contained in Annexure 20
81 Mboweni, Record, p 340 and 341

the proceeds of government's offshore borrowing and privatization.[82] *The bank believed that applying the existing rules and regulations to exclude speculative trading from our foreign exchange markets will reduce volatility in the Rand's exchange rate and would be to the benefit of non-resident investors in South Africa."*

230. Before the SARB issued the statement, it invited the chief executives of domestic and foreign banks which have a presence in South Africa to a meeting on Sunday 13 October 2001. The chief executive of each institution was accompanied by the head of treasury in that institution.[83]

The purpose was to inform chief executives of the SARB's intention to issue the statement and the statement.

Only two banks, both foreign, raised concerns. The first was Citi Bank which raised a concern that the SARB action could result in the development of the offshore market, over which the Reserve Bank would have no jurisdiction.

The second bank that raised a concern was Deutsche Bank which argued that the SARB was focusing on the wrong target to enforce existing rules and that the target may be somewhere else.[84]

Following the statement issued by the Governor on 14 October 2001, the Exchange Control Department issued an Exchange Control Circular D 342 to the Authorised Dealers on 16 October 2001.[85]

---

82 Witness Bundle, SARB, Vol 7, p 341
83 Mboweni, Record, p 662
84 Mboweni, Record, p 662 and 663
85 The Circular is contained in Annexure 21

235. The Circular requested Authorised Dealers to ensure that their overseas counterparties are fully conversant with the Exchange Control Rules applicable.

236. The Circular read as follows:

> *"To ensure that the provisions of the various Sections of the Exchange Control Rulings are applied uniformly by all Authorised Dealers, in particular when dealing with non-residents in the forward and other derivative foreign exchange markets, we deem it necessary to reiterate certain fundamental principles in this regard."*
>
> *"It is incumbent upon Authorised Dealers to ensure that their overseas counterparties are fully conversant with the rules applicable to dealing in the domestic forward and other derivative foreign exchange market.*
> *It follows, therefore, that when dealing with a non-resident counterparty, other than a correspondent Bank, supporting documentary evidence must be obtained confirming that such non-resident counterparty has a legitimate South African exposure resulting from an accrual, investment or asset denominated in Rand. Where the required supporting documentary evidence is not available at the time of entering into a transaction, such documentation must be presented within 14 days for endorsement. In the case of correspondent Bank, a written confirmation every two weeks to the effect that all transactions have been executed within the ambit of the aforementioned rules, signed by the compliance officer, is acceptable. Copies of the endorsed supporting documentation as well as the written confirmations must be retained for inspection purposes.*

Trading operations may continue to be undertaken by non-residents in the domestic markets in respect of their assets, liabilities or future firm and ascertained commitments and/or accrual."[86]

The purpose of the Circular was to bring to the attention of the Authorised Dealers the Governor's statement and to explain its contents. The Circular is a restatement of the Rules and Regulations.

The Reserve Bank Market Working Committee under the chairpersonship of the advisor to the Governor, Mr Lambertus van Zyl, held various subsequent meetings with the working committee established by the Authorised Dealers and finalised the wording of the compliance letter requested from the correspondent Banks.

With regard to the Exchange Control Rules and Regulations, it had also been decided to bring pertinent matters to the attention of non-resident counterparties. A notice for the attention of relationship managers, compliance officers and dealers was then issued through ACI to all Authorised Dealers for distribution to their foreign correspondent Banks. [87]

It was stated in a notice that the measures taken by the SARB on 14 October are not retrogressive in nature and represent an application of existing rules and regulations.[88]

This notice read in part:

The South African Reserve Bank has decided to ensure that existing exchange rules and regulations should be applied. After consultation with the Reserve Bank, the South African Authorised

86 Witness Bundle SARB, p 6, 215
87 Bruce-brand, Record, p 568 – the notice is extracted at Witness Bundle SARB Vol 6, p 224
88 Bruce-brand, Record, p 568

Dealers decided to inform their correspondents abroad of the requirements to deal in the South African foreign exchange market. We are of the opinion that the measures being applied are not retrogressive in nature and represent an application of existing rules and regulations. The authorities have no intention of generally denying non-residents access to the foreign exchange market, but believe that in the interest of fairness, existing rules should not only be applied to resident and non-resident investors in South Africa as is currently the case, but also to non-residents who have only a trading interest in the South Africa foreign exchange market. It should also be clear that the rules and regulations apply very specifically to the financing of short Rand positions in the foreign exchange and domestic financial markets."[89]

It appears that notwithstanding the explicit emphasis in the notice that the South African authorities remain committed to the orderly and gradual process of relaxation of exchange control and that the statement was in effect a restatement of existing exchange controls, it was misinterpreted by market participants. The SARB Governor stated in his evidence to the Commission that in some instances this misinterpretation was deliberate.[90]

Misinterpretation relates to the fact that instead of regarding it as a stricter enforcement of existing exchange controls, it was interpreted as a tightening of such controls.

Though there was no tightening of exchange control or rules, there was a new requirement that Authorised Dealers procure from correspondent non-resident banks a written statement, a letter of compliance letter from the compliance officer of the banks, that a firm and ascertainable commitment or accrual existed prior to entering into any foreign exchange

89 Bruce-Brand, Witness Bundle SARB, Vol 7, pg 344
90 Mboweni, Record 664

transaction. The Authorised Dealer previously had this obligation but the written certificate was not required.

Witnesses to the Commission argued that the statement reduced liquidity in the market. Foreign banks could have decided as a precautionary measure to avoid finding themselves in contravention of exchange control rules, and reduced their level of activity in South Africa's foreign exchange market.

However in his evidence the Governor of the SARB stated that:

> *"the causality could have been the other way, i.e. sharp movements in the Rand's value could have created uncertainty leading to the widening in the bid- offer spreads and a reduction in liquidity*".

247. In terms of the figures reported to the SARB, the net daily turnover in the Rand foreign exchange market had declined from an average level of USD 7.4 billion in October 2001 to USD 5.5 billion in November 2001 but increased again to a level of USD 6.1 billion during the week of 15th December 2001.

248. The most significant decline was in the stock market where the average daily net turnover declined from an average level of USD 5.8 billion in the first ten months of 2001 to an average USD 4.3 billion for the last two months. The turnover of non-residents – the most significant participants in this market – declined from USD 3.6 billion to USD 2.3 billion respectively. [91]

While it is accepted that turnover alone is not a perfect measure of liquidity, it does represent a reasonable proxy. When assessed together

---

91 Bruce-Brand, Record

with a widening of a bid-offer spread from 50 points to, at times, 1000 points, it does appear that liquidity in the foreign exchange market was affected.[92]

The issue of liquidity also arises when considering volatility. One month historical volatility of the Rand's exchange rate against the US dollar increased from a level of 9.1% in the first 9 months of 2001, to an average of 20.5% for the last quarter.[93]

251 These volatilities reached a high of 55% at the end of December 2001

252. As a result of the concern by the Minister of Finance and the Governor at the rate of depreciation, they issued a joint statement on 21 December 2001. The statement focused on the solid macro economic fundamentals and on the prudent policies being employed. The statement's concluding paragraph read as follows:

> *"In this uncertain environment, many experts and commentators have emerged, all with views and policy advice. While constructive input from stakeholders is always appreciated, it is important to point out that much of the volatility is driven by sentiment and opportunism. It is in times such as these that we should respond as a country, with full confidence in ourselves and the policies we have adopted."*

It was argued by expert witnesses that the statement was problematic in the following ways:

253.1 it led to confusion in the foreign exchange market generally and specifically among non-resident banks;

[92] See volume 9 Lambertus Van Zyl
[93] Mboweni, Witness Bundle, SARB, Vol 7, p 45

253.2 it made the foreign exchange market illiquid as a result of the exit of non-resident banks and traders.

The 14th October statement, liquidity and depreciation of the Rand

Witnesses sought to make a direct link between the lack of liquidity and the depreciation of the Rand. They argued that in an illiquid market, even small transactions that would not normally affect the exchange rate in a liquid market, affected the exchange rate in December. They therefore blame the depreciation in the exchange rate of the Rand on the Reserve Bank's action in issuing the statement of 14 October 2001.

From the evidence heard by the Commission, there was a significant reduction in liquidity in the latter part of 2001. [94]

It is clear from the evidence placed before the Commission that liquidity was reduced in the latter part of 2001.[95]

Both Abedian and Glynos acknowledged though that the 14 October 2001 statement removed "pure" speculators from the market which was one of the intentions of the 14 October 2001 statement by the SARB. It wanted to ensure that both resident and non-resident banks complied with all Exchange Control Regulations.

258. Glynos has stated that he believes the Reserve Bank's statement of 14 October 2001 was successful in scaring off speculators.[96]

---

94 See Graph 3 in SARB Volume 9
95 See Gouws Bundle, p 125
96 Glynos, Record, p 467

259. During cross examination by Counsel for the Reserve Bank, witnesses for FirstRand Bank Limited and Investec conceded the following with regard to the 14 October statement and Circular D342 respectively:

that Circular D342 was drafted by Authorised Dealers in response to the 14 October statement by the Governor of the Reserve Bank and was in effect a collaborative effort between the Reserve Bank and the Authorised Dealers. It was presented to the Reserve Bank for its final approval and only thereafter made public;

that the meaning of the Circular was unambiguous and easily understood by a reasonable Authorised Dealer and foreign correspondents;

259.3 that the wording of the compliance letter to be signed by non-resident banks was a collaborative effort between the SARB, (resident Authorised Dealers) and the Association of Commercial Authorised Dealers (ACI)[97];

made compliance with Exchange Control Regulation easier in that unlike a previous requirement (B7) where confidential information including the names of parties and the details of the transaction had to be forwarded by non-resident banks to the resident Authorised Dealer, only a written confirmation every two weeks to the effect that all transactions have been executed within the ambit of foreign exchange rules signed by the compliance officer was now acceptable;

259.5 removed the limitation that South African Authorised Dealers

97 Testimony of Jurie Bester, Head of Risk and Audit services for FirstRand Bank Limited, Record, p 1369 to 1374

could only deal with foreign banks and not foreign corporates and individuals.[98]

J. IMPACT OF ILLIQUIDITY IN THE MARKET ON THE EXCHANGE RATE OF THE RAND

The evidence of Mr Robert McCauley presented to the Commission confirmed that in a market where liquidity has been reduced, more often that not, a transaction of a given size can have a bigger effect than it has in a normal liquid market but that there is not necessarily a direct link between lack of liquidity and depreciation of a currency. Lack of liquidity therefore cannot on its own constitute an explanation of depreciation of the Rand. Referring to the statement of 14 October he stated that:

> *"….. to the extent that you focus on general liquidity, you can get decline in liquidity after such a measure and that, considered all by itself, can give you larger reaction to subsequent transactions that go through the market….yes the question is whether a less liquid market sort of explains a subsequent decline in the exchange rate and I guess that is a bit problematic. A less liquid market may mean that whatever flows go through, have more effect but that leaves the flows and the balance between supporting the currency and depreciating the currency sort of left unexplained."*[99]

In some instances the impact could be positive for example, if there are short positions that have to be closed out after a new measure is taken, the currency may appreciate. He illustrates this by indicating that when the Malaysian Central Bank on 1 September 1998 announced that they were imposing capital controls, the Malaysian Ringit appreciated

98 Pauline Trollop, Global Head of Treasury Compliance, Investec, Record, p 1421 to 1425
99 McCauley, Record, p 82

considerably after that. The specific circumstances in each case will determine the impact on the exchange rate.

The Reserve Bank also led evidence which questioned a simplistic linking of lack of liquidity with depreciation of the currency during 2001. Mr Lambertus van Zyl, former General Manager International Banking Department and currently advisor to the Governor, stated that there is no consistent relationship between changes in turnover in the domestic Rand foreign exchange market and the level of the exchange rate of the Rand. He illustrated this by looking at both the long term and short term causal link. For the purposes of the example, the total turnover in the domestic Rand foreign exchange market was used.

In 1996 the Rand depreciated from an average of USD1/ZAR3.6410 in January to USD1/ZAR4.2057, in April. This was a depreciation of 15,5%.[100] Over the same period the average daily turnover in the domestic Rand foreign exchange market increased by almost 42% from USD3.019 billion to USD4,284 billion[101]. Total turnover by non-residents increased by some 79% from USD0,683 billion to USD1,223 billion. It would appear as if a sharp depreciation of the Rand at the time coincided with an increase in turnover and particularly, an increase in turnover by non-residents.

264. In 1998 the Rand again depreciated sharply. Having traded at a monthly average of USD1 = ZAR4.9357 in February, the Rand fell by 26,4% to an average of UDS1 = ZAR6.2386 in July[102]. Over the same period total average daily turnover increased by some 139% from USD3,093 billion in February to USD7,395 billion in July[103]. Once more turnover with non-residents increased, this time by 213% from USD1,323 billion in February

[100] See Graph 3 in Volume 9
[101] See Graph 4 on p 17 of SARB Volume 9
[102] See Graph 3 on p 17 of SARB Volume 9
[103] See Graph 4 on p 17 of SARB Volume 9

to USD4,138 billion in July. Over different periods the increase in turnover was even more pronounced as it peaked at a level in excess of USD11 billion in June 1998.

The above shows that in the specified previous periods of Rand weakness, sharp depreciations of the currency coincided with significant increases in turnover in the domestic Rand foreign exchange market, and in particular with non-residents. This does not mean that increases in turnover would normally lead to a weaker Rand nor that increases in turnover would inevitably lead to a weaker Rand.

Turnover in the domestic Rand foreign exchange market increased significantly early in 1999 without a sizable depreciation of the Rand. In January 1999 the average daily turnover was USD6,855 billion. By June 1999 the average daily turnover had increased by almost 33% to USD9,089 billion. Over the same period the average daily exchange rate depreciated by a relatively small percentage of 1,7% from USD1 = ZAR5.9835 in January to USD1 = ZAR6.0883 in June.

Over shorter periods the link between turnover and the exchange rate is also uncertain.[104] For instance, the Rand averaged at USD1 = ZAR11.5467 in December 2001, fluctuating significantly and briefly depreciating to USD1 = ZAR13.84, on an average daily turnover of USD6,051 billion. In February 2002 average daily turnover had declined by 19,4% to USD4,876 billion, but the Rand was more stable, trading at an average exchange rate of USD1 = ZAR11.4847.

While much of the focus of economists giving evidence before the Commission was on the depreciation of the Rand after 14 October, the

[104] See Graph on p 3 hereof

Rand had been on a steady depreciating trend since the beginning of the year, accelerating in July.[105]

FINDINGS

Statutory Duty of the SARB

The statutory duty of the SARB is to intervene and administer exchange control policy and protect the value of the currency in the interest of balanced and sustainable economic growth in South Africa.

The volatility in the foreign exchange market during the third quarter of 2001 negatively influenced inflation, business decisions and the economy as a whole. The SARB's decision to issue the statement of 14 October 2001 was necessary. It was a measured statement which called on market participants to observe existing Exchange Control Regulations. It was careful to set out which transactions were legitimate and indicated that it would enforce existing exchange control measures. It went further and indicated that it had no intention of restricting the activities of banks in the South African market and more importantly reassured participants that it would not intervene in the market by purchasing foreign exchange for the purposes of reducing the NOFP.

From the evidence placed before the Commission, it is difficult to understand how Authorised Dealers, resident and non-resident, and other participants could not understand the 14 October statement or Circular D342. It may be that both South African and non-resident banks and commentators did not like the statement. This is no basis however for suggesting that the statement was confusing.

105 See Graph on p 33 hereof

The SARB took a range of steps to ensure that market participants understood the rationale for the statement.

There was only one change, not in policy, but in compliance with existing policy namely the written confirmation by a compliance officer of a non-resident bank to the effect that transactions were in accordance with South African Exchange Control Regulations. But even this measure, as the evidence shows, was a simplification of the same requirement in that it reduced the number of details that had to be provided.

The Commission is further of the view that no basis exists for linking the issuing of the 14 October statement and Circular D342 on the one hand and the depreciation of the Rand in 2001 on the other. There is no doubt that liquidity significantly reduced in the foreign exchange market after the issuing of the statement. There was no evidence placed before the Commission which showed a consistent link between lack of liquidity and contributed to the depreciation of the Rand either in 2001 or historically. Cogent evidence was placed before the Commission which shows the contrary.

What the action of the Reserve Bank resulted in, was to remove pure speculators and other participants who probably were not complying either with the letter or the spirit of Exchange Control Regulations. It may be that non-residents who felt unhappy about having to complete the compliance letter also decided not to trade in the South African market.

It seems to the Commission that if the Reserve Bank had not taken the step it did, the volatility would have continued and possibly increased and the currency may have depreciated further. Glynos states that given the conditions in the market during the third and fourth quarter of 2001, market talk and expectations were that the Rand would be approximately R20,00 to the US Dollar.[106]

277. The action of the Governor of the Reserve Bank more than likely contributed to halting the slide of the Rand. This can be seen by the fact that the Rand has stabilised and appreciated while the levels of liquidity have remained low at least insofar as figures are available from the Reserve Bank for February 2002.

106 Glynos – Witness Bundle, p 433

Deutsche Securities carries on the business of dealing in shares, options on shares and other securities and financial instruments the value of which are based on, or derived from shares.

In the course of its business, Deutsche Securities trades in JSE Securities Exchange listed securities for its clients and for its own account. It also advises on, arranges, executes and settles transactions in equities for its clients.

Deutsche Bank Johannesburg in conjunction with Deutsche Securities in the course of 2001 implemented 3 share placement schemes involving 3 South African corporates namely Sasol Limited, Nampak Limited and M-Cell Limited. All 3 corporates are South African residents.

The share placement transactions were implemented by the structured equity transaction group, SETG, at Deutsche Bank Johannesburg.

The Sasol Share Placement

The application of the Sasol share placement

297 On 25 January 2001, Deutsche Bank Johannesburg applied to SARB, on behalf of Sasol, to conclude a share placement to raise Euro 350 million (approximately R2.5 billion). The terms and conditions, as represented to SARB, were the following:

297.1 Existing Sasol shares would be sold to long term foreign investors;

297.2 The foreign currency raised from the foreign investors would be paid to Sasol directly, and there would be no conversion into or out of Rands;

297.3 The proceeds from the share placements, ie. the foreign currency raised, would be used to refinance a portion of a bridging loan facility and revolving credit facility utilised to finance the acquisition of the offshore purchase by Sasol of Condea, an international chemical company whose head quarters are in Germany;

297.4 The Sasol and Nampak share placements are represented in Annexure 23.

Approval of the Sasol share placement

298. On 25 January 2001, the SARB approved the application by Sasol based on the representations made by Deutsche Bank Johannesburg. These included that:

298.1 the placement of the Sasol shares should be for the specific purpose stated;

298.2 the approval is subject to the Sasol shares being placed with long term foreign investors at market related prices. The proceeds from the share placement shall be paid to Sasol International Holdings in foreign currency and no conversion into or out of Rands will take place. No South African party will participate in the placement exercise;

298.3 there should be no flowback and a 6 monthly report should be done by Deutsche Bank Johannesburg to the SARB to monitor this. It was a condition that Deutsche bank should point out to the corporates, in this instance Sasol, that in the event of any flowback, the SARB reserves the right to call upon the corporate to refinance the amount transferred from South Africa abroad in order to recover the loss in foreign currency.

Implementation of the Sasol share placement

The Deutsche Bank Group, including Deutsche Bank London, a non-resident branch of Deutsche Bank, then proceeded to implement certain transactions to give effect to the share placement.

The transactions implemented were all related to the share placement. Deutsche Bank confirmed this in its evidence to the Commission.[108]

The transaction was implemented on the following basis:

301.1 On 19 and 20 February 2001, the Deutsche Bank Group exchanged approximately R2.5 billion for Euro 350 million, predominantly in the South African foreign exchange market. The settlement date for these foreign currency transactions was 26 February 2001. The Rand appreciated on 19 or 20 February 2001;

301.2 On 26 February 2001, Sasol paid exactly the same amount of Rands that were converted for Euros to Deutsche Securities, and received the equivalent in Euros, ie. Euro 350 million.

302. The effect of implementing the transaction on this basis was that the foreign currency reserves of the country were depleted by Euro 350 million ultimately. Deutsche Bank confirmed that the transaction was not reserves neutral.[109]

108 Record, p 997
109 Record, p 998

The Deutsche Bank Group did not disclose this fact to the SARB. In terms of the application to SARB, Deutsche Bank represented as agent of Sasol that there would be no currency conversion. As late as 18 October 2001 when questioned by the SARB, it confirmed that in the case of Sasol there was unlikely to be any currency conversion as Sasol was a "natural currency hedge". By this date the currency conversion had already been completed by Deutsche Bank 8 months earlier on 9 February 2001. Deutsche Bank's evidence is that the conversion was part of its "cash flow management".[110] It was only on 18 February 2002 that Deutsche Bank finally disclosed all the transactions in response to queries from the Reserve Bank.[111]

SARB's evidence has been that had it known about the currency conversion it would not have approved the share placement.

Deutsche Bank contended that there was no depletion of the foreign currency reserves of SA as a result of the conversion, as Deutsche Bank London concluded a bond repurchase agreement with Deutsche Bank Johannesburg

306. While a repurchase agreement in a legal sense is a sale and a repurchase, in substance the seller-borrower borrows the proceeds of the sale from the buyer-lender and deposits the securities he has sold as collateral. This transaction in effect provided for Deutsche Bank Johannesburg to lend Deutsche Bank London approximately R2.5 billion Rand which amount was converted into foreign currency at the expense of the foreign currency reserves of SA

307. Deutsche Bank undertook to provide the Commission with evidence confirming the initial purchase by Deutsche Bank London of the bonds,

[110] Record, p 989 and 994

SARB Witness Bundle Volume 8, p 178

which formed the subject of the repurchase agreement, and the basis upon which they were funded. No such evidence was produced.

308. The Deutsche Bank Group gave evidence that Sasol shares, to the equivalent of approximately R2.5 billion were initially sold to Deutsche Bank London (who was represented to SARB as a long term investor), Deutsche Bank London then on-sold these shares to other long term foreign investors. Deutsche Bank London was a long term foreign investor whose only benefit from the shares was the fee earned.

According to Deutsche Bank 39 735 600 Sasol shares were initially placed with Deutsche Bank London and according to the Deutsche Bank Group, as at 31 December 2001 14 206 933 had been on-sold by Deutsche Bank London.

The Commission investigated a sample of the shares on-sold by Deutsche Bank London and based on the sample could find no evidence that the shares on-sold to long term foreign investors were settled in foreign currency. All sales were settled in Rand.

A comparison to share placements effected by Gensec Bank Limited confirms that sales to foreign investors should in all instances be settled in foreign currency.

Sale of Sasol shares by Deutsche Bank London and flowback

312. Deutsche Bank represented to the Reserve Bank that the Sasol shares would be on-sold to long term investors and it is clear from their evidence that they understood long term investors to be investors that would hold the shares for at least twelve months.

313. They made the application on 25 January and undertook to comply with this condition. The approval was granted on 30 January 2001. Approximately a week later on 9 February Deutsche Bank Johannesburg entered into a forward sale with Deutsche Bank London in terms of which Deutsche Bank London held a put option which expired on 31 December 2001. This put option was to the full knowledge of Deutsche Bank exercisable at the latest 31 December 2001. Effectively therefore Deutsche Bank London could sell the unplaced shares to Deutsche Securities before 31 December resulting in an outflow of foreign currency from South Africa.

The Deutsche Bank Group has indicated that as at 31 December 2001 possible flow back into South Africa of Sasol shares was approximately 6% ie 2.5 million shares. This figure excludes the shares not on-sold by Deutsche Bank London.

In a letter dated 22 January 2002, the SARB asked Deutsche Bank to request Sasol to refinance from abroad the amounts transferred from South Africa in respect of the flowback sales in order to recoup the loss in foreign currency.[112] This letter was forwarded to Sasol by Deutsche Bank on 4 February 2002.[113]

316. Deutsche Bank London is not recorded as a shareholder in the Sasol share register. In terms of the Companies Act the share register is the definitive source in determining ownership of shares in a company.

Deutsche Bank's evidence was that it is difficult if not impossible to track flowback, notwithstanding that it accepted the obligation imposed by SARB in terms of the application to track flowback.

[112] Sasol Witness Bundle, p 136
[113] Sasol Witness Bundle, p 138

Non- disclosure of related transactions

318 In the context of the share placement transaction, as implemented by the Deutsche Bank Group, the following transactions were not disclosed to the SARB:

The scrip lending agreement concluded between SIH and Deutsche Bank;

318.2 The conversion of R2 503 340 000 to Euro 350 million

The bond re-purchase agreement between Deutsche Bank London and Deutsche Bank Johannesburg;

318.4 The transfer of South African Government Bonds by Deutsche Bank Johannesburg to Deutsche Bank London as security for the scrip lending agreement referred to in paragraph 314.5

318.5 The scrip lending agreement between Deutsche Bank London and Deutsche Bank Johannesburg, where Deutsche Bank Johannesburg acted as agent for Deutsche Securities.

319 The forward sale of Sasol shares between Deutsche Bank London and Deutsche Securities was disclosed to SARB but not in the context of the Sasol share placement. The application for the forward sale was made on 9 February 2001 in terms of which permission to trade 50 million Sasol shares was sought. The maturity date of the contract was 31 December 2001

FINDINGS

The Sasol / Deutsche Bank transactions were all interrelated

The underlying transactions of the Sasol share placement were all related thereto and would not have been entered into had it not been for the share placement.

Impact of Sasol Transaction on the Exchange Rate of the Rand

On 19 and 20 December Deutsche Bank Johannesburg paid Deutsche Bank London and amount of R2 503 340 000 in exchange for Euro 350 million. Of this amount R1 787 525 000 was exchanged in the South African foreign exchange market for Euro 250 million.
The difference between the Euro 250 and 350 million is that the 100 million was not (necessarily) transacted in the South African foreign exchange market. It would however ultimately impact on the reserves of the country.

The evidence was that the effect of the conversion of the Rand would be that the total foreign currency reserves of South Africa were reduced by Euro 250 million at that date and eventually by Euros 350 million.

The currency conversions referred to in the paragraph 316 above were effected on 19 and 20 February 2001, the settlement date being 26 February 2001. The currency conversion took place on 19 and 20 February 2001 and on these days the currency appreciated in value.

325. The Commission received information that on those dates a South African Authorised Dealer was the seller of USD 200 million. This information has not been verified by the Commission. If in fact such selling of USD did occur on those particular days, the selling of Rand by Deutsche Bank

Johannesburg would then have been absorbed in the foreign exchange market without contributing to a depreciation in the exchange rate of the Rand. It would also mean that had the sale by Deutsche Bank Johannesburg of Rand not taken place on those particular days the Rand would have appreciated to a greater extent. It may be that the prevention of an appreciation can be regarded as causing a depreciation. This could be disputed however.

326. The Commission is of the view given its understanding of the manner in which transactions impact on the exchange rate of the Rand, that the Sasol share placement in all probability contributed to the rapid depreciation of the exchange rate of the Rand in the course of 2001. The Commission however cannot make a conclusive finding as on the transaction date the Rand appreciated. Furthermore the Commission has not been able to verify the allegation regarding the USD 200 million being sold by an Authorised Dealer on the transaction date.

Contravention of Exchange Control Regulations

The SARB in its evidence to the Commission stated that Sasol and Deutsche Bank Johannesburg contravened exchange control regulations. The SARB in response to a series of questions from the Chairman of the Commission again on 6 June 2002 advised that Deutsche Bank Johannesburg had contravened exchange control regulations.

The evidence of the SARB was corroborated by the Commission's own investigative team

However in view of the fact that the Commission is not able to make a firm finding that the Sasol share placement gave rise to or contributed to the rapid depreciation of the exchange rate of the Rand, it is not able to express an opinion on the evidence led before us with regard to the contravention of the Exchange Control Regulations.

330 The attorneys for Deutsche Bank has correctly argued that the Terms of Reference require the Commission to make a two stage inquiry, namely firstly whether the transactions in question contributed to or gave rise to the depreciation of the Rand and only if the answer is in the affirmative can the Commission then go on to make a finding on whether or not the transaction is illegal or unethical. For this reason the Commission refrains from making a finding in this regard.

The Nampak Share Placement

Application for the Nampak share placement

331 An application was made by Deutsche Bank Johannesburg on behalf of Nampak on 12 December 2000. The terms and conditions, as represented to SARB, by Deutsche Bank Johannesburg were the following:

Existing Nampak shares would be sold to long term foreign investors;

331.2 The foreign currency raised from the foreign investors would be paid to Nampak International Limited directly, and there would be no conversion into or out of Rands;

The proceeds from the share placement, ie. the foreign currency raised, would be used as equity ie capital to partly fund the capital expenditure programme of Nampak's UK subsidiary, Nampak plc, formerly Plysu plc. The capital expansion plans would be placed on record with SARB.

Approval of Nampak share placement

On 14 December 2000, SARB approved the application, based on the representations made by Deutsche Bank Johannesburg. SARB included the requirement that they should be informed on a six monthly basis of the success of the placement including full details of any flowbacks which occurred and in the event of substantial flow backs occurring, SARB reserved the right to call upon Nampak to refinance the amount transferred from South Africa in order to recoup the loss in foreign currency.

As a further condition the SARB stated the following

> *"It is noted that the full proceeds to be received offshore will be capitalized in the books of Nampak Holdings (United Kingdom) PLC which capital injection will be utilized to fund the capital expenditure programme of Plysu PLC. Any expansion plans must, of course, be placed on record with ourselves. Should the expansion be in a different line of business, our prior approval is required."*[114]

334 On 11 May 2001 Mr John Sayers, financial director of Nampak Limited wrote a memo to Nampak's board and recommended that the total proceeds of the asset swap that had been obtained from the Reserve Bank should be paid into Nampak Holdings (UK) as equity and that GBP 25 million of debt be redeemed by Nampak Holdings (UK) with United Kingdom Banks.[115]

335 One of the advantages Mr Sayers pointed out is that it would create a capacity of GBP 76 million within a revolving facility for further

114 SARB approval dated 12 December 2000 in Investigating Team Bundle Annexure "E"
115 John Sayers, Nampak Witnesses Bundle, p 12

acquisitions. The proceeds of the share placement were therefore used for the reduction of Nampak's indebtedness to United Kingdom Banks instead of for the capital expenditure programme of Nampak plc for which it was applied for.

Counsel for Nampak did not deny that there was a deviation but indicated that the deviation will be accepted by the SARB since it was minor. If it had been applied for it would have been approved.[116] Counsel for the Reserve Bank also indicated that he did not consider it a major departure.

Implementation of the Nampak share placement

The Deutsche Bank Group, proceeded to implement this transaction on the same basis as was the case with Sasol. The transaction was implemented as follows:

337.1 On 26, 27 June and 2 August 2001, the Deutsche Bank Group exchanged approximately R229 million for GBP 20 million, in the South African foreign exchange market. The settlement date for these foreign currency transactions was 3 July 2001 and 7 August 2001. The Rand did not depreciate on 26 June 2001 or 2 August 2001, but did depreciate on 27 June 2001;

337.2 On the dates the Rand were exchanged for foreign currency Nampak paid Deutsche Bank the equivalent amount of Rand as were converted and received the equivalent amount of foreign currency of the Rand converted;

337.3 No evidence was placed before the Commission to indicate that Nampak was aware of all the underlying transactions of the share placement scheme;

116 Nampak Record 1569

337.4 The effect of implementing the transaction on this basis was that the foreign currency reserves of the country were depleted by GBP 20 million.

The Deutsche Bank Group did not disclose this fact to SARB beforehand and even as late as October 2001 when questioned by SARB did not disclose this fact.

Deutsche Bank contends that there was no depletion of the foreign currency reserves of South Africa as Deutsche Bank London concluded a bond repurchase agreement with Deutsche Bank Johannesburg which transaction facilitated the payment by Deutsche Bank Johannesburg to Deutsche Bank London in the amount of approximately R230 million and the conversion of this amount into foreign currency.

Deutsche Bank was to provide the Commission with evidence confirming the initial purchase by Deutsche Bank London of the bonds, which formed the subject of the repurchase agreement. No such evidence was produced.

341 The SARB has argued that the Exchange Control Department would not take into account the acquisitions of South African assets by non-residents which occurred prior to an application for a share placement.[117]

Utilisation of Foreign Currency Proceeds

342. Nampak failed to comply with one of the conditions of the SARB's approval in that it deviated from the purpose for which it was originally sought and it failed to report to or obtain the prior approval of the SARB.

117 SARB, Vol 9 p 4

343. The foreign currency proceeds realised from the Nampak share placements were initially utilised by Nampak to reduce the loan raised from a syndicate of banks to settle the purchase price of Nampak (UK) plc and not for the specific purpose for which approval was granted by the Exchange Control Department of the SARB namely the capital expenditure programme of Nampak plc. Counsel for the SARB and Nampak's counsel argued that such a deviation would have been favourably considered had it been placed on record with the South African Reserve Bank.

Sale of Nampak shares and flowback

The Deutsche Bank Group contends that Nampak shares, to the equivalent of approximately R230 million were initially sold to Deutsche Bank London (who was represented to SARB as a long term investor). Deutsche Bank London then on-sold these shares to other long term foreign investors. 18 356 185 shares were initially placed with Deutsche Bank London and according to the Deutsche Bank Group, as at 15 February 2002, 4 737 689 had been on-sold by Deutsche Bank London.

The Commission investigated a sample of the shares on-sold by Deutsche Bank London and based on the sample could find no evidence that the shares on-sold to long term foreign investors were settled in foreign currency. All sales were settled in Rand. A comparison to share placements effected by Gensec Bank confirms that sales to foreign investors should in all instances be settled in foreign currency.

None of the long term foreign investors, to whom shares were sold, including Deutsche Bank London, appear as registered shareholders in the share register of Nampak.

Non-Disclosure of Related Transactions

347. The following transactions were not disclosed to the SARB:

347.1 The script lending agreement concluded between Standard Bank of South Africa and Deutsche Bank;

347.2 The conversion by Deutsche Bank London of a total of R229 350 000 for GBP 20 million;

347.3 The bond re-purchase agreement between Deutsche Bank London and Deutsche Bank Johannesburg;

347.4 The transfer of SA Government Bonds by Deutsche Bank Johannesburg to Deutsche Bank London as security for the script lending agreement between Deutsche Bank London and Deutsche Bank Johannesburg; and

347.5 The script lending agreement between Deutsche Bank London and Deutsche Bank Johannesburg, where Deutsche Bank acted as agent for Deutsche Securities.

348. The forward sale of Nampak shares between Deutsche Bank London and Deutsche Securities was disclosed to the SARB but not in context of the share placement. The application for the forward sale was made on 18 October 2000 in terms of which permission to trade 13,95 million Nampak shares was sought. The maturity date of the contract was 18 October 2001.

349. It was represented to the SARB that no currency conversion would take place.

Knowledge by Deutsche Bank

There has been a suggestion by Deutsche Bank that there may have been confusion around certain terms such as reserves neutrality.

The Commission is not persuaded to accept this argument and is satisfied that Deutsche Bank understood that at *all times the transactions* should not result in the outflow of capital from the country. This is from the evidence presented by the Reserve Bank, the correspondence between Deutsche Bank and the Reserve Bank, the terms of the application and Deutsche Bank's undertakings to the Reserve Bank regarding the issue of reserves neutrality. The Reserve Bank has defined the term in its Quarterly Bulletin which it must be presumed Deutsche Bank is familiar with

Even if Deutsche Bank did not understand the exact meaning, it had a duty to clarify issues with the Reserve Bank. Apart from the Rulings and Manual which Deutsche Bank is expected to be fully conversant with, there is also the Liaison Committee of the South African Reserve Bank where issues that are not clearly understood can be clarified and debated between the SARB and Authorised Dealers.

353 Deutsche Bank knew or should have known that while non residents such as Deutsche Bank London can deal in the South African foreign exchange market without being subject to exchange control, if they wish to hedge such transactions they must have a firm and ascertained exposure to possible losses arising from foreign exchange rates and other risks arising from such transactions.

354. In its correspondence with the SARB, Deutsche Bank's explanation of the term currency leakage shows that its understanding of the term does not differ from the SARB reserve neutral.

355. Given the fact that Deutsche Bank is one of the largest and most active traders in the foreign exchange market it is difficult to believe that it does not have the necessary knowledge of its obligations in terms of Exchange Control Regulations, Rulings and Orders and Rules.

FINDINGS

Nampak Share Placement

Impact on the exchange rate of the currency

356. The transaction dates of Nampak share placement are 26 and 27 June 2001.

357. On 27 June 2001 the Rand depreciated. The Commission is of the view that the Nampak share placement transaction contributed to the depreciation of the Rand on this date. What the Commission is not able to ascertain is the extent of the contribution to such depreciation.

Contravention of Exchange Control Regulations

358. The Exchange Control Regulations require strict compliance with its provisions. Of importance for present purposes is Regulation 10(1)(c) which reads as follows:

> 10.(1) *No person shall, except with the permission granted by the Treasury and in accordance with such conditions as the Treasury may impose:*
>
> *a)* ....
>
> *b)* ....
>
> *c) "Enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic."*

Since Treasury delegated its powers to the SARB, it is the SARB who sets conditions on which transactions may be entered into.

Any conditions contained therefore in an approval by the SARB must be complied with by the applicant notwithstanding that such conditions may not be contained in the Regulations, Rulings or Orders and Rules. Failure to comply with such conditions would be a contravention of Regulation 10(1)(c) as read with Regulation 22.

The Exchange Control Rulings set out the procedures to be followed by Authorised Dealers in administering the Exchange Control Regulations. Section A(B) of the Rulings state the following:

> *"Authorised Dealers will appreciate that in carrying out the important duties entrusted to them; uniformity of policy is essential, and that to ensure this, it is necessary for the Exchange Control Regulations and the Exchange Control Rulings and Circulars thereunder to be applied strictly and impartially by all concerned. Any deviation from or non compliance with the directives contained in the aforementioned documents is regarded in a serious light and Authorised Dealers are urged to adhere strictly to the letter and the spirit of these directives. In the interest of all parties concerned the severe penalties that may be imposed in the event of transgressions of the Regulations, Rulings, Circulars and other directives and authorities need to be emphasized."*[118]

362. With regard to disclosures, the Rulings are explicit. Section A(D)(ii) reads as follows:

> *"The Exchange Department of the South African Reserve Bank is required to be in possession of full information regarding the*

[118] Rulings contained in SARB Vol 1

transaction, its nature and purpose, before consulting with the Treasury or exercising the authority conferred on it by the Minister of Finance. When submitting applications for consideration, Authorised Dealers should ensure at all time that the full first names and surnames of an applicant are furnished and, unless specific attention is drawn thereto that the same names are used in subsequent applications. In addition, Authorised Dealers must also state whether or not they recommend a transaction and their reason for giving or withholding their recommendation."

Authorised Dealers are also required to provide full particulars of any underlying transactions. Section (D)(ii) further states:

"Applications submitted to the Exchange Control Department of the South African Reserve Bank, which do not contain sufficient information, will be returned to the applicant's banker and, accordingly, to avoid unnecessary work and delay Authorised Dealers must ensure that full and precise particulars of the underlying transactions *are given in the first instance."*

The Rulings further provide that no deviation should occur from the original application. Section A(D)(iv) reads in part:

"It is essential that any transaction of an exchange control nature must be finalised on the particular basis which was formally sanctioned and any deviation from the arrangement originally approved should be referred to the Exchange Control Department of the South African Reserve Bank."

Deutsche Bank Contravened the Rulings Section A(D)(ii) in that:

Deutsche Bank failed to disclose the following transactions:

365.1 The conversion by Deutsche Bank London of a total of R229 350 000 for GBP 20 million.

365.2 The script Lending Agreement concluded between Standard Bank of South Africa SBCSA and Deutsche Securities.

365.3 Bond repurchase agreement between Deutsche Bank London and Deutsche Bank Johannesburg.

365.4 The transfer of South African Bonds by Deutsche Bank Johannesburg to Deutsche Bank London as security for the script Lending Agreement between Deutsche Bank London and Deutsche Bank Johannesburg where Deutsche Bank Johannesburg acted as agent for Deutsche Securities.

365.5 The forward sale of Nampak shares between Deutsche Bank London and Deutsche Securities was disclosed to the SARB but it failed to disclose all the details and link it with the Nampak share placement.

Deutsche Bank contravened Regulation 10(1)(c) as read with Regulation 22 by exchanging R229 350 000 for GBP 20 million

As in the case of Sasol, Deutsche Bank as late as October 2001 when questioned by the SARB did not disclose that it had exchanged Rands for British Pounds. Deutsche Bank asserted that it did not deplete the reserves as it had done a bond re-purchase agreement but it failed to produce any evidence confirming an initial purchase by Deutsche Bank

London of the bonds which formed the subject of the re-purchase agreement.

<u>**Nampak contravened Regulation 10(1)(c) and the Section A(D)(iv) of the Rulings read with Regulation 22 in that it deviated from the purpose for which the share placement was approved without seeking the prior approval of the SARB.**</u>

<u>**Deutsche Bank failed to comply with the condition that such share should be bought by foreign investors with foreign currency and not Rands.**</u>

A sample of such shares investigated by the Commission found no evidence that the shares on-sold to long term investors were settled in foreign currency and in fact all sales were settled in Rand.

From the evidence it seems clear that there was no need for Deutsche Bank London to have a currency hedge. According to the Reserve Bank what occurred was in fact not a currency hedge but a spot transaction with a straight exchange of Rand for British Pounds.

RECOMMENDATION

The Commission recommends that the contraventions of exchange control committed by Nampak and Deutsche Bank be referred to the Director of Public Prosecutions for appropriate action.

LEGAL ARGUMENTS BY SARB AND DEUTSCHE BANK

REPRESENTATIONS BY DEUTSCHE BANK AND THE RESERVE BANK

370. Reference has been made elsewhere in this report to the investigation conducted by the SARB after it became concerned about the Sasol,

Nampak and M-Cell share placement executed by Deutsche Bank on behalf of the corporates.

371 Mr James Cross former Deputy Governor of the SARB, stated that late in September or early October a phone call was received from another person working for the same institution advising that according to information received by their bank certain offshore acquisitions by South African companies had been financed by using the domestic balance sheets of the company in question to fund the offshore acquisition which would normally have been in contravention of the Exchange Control Regulations. Sasol's name was mentioned in the course of the latter telephone conversation. The view of the person was that such transactions had negative implications for the exchange rate of the Rand. It was then suggested by Mr Cross to the Exchange Control Department that they should review the execution of the transactions in question.

The Exchange Control Department of the Reserve Bank began reviewing the share placements executed by Deutsche Bank at the beginning of October and the review culminated in a settlement agreement entered into between Deutsche Bank and the SARB. It appears that after significant delays in finalising the review, the two parties accelerated their efforts to reach a settlement at the same time as the public hearings of the Commission drew to a close.

On 24 May Deutsche Bank and the SARB requested a closed hearing with the Commission and presented to the Commission for the first time a settlement agreement which it requested not to be released to the public. Subsequently and as a result of the settlement details being leaked to the press, Deutsche Bank and the SARB agreed that it could be made public.

Initially it was not clear why either party thought to present the settlement agreement to the Commission as the proceedings of the Commission and the review by the Reserve Bank are two independent processes followed by each institution with have its own mandate. The reason for bringing the settlement agreement to the Commission became clear during the then closed and confidential hearing as a result of the submissions by Counsel for the Reserve Bank, Mr Ginsberg,supported by Deutsche Bank Counsel.

It would be worthwhile to summarise the submissions by the SARB's legal representative and Deutsche Bank. Mr Ginsberg's submissions centered on Regulation 12 of the Regulations in terms which this Commission was set up. (Government Gazette 23094).

Regulation 12 provides that where the Commission is satisfied upon evidence or information presented to it that its enquiry may adversely affect any existing, instituted or pending legal proceedings or any investigation instituted in terms of any law, such evidence shall be handled in a manner so as not to adversely affect such legal proceedings or investigations.

It is not necessary to establish whether or not the review conducted by the Reserve Bank falls within the meaning of Regulation 12. Even if it did, the settlement agreement was a conclusion of the investigation by the Reserve Bank.

378 Counsel for the SARB sought to argue that the Commission is prevented from making a finding in relation to the exchange control matters raised by the evidence as this could be interpreted as being in conflict with Regulation 12 and secondly it would breach the secrecy provisions of Section 33(2) of the Reserve Bank Act.

379. Both arguments have no legal substance. There is no investigation or legal proceedings that a finding of the Commission can have any adverse effect on even if the Commission should come to the conclusion (which it

does not) that the investigation by the SARB is an investigation which Regulation 12 refers to. The settlement agreement was finalised on 22 May, two days prior to the hearing. It was signed by both Deutsche Bank and the SARB and by their own admission was a finalisation of the review by the SARB. In as far as Section 33 of the Reserve Bank Act is concerned, the SARB effectively withdrew this submission as it and Deutsche Bank agreed that the settlement agreement could be made public.

The SARB further argued at the hearing that in view of the fact that the settlement between it and Deutsche Bank was in full and final settlement of all disputes and claims between the Reserve Bank and Deutsche Bank, the Commission is precluded from expressing an opinion and making a finding on the exchange control issue.

Counsel for SARB further submitted that evidence has been led and had been "*very clear*" that the transactions did not affect or lead to or cause the rapid depreciation of the exchange rate of the Rand. Since this is the Commission's purpose it has no mandate to pronounce on the exchange control issue.

In a letter dated 7 June 2002 Deutsche Bank through its attorneys also argued that in view of the fact that there has been "*no evidence before the Commission that any of the transactions comprising the assets swaps gave rise or contributed to the rapid depreciation of the Rand*" and because the Commission can only proceed to look into the illegality or otherwise of such transactions if it had found that it had an impact, the Commission is precluded, not only from making any finding but also reporting on the legality or ethics of the assets swaps and related transactions.[119]

119 See Annexure 24

383 Deutsche Bank further argued that the settlement agreement provides for a full and final settlement of all claims, disputes and proceedings that either it or the SARB may have against each other and the Commission cannot make a finding in respect of the asset swaps as it would be a repudiation of the Reserve Bank's authority.

384 Both Counsel for SARB and Deutsche Bank make a factual error in asserting that there was no evidence before the Commission that the transactions had an impact on the exchange rate. In response to a question by Deutsche Bank's counsel, Mr Grové from the Reserve Bank stated that he was not able to state that the transactions had an impact on the exchange rate of the Rand. This is quite different from stating that it had no impact and no such assertion was made by the SARB. Presumably because that was not the focus of the SARB's investigation but rather whether or not the corporates and Deutsche Bank had complied with Exchange Control Regulations.

385 The investigating team who investigated the Deutsche Bank transactions on behalf of the Commission indicated that they were not able to state whether or not these transactions contributed, or gave rise to the rapid depreciation of the exchange rate of the Rand. They did however state that in the case of Nampak, on the transaction date, the Rand depreciated

386 During the Commission hearing it was pointed out to both the SARB and Deutsche Bank that the review that the SARB had undertaken and the work of the Commission were two independent processes which while having in common the same subject matter are distinct and unrelated. One is a Commission of Inquiry, duly established by the President of South Africa and the other the SARB. The mandate of the Commission is established by the Terms of Reference. The Commission cannot be

constrained from carrying out its mandate by a private settlement between the SARB and Deutsche Bank.

The settlement cannot in any way affect the Commissions Report, its findings or its recommendations to the President. If the recommendations do entail any criminal proceedings being instituted, it is the responsibility of the State to prosecute and not the SARB.

As a justification for entering into the settlement agreement, the SARB clearly acting on advice from its legal advisors argued they chose to enter into a settlement agreement with Deutsche Bank Johannesburg for two reasons. Firstly on account of the fact that they may not be able to prove that Deutsche Bank Johannesburg failed to adhere to Exchange Control Regulations wilfully or negligently. They may have therefore been able to show the absence the *dolus* or *culpa*. Either of these would be essential for establishing *mens rea* for the purpose of securing a criminal conviction.

The SARB's legal advisors refer to S v De Blom (1977 (3) SA 513(A) [120] S v De Blom deals with the contravention of Exchange Control Regulations in particular Regulation 22 of the Exchange Control Regulations. It and the cases that followed it established the principle that guilt in the form of either willfulness (*mens rea* in the form *dolus*) or negligence being *mens rea* in the form of *culpa* is sufficient and that in the interpretation of a definition of a statutory offence it is presumed until the contrary appears that the legislature did not wish to make an innocent illegal act punishable. It further held that although *mens rea* is not expressly required in Regulation 22 of the Exchange Control Regulations, it seems clear that an innocent illegal act or omission is not punishable.

390. While the Commission does not wish to pronounce on the settlement because it is not within its mandate and does not affect its findings, it does

[120] See Annexure 25

feel that the cautiousness of the Reserve Bank's legal advisors is not justified as the evidence placed before the Commission shows that Deutsche Bank had knowledge of the provisions of the Exchange Control Regulations, Rulings and Orders and Rules and would therefore have known what could or could not be done in terms of those Rules and Regulations. Alternatively, as an Authorised Dealer it should have been completely and fully familiar with requirements of the Exchange Control Regulations, Rulings and Orders and Rules.

391 The submission by Deutsche Bank's attorneys that the Commission should establish firstly that a particular transaction gave rise to or contributed to the rapid depreciation of the Rand for the period under review and only in such a case can it proceed to establish whether such transactions were illegal or unethical or contravened the Exchange Control Regulations does have substance. The Commission agrees with this view but is satisfied that in the instance of Nampak the Commission has made a positive finding and is therefore entitled to make a finding relating to the Exchange Control Regulations.

The M-Cell Share Placement

The M-Cell share placement was investigated by the Commission and falls outside the period under review and is therefore not dealt within this Report.

The currency conversion was effected subsequent to 31 December 2001

RECOMMENDATION

The M-Cell share placement should be investigated as it appears to have been implemented on the same basis as the Sasol and Nampak transactions.

Equity Diamond Cutting Works (Pty) transactions

Equity Diamond Cutting Works exports approximately USD 5 million per month. It also has some imports payable in USD.

In the week ending 7 December 2001, Equity Diamonds bought USD 65 million spot and sold USD 50 million spot and USD 10 million forward. These amounts were done in USD 10, USD 5 and USD 3 million transactions. Equity Diamonds made a loss of R7 950 700 on these deals.

All these transactions were dealt through Nedbank. Nedbank identified the excessive trading in December and suspended the direct dealing facility that Equity Diamonds had with the dealing room.

The Managing Director of Equity Diamonds that they had no intention of speculating in the Rand and were merely trying to ensure that their profits were protected from movements in exchange rates.

399. Equity Diamonds had underlying commitments of a maximum of USD 10 million and accordingly to the extent to which its dealings exceed normal hedging activities they would be speculative in nature. At one point on 7 December 2001 Equity Diamonds had sold USD 39 million with an underlying exposure of USD 10 million. Exchange control prohibits a South African resident, either a person or entity from speculating in the Rand. The transactions in excess of underlying commitments would be a contravention of exchange control.

FINDINGS

400. During the week of 7 December when the Equity Diamond transactions took place, the Rand depreciated against the US from 10,25 to 11.19.

The Commission finds that the Equity Diamond transactions contributed to the depreciation of the Rand in the week of 7 December 2001.

PROFITS AND LOSSES OF AUTHORISED DEALERS

All material authorised dealers are market makers in the local foreign exchange market. Market makers quote both a bid and offer price to the market and stand ready to buy or sell at those quotes. They profit or make losses from the spread between bid and offer prices as well as from changes in market prices.

Market makers adjust their bid or offer prices depending upon positions that they hold and/or upon their outlook for changes in prices. Transactions are concluded on behalf of clients (client trading) or the authorised dealer's own account (proprietary trading).

403 Proprietary trading is conducted for profit and by its nature is speculative. Most authorised dealers stated that speculation is often used in a pejorative sense, implying that speculative activities are in some way improper or unethical. This they say is unjustified and choose rather to define speculation as adopting a view as to the likely movement in the exchange rate of the currency and acting on that view with the intent of making a profit or preventing a loss. They believe that speculation in fact has a positive effect on the markets as a result of the liquidity that speculators bring to the market. All agreed that according to their definition of speculation they do engage in speculation but that this is in no way unethical, improper or illegal.

404 However some authorised dealers found their market making role increasing as non-resident banks withdrew from the market.

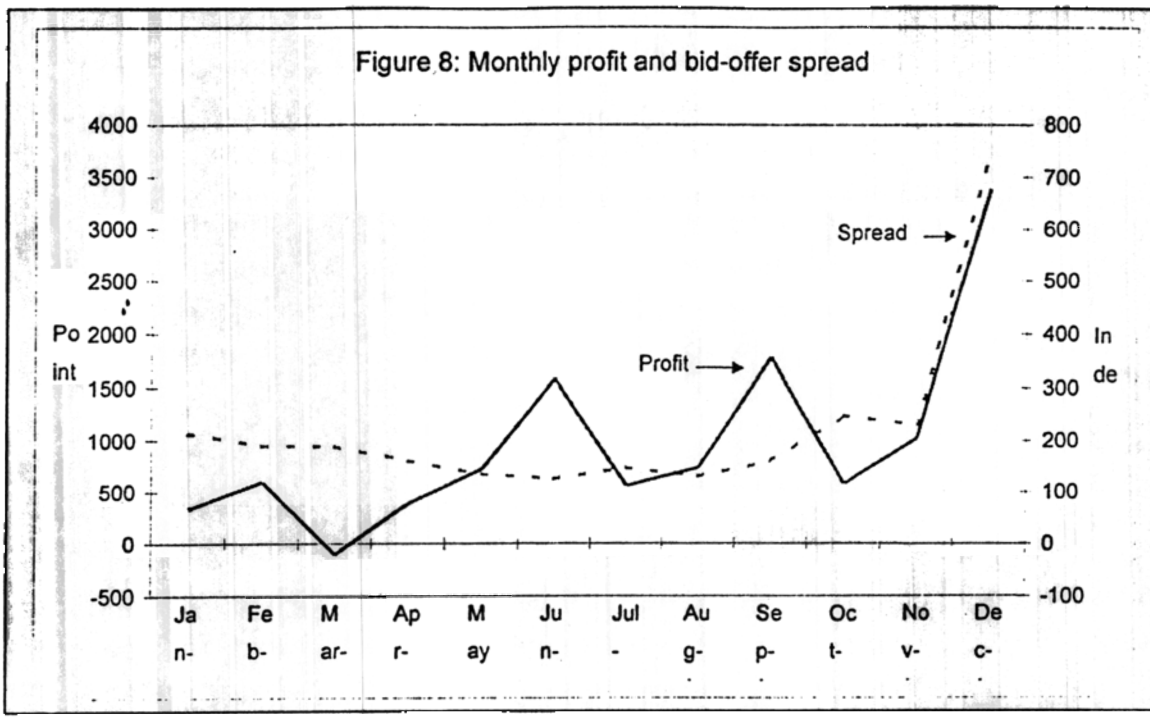
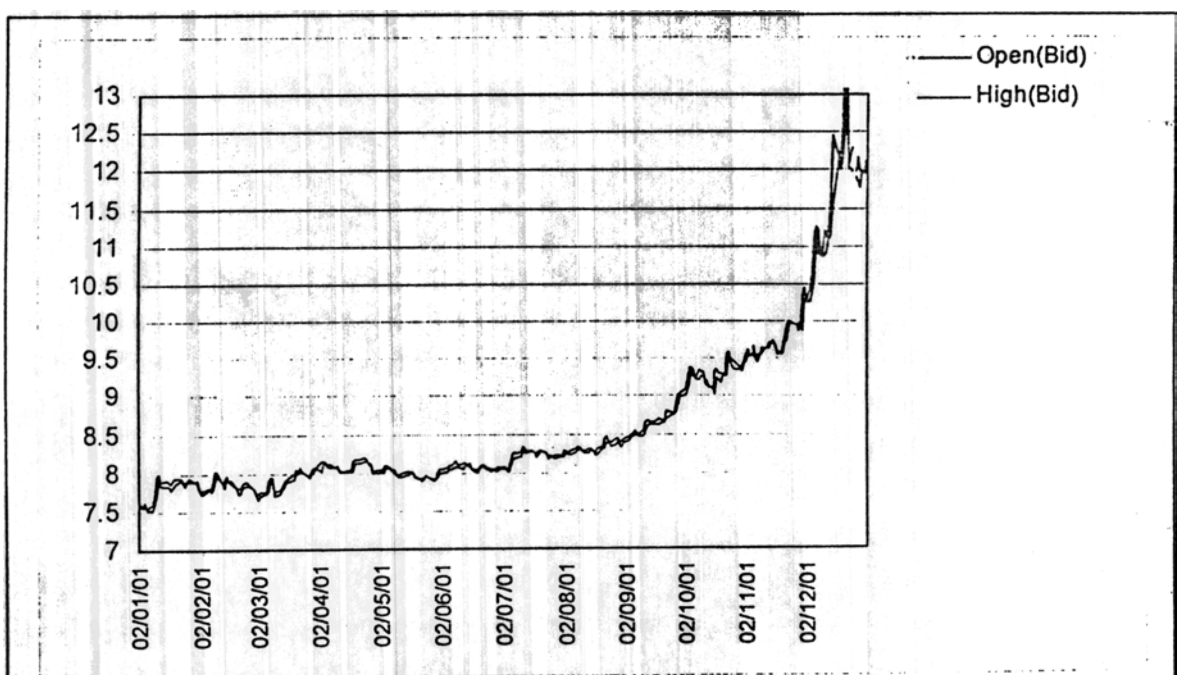


Figure 8: Monthly profit and bid-offer spread
4000
3500
3000
2500
Po int
2000
1500
1000
500
0
-500
800
700
600
500
400
300
200
100
0
-100
In de
Spread
Profit
Ja n-
Fe b-
M ar-
Ap r-
M ay
Ju n-
Jul -
Au g-
Se p-
Oc t-
No v-
De c-


Open(Bid)
High(Bid)
13
12.5
12
11.5
11
10.5
10
9.5
9
8.5
8
7.5
7
02/01/01
02/02/01
02/03/01
02/04/01
02/05/01
02/06/01
02/07/01
02/08/01
02/09/01
02/10/01
02/11/01
02/12/01

The average monthly bid-offer spread provided by authorised dealers was calculated from daily bid and offer rates sourced from Bloombergs.

406. The profits of individual authorised dealers are indexed to 100 in January 2001. The actual foreign exchange revenues for the last quarter of 2001 were R212 million for October, R189 million for November and R461 million for December 2001. The average monthly revenues of the foreign exchange trading operations were R148 million per month for the first nine months, and R288 million per month for the last three months of 2001.

Spreads were fairly consistent until September 2001. Thereafter the spreads widened peaking in December 2001. Profits of authorised dealers are volatile over the year and peak in December 2001.

408. The volatility in the exchange rate over the period under investigation contributed significantly to the volatility in profits recorded by the authorised dealers. The volatility of the profits can be ascribed to the authorised dealers' market-making role. The spreads existing over this period would translate into profits for market makers they profit from the spread between bid and offer prices as well as from changes in market prices, the magnitude of which would be determined by the materiality of the foreign denominated currency positions and the volume of transactions, which authorised dealers hold.

409. Foreign exchange profits are comprised of both realised (difference between bid and offer spread for spot transactions and between contract and spot rates on settlement of forward transactions) and unrealised (movement in value of net open position) profits. Unrealised revaluation profit would increase or reduce in subsequent periods as the Rand appreciates or depreciates. These profits would only be realised at the levels reported should these rates have been sustained in the market and

should the currency positions have been subsequently closed out at these revaluation rates.

The graphs on page 111 reflect a direct correlation between the widening in the spreads, particularly in December 2001 and the levels of profits generated by authorised dealers by virtue of uni-directional trading in the Rand. This would mean that during December 2001 authorised dealers viewed the Rand as a "one way bet" and speculated that the Rand would depreciate. There is a direct inverse relationship between the movement in spreads, and profits made, particularly in December 2001 and the depreciation in the value of the Rand.

EFFECTIVENESS OF THE ADMINISTRATION OF EXCHANGE CONTROL

A total of 5,6 million foreign exchange transactions took place in 2001, 99% of which were dealt with by the Authorised Dealers without prior reference to the exchange control department. [121] The exchange control department of the SARB received only 36,634 for application from all Authorised Dealers during the calendar year 2001. Except for ordinary matters requiring the consent of the Minister of Finance like the appointment of Authorised Dealers, only matter falling outside the current exchange control policy and requiring an exemption from the Minister as referred to National Treasury as advisors to the Minister. In 2001, only 28 matters were referred to the National Treasury.

412. Authorised dealers are appointed by the Minister of Finance to deal in foreign exchange. As such, they are co-responsible with the Exchange Control Department to ensure compliance with exchange control by assisting Exchange Control Department to administer exchange control. They administer exchange control predominantly over transactions concluded by clients of the authorised dealers.

[121] National Treasury Witness Statement p 18 - 19

413. To the extent that such a relationship constitutes a conflict of interest, ie. authorised dealers generating revenue from their clients from transactions effected in terms of exchange control, and at the same time, policing compliance therewith, was not addressed in the KPMG report, nor was the impact thereof on the efficient administration of exchange control considered. The relationship between and the authorised dealers is based, almost entirely, on trust, as per the statement by Bruce Brand.

414. The purpose of exchange control is to monitor the in and outflow of foreign exchange from the country, thereby protecting the foreign currency reserves of the country.

415. In the KPMG report, several weaknesses were identified, and can be summarised as follows:

415.1 The time periods during which export proceeds can be repatriated. In terms thereof it is possible for exporters to extend the time period within which exports proceeds have to be converted into Rand for up to 570 days from date of export. This notwithstanding the fact that the foreign currency proceeds may gave been received prior thereto. *Vide* the minutes of Sasol, where schemes can be devised to extend the time period for the repatriation of export proceeds. The possibilities of exceeding the 180 days limit in a CFC account can also be abused by opening CFC accounts with more than one authorised dealer and moving the foreign currency between the different CFC accounts. No details or quantum were provided in this respect.

415.2 Reference is made to the fact that the MT100 form procedure is not consistently and correctly applied by authorised dealers. The conclusion is then made that the repatriation of export proceeds cannot be completely controlled, and it is furthermore not practical for Exchange Control Department or authorised dealers to monitor such, as reliance has to be placed on exporters.

415.3 The possible contraventions relating to local financial assistance to non-residents or affected persons in terms of which they may borrow securities or funds from a local bank or other entity or person, and utilise such proceeds to borrow from another bank. These funds can be utilised to speculate against the Rand. It is concluded that it is impossible for the lender to ensure compliance with exchange control. This is called double counting. The extent of the problem could not be assessed.

415.4 **Shorting the Rand**. This entails a non-resident buying an FEC to hedge an underlying Rand asset, which asset is subsequently disposed, the proceeds converted to foreign currency, which are then remitted offshore, while at the same time not closing out the FEC. This enables a non-resident to effectively short the Rand. This form of shorting cannot be controlled or identified, and the extent thereof was not investigated.

414.5 **Transfer pricing**. This allows profits to be transferred abroad by a South African importer being over-invoiced for goods purchased or a South African exporter under-invoicing for its exports. Furthermore, foreign companies may over-invoice their South African subsidiaries in order to export the profits of the South African subsidiaries. The extent of such a practice could not be assessed. Although transactions pertaining to import / export require external auditors to assess the reasonableness of the price, in most cases, auditors are unable to assess the reasonableness thereof. This would further be a case where the auditors of an importer / exporter earn a fee from the client, but at the same time are required to report to Exchange Control Department any irregularities.

FINDINGS

415. The effective administration of Exchange Control is premised on a basis of trust, willingness and capability of Exchange Control, authorised dealers and corporates, to administer their responsibilities. The commensurate increase in cost of administration and considerations of whether exchange control is moral or not, can increase the propensity to circumvent exchange control. Exchange control is seen by foreign investors, authorised dealers and corporates as a hindrance, and is negatively perceived. These are the very entities who are co-responsible for its effective administration.

The effectiveness of the administration of exchange control by Exchange Control has not been benchmarked against other countries who also have exchange control in place.

In respect of the 1% of transactions that are dealt by the Exchange Control Department of the SARB, no evidence has been placed before the Commission that suggests that the SARB's management of exchange control is ineffectual. There may have been a perception that the Exchange Control Department monitors compliance less in view of the gradual relaxation of exchange control.

In respect of the 99% of transactions which are administered by the Authorised Dealers, it is not possible for Commission to come to a view as to whether or not the Authorised Dealers are complying with their obligations as co-administrators of Exchange Control Regulations. This is on account of the fact that no proper investigation has been done on for instance the management of CFC accounts, non-resident transactions of the Securities Exchange and the Bond Exchange of South Africa as well as the treasury departments of Authorised Dealers.

The conflicts of interest that arise as a result of Authorised Dealers being both exchange control administrators and beneficiaries of business from corporates create problems which need further attention.

MATTERS THAT WARRANTED INVESTIGATION

The matters below came to the attention of the Commission through a variety of means and should have been investigated but the Commission could not for a variety of reasons do so.

Share Placements

421. In addition to the share placements of Sasol, Nampak and M-Cell, the Commission requested information regarding any further share placements that took place in the course of 2001. The SARB provided the information. Attorneys for the SARB advised the Commission that the names and details of the relevant parties were confidential and could not be made available to the public, nor should it be contained in the Commission's final report. Should the Commission wish to use the details in the final report, it must first obtain the individual party's consent to this. The Commission has decided not to disclose the names and details.

422. The Commission however feels that reference should be made to the transactions. The SARB approved twelve share placements to the value of approximately 23 billion during the course of 2001. Of these the SARB that 7 to the value of approximately 6.4 billion were not proceeded with.

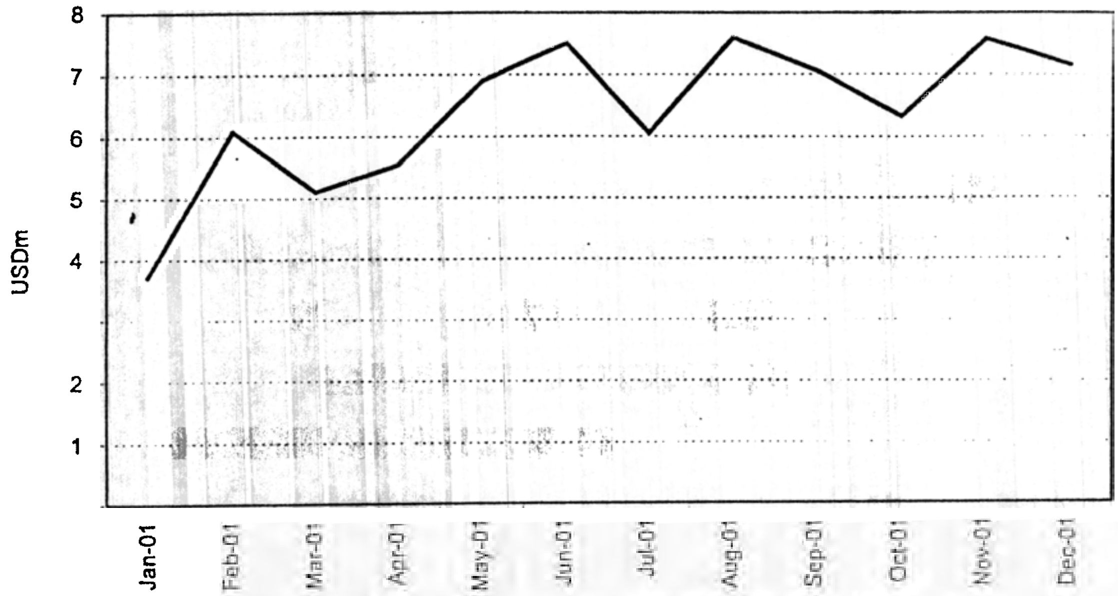
CFC Accounts

423. Many witnesses before the Commission mentioned the impact of CFC's on the exchange rate of the Rand either positively or negatively but the Commission did not investigate these. The average balance on the 10 largest CFC accounts increased substantially over the period October to December 2001.[122] At the end of 1998 the CFC balances amounted to USD 995 million and increased to USD 1.981 million at the end of December 2000. During the year 2001 these balances increased by a further USD 644 million to a balance of USD 2625 million on 31 December 2001.[123]

424. The average balance on the 10 largest Client Foreign Currency (CFC) accounts held with authorised dealers increased over the period October to December 2001.[124] This indicates that the clients of banks tended to hold more foreign currency.

[122] See Annexure 6
[123] Mboweni, Witness Bundle, p 37
[124] See Annexure 6

Figure 10: Average balance on 10 largest CFC accounts



The analysis of authorised dealers' client transactions show that the clients of authorised dealers were reluctant to hold Rand. Clients moving their funds from Rand into foreign currency would have negatively impacted the value of the Rand.

No transactions were specifically investigated with a view to determining whether any regulations were contravened, or to the extent that exporters delayed the repatriation of foreign exchange in contravention of prescribed regulations.

Institutional Investors

427 It is apparent from the figures provided by the Reserve Bank for the outflows during the course of 2001 attributed to institutional investors that they are responsible for a significant outflow of capital and this warrants a very detailed investigation.

Swap Market

The BIS measured global trading in Rand for the first time in April 2001 and found that it amounts to USD 11.3 billion[125]. It is the case that swaps that are usually larger than the sum of spot and forward trading. However McCauley thought that it was significant that swaps accounted for over USD8 billion of the total of USD11.3 billion or about 75% of transactions. He found this puzzling but indicated that the reason for this was not clear.

It appears that in the domestic Rand foreign exchange market swap transactions accounted for 75% of total turnover. Non-residents are major participants in the swap market in South Africa accounting for 60,5% of swap market turnover in the year 2001 while Authorised Dealers accounted for almost 37%.[126]

Swaps are normally used to raise Rand to fund short positions. The size of the swap market gives an indication of the level of speculative activities in the market. Evidence from Malaysia shows that as the speculation in the Ringit increased so did the swap market. When the Malaysian Central Bank closed access to the local currency market to curb speculation during the Asian crisis, speculators raised Ringit through the swap market to obtain funding for shorting the Ringget. When domestic rates were raised from 8% to 11% in the domestic market interest rates rose overnight in the swap market by up to 400% per annum.[127] The extraordinary high volume of swap transactions deserved proper investigation to establish the reasons for this. It is important as though swap transactions do not directly impact on the exchange rate, they impact to extent that knowledge of Authorised Dealers' swap books has an impact on the trading behaviour of traders.

125 McCauley, Expert Witness Bundle, p 18
126 Mboweni Witness Bundle, p 105
127 Bakarudin, Record, p 1727

GENERAL RECOMMENDATION

South Africa experienced its biggest financial crisis in 2001. It is therefore essential that the reasons for the collapse of the currency be investigated in more detail than this Commission has been able to.

It is therefore recommended that a further investigation takes place which will investigate the crisis that occurred in 2001. In view of the serious problems of confidentiality, such an investigation should not be a public one in order to meet some of the legitimate concerns of confidentiality of persons and institutions who may be the subject of investigations.

ABBREVIATIONS

Company and other terms

"ABSA"	ABSA Group Limited;
"ACI"	Association Cambiste Internationale;
"Barolays"	Barclays Bank Limited;
"BILLITON"	BHP Billiton SA Limited;
"BESA"	The Bond Exchange of South Africa;
"BIS"	Bank of International Settlements;
"BOE"	BOE Bank Limited;
"CFC"	Customer Foreign Currency
"CitiBank"	CitiBank NA;
"CMA"	Common Monetory Area;
"CPI"	Consumer Price Index;
"Constitution"	The Constitution of the Republic of South Africa Act 108 of 1996;
"Deutsche Securities"	Deutsche Securities (Pty) Ltd
"Deutsche Bank, Johannesburg"	Deutsche Bank AG, Johannesburg (Pty) Ltd
"Deutsche Bank, London"	Deutsche Bank AG, London (Pty) Ltd;
"EMU"	European Monetary Union;
"First Rand"	First Rand Bank Limited;
"GDP"	Gross Domestic Products;
"Government"	The Government of the Republic of South Africa;
"Governor"	The Governor of the South African Reserve Bank;
"ICI"	Association of Commercial Authorized Dealers;

"IMP"	International Monetary Fund;
"INVESTEC"	Investec Limited;
"JP Morgan"	JP Morgan Chase Bank;
"JSE"	The Johannesburg Securities Exchange of South Africa;
"M-CELL"	M-Cell Limited
"MPC"	Monetary Policy Committee of the South Reserve Bank;
"NAMPAK"	Nampak Limited;
"Nampak Holdings"	Nampak Holdings (United Kingdom) PLC;
"Nampak International"	Nampak International Limited;
"Nedcor"	Nedcor Bank Limited;
"NIB"	Nedcor Investment Bank Limited;
"NOFP"	Nett Open Forward Position
"OTC"	Over-the-counter;
"PPP"	Purchasing Power Parity;
"President"	President of the Republic of South African;
"rep offices"	Representative offices in South Africa of foreign banks;
"SAFEX"	South African Future Exchange;
"SACOP"	South African Chamber of Commerce;
"SARB"	The South African Reserve Bank;
"SARB Act"	South African Reserve Bank Act 90 of 1989 as amended;
"SASOL"	Sasol Limited;
"SBIC"	Standard Bank Investment Corporation Limited;
"SBSA"	Standard Bank of South Africa Limited, a subsidiary of SBIC;

"SCMB"	Standard Corporate and Merchant Bank, a division of SBSA;
"SDBL"	Deutsche Bank of London;
"Summers"	Lawrence Summers, US Deputy Treasury Secretary;
"the Bank"	The South African Reserve Bank;
"Interbrew"	Nv Interbrew SA
"De Beers"	De Beers Consolidated Mines Limited
"Dow Ago"	Dow Agro Sciences Southern Africa(PTY)LTD
"Amplets"	Anglo American Platinum Corporation Limited
"Anglo American"	Anglo American Corporation South Africa LTD
"Engen"	Engen Petroleum limited

Individuals

"Abediam"	Dr Iraj Abediam, professor at UCT;
"Bester"	Jurie Bester, Head of Risk and Audit Service for First Rand Bank;
"Cross"	James Cross, former Deputy Governor of the SARB;
"De Villiers"	Patrick De Villiers, Global Hed of Foreign Exchange trading;
"Jammine"	Dr Azar Jammine, Director and Chief Ecomonist, Econometrix (Pty) Ltd;
'Mboweni"	Tito Mboweni, Governor of Reserve Bank;
"Luüs"	Christo Luüs, Chief Economic of Absa Group Limited;
"Gouws"	Rudolph Gouws, Chief Economist of Rand Merchant Bank;
"Glynos"	George Glynos, Chief Market Analyst, Chief Economist of the Standard Bank of South Africa;
"Wakeford"	Kevin Wakeford, President of the Republic of South Africa Chamber of Commerce;
"Trollip"	Pauline Trollip, Global Head of Treasury Compliance;
"McCauley"	Robert N McCauley, Deputy Chief Representative of the Bank of International Settlements;
"Ramos"	Ms M Ramos, Director-General, National, Treasury;
"Van Zyl"	Lambertes Van Zyl, the former General Manager International Bank Department, advisor to the Governor and Chairman of the Reserve Bank Marketing working committee;

Annexure 1

Definitions

"Spot transaction"	The purchase of one currency against the sale of another for settlement in two business days.
"Forward transaction'	The purchase or sale of a currency against the purchase or sale of another, but for settlement greater than two business days. The exchange rate will differ from the prevailing spot rate, reflecting interest rate differentials in two currencies.
"Swap transaction"	A combination of a spot and a forward transaction and involves a simultaneous purchase and sale of a currency against another for a future date. These transactions are primarily used to fund positions and hedge against yield curve moves in two different currencies.
"Option transactions"	It provides the rights not the obligation, to buy or sell a currency at a fixed rate (strike) on or before a fixed future date, in exchange for consideration (premium). It can be compared to an insurance contract.
"Capital movements (in the context of the balance of payments)"	Transactions in which residents of one Country purchase/acquire or sell/liquidate financial assets issued by residents of another country.
"Domestic demand (or domestic expenditure)"	The total of final consumption expenditure by households, final consumption expenditure by general government, gross fixed capital formation and changes in inventories.
"Economic growth"	A process in which the quantity of goods and services produced in the economy expands, usually measured as the percentage increase over one year of the gross domestic product ("GDP") at constant prices.
"EMBI spread", or "JP Morgan Emerging Markets Bond Index spread"	The margin by which the weighted average yield on US dollar denominated bonds issued by the governments of a set of emerging markets,

	exceeds the yield on United States government bonds.
"Fixed capital formation"	Expenditure on assets which have been produced and are themselves used repeatedly or continuously in the processed of production for more than a year. Machinery, buildings and roads are examples of such assets. Also loosely called "capital spending".
"Foreign direct investment"	International investment which reflects the objective of an investor in one country to obtain a lasting interest in an enterprise in another country usually deemed to be present if the investor obtains an interest of 10% (ten percent) or more in the said enterprise.
"Foreign portfolio investment"	Investment in equity and debt securities by and investor in one country in another country, not classified as direct investment.
"Forward market"	A market in which foreign currency, and some money market instruments, are traded for future delivery, with the price at which the foreign currency will be traded at that future date being fixed at inception of the forward contract. There are usually no margin requirements to be met in this market-an over-the-counter market. Most transaction are closed directly between the buying and selling parties, and it is difficult to cancel a contract.
"Gross domestic product"	The value of all final goods and services produced inside the borders of a country in a specific period, usually one year.
"Inflation"	A process of sustained increases in the general price level in the economy, measured in practice by surveying the prices in a wide "basket" of goods and services such as that, which is used in the Consumer Price Index ("CPI"). Usually the year-on-year increase in the price of such basket is quoted as the inflation rate.
"Institutional investors'	(In the contexts of South Africa's exchange controls) Insurers, pension funds and unit trusts.
"Marginal cost of funding"	Cost or interest rate attached to attracting an additional million rand of funding (liabilities). A bank would monitor it closely to maximise its

profitability. It would market its various funding instruments to the point where the marginal cost of funding from each source is roughly the same, and expand business until the marginal revenue (typical interest income) attached to expanding its asset book by an additional million rand is roughly the same as the marginal cost of funding.

"Money supply" — The stock of assets used as generally accepted means of payment in the economy. In South Africa the M3 money; it consists of notes and coin in the hands of the public and all deposits of the domestic private sector with the banking system.

"NOFP" "net open forward position or net foreign-currency position" — The net underlying amount to which the Reserve Bank is expose to exchange rate risk. The NOFP is expressed in US dollar terms and is defined as the sum of the net reserves (gross gold and foreign currency reserves minus foreign loans) of the Reserve Bank's future obligations to deliver US dollars are not covered by the Reserve Bank's net reserves.

""Nominal effective exchange rate of trade-weighted index value of the rand" — The indexed exchange rate value of the rand against a basket of currencies. The basket and the weights of the currencies included in the basket are based on international trade in manufactured goods.

"Other foreign investment" — International investment in all forms not covered by direct investment and portfolio investment, and consisting of trade credits, short-term and long-term loans and cross-border bank deposits.

"Proxy hedge asset" — Asset that displays a high degree of price correlation with another class of asset, enabling investors to run positions in the former asset in order to hedge positions in the latter asset class if little or not trading in latter is possible.

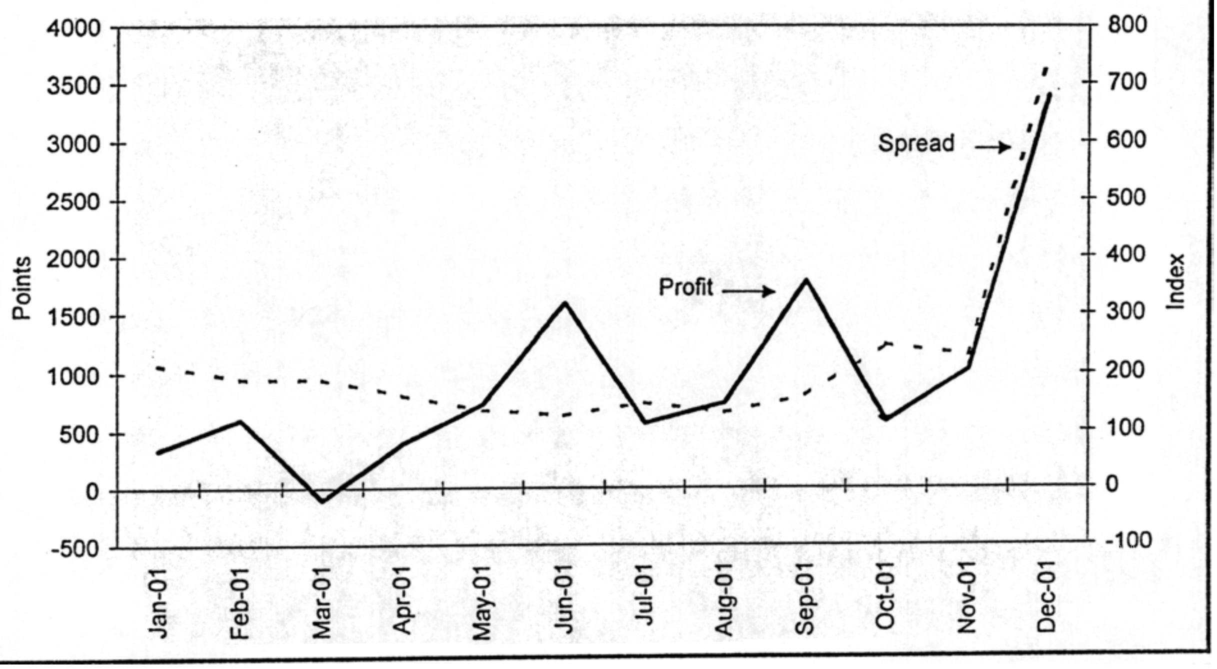
"Real effective exchange rate" — The nominal effective exchange rate adjusted for inflation differentials between South Africa and the countries included in the basket. It gives an indication of increased or decreases ,in South Africa's international competitiveness. For

	example, if the nominal effective exchange rate of the rand depreciates but prices in South Africa and abroad stay unchanged, South African exporters will be able to undercut their foreign competitors.
"Repo rate"	Repurchase rate of the Reserve Bank. This is the interest rate at which the Reserve Bank in the ordinary course of business lends funds to South African banks experiencing a shortage of cash. Its level is set by the Reserve Bank's Monetary Policy Committee, and has a strong influence on the level of all short-term interest rates.
"US Treasuries"	Bonds and bills issued by the United States government.
"Volatility (In exchange rate context)"	The variability of the exchange rate. This may refer to its variability during a particular episode, its typical variability as demonstrated over a long period, or its expected variability into the future. By analysing the percentage changes in the exchange rate from day to day (or even intraday), market participants extract the typical volatility of the exchange rate over a certain time horizon, for instance one month. So-called one-month historical volatility indicates by what percentage at an annual rate the exchange rate would typically change, given a one-month period. Statistically (for option pricing models) it is defined as the standard deviation in the logarithm of the exchange rate, expressed at an annual rate.

Firms of Assistants to the Commission of Inquiry Into the Rapid Depreciation of the Exchange Rate of the Rand and Related Matters
AUDITING
DELOITTE & TOUCHE
KPMG SERVICES (PTY) LTD
GOBODO FORENSIC & INVESTIGATIVE ACCOUNTING (PTY) LTD
NKONKI SIZWE NTSALUBA INCORPORATED
BRIAN ELLIS ABRAHAMS
ATTORNEYS
MUKWEVHO ADEKEYE INCORPORATED
TABACKS INCORPORATED
HOFMEYR HERBSTEIN & GIHWALA INCORPORATED
ADVOCATES
ADV NH MAENETJE
ADV HK NAIDU, SC

NAME	
Mr RN McCauley	
Mr RP Gouws	
Mr M Langley	
Dr CL Stals	etired
Mr CW Luüs	\bsa Group Ltd
Mr P de Villiers	
Dr I Abedian	Standard Bank South Africa Ltd
Dr A Jammine	Econometrix (Pty) Ltd
	Econometrix (Pty) Ltd
Dr TJ O'Neill	Goldman Sachs
Mr BI Bakarudin (*in camera*	Bank Negara Malaysia

Figure 8: Monthly profit and bid-offer spread



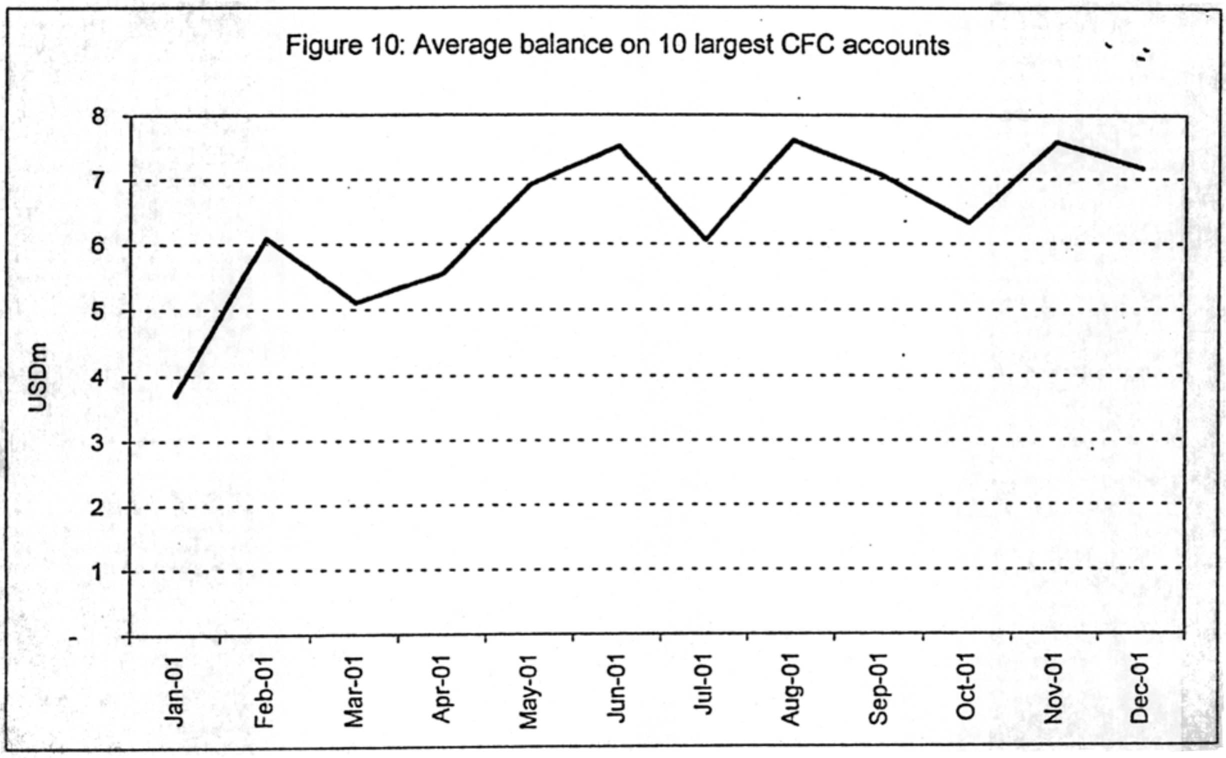


Figure 10: Average balance on 10 largest CFC accounts
USDm
8
7
6
5
4
3
2
1
-
Jan-01
Feb-01
Mar-01
Apr-01
May-01
Jun-01
Jul-01
Aug-01
Sep-01
Oct-01
Nov-01
Dec-01

highlight the following

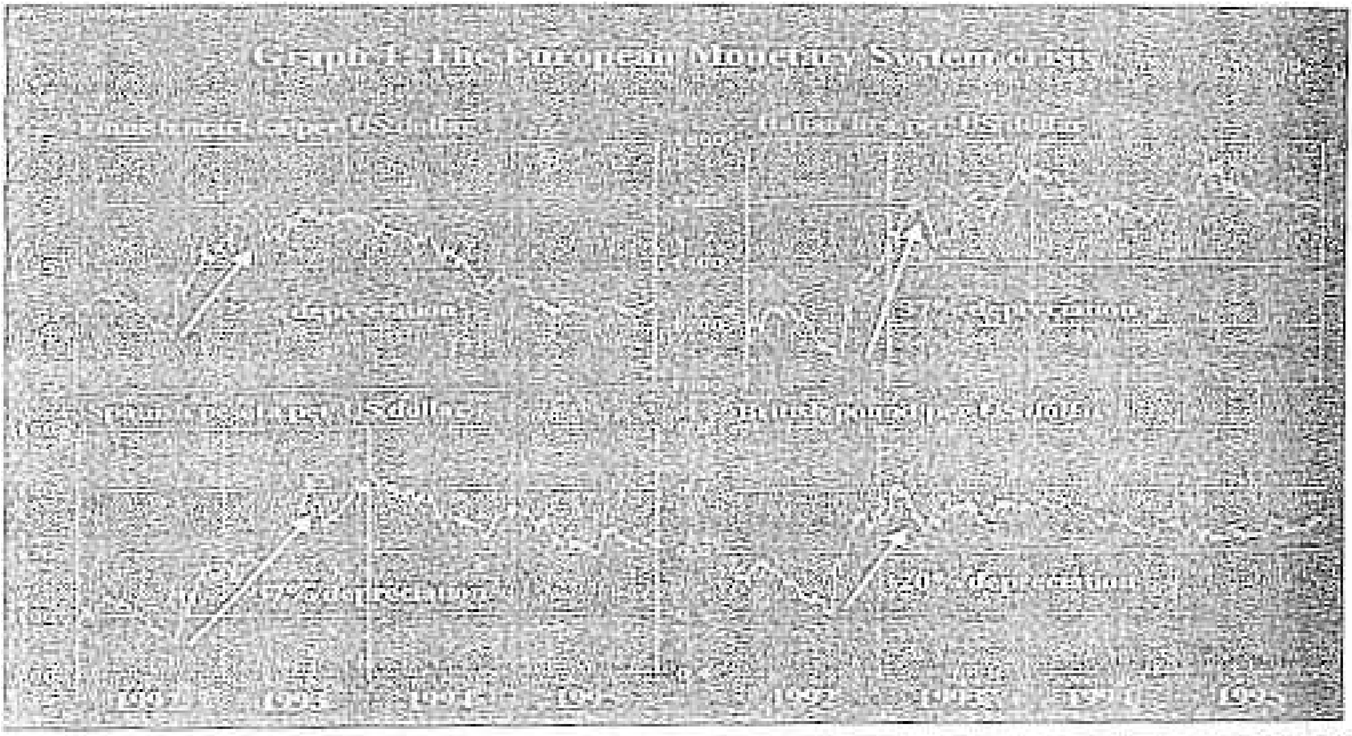
(a) The forex markets are both incomplete and imperfect; [a consequence is that they are inherently inefficient and socially sub-optimal].
(b) These markets are commonly subject to 'overshooting' and 'undershooting'. For small open economies this can entail high degree of volatility with resultant financial and social costs. The bulk of costs pertain to structural damages to the economy and short term macroeconomic imbalances in the form of higher interest rates, inflation rates, and welfare losses.
(c) To a large extent the forex markets subsume all the inadequacies of the other financial markets as well; as a result, developments in the forex markets are both more pronounced and more socially consequential. This is largely due to the fact that markets for equities and bonds are organically interrelated with the market for the foreign value of the currency. A we\l-functioning equities market, underpinned by a well-performing economy is thus likely to be reflected in the forex market in the form of a strengthening foreign value of the currency. Both actual and expected volumes and prices in equities and bond markets have direct bearings on the forex market.
(d) An important corollary of the above is the critical and pervasive role of 'expectations/perceptions' in the forex market. That is to say, *foreign* value of a currency is neither solely nor entirely dependent on actual volumes of trade and GO? growth; it is also influenced by the softer issues such as future policy directions, political economy developments, and the collective, albeit imperfect, assessment by the market of the overall sustainability of socio-economic stability and progress.
(e) The forex market has a systemic national impact. In the equities market, an undershooting may lead to a temporary or prolonged under-valuation of a given share with associated negative impact on the wealth and welfare *of* its shareholders only. On the other hand, a similar phenomenon in the forex market would have systemic implications not only for the currency market but also for the bond and equity markets. There would thus be both financial/economic and social consequences.

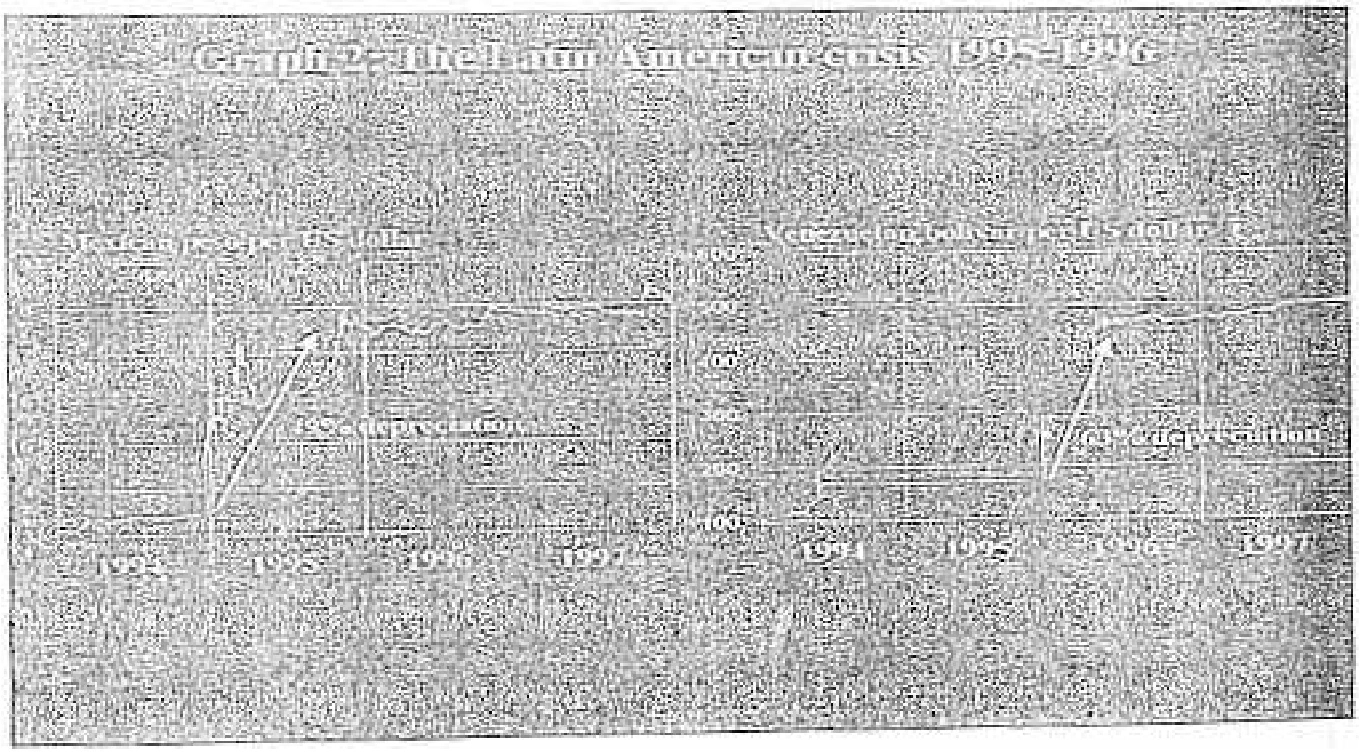
2.10

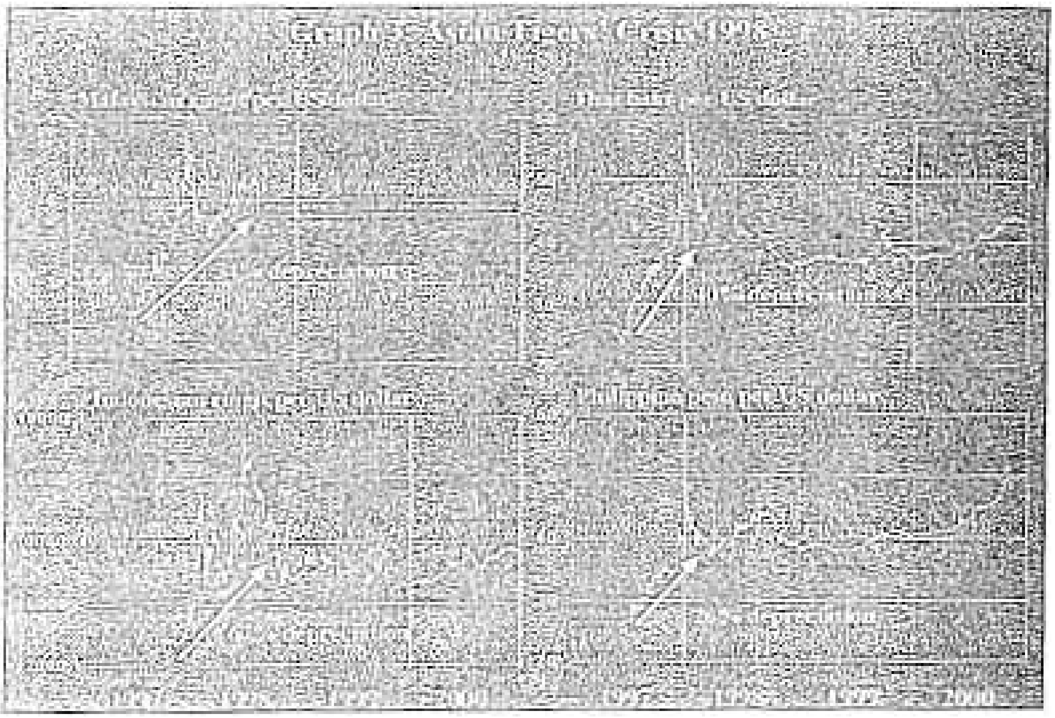
In the light of the foregoing it is not surprising that currency and financial market crises have become synonymous with the operations of the global financial markets. The more the global markets integrate and in the absence of an international regulatory and prudential framework, the more frequently financial market crises occur. Table 1 below summarises the crises and the extent of currency depreciation in each case. Graphs 1 to 4 depict the extent of currency movements.

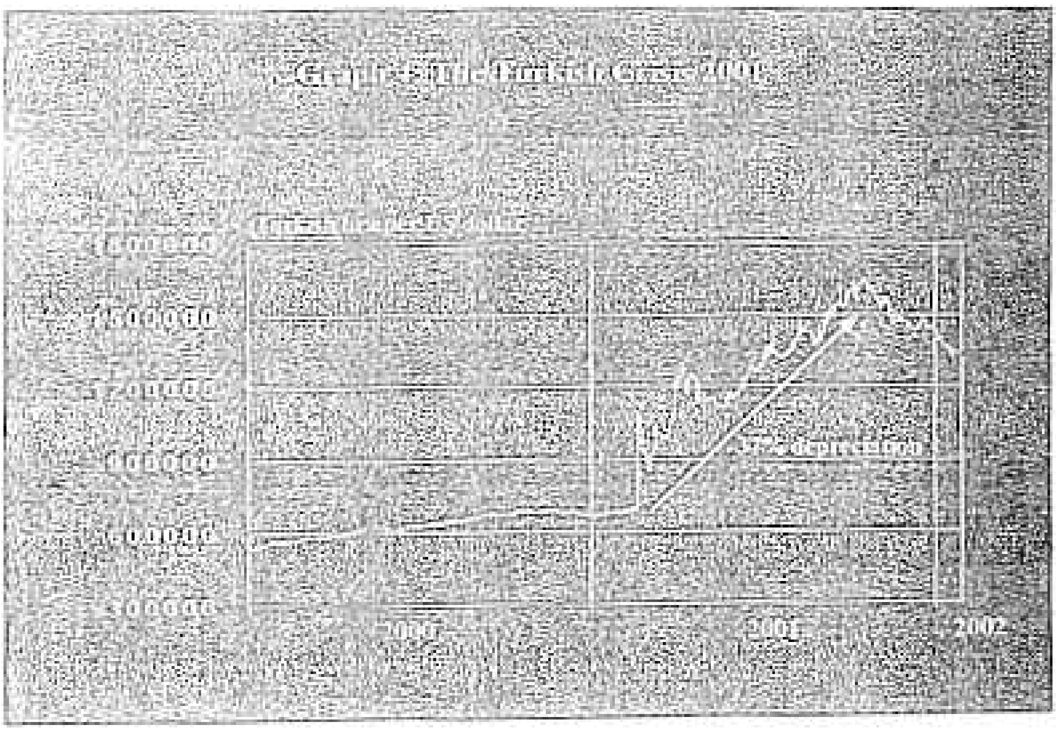
Table 1: Currency crises

European Monetary System crises 1992-93		Asian flu 1997-98	
	Value lost		Value lost
Britain	20%	Thailand	40%
Italy	37%	Malaysia	34%
Spain	37%	Indonesia	67%
Finland	22%	Philippines	26%
Latin American crisis 1994-95		January 2001	
	Value lost		Value lost
Mexico	49%	Turkey	37%
Venezuela	63%		
		January 2002	
		Argentina	44%


Graph 1 - The European Monetary System crisis
27% depreciation
20% depreciation
1992
1993
1994
1995


Graph 2 - The Latin American crisis 1995-1996
1994
1995
1996
1997




depreciation
2000
2001
2002

REAL EFFECTIVE EXCHANGE RATE

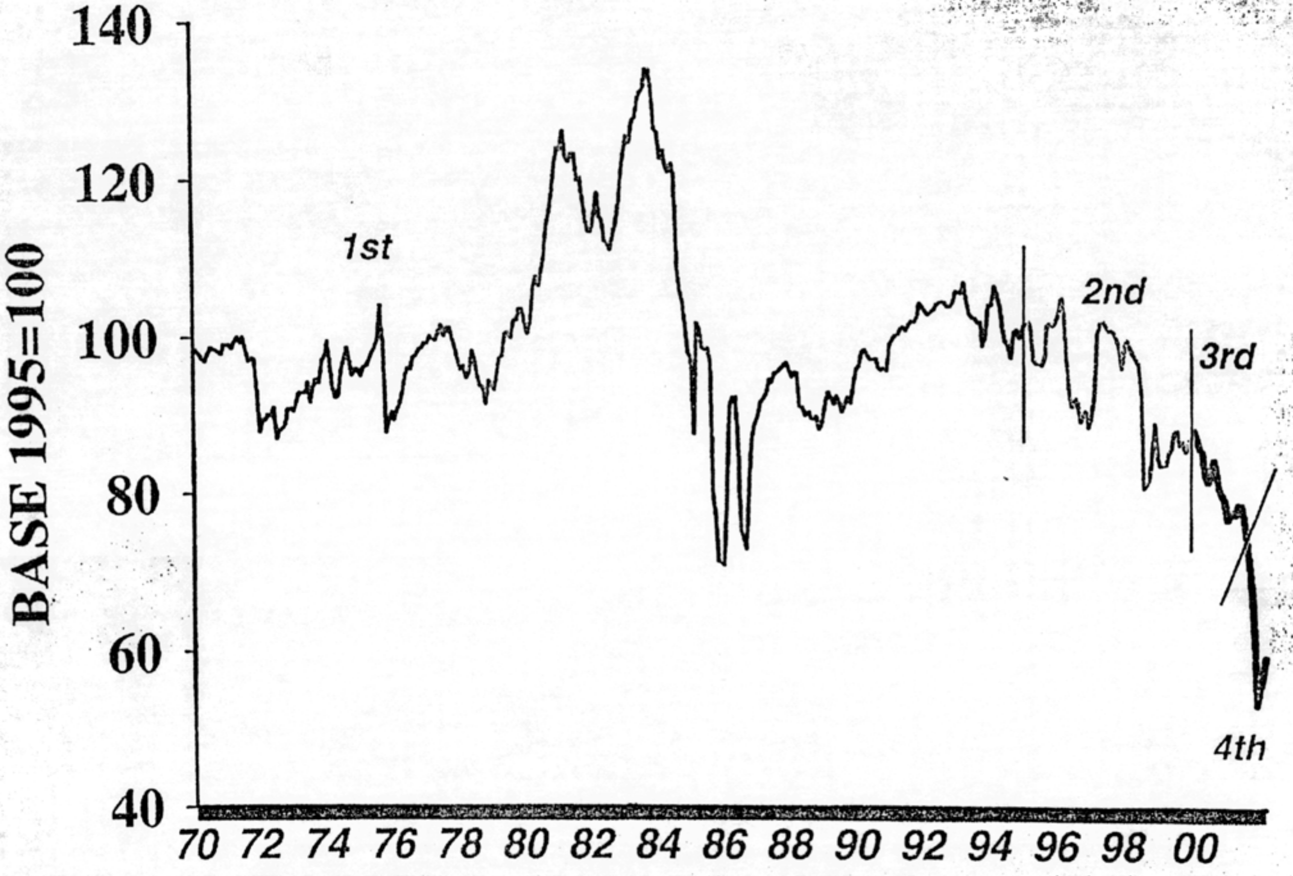
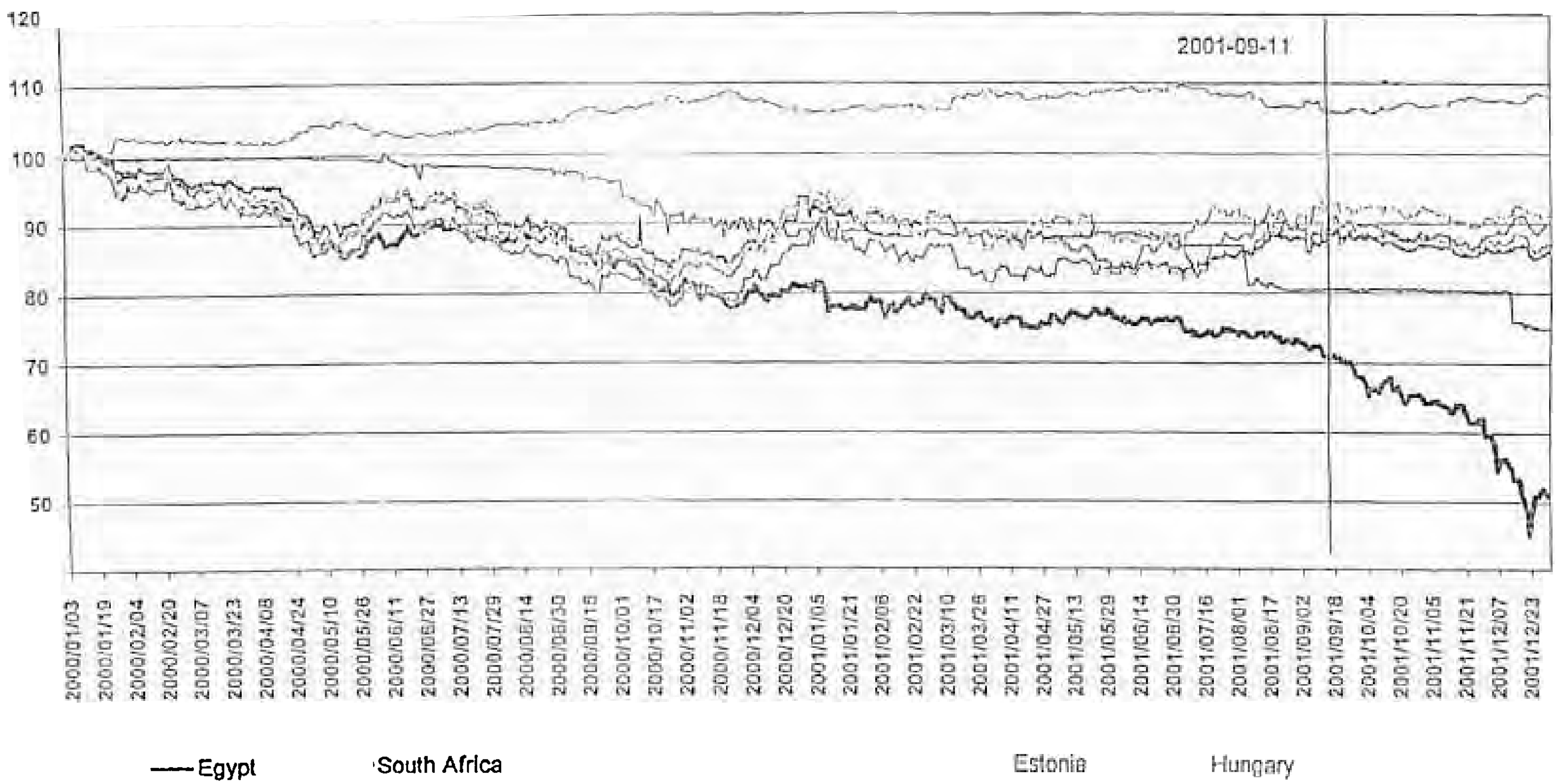
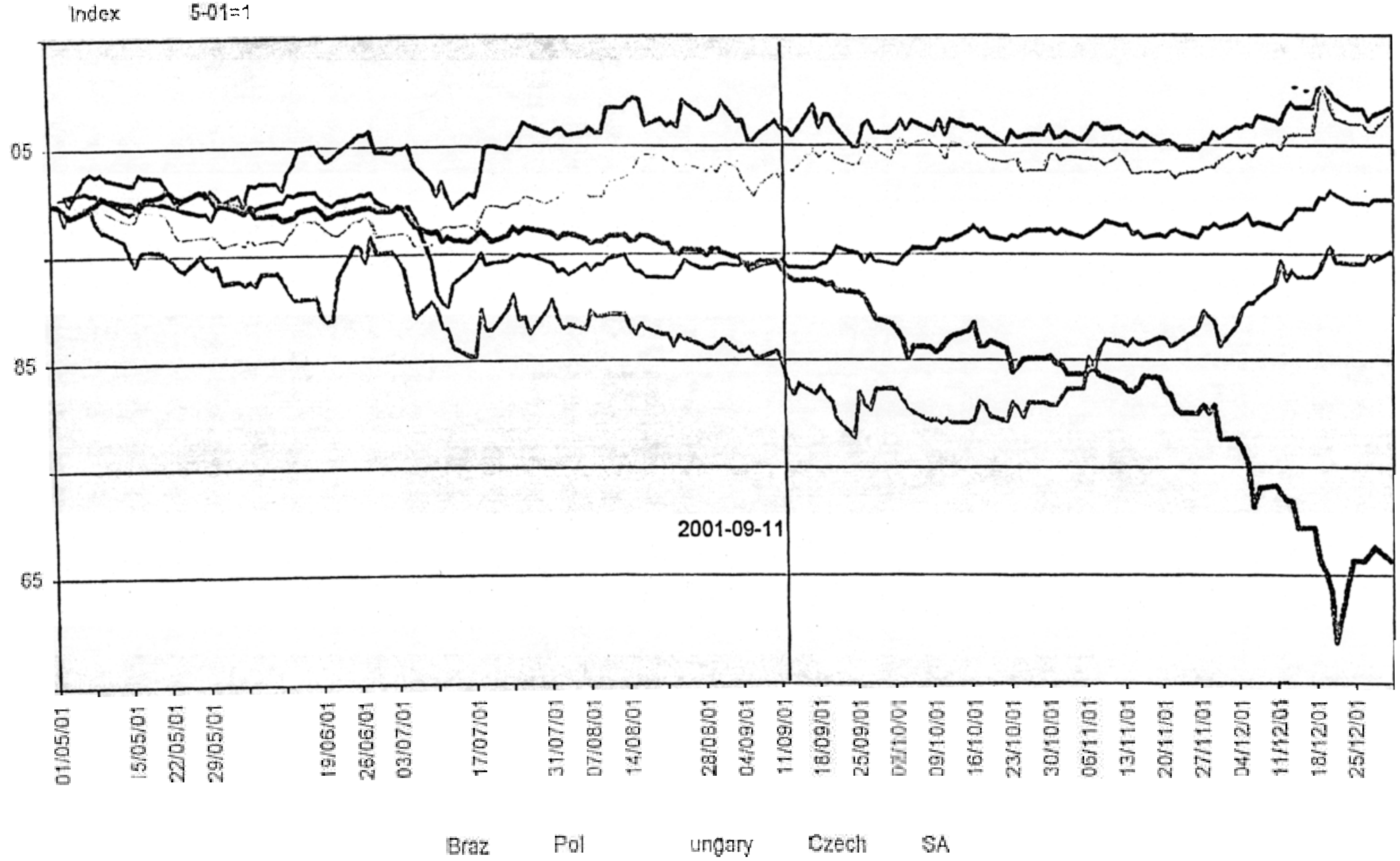


Chart 1

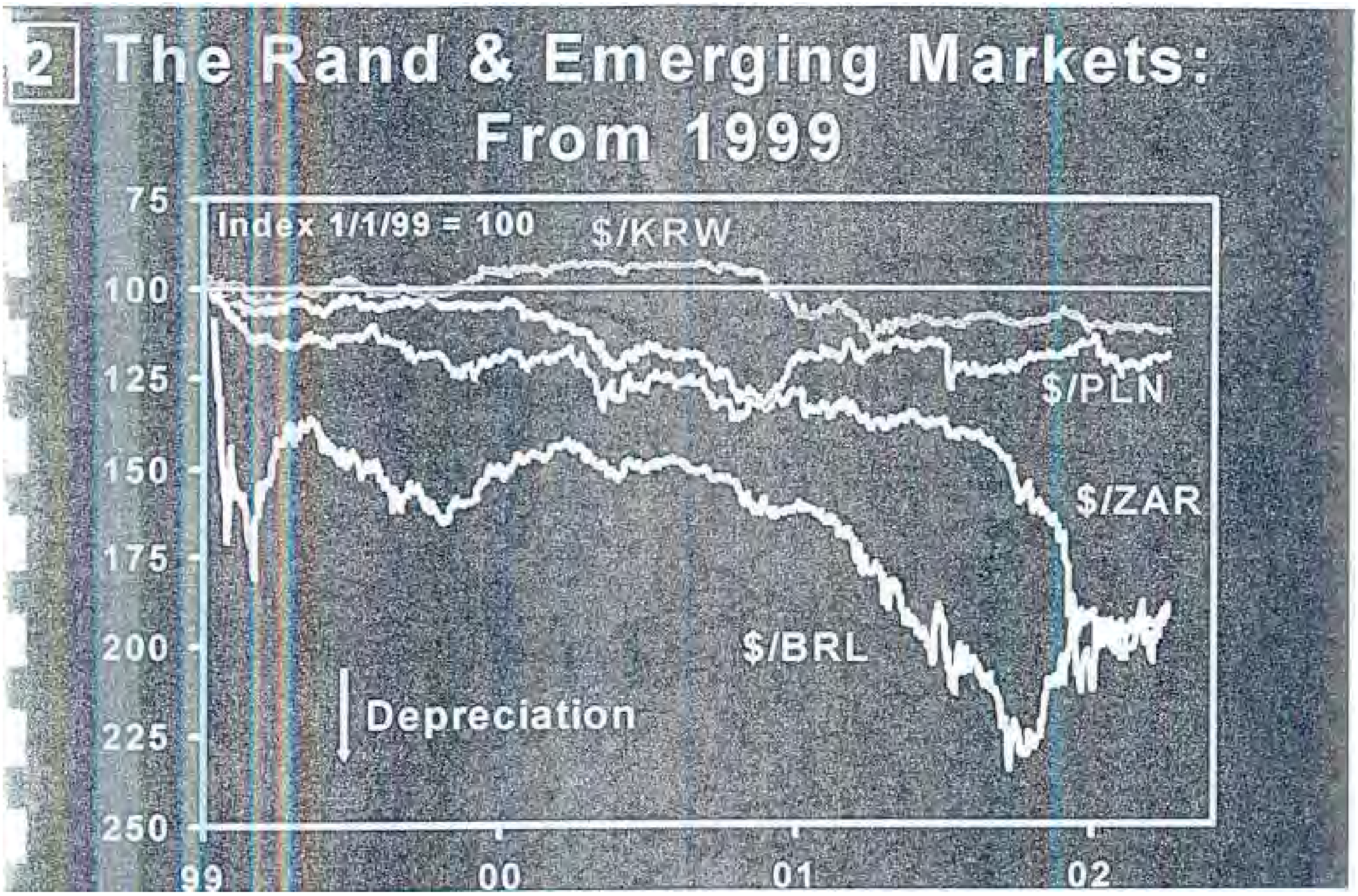
ınge rates of couı (BBB rated) against the US dollar



Exchang rates of vari cou tries ga nst th U dol



Graph 12


2
The Rand & Emerging Markets: From 1999
Index 1/1/99 = 100
$/KRW
$/PLN
$/ZAR
$/BRL
Depreciation
75
100
125
150
175
200
225
250
99
00
01
02

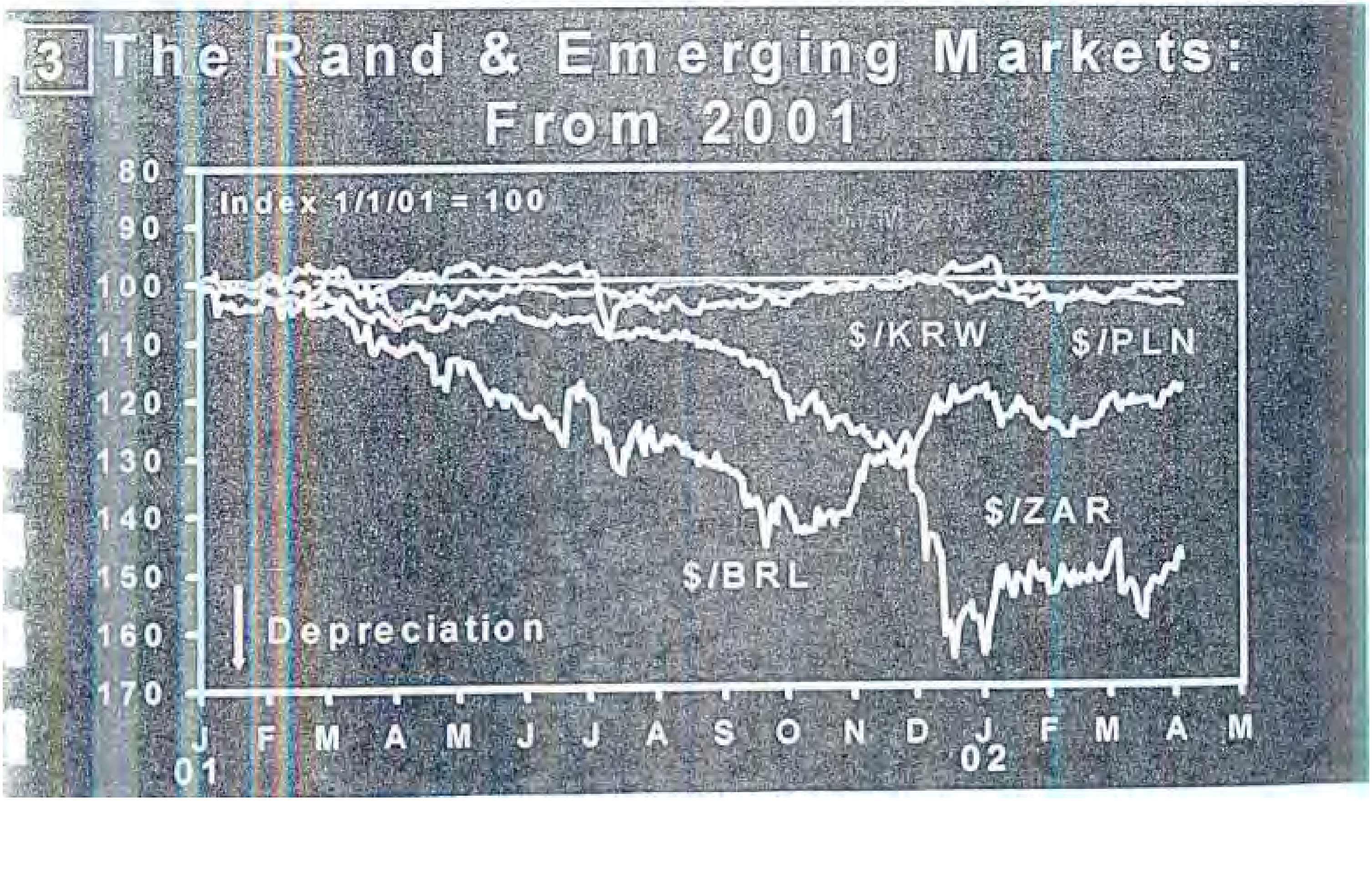
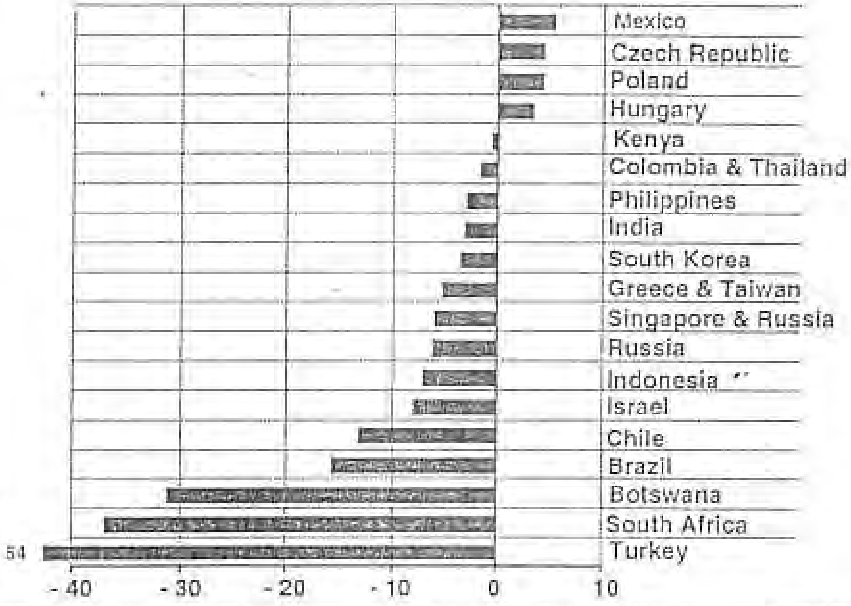

3
The Rand & Emerging Markets: From 2001
Index 1/1/01 = 100
$/KRW
$/PLN
$/ZAR
$/BRL
Depreciation
80
90
100
110
120
130
140
150
160
170
J F M A M J J A S O N D J F M A M
01
02

Diagram 5

Currencies against the US Dollar

31 December 2000 - 31 December 2001



DEFICIT AS % GDP

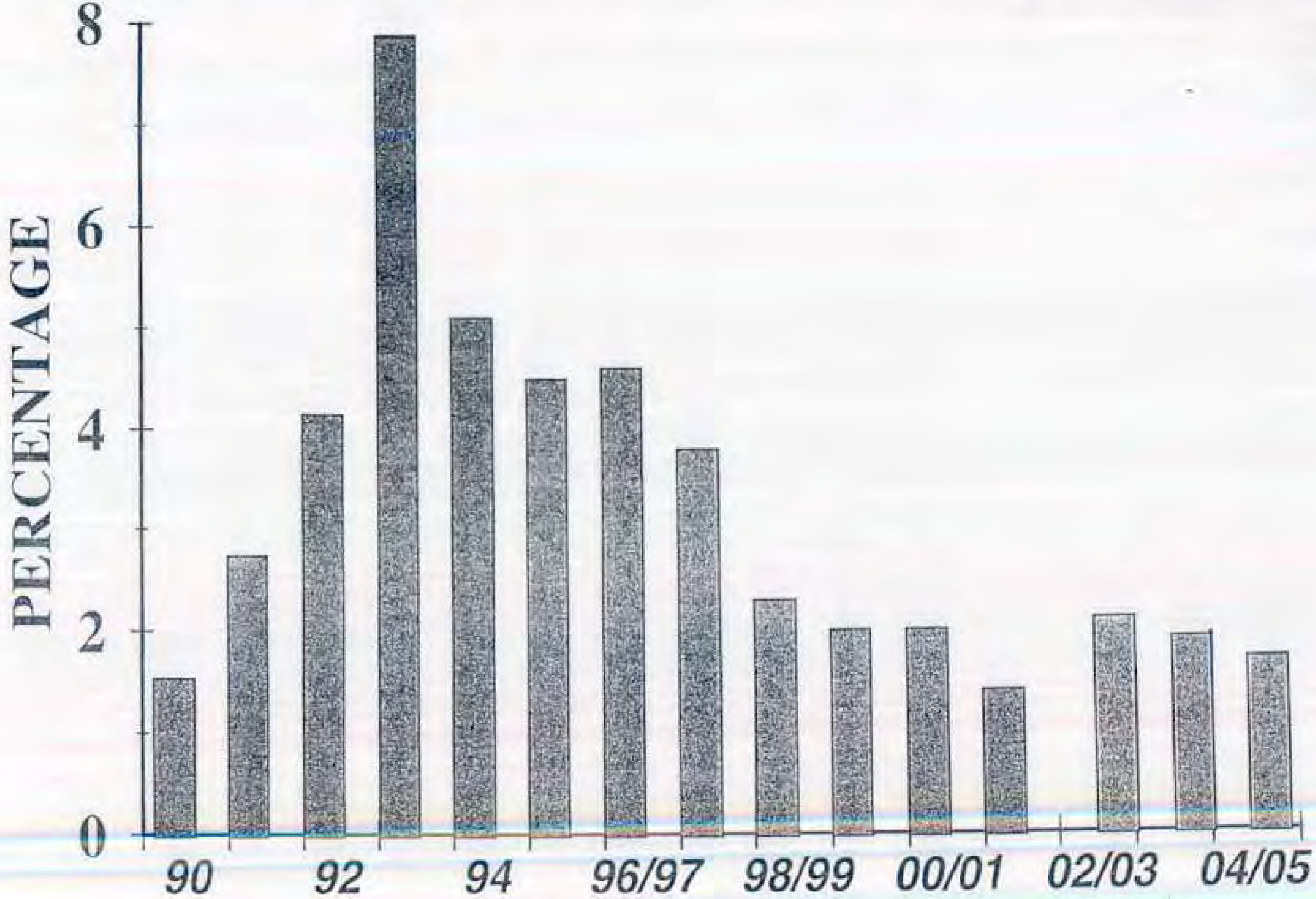
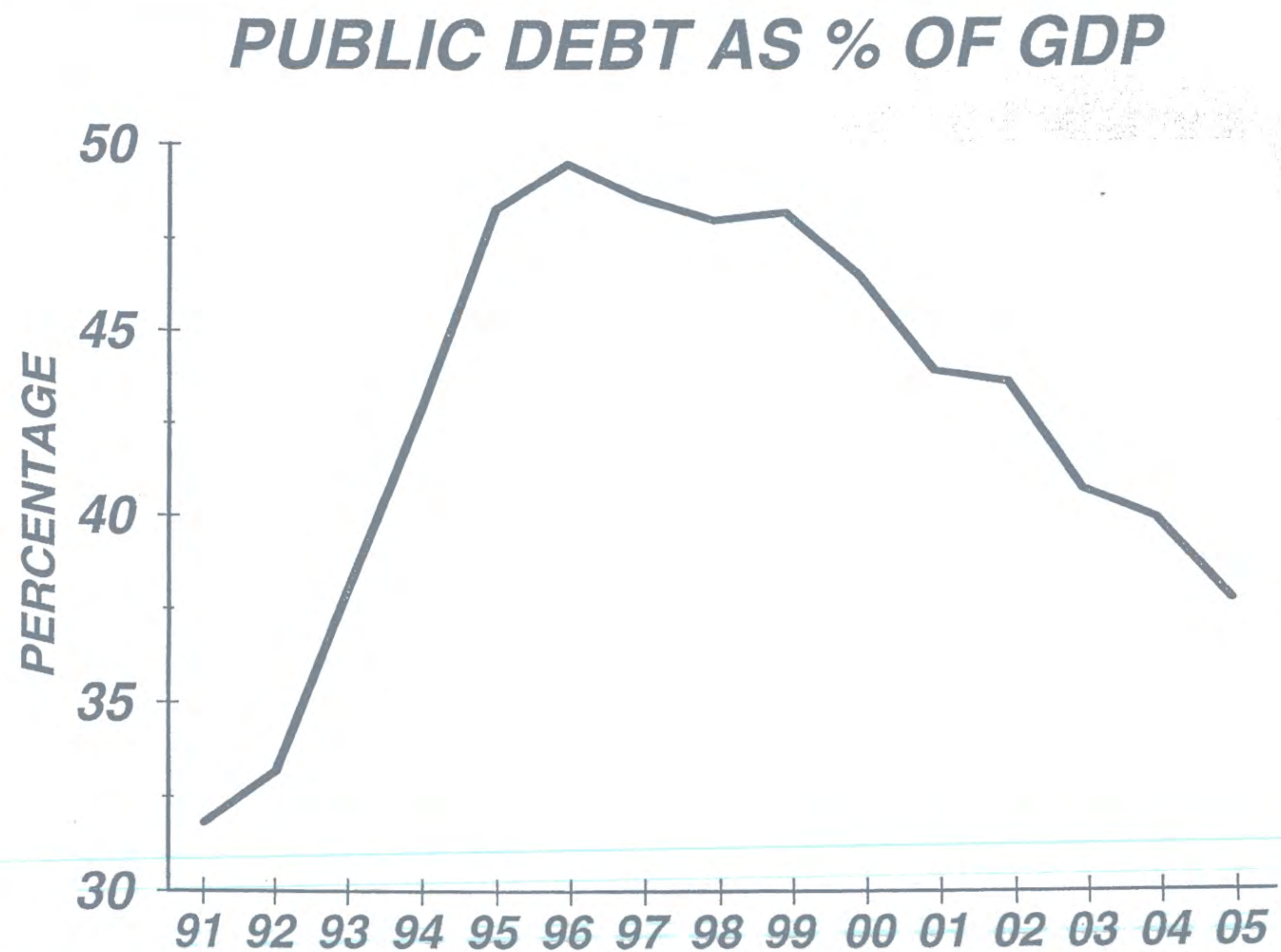


Chart 36


PUBLIC DEBT AS % OF GDP
PERCENTAGE
50
45
40
35
30
91 92 93 94 95 96 97 98 99 00 01 02 03 04 05
Chart 37

Distribution of Global Foreign Exchange Turnover

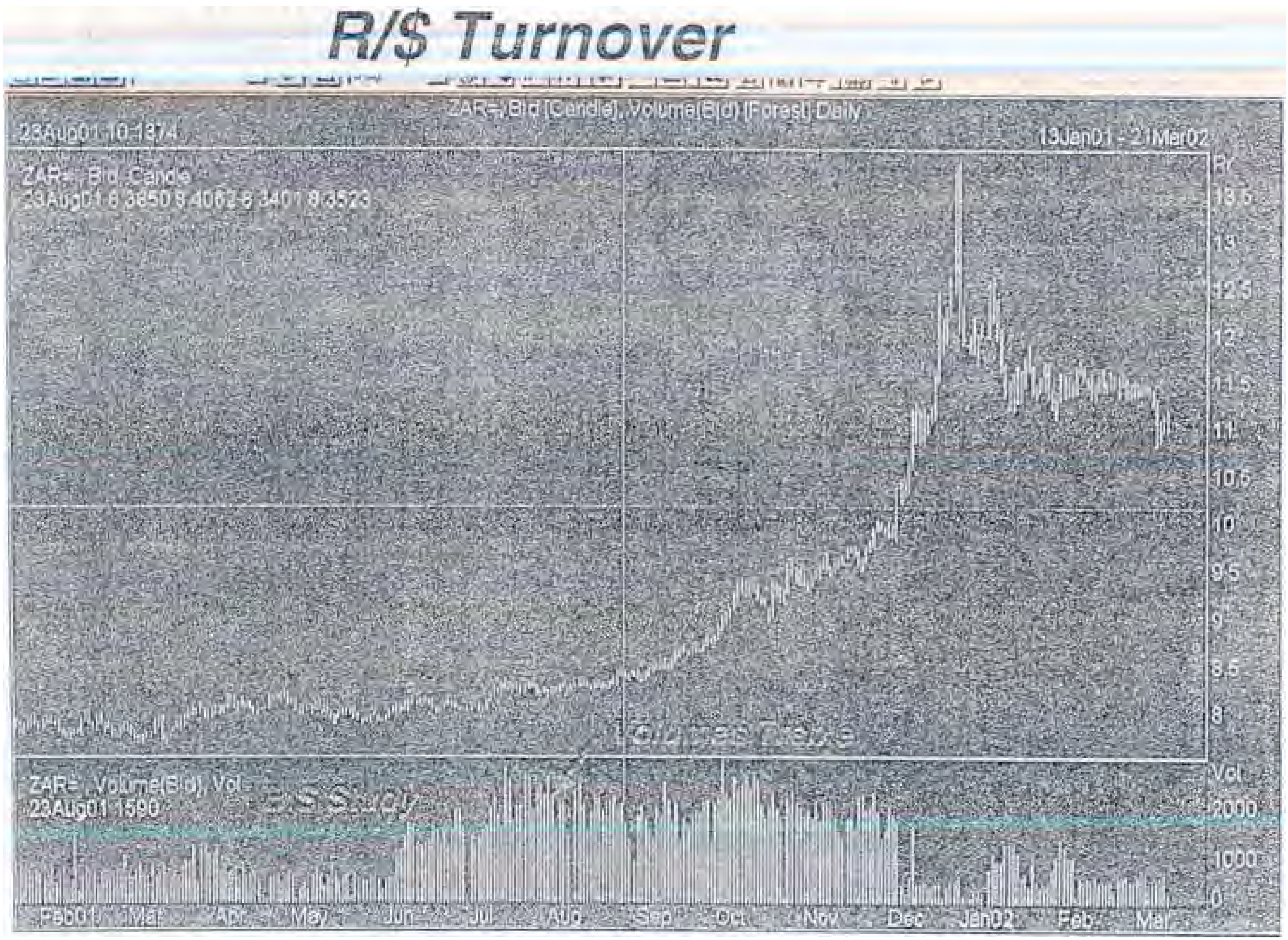
Currency Distribution (%)	
Dollar	45.2
Euro	18.8
Yen	10.9
Pound	6.6
Swiss Franc	3.0
Canadian Dollar	2.3
Australian Dollar	2.1
Swedish Krona	1.3
Hong Kong Dollar	1.2
Norwegian Krone	0.8
Singapore Dollar	0.6
South African Rand	0.5
Mexican Peso	0.5
Korean Won	0.4
New Zealand Dollar	0.3
Polish Zloty	0.3
Brazilian Real	0.2
Russian Rouble	0.2
Taiwan Dollar	0.2
Chilean Peso	0.1
Czech Koruna	0.1
Indian Rupee	0.1
Thai Baht	0.1
Malaysian Ringgit	0.1
Saudi Riyal	0.1
Other Currencies	4.0
Total	*100.0*

South African Rand	0.1 in 1992
South African Rand	0.1 in 1995
South African Rand	0.3 in 1998

Geographic Distribution April 2001	
US	15.7
UK	31.1
Japan	9.1
Singapore	6.2
Germany	5.4
Switzerland	4.4
Hong Kong	4.1
Australia	3.2
France	3.0
Canada	2.6
Netherlands	1.9
Sweden	1.5
Denmark	1.4
Italy	1.0
Luxembourg	0.8
Norway	0.8
South Africa	0.6
Belgium	0.6
Korea	0.6
Poland	0.5
Spain	0.5
Ireland	0.5
Austria	0.5
Brazil	0.3
Taiwan	0.2
Bahrain	0.2
Chile	0.1
Czech Republic	0.1
Malaysia	0.1
Thailand	0.1
Turkey	0.1
Portugal	0.1
Saudi Arabia	0.1
Total	*100*

South Africa	0.0 in 1989
South Africa	0.3 in 1992
South Africa	0.5 in 1998

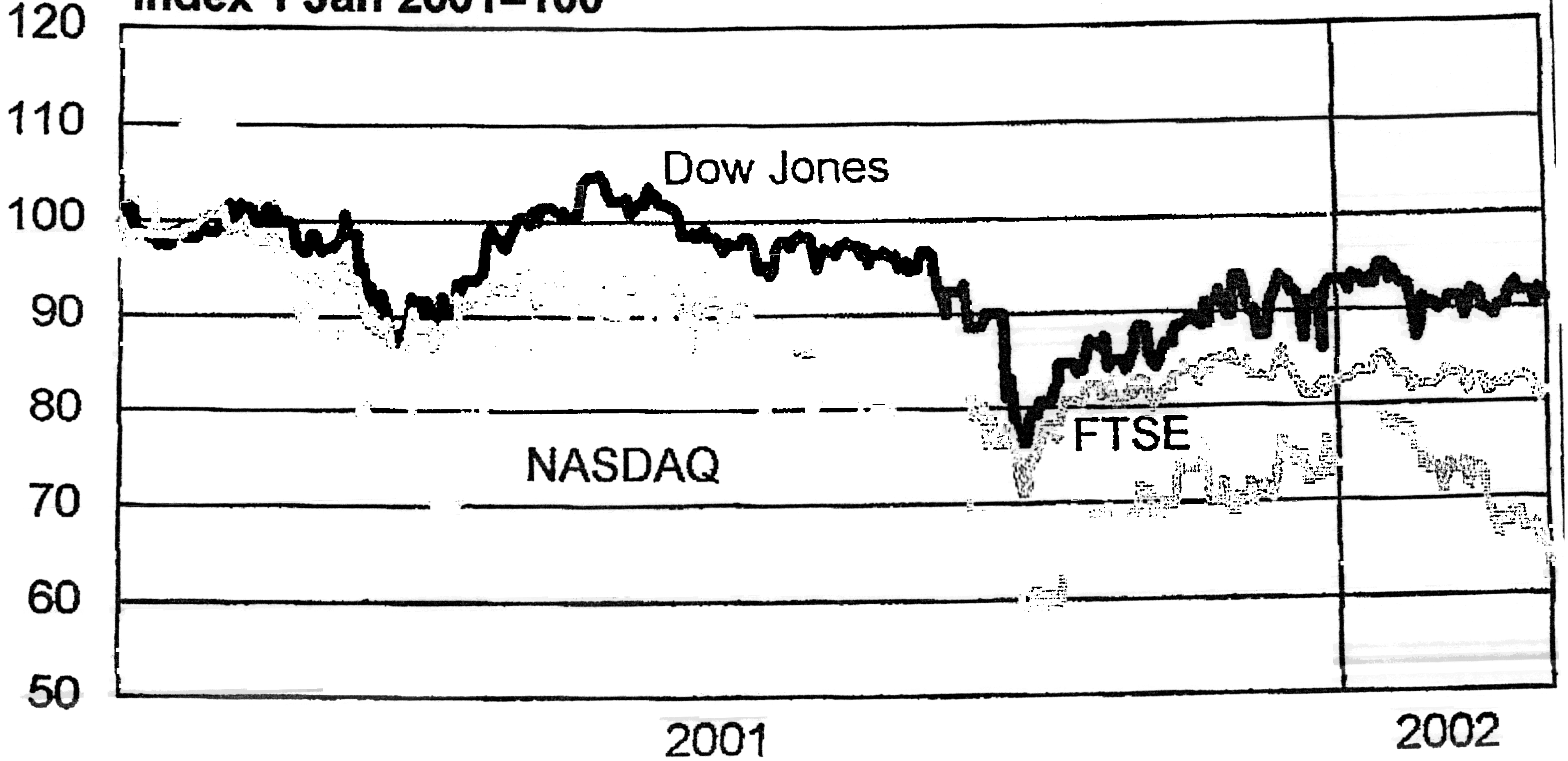
Table 14



R/$ Turnover
ZAR=, Bid (Candle), Volume(Bid) (Forest) Daily
23Aug01 10:1874
13Jan01 - 21Mar02
ZAR=, Bid, Candle
23Aug01 8.3850 8.4063 8.3401 8.3523
Rr
13.5
13
12.5
12
11.5
11
10.5
10
9.5
9
8.5
8
ZAR=, Volume(Bid), Vol
23Aug01 1590
Vol
2000
1000
0
Feb01
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Jan02
Feb
Mar

Chart 57

Graph 10:
Potential losses in global market investments
Index 1 Jan 2001=100



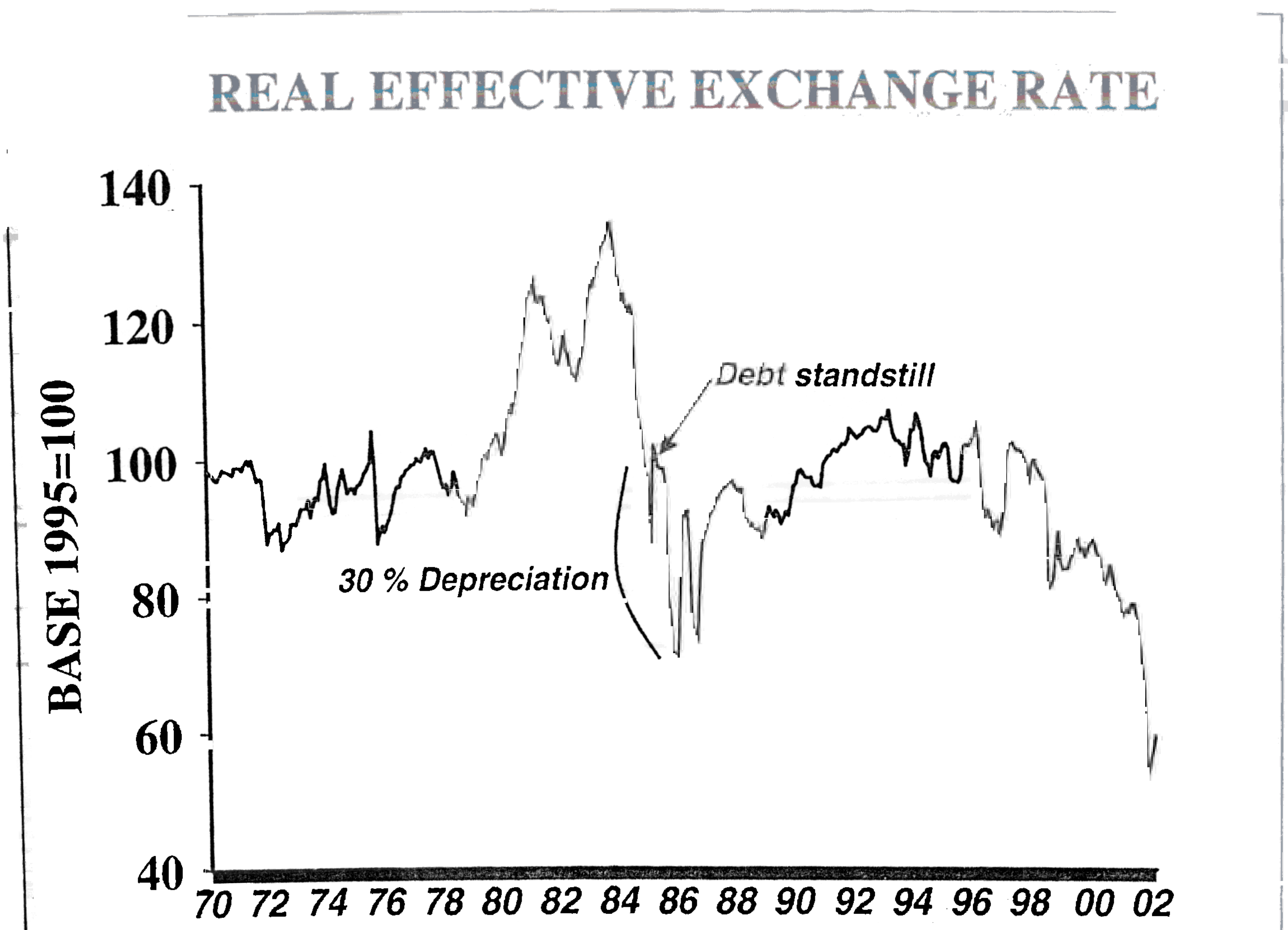
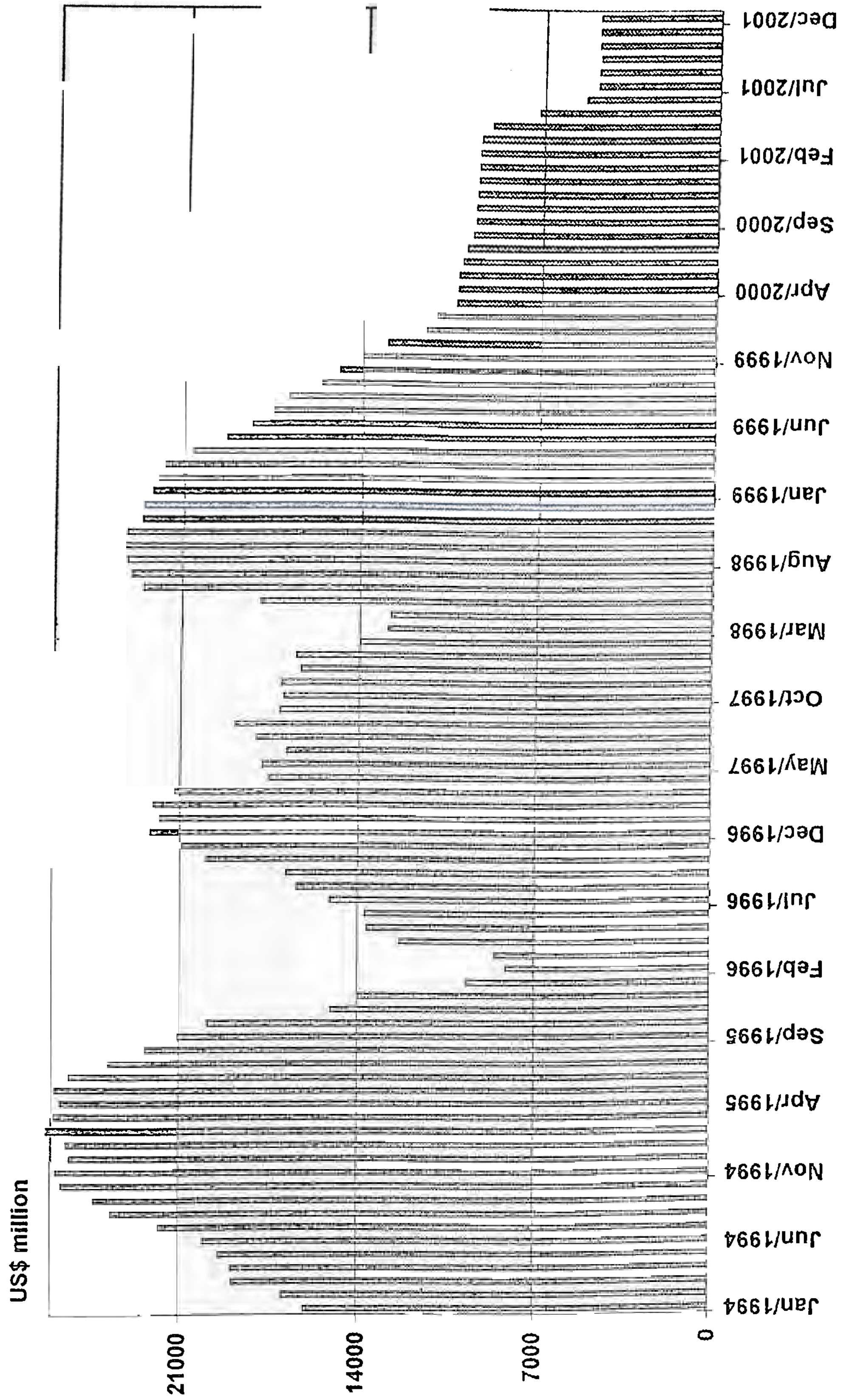

REAL EFFECTIVE EXCHANGE RATE
BASE 1995=100
140
120
100
80
60
40
70 72 74 76 78 80 82 84 86 88 90 92 94 96 98 00 02
Debt standstill
30 % Depreciation

Chart 11

Graph 13

The net oversold open forward position of the SARB since 1994



STATEMENT BY THE GOVERNOR OF THE SOUTH AFRICAN RESERVE BANK MR T.T. MBOWENI

The 11th September 2001 attacks in the USA and the ensuing international tension and conflict, have impacted on many of the world's financial markets, including our own. In particular, the recent volatility in the domestic foreign exchange market is of concern to the authorities since the interests of South Africans and non-resident investors are of paramount importance

The Reserve Bank wishes to reiterate its position that, with the adoption of an inflation-targeting monetary policy framework, it no longer has any intermediate policy targets or guidelines such as the exchange rate or growth in the monetary aggregates. The authorities are committed to continue allowing the value of the rand to be determined by the market, but are concerned that excessive volatility in the foreign exchange market negatively influences inflation, business decisions and the economy as a whole.

The Reserve Bank stands ready to take appropriate firm steps against trading activities inconsistent with existing rules and regulations. The enforcement of existing rules serves to ensure that only legitimate transactions take place in the foreign exchange market. This does not restrict, for example, the ability of a non-resident investor to either hedge or repatriate the sale proceeds of an investment in South Africa. It does, however, exclude the financing of short rand positions in the domestic markets, which is consistent with the requirement that domestic borrowing by non-resident investors is subject to certain restrictions. This communication should not be construed as an attempt to restrict the activities of banks in the South African markets, provided they adhere to the existing rules and regulations. Normal commercial and financial transactions remain unaffected.

The net open foreign currency position (NOFP) has declined from USD23,2 billion at the end of September 1998 to USD4,8 billion. Given the negative perceptions resulting from the NOFP, the Reserve Bank reduced this position by purchasing foreign currency in the domestic foreign exchange market, which may have contributed to the depreciation of the rand over this period.

The South African Government's exposure to foreign currency risk, including the NOFP, as a percentage of GDP, is now on par with those prevailing in certain G10 countries. With the NOFP at a more comfortable level, any perceived vulnerability has declined significantly. The Reserve Bank is consequently in a position to alter its approach in dealing with the NOFP.

In future, the Reserve Bank will not intervene by purchasing foreign exchange from the market for purposes of reducing the NOFP. The NOFP will be expunged from cash flows derived from the proceeds of Government's offshore borrowings and privatisation. Accordingly, it is no longer deemed necessary to publish a special monthly report on the forward book and the NOFP. In line with international practice, this information will be published monthly on the Reserve Bank's Internet site in accordance with the specifications of the IMF's Special Data Dissemination Standard (www.resbank.co.za/Economics/templatemain.htm).

Lastly, I wish to emphasise that the South African authorities remain committed to the orderly and gradual process of relaxation of exchange controls.

Enquiries:

A.M. Bruce-Brand
Head: Exchange Control Department
(012) 313 3576

L. van Zyl
Advisor to the Governor
(012) 313 3796

A.D. Mminele
General Manager: International Banking Department
(012) 313 3740

2001-10-14

SOUTH AFRICAN RESERVE BANK

FROM THE OFFICE OF
THE HEAD : EXCHANGE CONTROL DEPARTMENT

2001-10-16

EXCHANGE CONTROL CIRCULAR NO. D.342

PURCHASES AND SALES OF FOREIGN EXCHANGE

With reference to Exchange Control Circular No. D.341 of 2001-10-15, Authorised Dealers are again reminded of their obligations, as duly appointed Authorised Dealers in foreign exchange, to ensure that the provisions of the Exchange Control Rulings are strictly adhered to.

To ensure that the provisions of the various Sections of the Exchange Control Rulings are applied uniformly by all Authorised Dealers, in particular when dealing with non-residents in the forward and other derivative foreign exchange markets, we deem it necessary to reiterate certain fundamental principles in this regard.

It is incumbent upon Authorised Dealers to ensure that their overseas counterparties are fully conversant with the rules applicable to dealing in the domestic forward and other derivative foreign exchange markets.

It follows, therefore, that when dealing with a non-resident counterparty, other than a correspondent bank, supporting documentary evidence must be obtained confirming that such non-resident counterparty has a legitimate South African exposure resulting from an accrual, investment or asset denominated in Rand. Where the required supporting documentary evidence is not available at the time of entering into the transaction, such documentation must be presented within 14 days for endorsement. In the case of a correspondent bank, a written confirmation every two weeks to the effect that all transactions have been executed within the ambit of the aforementioned rules, signed by the compliance officer, is acceptable. Copies of the endorsed supporting documentation as well as the written confirmations must be retained for inspection purposes.

Trading operations may continue to be undertaken by non-residents in the domestic markets in respect of their assets, liabilities or future firm and ascertained commitments and/or accruals.

Where a non-resident counterparty wishes to borrow Rand locally in order to effect settlement of any transaction undertaken in the South African markets, Authorised Dealers must ensure that such borrowing is in strict compliance with the rules relating to the granting of local financial assistance. Any local borrowings in this regard, cash

80

or assets, must be fully secured with the lender by cash cover in Rand or the pledge of unencumbered non-resident owned local assets.

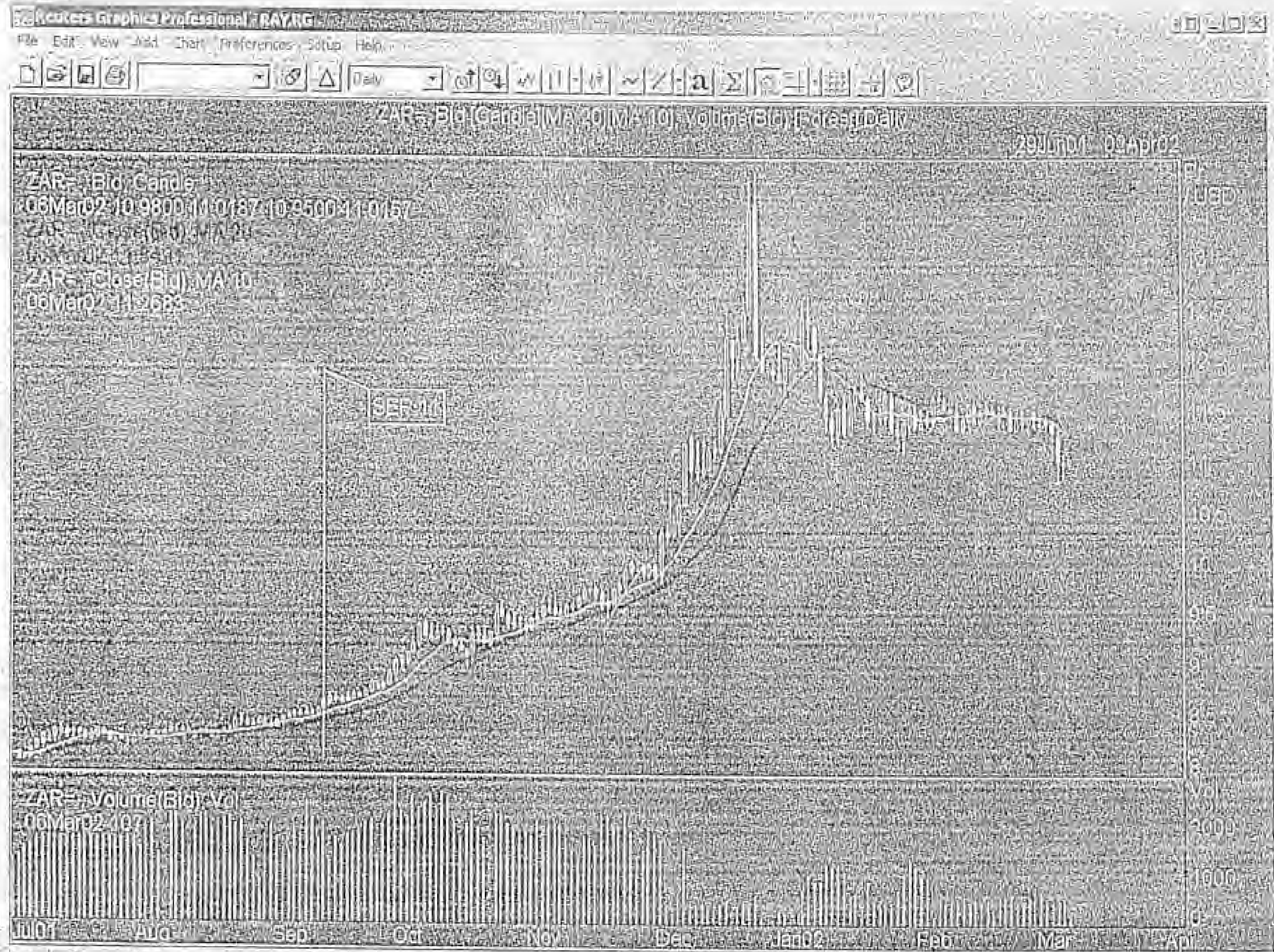
It follows that any Rand asset owned by a non-resident may be accepted as collateral for any local borrowing of cash, bonds or equities, provided such assets have not been used for an existing hedging transaction.

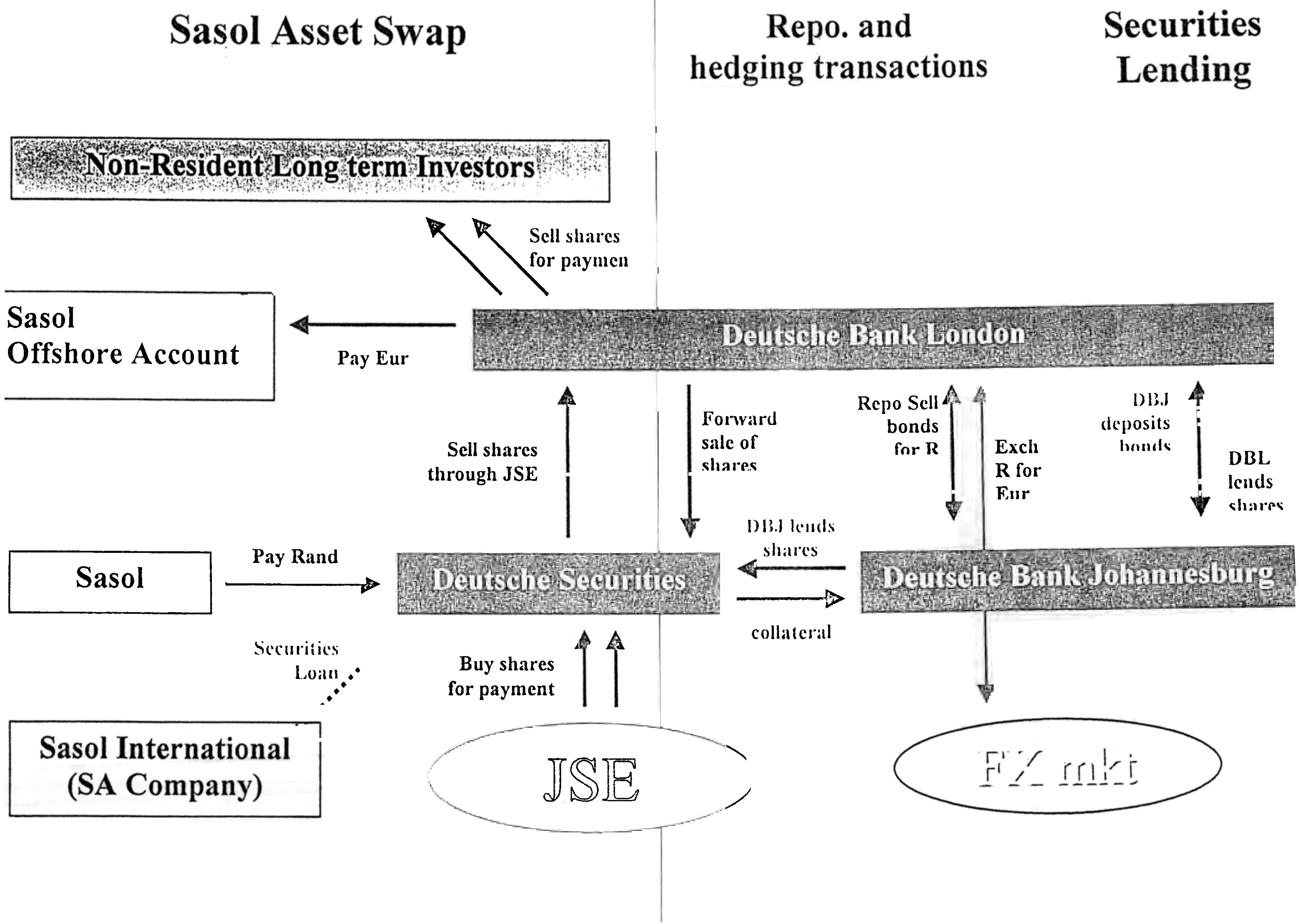
Although the applicable rules are explained in the Exchange Control Rulings, a summarised version will be made available on the South African Reserve Bank Internet site in due course.

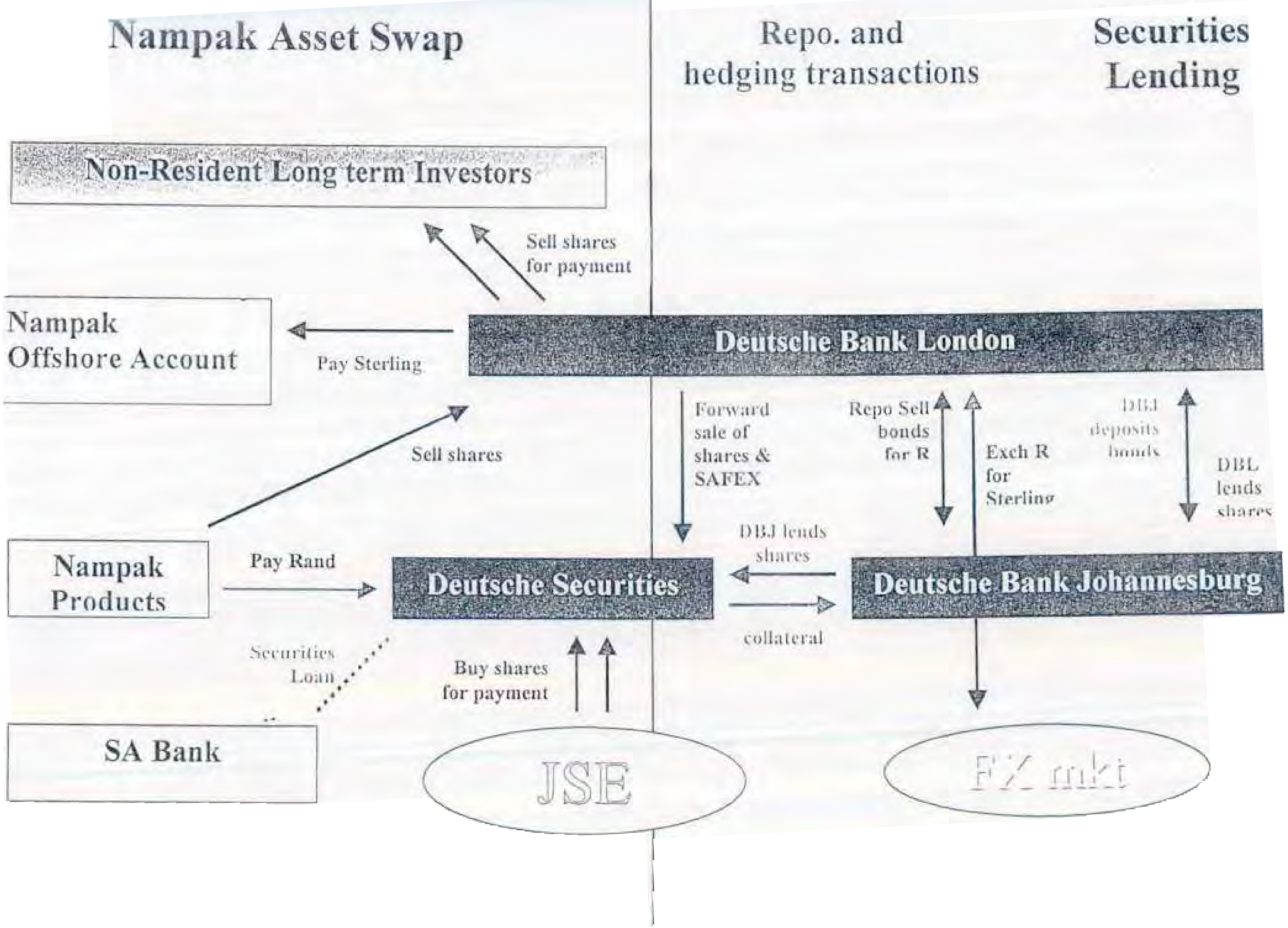
DEPUTY GENERAL MANAGER

H:\REGS\CIRCULAR\D.342.doc

CHART 9


Reuters Graphics Professional - RAY.RG
File Edit View Add Chart Preferences Setup Help
ZAR=, Bid (Candle) MA 20 MA 10, Volume(Bid) Forex Daily
29Jun01 - 04Apr02
ZAR= , Bid, Candle
06Mar02 10.9800 11.0187 10.9500 11.0157
ZAR= , Close(Bid), MA 10
06Mar02 11.2583
SEP-11
USD
ZAR= , Volume(Bid), Vol
06Mar02 407
Jul01
Aug
Sep
Oct
Nov
Dec
Jan02
Feb
Mar
Apr


Sasol Asset Swap
Repo. and hedging transactions
Securities Lending
Non-Resident Long term Investors
Sell shares for paymen
Sasol Offshore Account
Pay Eur
Deutsche Bank London
Sell shares through JSE
Forward sale of shares
Repo Sell bonds for R
Exch R for Eur
DBJ deposits bonds
DBL lends shares
DBJ lends shares
collateral
Sasol
Pay Rand
Deutsche Securities
Deutsche Bank Johannesburg
Securities Loan
Buy shares for payment
Sasol International (SA Company)
JSE


Nampak Asset Swap
Repo. and hedging transactions
Securities Lending
Non-Resident Long term Investors
Sell shares for payment
Nampak Offshore Account
Pay Sterling
Deutsche Bank London
Sell shares
Forward sale of shares & SAFEX
Repo Sell bonds for R
Exch R for Sterling
DBJ deposits bonds
DBL lends shares
Nampak Products
Pay Rand
Deutsche Securities
DBJ lends shares
collateral
Deutsche Bank Johannesburg
Securities Loan
Buy shares for payment
SA Bank
JSE
FX mkt

JURGENS BEZUIDENHOUT ATTORNEYS
Harrow Court 3, Isle of Houghton, Boundary Road, Parktown
Private Bag X3119, Houghton 2041
South Africa
Tel: +27 11 645 6040
Fax: +27 11 484 1165

Our Ref: J Bezuidenhout/Commission8.doc
Direct Tel: 645-6045
E-mail: jurgensb@jjb.co.za

7 June 2002

Mr J Myburgh
Commission of Inquiry into the
Rapid Depreciation of the Rand
2nd Floor, Rex Welsch House
cnr Gwen & Maude Streets
Sandown Village
Sandton

Telefax: (011) 263 9005

Dear Sir

REPORT BY COMMISSION ON THE LEGALITY AND ETHICS OF THE ASSET SWAP TRANSACTIONS ARRANGED BY DEUTSCHE SECURITIES

As requested, we set out below reasons in support of the view that it is not appropriate for the Commission to deal in its final report with the legality and ethics relating to the conclusion of the Sasol, Nampak and M-Cell asset swaps and related transactions:

A commission of inquiry is an ad hoc body established by the executive function of government to assist the latter in the discharge of its functions by providing it with a report on a specified matter of public interest. The investigation and report by a commission of inquiry is an unusual procedure of an invasive nature aimed at allaying public fears and concerns in respect of a matter of public concern. The exercise of powers by a commission of inquiry must therefore be strictly in accordance with the statutory or other authority whereby it was created.

2. The Commissions Act, 1947 provides that the President may for the purpose of investigating a matter of "public concern" declare the provisions of the Commissions Act applicable to a commission of inquiry. A commission appointed in terms of the Commissions Act is only empowered to inquire into the specific matter of public concern for which it was appointed. Where a commission publicly investigates or reports on a matter that is not in its terms of reference, it would be acting outside its mandate. In essence, therefore, it would lack the necessary power to investigate and report on such a matter.

3. The Commissions Act, 1947 was made applicable to the Commission by proclamation published in *Government Gazette* 23084. The matter of public concern that the Commission was appointed to investigate and report on was the "rapid depreciation of the Rand". For this reason the terms of reference of the Commission had to be so limited, and they were. The terms of reference of the Commission published in *Government Gazette* 23091 (the "Terms of Reference") provides in paragraph one thereof that the Commission is to inquire and report on whether between 1 January and 31 December 2001, any person directly or indirectly, entered into, concluded or caused any transactions which contributed or gave rise to the rapid depreciation of the value of the Rand during the relevant period relative to other currencies *and* whether any *such transactions* were illegal, or unethical, albeit legal. All additional directives to the Commission contained in the Terms of Reference refer to "the transactions in question" and "such transactions", i.e. transactions that gave rise or contributed to the rapid depreciation of the Rand. The Terms of Reference therefore essentially limit the Commission's inquiry (and accordingly the scope of its report) to transactions that gave rise or contributed to the rapid depreciation of the currency during the period under review. Where it is established during the Commission's inquiry that a particular transaction did not give rise or contribute to the rapid depreciation of the Rand in the period under review, it would be outside the scope of the Commission's Terms of Reference to come to any conclusion as to the legality and ethics of the particular transaction.

4. There has been no evidence before the Commission that any of the transactions comprising the asset swaps gave rise or contributed to the rapid depreciation of the Rand, and in our view this has been conclusively established. There had been the suggestion at the Commission's hearings that the currency could have appreciated more than it eventually did on the days that the relevant currency hedging transactions in respect of the asset swaps were implemented. This alleged lack of appreciation has in no way been proved in any investigation carried out by the Commission or at the Commission's hearings. Even if the Commission should find that the asset swaps or related transactions caused a lack of appreciation, it would be outside the scope and powers of the Commission to report on such alleged lack of appreciation. The Terms of Reference clearly only authorise the Commission to investigate and report on transactions that gave rise or contributed to the *rapid depreciation* of the currency, and not any transaction that could have caused a *lack of appreciation*. The same argument would apply in the unlikely event that the Commission were to find that the asset swaps and related transactions did contribute, albeit in a very tiny fashion, to a decline in the Rand. Therefore, any report by the Commission on the legality and ethics of transactions that could have caused a lack of appreciation or a negligible depreciation in the currency, would be pedantic and outside the Commission's Terms of Reference.

5. It is therefore our respectful submission that the report of the Commission in respect of the asset swaps and related transactions should be confined, in the first instance, to a finding on whether the asset swaps and related transactions gave rise or contributed to the *rapid depreciation* of the Rand in the period under review. Were the Commission to find that the asset swaps and related transactions did not give rise or contribute to the rapid depreciation of the Rand in the period under review, it would be beyond the scope and powers of the Commission to make any finding, or to report, on the legality or ethics of the asset swaps and related transactions.

6. The Exchange Control Regulations, 1961 (the "Regulations") provide the basis of exchange control in South Africa. The legality or otherwise of an exchange control related transaction must have its foundation in the Regulations. In terms of the Regulations the legality or otherwise of an exchange control related transaction would depend on whether or not the Reserve Bank approves such transaction. Therefore, an exchange control related transaction is legal if approved by the Reserve Bank. Deutsche Bank has always maintained and demonstrated that it did not contravene any provisions of the Regulations – the transactions forming part of the asset swaps were either specifically approved by the Reserve Bank or fell within general Reserve Bank approvals, and disclosure to the Reserve Bank was made accordingly. However, in 2002, during the Commission's hearings, it became apparent that a dispute existed between the Reserve Bank and Deutsche Bank. This dispute has now been resolved. The settlement agreement provides for a full and final settlement of all claims, disputes and proceedings of any nature that either party may have against the other in relation to the asset swaps, and the Reserve Bank does not require the unwinding of the asset swaps and related transactions. By agreeing to the terms of the settlement agreement, the Reserve Bank has approved all the transactions comprising the asset swaps and has with finality resolved the issues raised in the dispute and rendered an alternative resolution of the dispute or a finding by the Commission in respect thereof irrelevant. In these circumstances, any finding by the Commission as to the legality and ethics of the asset swaps and related transactions could only be interpreted as a repudiation of the Reserve Bank's authority. In fact, all confidential settlements or proceedings that the Reserve Bank may presently be administering or has concluded would be brought into question by any further finding by the Commission.

7. Given the prominence of the allegations against Deutsche Bank, Deutsche Bank is concerned that a perception is developing that the Commission's relatively intense scrutiny of Deutsche Bank suggests that there is something especially "dubious" about Deutsche Bank's role in the market. We respectfully request that the Commission be sensitive to an unfair perception developing that could disproportionately affect Deutsche Bank's business in South Africa. The genesis of the disproportionate focus on Deutsche Bank lies with Mr Wakeford's baseless allegations in his letter to the President and information obtained from sources in a competitor bank. Equity of treatment before the Commission would require the Commission to consider the asset swaps in proper perspective and relative to all the factors and other substantial transactions that *did* give rise to the rapid depreciation of the Rand, as shown in evidence heard by the Commission.

8. We thank you for affording us the opportunity to make this submission.

Yours faithfully

Jurgens Bezuidenhout Attorneys

Commission7.doc

SOUTH AFRICAN RESERVE BANK
FROM THE OFFICE OF
THE HEAD : EXCHANGE CONTROL DEPARTMENT

CONFIDENTIAL

2002-06-06

Advocate John Myburgh SC
Chairman of the Rand Commission
2nd Floor
Rex Welsh House
Cnr Gwen and Maude Street
Sandown Village
Sandton

Dear Advocate Myburgh

CONTRAVENTIONS OF EXCHANGE CONTROL REGULATIONS BY DEUTSCHE BANK AG, JOHANNESBURG BRANCH

I refer to your letter of 30 May 2002 addressed to the Governor who has requested me to respond to you on his behalf.

The South African Reserve Bank ("SARB") has been requested to revert to the Commission with regard to -

1.1 the legal duty of Deutsche Bank AG, Johannesburg Branch ("DBJ"), in respect of certain exchange control applications submitted by DBJ on behalf of Sasol Limited ("Sasol") and Nampak Limited ("Nampak");

whether a breach of the legal duty referred to in 1.1 by DBJ constituted prima facie evidence of criminal conduct.

2 In this letter I deal with the Exchange Control Department of SARB's ("Excon") submissions with regard to the issues referred to in your letter. These submissions will be dealt with under the following headings –

the legal duty of DBJ -

2.1.1 to make the disclosures referred to in paragraphs 1(1) and 1(2) of your letter ("Disclosures");

to ensure reserves neutrality in terms of paragraph 1(3) of your letter ("Reserves Neutrality");

2.2 in terms of what law the duties in 1(1) 1(2) and 1(3) of your letter arose ("Applicable Law");

2.3 whether a breach of the legal duty referred to in 2.1, as read with 2.2 above, constituted prima facie evidence of criminal conduct, such as a contravention of the Exchange Control Regulations ("Criminal Conduct").

3 In order to properly contextualise and deal with the issues raised in 2 above, I believe it is necessary, in the first instance, to examine the legal framework of Excon ("Legal Framework").

4 Before dealing with the substance of your enquiries, it is apposite to record that, as will appear from this letter itself, I have relied upon the Bank's advisors, including legal advisors, to assist me with the preparation of its content.

APPLICABLE LAW

5. The precise nature and content of the Legal Framework, affecting exchange controls in South Africa, which is set forth in considerable detail in SARB Volume 1, pages 2 to 7 is founded upon and is to be discerned from –

5.1 the Currency and Exchanges Act, No. 9 of 1933 ("the Currency and Exchanges Act") (see SARB Volume 1 pages 12 to 17);

5.2 the Exchange Control Regulations issued in terms of Section 9 of the Currency and Exchanges Act ("the Exchange Control Regulations") (See SARB Volume 1, pages 18 to 40);

5.3 the Orders and Rules Issued under the Exchange Control Regulations ("Orders and Rules") (See SARB Volume 1 pages 41 to 52);

the delegation to Excon of most of the powers, functions and duties assigned to and imposed upon the Treasury (as defined in the Exchange Control Regulations) by the Exchange Control Regulations (See SARB Volume 1 pages 53 to 58);

5.5 the system of appointment of Authorised Dealers in foreign exchange ("Authorised Dealers"); and

the Issue by Excon of the Exchange Control Rulings ("Rulings") (See SARB Volume 1 pages 59 to 295), which are from time to time amended by circulars ("Circulars") and which shall hereinafter only be referred to as the Rulings.

6 An overview of the Legal Framework in 5 makes it apparent that -

6. the Exchange Control Regulations contain either an absolute prohibition or an absolute direction or decree in each case tempered by a provision

creating the possibility of exemptions and/or permissions to be granted by Treasury (and thus Excon by virtue of the delegation referred to in 5.4 above);

6.2 the Rulings contain the conditions, permissions and limits applicable to the transactions in foreign exchange which may be undertaken by Authorised Dealers, as well as details of related and administrative responsibilities; and

6.3 Excon has the power, in specific cases referred to it by Authorised Dealers for consideration, to grant permissions and/or exemptions subject to conditions ("Conditions"), which Excon itself imposes in regard to any such matter.

7 From the contents of 5 and 6 above, it is apparent that the Exchange Control Regulations, the Orders and Rules, the Rulings and Conditions confer legal rights in favour of -

7.1 Treasury (most of which have been delegated to Excon in terms of 5.4 above); and

7.2 the State (as the prosecuting authority)

8 Each member of the public, including an Authorised Dealer such as DBJ when dealing in matters concerning foreign exchange has a legal duty

8.1 to Treasury (and therefore also to Excon) ("the Administrative Law Duty" and

8.2 to the State (as the prosecuting authority) ("the Criminal Law Duty"), regarding adherence to the Exchange Control Regulations, the Orders and Rules, the Rulings and/or the Conditions.

and in any event falls within the provisions of Regulation 10(1)(c) of the Exchange Control Regulations and accordingly, application was required to be made to Excon for the authority to implement such share placements. Such applications were in fact made and, in this regard, see pages 147 and 190 of SARB Volume 8. The dispute which has arisen, I am advised, is whether DBJ was required to disclose to Excon the hedging, funding and related transactions which were implemented in consequence of these share placements;

11.2 Regulation 10(1)(c) (see SARB Volume 1, page 28) reads as follows

"10(1) No person shall, except with the permission granted by the Treasury and in accordance with such conditions as the Treasury may impose;

(a)

(b)

enter into any transaction whereby capital or any right to capital is directly or indirectly exported from the Republic." (my underlining);

11.3 Disclosure, and the manner in which Disclosure is required to be made, is dealt with in Section A of the Rulings under subsection (D)(ii) (See SARB Volume 1, page 64) which reads as follows -

"(D)(ii) The Exchange Control Department of the South African Reserve Bank is required to be in possession of full information regarding the transaction, its nature and purpose, before consulting with the Treasury or exercising the authority conferred on it by the Minister of Finance. When submitting applications for consideration Authorised Dealers should ensure at all times that the full names and surname of an applicant are furnished and, unless specific attention is drawn thereto, that the same names are used in subsequent applications. In addition, Authorised Dealers must also state whether or not they recommend the transactions and their reasons for giving or withholding their recommendation.

Applications submitted to the Exchange Control Department of the South African Reserve Bank, which do not contain sufficient information, will be returned to the applicants banker and, accordingly, to avoid unnecessary work and delay, Authorised Dealers must ensure that full and precise particulars of the underlying transactions are given in the first instance.

Replies to applications will be addressed to the head offices of Authorised Dealers who should ensure that the requirements of the Exchange Control Department of the South African Reserve Bank are fully explained to branches to avoid any misunderstandings on the part of the latter and the applicants concerned." (my underlining);

11.4 the Ruling referred to in 11.3 above must, in my submission, be read in conjunction with the absolute prohibition or the absolute direction or decree referred to in 6.1 above;

Deutsche Bank London ("DBL"), a party related to DBJ has, as a non-resident, been granted general approval to deal in South African assets, in terms of the Rulings. Such approval, it is submitted, can however never be used to facilitate the transactions of residents, in this case DBJ, who are subject to the Exchange Control Regulations and the Rulings;

the hedging, funding and related transactions would not have occurred, but for the share placements. These transactions, accordingly, form an integral part of such share placements, which go to the heart of the nature and purpose of such share placements;

11.7 It is apparent, if regard is had to the Exchange Control Ruling referred to in 11.3, as read with the absolute prohibition or the absolute direction or decree referred to in 6.1 above, that DBJ in applying for the authority to implement the share placements on behalf of Sasol and Nampak, should have placed Excon in possession of "full information regarding the transaction, its nature and purpose" which, I submit, would include the hedging, funding and related transactions implemented by DBL, as such transactions went to the very heart of the nature and purpose of the share placements;

11.8 It is perhaps instructive to consider the definitions of the terms "nature" and "purpose" used in Section A of the Rulings referred to in 11.3 above;

11.9 the Oxford English Dictionary defines

1.9.1 "nature" as "the essential qualities of a thing; the inherent and inseparable combination of properties essentially pertaining to anything and giving it its fundamental character";

11.9.2 "purpose" as "the object which one has in view; that which forms the subject of discourse; the matter in hand; the point at issue";

11.10 It is quite clear from the definitions of nature and purpose, referred to in 11.9 above, that DBJ was obliged to have disclosed to and placed Excon in possession of full information relating to <u>all</u> aspects of the share placement transactions, including the hedging, funding and related transactions, as but for so doing, proper meaning cannot be given to the terms "nature" and "purpose". Further support for this submission is undoubtedly contained in the second paragraph of Ruling A(D)(ii) which requires "Authorised Dealers to ensure that <u>full and precise particulars of the underlying transaction are given in the first instance</u>". (my underlining). I submit that the plain meaning of these words must infer that DBJ had an obligation to disclose all related and underlying transactions which include the hedging, funding and related transactions;

11.11 I submit that in light of what is set out above, it is apparent that DBJ should have disclosed in -

11.11.1 the original application in the Sasol share placement, the transactions subsequently disclosed and which are referred to in paragraphs 50 to 59 of the statement to this Commission by Mr Christiaan Tielman Grové (SARB Volume 8, pages 26 to 37);

11.11.2 the original application in the Nampak share placement, the transactions subsequently disclosed and which are referred to in paragraphs 78 to 79 of the statement to this Commission by Mr Christiaan Tielman Grové (SARB Volume 8, pages 44 to 50);

11.12 the non-disclosure on the part of DBJ constituted, in my submission, a breach of the Exchange Control Regulations, and in particular Regulation 10(1)(c) read with Regulation 22 as well as with Section A of the Rulings;

11.13 the submissions regarding non-disclosure, which I have made above, relate both to the purported currency hedges in terms of which DBJ entered into repurchase agreements in respect of South African bonds ("Currency Hedges") and to the forward sale of the corporates' shares by DBL to Deutsche Securities (Proprietary) Limited ("DS") ("Forward Sale"). By this means DBL converted Rand to foreign currency which was then used to pay the individual corporates for the shares acquired, and which would thereafter be placed with long term investors;

11.14 with regard to -

1.1.14.1 the Currency Hedges: It is apparent that DBL, as a non-resident is free to deal in South African assets. However if they wish to hedge such transactions then they must have a firm and ascertained exposure to possible losses arising from adverse movements in interest rates, commodity prices or foreign exchange rates arising from such transactions. DBL however dealt with South African assets solely for the purpose of facilitating the share placement transactions implemented by DBJ in respect of Sasol and Nampak. This therefore constituted a breach by DBJ of the Exchange Control Regulations and in particular that which is referred to in 11.12 above. Excon contends that DBJ did not transact a Currency Hedge, but in truth and in fact conducted a spot transaction.

11.14.2 the Forward Sale: permission was granted to DBL to implement the Forward Sale, (SARB Volume 8 pages 185 to 187 in respect of the Sasol shares and pages 211 to 213 in respect of the Nampak shares). These applications were, however, ostensibly utilised for a different purpose and were never disclosed as having formed part of the relevant share placement transactions. Accordingly, they should have been disclosed to Excon in their proper context and as being related to the relevant share placement transactions;

11.15 the obligation on DBJ was to make full disclosure (including disclosure of the hedging, funding and related transactions) in the first instance (ie. at the time of the original application being made for the relevant share placements);

1.16 DBJ's failure to immediately disclose details of the Sasol hedging, funding and related transactions referred to in paragraph 1.2 of the Commission's letter dated 30 May 2002, in response to Excon's request for information (paragraph 45 of the statement of Mr Christiaan Tielman Grové, SARB Volume 8, page 25) is not in itself a breach of the Exchange Control Regulations, (as full disclosure is required in the first instance), but is a

8C

factor in aggravation of DBJ's failure to disclose full details in the first instance.

RESERVES NEUTRALITY

12 It is also Excon's submission that DBJ breached its Administrative Law Duty, in regard to Reserves Neutrality, by virtue of the following considerations –

12.1 there is no Exchange Control Regulation or Ruling which requires a share placement (of the nature implemented on behalf of Sasol and Nampak) to be reserves neutral at the time of implementation, or that a reserves neutral position should be maintained at all times, in respect of such transactions. However, it is generally accepted amongst Authorised Dealers that Reserves Neutrality is a requirement of share placements. In this regard I submit that in an exchange control environment, the only purpose for allowing share placements would be if a reserves neutral position with regard to such share placement, was maintained as a consequence thereof. The policy of Excon in allowing share placements is such that they will only do so if satisfied that Reserves Neutrality will be maintained at all times;

12.2 the basis on which Excon will allow a foreign direct investment by means of a share placement is dealt with at pages 11 to 13 of SARB Volume 8, as read with pages 144 to 146 thereof. Share placements implemented in this manner ensure not only Reserves Neutrality, but that such Reserves Neutrality, with regard to the *relevant* share placement transaction, is maintained at all times;

12.3 in further support of the requirement that a share placement be implemented in a reserves neutral manner, I refer this Commission to page 150 of SARB Volume 8 and in particular to the paragraph headed "Settlement of Asset Swap", as read with pages 153 and 154 thereof.

This clearly sets out Excon's requirement that a reserves neutral position must be maintained, at all times, with regard to share placement transactions;

12.4 If regard is had to the evidence of Mr Niall Smith before this Commission, it is apparent that, on the date of implementation of the relevant share placement transactions, the reserves of South Africa were negatively affected. South African Rands were converted into foreign currency by DBL, in order to settle the Rand amounts paid by Sasol and Nampak to DS. The reserves of South Africa would eventually be restored in that foreign currency would be used to acquire the Sasol and Nampak shares to be placed with long term foreign investors. It is therefore apparent that a Reserves Neutral position was not maintained at all times. Mr Christiaan Tielman Grové testified, before this Commission, that had Excon been aware of the hedging, funding and related transactions at the time the original authorities were granted to implement such transactions, Excon would not have granted approval;

12.5 In my statement, on behalf of Excon, to this Commission (SARB Volume 9 page 2), and from the evidence presented on behalf of SARB by Mr Lambertus Van Zyl (transcript page 1683), it is submitted that -

12.5.1 reserves, in an exchange control context, cannot and does not refer to any reserves other than the total gold and foreign exchange reserves of South Africa as a country; and

12.5.2 Authorised Dealers (of which DBJ is one) are aware of the basis on which the reserves of the country are calculated, as this is clearly set out in, inter alia, SARB's Quarterly Bulletin;

12.6 It is therefore apparent that the hedging, funding and related transactions implemented by DBL, in consequence of the share placements, prejudiced the obligation placed on DBJ to ensure Reserves Neutrality.

CRIMINAL CONDUCT

13 The content and nature of any Criminal Law Duty which DBJ has in regard to Disclosure and/or Reserves Neutrality must, so I have been advised, be discerned from -

13.1 Regulation 22 of the Exchange Control Regulations which reads as follows -

> "<u>Penalty</u>
>
> Every person who contravenes or fails to comply with any provision of these regulations, or contravenes or fails to comply with the terms of any notice, order, permission, exemption or condition made, conferred or imposed thereunder, or who obstructs any person in the execution of any power or function assigned to him by or under these regulations, or who makes any incorrect statement in any declaration made or return rendered for the purposes of these regulations (unless he proves that he did not know, and could not by the exercise of a reasonable degree of care have ascertained, that the statement was incorrect) or refuses or neglects to furnish any information which he is required to furnish under these regulations, shall be guilty of an offence and liable upon conviction to a fine not exceeding R250 000 or to imprisonment for a period not exceeding five years or to both such fine or such imprisonment; provided that where he is convicted of an offence against any of these regulations in relation to any security, foreign currency, gold, bank note, cheque, postal order, bill, note, debt, payment or goods, the fine which may be imposed on him shall be a fine not exceeding R250 000, or a sum equal to the value of the security, foreign currency, gold, bank note, postal order, bill, note, debt, payment or goods, whichever shall be greater.";

13.2 the Criminal Law principles which have been developed in the cases commencing with *S v De Blom 1977 (3) SA 513 (A)* and followed by *S v*

8

Jadwat Bros (Proprietary) Limited 1977 (4) SA 815(D), *S v Pamensky* 1978(3) SA 932 and *S v African Bank and Others* (unreported WLD case number 69/1987); which legal principles have, in the aforementioned cases, been crystallised to establish that -

13.2.1 in matters involving the Exchange Control Regulations, guilt in the form of either wilfulness (mens rea in the form dolus) or negligence (mens rea in the form of culpa) is sufficient; and

13.2.2 ignorance of the law on the part of an accused would exclude negligence (culpa) if that is the basis upon which guilt is founded, provided that such ignorance of the law must be reasonable in the sense that, if an accused is to escape liability, he will have to show that he acted with the circumspection required of a reasonable person in the context of the relevant enactments; and

13.3 the case of *S v Du Toit* 1981(2) SA 33 which, though not related to a contravention of the Exchange Control Regulations, but in the context of the provisions of the Petroleum Products Act, No. 120 of 1977, confirmed the approach by the courts in the cases quoted in 13.2 above.

14 Excon, in considering the terms of a settlement with DBJ, as finally contained in the settlement agreement entered into with DBJ, dated 22 May 2002, took into account that DBJ, in failing to adhere to the Exchange Control Regulations may have -

14.1 not done so wilfully (that is DBJ may have *been able* to demonstrate an absence of dolus), or negligently (that is DBJ may have been able to show an absence of culpa); and

14.2 been able to demonstrate an absence of negligence (culpa) and possibly been able, on the balance of probabilities, to show that it acted in ignorance of the exact position in connection with Disclosure and

C

Reserves Neutrality in the context of the Exchange Control Regulations, the Orders and Rules, the Rulings and/or the Conditions, and that in so doing it was not culpable (in the criminal law sense) in its actions or any assumptions which it may have made.

CONCLUSION

15 In conclusion it is the submission of SARB and Excon that, for the reasons stated in 11 and 12, DBJ was under a legal duty to -

make disclosure of the hedging, funding and related transactions which were implemented in consequence of the share placements; and

ensure that Reserves Neutrality was maintained at all times with regard to the manner in which the share placement transactions were implemented.

16 Excon having considered, inter alia, all the facts and principles alluded to in this letter, on consideration of legal advice received and the representations made to it by DBJ, deemed it appropriate to enter into a settlement agreement with DBJ, a copy of which was handed to the Commission on Friday, 24 May 2002. In this way Excon sought to ensure the restoration of Reserves Neutrality.

17 Mr Chris Van Niekerk, the Secretary to the Commission, requested SARB's senior counsel, Mr Philip Ginsburg SC, to advise the Commission as to the standing of SARB's oral submissions made to the Commission at an in-camera hearing on 24 May 2002 and which dealt with the finality of the process resulting from the settlement agreement referred to in 16 above. SARB hereby advises the Commission that it does not withdraw those oral submissions, which were made as a consequence of the provisions of Regulation 12 of the regulations promulgated in terms of this Commission.

18 I thank you for the opportunity of explaining Excon's position and the background circumstances pertaining to the settlement reached with DBJ. If I can be of further assistance I shall gladly do so.

Yours sincerely

A.M. BRUCE-BRAND
GENERAL MANAGER

G:\grc\Governor's Submission.doc