

# The Political Economy of Bank Failure and Supervision in the Republic of South Africa

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## Abstract

*The failure of banks has financial, economic, social and political implications. Banks serve as deposit holders and financial intermediaries. As deposit holders they are the custodians of savings and via the market for capital, transfer the savings into investment or consumption. The particular role which banks play in the modern economy is significant and accordingly they are subjected to an extensive regulatory framework to ensure that they can continue to play the role for which they have been designed and to maintain confidence in the monetary and financial system. Despite these regulations (some would argue, because of these regulations) banks still become insolvent or fail to meet the conditions for maintenance or renewal of their licences. The final arbiter of this decision is usually the central bank. In the Republic of South Africa (RSA),<sup>1</sup> it has been suggested that the central bank – Reserve Bank of South Africa (RB) – has been unduly political in determining the manner in which it has applied banking regulation and conducted its role as lender of last resort. This paper contributes to this debate by discussing the manner in which the RB has performed its role and ways in which bank supervision in South Africa can be improved.*

## Introduction

The failure of banks has financial, economic and political implications. Banks are usually subjected to two types of regulation -economic and prudential. Broadly speaking the objective of economic regulation in banking is to ensure social welfare rights. So economic regulation encourages higher competition (in commercial banks narrow spread between deposit and lending rates), less collusion and lower industry concentration. In practice, for example, economic regulation may

entail providing legal requirements which stipulate the minimum number of full or agency bank branches which a commercial bank must operate in particular areas. Prudential regulation is concerned with ensuring that depositors' funds are protected and the financial system is not compromised. This is done primarily by ensuring that banks are adequately capitalised by an appropriate amount and risk adjusted quality of equity. The prime practical example of prudential regulation, is that in accordance with the Basle Accord which has recently been further endorsed by the 25 Core Principles for Effective Bank Supervision 1997, banks may only lend up to a multiple of 12.5 of their risk adjusted *equity* capital. Of late, greater emphasis has been placed on prudential regulation with some even suggesting that economic regulation is inefficient and irrelevant. In South Africa, the regulatory process is allocated to the Reserve Bank (RB) and to the Registrar of Banks (RoB). Although overall responsibility for bank supervision (economic and prudential regulation) rests with the RB, day to day operational prudential regulation is the responsibility of the RoB. The RoB therefore is responsible for the day to day monitoring of the performance of banks. The RoB can use early warning models to determine the likelihood of failure of a bank and take appropriate action to forestall it. Depositors make explicit contracts with the financial institution in which they deposit their funds and implicit contracts with the regulator, who is also seen as the lender of last resort. Prior to the change of government in 1994, this principle appeared to work well. However, since the change of government this has not been the case and it has emerged that the RB has acted haphazardly and with partiality. It has been suggested that the role of the RB owes more to politics than it does to economics. This view is further accentuated by the track record which the RB has of coming to the rescue of financial institutions for political reasons.

The Second section provides a brief description of the banking industry in the RSA. The Third section discusses the role of the regulator and the too-big-to-fail-principle. The Fourth section discusses recent incidents of bank failure in the RSA. The Fifth section assesses the ways in which the RB performed its prudential regulatory role and the political economy of the decision to rescue or not to rescue a failed bank or financial institution. Given the inadequacy and selective political nature of bank regulation in the RSA, the Sixth section suggests ways in which the bank regulation framework might be improved. The Final section concludes.

### **A Brief Description of the South African Banking Industry**

South Africa has a fairly well developed banking sector which uses advanced technology and management information systems. At first blush, it appears fairly similar to the UK banking sector in that it is dominated by four major "core" banks – Amalgamated Banks of South Africa Limited (ABSA), Standard Bank Investment Corporation Limited (Stanbic), First National Bank Holdings Limited (FNB) and Nedcor Limited (Nedcor).<sup>2</sup> Core banks are banking institutions whose failure

would create systemic instability in the domestic banking system and the national economy. Since the authorities consider the continued existence of the core banks as essential to financial and economic stability, they will do all that they can to ensure that core banks do not fail. Because of the moral hazard of espoused unconditional support for core banks, it is unlikely that the authorities would wish to be explicit or unconditional in their support. Each of these banks has extensive branch networks. There is also a number of smaller banks which operate in specific market niches.

As a result of apartheid, political pressure made many foreign banks close down and withdraw their RSA operations. After the 1994 elections, a number of foreign banking firms returned and by the end of 1997 there were 59 foreign banking firms with approved local representative offices in South Africa. This is up from 40 prior to the election. In addition, by the end of 1997, seven foreign banks had established branches. So far foreign entrants have concentrated primarily on the development of corporate relationships with multinationals and domestic companies interested in foreign direct investment. Accordingly, this increase in entry into the RSA banking market has increased competition in the corporate banking and stock brokering market segments of the sector, particularly since the deregulation of the Johannesburg Stock Exchange (JSE).

Margins in the RSA banking market have historically been wide in comparison with those in other banking markets.<sup>3</sup> By maintaining very wide net interest margins, which have been facilitated by high real interest rates, the big four and the majority of other RSA banks have historically been able to report high profitability by international standards. Indeed, the influx of foreign banks and the non-intervention of the market has led only to a marginal reduction in profits of the big four banks. Furthermore, despite the periods of economic and political instability which prevailed prior to the elections of 1994, the major South African banks developed rapidly; capitalization improved, the extent and scope of use of information technology increased, risk management techniques and banking sector skills improved also. When foreign banks divested from the RSA, a small group of industrial (and in particular insurance) firms which already played a significant role in the RSA economy bought the assets of the divesting firms.

This led to high concentration, which in turn increased the concentration of retail and commercial corporate lending to a greater extent than is usual in many other countries. The upshot of this is that the larger lending exposures of the banks are a greater proportion of capital reserves. The increase in competition has not yet reversed this. However, since the elections and the formal return of the RSA into international markets, the increase in capital market and exchange rate volatility and reluctance of the RB to decrease interest rates has squeezed industry margins. Increased competition has pushed down interest margins (difference between deposit and lending rates) which are now still on a declining trend and is a principle

**Table 1: Major Share holders of the Four "Core" Banks in South Africa**

ABSA	Stanbic	FNB	Nedcor
Sanlam (25.1)	Liberty Life (39.9)	Southern Life (20.4)	Old Mutual (53.4)
Universal (25.0)a	Old Mutual (20.5)	Anglo American (24.4)	Nominee Cos (32.8)
Individuals (14.9)	Gold Fields (9.1)	De Beers (5.7)	Pension & Provident
Other Corps (13.3)	SB Groups PF (5.0)e	Sanlam (5.1)	Funds (6.7)
Old Mutual (10)b	Transnet PF (4.3)		Other Insurers (2.4)
SB Nominees (7.6)c	Sanlam (1.6)		Individuals (3.3)
FNB & Associates (4.1)d	Mine Official PF(1.4)		Other Corps (1.3)
	State St Bank Trust(1.1)		Non-residents (0.1)
	Eng Ind Prov Fund(0.8)		
	Mine Employee PF (0.7)		

Notes: (a) Of which the major shareholders are Rembrandt Holdings, Mine Employees Pension Fund and Sage Holdings.

(b) Otherwise known as South African Mutual Life.

(c) Standard Bank Nominees.

(d) Rand Merchant Bank Holdings.

(e) Standard Bank Group Pension Fund (PF).

Source: Fitch-IBCA(1997).

motivation of some of the larger groups in diversifying away from traditional banking products to other areas of financial services. Increased competition has also increased the demand for qualified bankers and pushed up the costs of such skills. Apart from narrowing margins, competition has clearly exposed the cost burden of the extensive branch networks of the big four banks. Indeed, 1996 estimates indicate cost/income ratios, of the big four banks, of between 65% and 69% compared to estimates of 59-65% for most of the major banks in the countries mentioned below. The big four have instituted restructuring programmes to attempt to bring their costs down to international levels. Nedcor leads the way in this regard and analysts expectations are for a cost to income ratio of approximately 64 % for 1997 and FNB and Stanbic (with cost to income ratios in 1996 of 66.8% and 67% in 1996 respectively) plan to get their ratios down to 60% by the year 2000. ABSA has recently divulged plans to merge the four separate banks which it owns; Allied Bank, Trust Bank, United Bank and Volkskas Bank into one operation. This will bring down its 1997 cost-to-income ratio of 67.2% the highest in the RSA banking industry. In addition, there has been a strategic shift in focus to grow other sources of revenue and to aggressively control costs by careful bank product market segmentation and the increased use of technology to deliver the services.

Ironically, the sanctions and commercial and trade boycotts have had hidden blessings for South African banks. They were able to avoid the problems of property loans and the LDC non-performing loan problem which was encountered by their counterparts in some other countries notably, the USA, UK and Japan. As a result, they avoided the large write-offs and high provision which banks in these other countries have faced.

Apart from the big four there are other agents in the RSA banking sector. These smaller operators aim their savings and instalment finance products in different ways to individuals and the small, medium and micro enterprise (SMME) sector. These niche players have limited scope for competing with the big four in terms of their capital bases and so have developed expertise in niche markets in geographic and service terms. To counter the obvious impact of scale dis-economies and efficiency costs, there have been mergers most notably between NBS (the fifth largest bank which enjoys a large market presence in the Kwazulu Natal province) and Boland Bank which has a large market presence in the Western Cape province. The new entity created from the merger will try to compete directly with the big four to form a "big five" category of core banks. Furthermore, Citizen Bank, Future Bank, and the Bophuthatswana Building Society (BBS) have merged to form Future Bank Corporation. This new bank is still relatively small and is primarily engaged in the provision of products to the black emerging market. In addition there are mutual banks which are basically former building societies which provide the opportunity for broader community involvement in the provision of credit and savings mechanisms via the mutual principle.<sup>4</sup> Essentially, they have no paid up share capital and so are regulated under the Mutual Banks Act 1993 and are also subject to prudential regulations of the Banks Act 1990 as faced by all other types of bank in the RSA.

### **Too-Big-To-Fail and Bank Failure**

While the core banks have performed well, on the whole their performance may be misleading given their dominant market position and the fact that in some ways they are protected by the twin doctrines of "too-big-to-fail" (TBTF) or "too-important-to-fail" (TITF).<sup>5</sup> The principle underlying TBTF is that once a bank – usually a core bank – has reached a particular size, if it experiences any difficulties in meeting its liabilities, it should receive all the financial support which is available to make sure that it does not fail. Furthermore, all obligations to depositors, whether insured or uninsured will be protected by a government guarantee. In addition, professional creditors may also be protected but after liabilities to depositors have been met. However, equity holders, bond holders and senior management are not guaranteed any protection. There have been several non-core bank failures in the RSA which has led to debate as to the way in which the RB and RoB deal with these failures.

From a depositor's point of view, the classification of a bank as a core bank presents implicit guarantees which non-core banks are unable to match; invariably depositors funds held in core banks are protected by the regulatory authority as a lender of last resort. The trade-off is usually marginally lower deposit rates at core banks given that depositors face lower risks by placing their deposits with core banks. It would also appear that in the long run, higher deposit rates are rarely sufficient to attract a sizeable enough demand for deposits in non-core banks. This is particularly the case given that economies of scale allow for competitive lending rates (with neutral credit rating) and the lender of last resort provision which is made more readily available to core bank than it is to non-core banks.

Given the doctrines of TBTF and TITF, the regulation of core banks appears to be less problematic than the regulation of non-core banks. In South Africa, none of the core banks has ever failed, and the public are not privy to information with which to discern whether, either the TBTF or the TITF doctrines have actually been tested. The closest that South Africa has apparently come to the failure of a core bank, has been with regard to Volkskas Bank which, although a leading bank at the time, could not readily be classified as either TBTF or TITF.<sup>6</sup> At the other end of the scale, the failure of small banks carries a low probability of systemic risks therefore regulators are less likely to guarantee their survival in the event of default. The contagion impact of runs on small banks is unlikely to significantly destabilize the system since depositors will usually run to larger core banks. The regulator's cost-benefit analysis in such circumstances usually arrives at the conclusion that the taxpayer should not bail out a bank in difficulty unless there are considerations regarding aggregate financial and economic stability. This stance of the regulator has a market discipline impact in that it creates a disincentive to attempt to increase scale by taking aggressive deposit/lending margin strategies. While this maintains financial stability, it makes entry into the core bank category extremely difficult for non-core banks. Accordingly, a negative externality of such policy is the high concentration ratios normally found in commercial banking and its implications for competition, (Berger and Hannan 1989; Bentson and Kaufman 1996 and Okeahalam 1997). Furthermore, small community banks such as the Islamic Bank hold the deposits and provide a intermediation function in specific market niches which may not be covered by core banks. They may also help in the economic development process (Minsky, Papadimitriou, Phillips and Wray 1996) and the credit channel to sectors of the economy, (Samolyk 1994). The perception that the regulator is not sufficiently sensitive or at best has been selective in interpreting the rules which govern the decision to let a bank go under, or not, has received significant press attention in the RSA which, given its history, still provides very fertile ground for racial conspiracy theories in all aspects of economic and social life. The fact that failed institutions may not actually disappear entirely even when they fail (the exception is the Bank of Credit and Commerce International (BCCI))

appears to be of little comfort to critics of the RB and the RoB regarding their handling of bank failures.<sup>7</sup> All said and done however, small banks are not too difficult to either rescue or let fail, or restructure. It is the second tier bank group, which, should they fail, present bank regulators with the greatest policy difficulties. By definition, they are neither core banks nor are they small banks. So while they may not be TBTF they may be TITF. Their liabilities on their own, i.e. from one such banking firm, may not threaten the banking system significantly. However a bank run on such a firm may, via contagion, indeed lead to bank runs in other banking firms of similar size or characteristics with added risks of spillover into other institutions in different size cohorts. The cumulative impact of these runs may lead to a lack of confidence in the system which may be analogous in significance to the failure of a core bank. Strictly speaking, in theory, the systemic impact of cumulative banks failures may not be the same as that of the failure of core banks, even if the outstanding liabilities in both scenarios are the same. There are two views which can be taken. Firstly, what I term the bank “confidence” argument. Since banking is all about confidence in the system, the failure of a core bank represents a greater loss of confidence since depositors and creditors will believe that there is a fundamental flaw in the system since all things being equal a core bank will not be allowed to fail by the authorities. Secondly, the “multiplier” argument suggests that bank failure also indicates regulatory failure and carries with it the cost of potentially wider groups of depositors, creditors, and equity holders. The argument here is that the cumulative loss to depositors and importantly creditors and equity holders in institutions where the bank run did not start may have significant negative multiplier effects, not just in the monetary sector but also in the real economy. The moral dilemma, which also carries with it a moral hazard is that while rightly the regulator should not compensate equity holders in the event of wide spread bank failure, some banks which fail may indeed be adequately capitalised and are simply the industry victims of contagion. The US view as explained by Kaufman (1994) suggests that bank contagion systemic risk is highly unlikely, even where there is no deposit insurance and that truly solvent banks will not fail because of contagion. One way of dealing with this is to simply say, “tough”, this is one of the risks which bankers should evaluate more carefully in determining whether the opportunity cost of capital justifies their investment in the sector (Clark 1996). The other view (popular in Europe and Japan) would be to take an agency – led case study approach to determine on a case by case basis, which banks (and possibly equity holders) should be bailed out and those which should not.<sup>8</sup>

### **The Recent History of Bank Failure in the RSA**

Since 1990, a number of banks have failed in South Africa. The RB prefers to encourage other banks to come in and rescue them, and of late has become

increasingly reluctant to offer support to failed banks. Liquidity and poor management have been the prevalent reasons for bank failure in RSA. This section discusses the recent bank failures.

The failure of Alpha Bank in 1990 as a result of high level fraud, which was heightened by the risk exposure of its holding company Pinnacle Holdings, was the first of several bank failures in South Africa during the 1990s. As part of the rescue package, and RB injected R150 million into the bank, primarily to protect depositors. However this was not sufficient to resuscitate the bank and after four years of RoB curatorship the bank was placed in final liquidation in 1994.

Cape Investment Bank (CIB) was also the victim of fraud. In this case, it failed to disclose the significant number of non performing assets in its balance sheet until this was exposed when Prima Bank (which subsequently failed itself) withdrew from a takeover deal. This led to a liquidity problem which caused the bank to fail in the second quarter of 1991. After protracted negotiations the RB provided R5 million to compensate depositors.

Pretoria Bank had been poorly managed for a while before failing in July 1991. Top management believed that merging Pretoria Bank with Masterbond – a participation mortgage bond company – to form a company called Novabank would strengthen Pretoria Bank's balance sheet by providing high yield returns from the mortgage market in which Masterbond operated. However when Masterbond became unable to service its commercial paper and debenture obligations, which were the primary source of its funding, it collapsed. This caused the proposed joint venture to fail and closed the strategic rescue line of Pretoria Bank, which then failed. For reasons which are still unclear and indeed are at odds with its subsequent depositor compensation policy the RB repaid all the deposits which were placed with Pretoria Bank.

Sechold Bank failed in December 1993 because of liquidity problems brought on after a wholly owned subsidiary Securities Equities Limited lost R180 million in derivative trading positions. This resulted in a loss of depositor and investor confidence and resulted in significant erosion of the Sechold capital base. The RB extended some liquidity to Sechold while it was in curatorship and Investec Bank Holdings a leading merchant bank acquired 78% and managerial control. The extent to which depositors were indemnified is unclear.

Prima Bank failed and was placed into liquidation in the second quarter of 1994. It also had liquidity problems brought on by a large number of non-performing loans. The problems of Prima Bank were accentuated after the bank failed to recapitalise via a complex joint venture which was to have led to the establishment of a corporate entity called Merchant Bank of Africa (MIBA). MIBA was to have been established by a consortium of black businessmen called the South African Investment Corporation which would own 51% and Prima Bank would own 49%.

The recapitalised bank would have been used to increase black participation in the banking sector. After the joint venture failed because of insufficient capital, in line with section 311 of the Companies Act 1973, the Court agreed to a restructuring proposal in which Unibank transferred some of the assets of Prima Bank. A portion of the assets of Prima Bank was transferred to Unibank, while another portion was placed in an escrow type of account to compensate unsecured depositors. Unsecured depositors recouped 50% of their deposits.

More recently a number of black managed and controlled banks have failed.<sup>9</sup> In the last quarter of 1995, African Bank had liquidity problems and was placed under curatorship. During investigations, it emerged that poor management and inadequate capital were considered to be the main problems. As a result, a restructuring plan was implemented and the government agreed to a recapitalisation plan in which it guaranteed African Bank's non-performing assets. At the same time the major black industrial group New Africa Investments Limited (NAIL) and South Africa's fifth largest banking group NBS holdings made a successful bid for control of the Bank in the RSA. The holding company owns the majority of shares, and the agreement cedes management control to NBS for five years and R103 million was injected into the bank. This raised capital to R130 million. Curators were appointed by the RoB in September 1993 but this came to an end in March 1996. Although depositors did not suffer losses, the failure and restructuring of African Bank was particularly poignant since it was the first black owned and managed bank in South Africa.

Soon after that, another small bank with black management failed. Community Bank also failed due to problems with liquidity. Its liquidity problems were the result of a very high expense to income ratio which were the result of inefficient management and inadequate returns on investment at branch level. In December 1996, in agreement with the RoB curator, Unibank acquired Community Bank for R50m. Although the bank's strategic focus (low cost housing) remains, as part of the restructuring programme Unibank has significantly reduced the number of branches from 15 to 7.

The Islamic Bank of South Africa (IBSA) is the most recent bank to fail in the RSA.<sup>10</sup> It failed in November 1997 with debts of between R50 million and R70 million and is currently under RoB curatorship-so the finer details of the cause of its failure and the exact position which the RB is going to take with regard to compensating depositors is unclear. However, it is emerging that bad management and improper accounting and management systems (some imply corrupt management) caused the bank to fail. Apparently, a large amount of insider unsecured lending has taken place which has resulted in a large proportion of non-performing assets in the balance sheet. In line with section 417 and 418 of the Companies Act, an investigation led by a commissioner appointed by the Master of the High Court with the support of the accounting firm Deloitte and Touche is currently

underway. Meanwhile, the RB has agreed to compensate the investors up to a maximum of R50 000 per depositor. This covers 80% of depositors since the primary depositor base of ISBA is small depositors; mostly Muslim people who saw the IBSA as a community bank and saved their money there to make the Hadj pilgrimage to Mecca. Given the size of the bail out package, while the RB solution will compensate most depositors fully, it will not compensate all depositors fully so is seen as insufficient. Furthermore, it has been argued that the management of IBSA hid behind the self-regulatory position accorded to true Islamic banks, and that in any event, given that it was operating in South Africa it was unlikely to be able to operate as a true Islamic bank and that the RoB and the RB should therefore have been more vigilant. Accordingly, a series of court cases against the directors of IBSA has been lodged by depositors not fully compensated. There is also a significant debate as to the decision of the RB to only partially compensate depositors. This criticism of the RB is the result of further evidence of haphazard and inconsistent management of bank failure.

### **The Role and Conduct of the Reserve Bank**

As can be seen above, several banks have failed in South Africa. On its own, as discussed elsewhere in this paper, as long as it does not threaten the system, bank failure is not necessarily a bad thing. Failure may be the result of sound competition: the result of healthy entry and exit in the sector. However, as Abraham and Settle (1992) show, since failure can be influenced by the regulatory regime, the role and decisions of the central bank (the usual regulator) need careful scrutiny. They are scrutinised by equity holders and management of banks to evaluate the extent to which they can devise and implement sufficiently aggressive strategies – the “upside” of moral hazard. The role of the regulator as explained earlier is also scrutinised by depositors who (depending on their risk preferences) wish to make an evaluation of the benefits of placing their deposits in different types of bank. The decisions of RB in bank failure management are analysed for consistency, and these decisions have been greatly criticised for being based more on politics than on appropriate central bank ethics. This is also very important because of the absence of a deposit insurance scheme in South Africa, as exists elsewhere.<sup>11</sup> Although the RB view on deposit insurance has always been that it encourages moral hazard, the perception that the RB has been at worst politically selective, and at best negligent in performing its duties as a lender of last resort has led to calls for the establishment of a deposit insurance scheme with clear guidelines and checks not only to avoid moral hazard but also to control the role of the RB and RoB with a clear legal framework for the regulation of banks and financial institutions and the management of crises within these sectors.

This is important because there is now significant evidence to back the earlier perception that the RB has misused its position of lender of last resort and that in

general it is an institution in need of reform. This section refers to the cases of bank failure above to discuss this latter perspective.

After extensive enquiry, under the chairmanship of Judge Hennie Nel, and released in 1997, the First Report of the Commission of Inquiry into the Affairs of Masterbond Group and Investor Protection in South Africa (Nel Commission Report (NCR)), provides clear evidence to support the long held perspective that the RB and some of the auditing firms that have worked with the RB in evaluating banks have been at best, non-transparent, and at worst, dishonest. The primary remit of the Nel Commission was to evaluate the Masterbond crises.<sup>12</sup> However, part of the broader terms of reference was to examine the extent of investor protection in the RSA. It was while exploring this wider term of reference that evidence to support the view of corrupt behaviour in the regulatory system was exposed. It appears that the RB has been corrupt and biased in its decisions to provide lender of last resort facilities to banks and that it has provided lifeboats to rescue particular banks without approval, full disclosure, or in contravention of proper practice.

For example, as explained earlier in this paper Cape Investment Bank (CIB) failed in 1991. The SA Rail Commuters Corporation (SACC) had major deposits with CIB when it failed. When CIB faced difficulties RB granted a secret loan to CIB. However when CIB was put into liquidation by the RB, the SACC protested that the RB had protected its loan rather than depositors. However, it soon emerged that the loan to CIB was fictitious and that RB had not actually transferred any funds to CIB and had only made it appear that it had done so.

In a different but related incident in contravention of the Financial Markets Control Act, the RB paid R5 million to Prima Bank to gain support for liquidating CIB, i.e., to allow CIB to fail.

A secret Section 417 Commission of Inquiry which was held to find out why the R5 million was paid, clearly shows that the money was not actually transferred to the accounts of CIB, and that either the Governor of the RB or his officials were being economical with the truth. The RB has not yet explained its actions in this case.

On other occasions between 1985 and 1995, the RB has apparently provided lender of last resort support to one of the core banks, ABSA, and one of its subsidiary companies, Bankorp. The Governor of the RB testified to another secret Section 417 Commission of Inquiry that all loans made by the RB to ABSA and Bankorp "were at all times recorded in the (Bank's) books regularly audited by the Bank's internal and external auditors and were included in the published financial statements of the Bank". However, once again it has emerged that no funds were actually paid to either ABSA or Bankorp and that six different groups of auditors collaborated with the RB to make it appear that funds were sent to the two banks.<sup>13</sup>

There have been other incidents from which the RB has emerged with its

reputation further damaged. In one incident, inappropriate supervision and regulation allowed a senior manager (Albert Vermaas), to use the Volkskas Bank to launder money and flout exchange control regulations. This led to the failure of a community development bank in the independent Ciskei homeland. The subsequent enquiry under the chairmanship of Justice Harms (The Harms Commission) arrived at the conclusion that the RB, RoB, and Receiver of Revenue (RoR) had been incompetent and that their negligence or compliance assisted Albert Vermaas to defraud the Ciskei Community Bank (CCB).

### **Bank Failure and Supervision in the RSA: The Way Forward**

When one reviews the way in which the RB has played its role as regulator and lender of last resort, one is led to one or all of the following conclusions. Firstly, that (in its current guise) the RB is politically biased and therefore is a potentially corrupting influence in the financial system. Secondly, it is a fairly incompetent organisation, and thirdly, that the prudential regulatory framework in the RSA is in need of reform. The recent history of perceived political bias in supervision and bank failure management undermines the prudential system. The allegation of corruption, while strong, can only meaningfully be countered by the acceptance of the charge of gross negligence and ineptitude. In either event, the regulatory framework needs to be reformed.

The first step is to revisit the statutes governing prudential regulation. Greater emphasis will need to be placed on revising the legislation so as to limit the discretionary power of officials in the RB and RoB.<sup>14</sup> The reform would allow for officials at the RB and RoB to retain discretion for marginal decisions but would greatly circumscribe their power with regard to decisions to either offer or decline lender of last resort life boats. Statutes governing the core banks (TBTF, and TITF) should also be reviewed. At all times, the possibility of encouraging moral hazard should be borne in mind. In this regard, the RSA may gain by taking a good look at the Financial Institutions, Reform, Recovery and Enforcement Act (FIRREA) 1989. While FIRREA did not prevent high numbers of commercial bank failure in 1990 and 1991 or the failure of the Bank Insurance Fund it augmented the authority of federal agencies to dig out potential problems, impose timely regulation-based restrictions and discipline bank officials who did not comply. Most importantly, it reduced the limitations on the discretion of the regulatory officials in application of the law. Furthermore, the regulatory framework has to become more unitary so that RoB and RB are placed under the same legislative umbrella to ensure that information asymmetries are reduced and that the agency costs associated with monitoring banks also decline. This however, should not be allowed to represent an excuse for collusion in corrupt behaviour at both establishments, as probably exists.

Furthermore, a way forward may be for South Africa to adopt a scheme which

is similar in essence to that which now prevails in the United States under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) 1991 where rules have clearly been substituted for discretion.<sup>15</sup> Indeed, under FIRREA (1989) five bank capitalisation categories were established: well capitalised; adequately capitalised; undercapitalised, significantly undercapitalised; and critically undercapitalised. If during evaluation, a bank falls into one of the three lower categories the FIRREA requires that without discretion it must submit an acceptable capital restoration plan within a specified time which is dictated by the extent to which it is undercapitalised. If a suitable capital restoration plan is not provided the bank will be subject to constraints on asset growth, non-traditional activities, transactions with affiliates and deposit rates of interest. Furthermore, critically undercapitalised banks must be closed immediately-although there is some latitude for discretion given the finality of this last step. Soyibo, *et al* (1997) illustrate how a deposit insurance scheme modelled to some extent on the US system works in Nigeria.

In tandem with the introduction of legislation to reduce RB discretion, the RSA needs to carefully consider the introduction of a deposit insurance scheme. The US has had a Federal Deposit Insurance Corporation since 1933 and its experience is once again valuable for the situation in the RSA. Firstly, US experience supports the assertion that deposit insurance is capable of encouraging moral hazard and secondly, on its own, it is not capable of preventing bank failure. However, by the introduction of risk-adjusted deposit insurance premiums and risk-adjusted capital requirements, the FDICIA (1991) has reduced the moral hazard deficiencies of excessive risk taking and forbearance which the previous Act had. Accordingly it can serve as a good model.

A further area of reform is the regulatory role of the core banks. The core banks do already play a regulatory role in the RSA banking market. This needs to be encouraged further. Indeed, proponents of "free" banking such as Gorton and Mullineaux (1987), Dowd (1994 and 1996) would argue that the market regulatory function should be further emphasized and that the leading members of the Council of South African Bankers (COSAB) should develop a greater regulatory presence to provide liquidity, governance, and market discipline. The problem with this free market solution is that it is at odds with the role which the RB has played to date, and increases the likelihood that senior members of such a club might attempt to replicate the RB's position in order to maintain the *status quo*.

Given the benefit of the doubt, although highly unlikely, some of the RB decisions of the past may have been based on ignorance. If so, there is a need for education of regulatory officials to keep them abreast of developments and make them capable of tracking the behaviour of bank officials. This is particularly important as banking has become more complex with the increased use of derivative instruments, off-balance sheet techniques, and cross-border deals.

Finally, since liquidity has been the apparent reason for the majority of bank failures, there is a need to examine leverage and risk-adjusted capital requirements carefully.<sup>16</sup>

## Conclusions

By being inconsistent in performing its regulatory duties the RB leaves itself open to the charge that it is partial to certain interest groups and prejudicial to others. For the reasons cited above, the perception is that the RB may be using its position to maintain the economic *status quo* by preventing the emergence of other players in the banking industry. However, in some ways this all pales in comparison with the view that the behavior of the RB undermines confidence in the RSA banking industry, the financial system, and the economy in general. This is a major allegation given South Africa's pressing social and economic problems, which call not only for significant foreign investment, but also for an increase in the domestic savings rate. This latter requirement is unlikely to manifest itself if depositors believe that clear prudential regulations and guidelines governing the institutions holding their funds are not being implemented or that there is bias in the system.

In summary, this paper suggests that while the banking industry in the RSA is relatively sophisticated by international standards, and given the presence of the JSE (at the time of writing the tenth largest in the world by market capitalization) there is a requirement for the regulatory framework to be improved. The history of bank failures in South Africa and the ways in which the RB and RoB have managed these events to date, suggests that fundamental reform of the regulatory framework is required. Two important steps are required. Firstly, without encouraging moral hazard, there is a need to reduce the discretionary power of the RB and RoB by the enactment of legislation which sets parameters within which the regulators can operate. Secondly, for this to be effective the RSA needs to establish a deposit insurance corporation. Although the banking industry in the US and the RSA are very different, with regard to both key reforms, the experience of the USA in applying FIRREA (1989) and FDICIA (1991) should be very useful. These reforms are made ever more urgent given the significance of the RSA in the economic and financial affairs of the Southern Africa Development Community (SADC) region. In addition it has emerged that unsound and imprudent lending and ineffective prudential monitoring and supervision of compliance with bank prudential regulations contributed to the recent South-East Asia economic crises and created opportunities for speculative attacks on currencies in that region. Given this fact, as the countries within the SADC region attempt to integrate, there is a need for the monetary and financial authorities of the region to ensure that there is effective adherence to prudential rules, harmonization of supervision and monitoring and no opportunities for regulatory arbitrage.<sup>17</sup>

## Notes

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1. The terms RSA and South Africa are used interchangeably throughout the paper.
  2. It has also been suggested (Dowd, 1996), that espoused or not, the implicit contract between core banks and the authorities creates moral hazard. As an indirect form of compensation for their privileges core banks have duties such as using their dominant industry positions to assist the regulator in monitoring the banking system by imposing market regulations and serving as clearing houses. See Dowd (1994) for more on the market based regulatory role and bankers clubs.
  3. Net interest margins for the big four have narrowed from an average of 4.5% in 1993/4 to an average of 4.1% in 1996/7. According to data from the credit rating agency Fitch IBCA, South Africa, this still compares favourably with the averages of the top four banks ranked by assets in other countries: Australia (3.3%) France (1.7%), Germany (1.5%), Japan (1.2%), UK (2.3%), and the USA (1.2%). The big four have achieved strong growth in assets and equity and their profitability ratios (return on assets (ROA) and return on equity (ROE) have so far been stable at rates which are higher than those recorded for the big four banks in the countries listed above.
  4. There are currently five registered mutual banks. However Community Bank, founded in July 1994, experienced liquidity problems soon after, and has been placed under curatorship. In terms of the Supervision of Financial Institutions Rationalisation Act 1996 (Act No. 32 of 1996), the Venda Building Society (previously registered in Venda, a former homeland that was amalgamated with South Africa after the elections) became a mutual bank with effect from July 1996. The remaining three are Credit and Savings Help Bank, GBS Mutual and TNBS Mutual which is now under provisional registration.
  5. There are several recent examples of the application of the TBTF principle. In Japan, the Ministry of Finance considers the top twenty-one largest banks as TBTF and has intervened with rescue packages and restructuring strategies for three banks recently; Hanwa Bank in November 1996, Nippon Credit Bank in February 1997 and Hokkaido Tokashuku in April 1997. In Europe, particularly

- in France and the Scandinavian countries the TBTF principle has been applied to prevent systemic risk. 40% of banking assets in France are owned by the state. Some of the core banks for example Credit Lyonnais, Banque National de Paris (BNP) and Societe General have been, or are still state-owned, and thus would be all deemed to TBTF. In Norway, Fokus Bank was rescued by the deposit insurance corporation and the establishment of a Government Bank Investment Fund. In Finland, the Government used FMK 20 billion (at that time equal to 4.1% of the country's GNP) to establish the Government Guarantee Fund in April 1992. This avoided a bank capitalisation crises. In Sweden, the government has intervened several times in Nordbanken, (which is 71% state owned) to prevent it from failing. A bank support programme costing approximately 3% of GDP was introduced in 1992. The TITF principle accords banks higher status than they would otherwise receive if size is used as the only variable when rendering "core" bank status. These are normally banks which have had a long track record as a major domestic bank and which may still be significant in certain sections of the industry. In this vein, Gardener and Molyneux (1997) suggest that in the UK, Lloyds Bank – the UK's fifth largest bank – is more likely to be protected than Abbey National Bank – which is a recently converted building society. In Germany, Westdeutsche Landesbank is the third largest bank by asset size, however it is not considered one of the three core banks. These are Deutsche Bank, Dresdner Bank and Commerzbank. In the same spirit, with regard to South African banks, one could suggest that Investec Bank Holdings (which is consistently rated by the international rating agencies and the professional magazine "The Banker" as the best managed and capitalised bank in South Africa"), may now have entered the TITF category.
6. Volkskas Bank was acquired by ABSA as part of a recapitalisation exercise, after a crises prompted by non-performing assets.
  7. When a bank faces difficulties, it is usually restructured through the injection of capital to the equity base by the new acquiring group, or the government. Its liabilities are then incorporated into the consolidated balance sheet of the new restructuring group, which may then take on the task of handling non-performing loans, (if that is the cause of the problem). For example, in the RSA, Volkskas Bank by ABSA, African Bank by NBS, and internationally, Barings Bank by ING Bank of Netherlands. It would appear that perceptions of where ultimate control and ownership rests is of more importance to critics.
  8. This is the approach which has been adopted in Indonesia in light of the Asia crises of 1997 which removed US\$52 billion from the Jakarta Stock Exchange – some of which was from the banking and financial services sector. An Indonesia Bank Restructuring Agency (IBRA) has been established to evaluate banks on a case- by-case basis. This is the same method that is being used by the Nigeria Deposit Insurance Corporation (NDIC) as part of the "sanitisation"

of the domestic banking sector. See Soyibo, Alashi, and Ahmad (1997) for further details.

9. The way in which these banks have been treated by the RB, in comparison to how other banks which failed earlier were treated, has created significant and at times emotional criticism of the role of the RB. For example after comparing some of the earlier actions of the RB, such as the rescue of Volkskass Bank and Bankorp, Mashele (1997), suggests that the RB's recent bank failure policy is designed to prevent, or at best delay for as long as possible, the emergence of a black capital class.
10. Haron (1996) and others have suggested that Islamic banks should be considered as a different sector from conventional banks since they have different objectives, rely on different economic concepts and different sets of operations. However, as with conventional banks the demand and savings deposit facilities at Islamic Banks carry the unqualified obligation to pay currency or its equivalent on demand or within the stipulated time frame governing the depositor agreement. The principle of fair practice in dealing with shareholders, depositors, and customers plays a significant self regulatory role in management practice at Islamic banks so less formal external regulation of the type found in conventional banks is required. However there is much debate regarding the ability to truly practise Islamic banking in a secular state or a state in which Islamic Shari'a Law is not the legal basis. Iqbal and Mirakhor (1987).
11. A detailed and comprehensive proposal to establish a deposit insurance scheme in the RSA was discussed in September 1996 by the Standing Committee for the Banks Act 1990. The RB Governor's Committee approved the proposal on 21 October 1996 and it has been submitted to the Minister of Finance who is considering it.
12. Masterbond – a mortgage finance company – owed Bankorp R1.1 billion. When Masterbond collapsed, the loan asset portfolio failed to perform and Bankorp failed. As part of the rescue package the RB provided Bankorp with an interest free loan of R 1.1 billion. This loan was provided in secret. It only emerged, when, as part of the rescue package, ABSA agreed to acquire Bankorp. The RB track record of not actually providing life boats which it announces, makes it difficult to determine the true size of the life boat. However on the assumption that funds were actually transferred, critics suggest that given the size and secrecy of the life boat, there is no way of establishing whether or not the package compensated depositors and equity holders of Masterbond and Bankorp – which it should not, and whether or not shareholders in ABSA such as the life insurance and pensions investment group Sanlam (see Table 1) received tax benefits from the lifeboat – which they should not have. The Masterbond case is currently in the courts.
13. The internal and external auditors of the RB, ABSA, and Bankorp all collabo-

rated in the deception. This finding has not only further damaged the RB's credibility but has also damaged the credibility of auditing practice in the RSA. Given the importance of auditing in the determination of true financial values, the implications of reduction in auditor credibility are not trivial, see Menon and Williams (1991). This view is echoed by Justice Nel who states that "The standards set by the Reserve Bank by its philosophy that "the end justifies the means" and the apparent acceptance thereof by the auditors concerned ... could only have had a negative influence on the auditing profession in SA.

14. This should not be confused with interference in monetary policy – an area in which the RB has an enviable track record. The irony is that some of the RB's hard work in this area is periodically undermined by its poor track record in prudential regulation. There is debate as to whether or not open market operations and changes in bank required reserve ratios which central banks use as part of prudential regulation create a negative externality, Bentson and Kaufman(1996) or reduce negative externality, Dowd (1996).
15. As Shull (1996) states "FDICIA coupled the reaffirmation of public interest banks and the augmentation of supervision with the requirements that rules be substituted for discretion in evaluating bank condition and dealing with weak institutions ... FDICIA further limits supervisory discretion on a case by case basis through what has been termed prompt corrective action involving the imposition of escalating constraints on undercapitalised banks".
16. The current thinking on leverage and risk-based capital requirements are as follows. Leverage requirement refers to the ratio of tangible equity capital to total assets. Tangible capital is primarily equity (Tier 1) capital, does not include intangibles such as goodwill, and should be differentiated from Tier 2 capital such as subordinated debt, loan loss allowances and preferred stock. Risk-based capital requirements make it necessary to weight credit risk in specific types of assets on bank balance sheets and in off — balance sheet items such as standby letters of credit. In the USA, the FDICIA also requires the regulatory authorities to back-up the above risk-based capital analysis with interest rate, concentration, and non-traditional activity risk analysis.
17. A system by which banks attempt to have themselves regulated by what they perceive to be the most liberal regulatory authority.

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