

ANNEXURE 2

10.2 DEFINITIONS

1 Capital

The difference between the value of a bank's liabilities and the value of its assets (see **solvency**). Measuring capital is largely determined by the value attributed to the assets. Where these are doubtful, a bank may well overstate the book value by failing to make adequate provision for diminution of value.

2 Deposit Insurance

Sometimes known as deposit protection, deposit insurance ("DI") schemes provide compensation to the creditors of failed intuitions. They are financed by premiums levied on the institutions concerned. In order to avoid **moral hazard**, payments under DI schemes are normally confined to small depositors. Large depositors are expected to be capable of assessing the relative risks in lending to different institutions. This ensures that banks are still exposed to market discipline. DI can play a limited role in preventing contagion when a bank fails. It helps the authorities resist pressure to support an unviable bank, by ensuring that the smaller and more vulnerable depositors will be protected even if the bank has to be liquidated.

3 Donation

A gift, or a transfer of an asset without the recipient providing anything of value in exchange. The assistance in the Bankorp case can be described as a donation, because the substance was a gift of the interest on the collateral, less the interest payable on the loan. A loan or an investment is not a donation because the provider receives in exchange a right to something. This right can take a variety of forms. It may be a series of interest payments, as on a normal loan. It may be a right to a share in the recipient's profits, e.g. on an equity or share investment, or it may be some combination, as on a convertible loan or preference share. On some occasions the lender or investor may waive his rights, or accumulate them, or make payment conditional on some future event. But a donor has no rights.

4 Enquiry in terms of section 417 of the Companies Act, No 61 of 1973

Section 417(1) of the Companies Act states:

In any winding-up of a company unable to pay its debts, the Master or the Court may, at any time after a winding-up order has been made, summon before him or it any director or officer of the company or person known or suspected to have in his possession any property of the company or believed to be indebted to the company, or any person whom the Master or the Court deems capable of giving information concerning the trade, dealings, affairs or property of the company.

Section 417 of the Companies Act only applies in the case of a compulsory winding-up of a company. In the winding-up of a company there may arise the requirement to collect information about the company's affairs which, once collected, should be confidential. Section 417 of the Companies Act provides a process through which information can be collected for the purposes as stated above.

5 Lender of last resort

A facility offered, normally by a central bank, to financial institutions designed to provide liquidity to the beneficiary, after it has tapped all other sources. The term is used in two senses. First, it can be used to describe the facility available to any individual bank that has failed to meet all its **liquidity** requirements in the market, or through the central bank's normal competitive open-market operations offered to all participants. In most countries, institutions then have a right of access to the central bank at the end of the business day. This facility is sometimes known as a "Lombard" facility. The terms are usually known in advance and banks have a right of access up to a certain limit. The second use is to describe a facility offered to a bank that is having difficulty in obtaining liquidity in the market, either because the bank has failed to manage its liquidity position effectively, or because other potential lenders doubt its creditworthiness. It is the second use that is dealt with in this Report (see Chapter 6, specifically Section 6.2.3). Some central banks offer such facilities only to institutions that are solvent, but **solvency** is not something that can always be determined with much accuracy, especially within the short space of time normally available to a central bank dealing with an illiquid institution. It is also a dynamic concept. A bank may be solvent when it first applies to the central bank, but may become insolvent subsequently.

6 Lifeboat

A description first used in the UK at the time of the “fringe” banking crisis in the 1970s to describe the facility, offered jointly by a committee comprising representatives of the major banks and chaired by the Bank of England, to provide **liquidity** to small deposit-taking institutions that were judged, after investigation, solvent and likely to remain solvent if provided with liquidity, but were unable to obtain liquidity in the market and had no large shareholders capable of providing the necessary support. Applicants judged to be solvent were normally accommodated by all the members of the lifeboat, acting jointly, with the Bank of England taking a 10 per cent share in the facility. At one point the outstanding amount became large enough to threaten the market standing of some of the participating banks; at that point the Bank of England agreed that any advances above a cap would be provided solely by the Bank. The lifeboat’s funding was provided at a margin over inter-bank rates judged to be sufficient to induce the borrower to replace the funding with market sources as soon as it was able to do so. Some recipients were subsequently discovered to have solvency problems. Where a finding of insolvency was made, then the facility was withdrawn and the institution put into liquidation. A full account appears in the Bank of England’s *Quarterly Bulletin* of June 1978.

The term “lifeboat” was subsequently used in South Africa to describe the rather different process whereby the South African authorities provided solvency support to failing banks or their depositors. In this case the problem, and indeed the solution, was directed not so much to the recycling of liquidity by the major banks to enable the business to continue, but to the provision of capital, where the authorities judged this was necessary to protect the interests of depositors, and the integrity of the financial system as a whole.

7 Liquidity

A function of the maturity structure of a bank’s liabilities and assets. A bank is liquid if it is able to meet its obligations as they fall due. As most banks have liabilities that are of shorter term than their assets (the transformation of maturity is one of the principle functions of banks) all banks are potentially illiquid, and rely on being able to roll over maturing liabilities. That is why confidence is such a vital factor. An illiquid bank may fail, even though it may have no **solvency** problem. However, a bank that

cannot fund its assets will often have got itself in that position because the market doubts its solvency.

8 **Moral hazard**

Moral hazard arises when central banks, governments, or supervisory agencies lead economic agents to believe that they will intervene to protect an institution and its creditors from failure. The result can be that creditors of financial institutions cease to take any notice of relative risk, because they believe that they will be protected by the authorities even if the management of the bank behaves imprudently and the bank fails.

9 **Regulation**

Regulation is the process whereby government controls what regulated bodies may and may not do and the basis on which they do it. In the financial sector this can mean requiring certain institutions to hold, or not hold, certain assets, to pay or to charge specified interest rates or at least to observe defined minimum and maximum rates. Most countries have removed such regulations, favouring deregulation on the grounds that competition will be encouraged and that consumers will benefit from more choice and innovation. But the process has the effect of allowing institutions to run more risk. Most countries still have certain regulations, such as minimum capital requirements, limits on loans to single large borrowers, and in some cases, minimum holdings of assets defined as “liquid”, and have stepped up the process of **supervision**.

10 **Simulated transaction**

Any transaction that purports to be, or appears to be what it is not. Modern accounting standards attempt to avoid the possibility of simulated transaction by adopting the principle of “substance over form”: financial statements should portray what the substance is rather than the legal form. At the time of the Reserve Bank’s assistance to Bankorp, this principle was less developed, and the parties were able to disguise as a loan what was in fact solvency support. In this case what appeared to be a secured loan, was a **donation** of the difference between the interest rate on the “loan” and that on the collateral.

11 Solvency

The margin by which a bank's assets exceed its liabilities (see **capital**). Because solvency depends upon the value attributed to assets, it is not always easy to measure. A central bank that is constrained to provide last-resort facilities only to solvent banks may still lose money if the recipient appeared to be solvent but turned out to be insolvent. Liquidation of a bank will tend to reduce the solvency margin as forced sale of assets may reduce the amount realised below the book value.

12 Special Investigating Unit

The Special Investigation Units and Special Tribunals Act, No 74 of 1996, provides, *inter alia*, for the establishment of one or more investigating unit(s) for the purpose of investigating serious malpractices, maladministration or unlawful expenditure in connection with the administration of government institutions and/or assets, public money and any conduct harming seriously the interest of the public. In 1996 an investigative unit was established under The Hon Mr Justice W H Heath, and this Special Investigating Unit investigated, *inter alia*, the Reserve Bank's assistance to Bankorp/ABSA.

13 Supervision

In contrast to **regulation**, supervision is the process of ensuring that the supervised entity behaves prudently. This involves understanding, by means of the reporting of statistics and financial statements, and by inspection, the risks that a financial institutions runs and discussing with management. The preference for supervision as opposed to regulation derives from the belief, now common in all developed financial systems, that regulation stifles innovation and competition to the detriment of the users of financial institutions. But those responsible for supervision appreciate that the absence of regulation allows supervised entities to run more and different risks. Many countries have experienced problems because deregulation has not been accompanied by enhanced supervision.

14 Systemic risk

The risk that an event, such as the failure of a bank, will prove to be contagious thereby leading to concerns by depositors about other financial institutions, thus

precipitating a run on otherwise sound banks, and ultimately precipitating a collapse of a large part of the financial system and destroying confidence in the system as a whole. Once systemic risk is triggered, it becomes difficult, and ultimately very expensive to restore confidence in the system. Central banks and governments therefore tend to be generous in their provision of assistance to individual institutions if they believe that the chance of failure to do so could trigger systemic risk is high. The problem is that it is difficult to measure accurately such risks. Excessive concern about systemic risk can lead to **moral hazard** (q.v.).

15 Tollgate Holdings Ltd

A commission of enquiry was appointed in terms of section 417, read with section 418 of the Companies Act, to investigate the serious allegations of impropriety and irregularities pertaining to the financial and business affairs of Tollgate Holdings Ltd. The enquiry was directed at establishing ABSA's dealings and associations with Tollgate with a view to gleaning information concerning Tollgate's business, trade, property and affairs. This investigation also considered the liquidation of Tollgate.