

5 CHAPTER 5: REVIEW IN TERMS OF THE FINANCIAL POLICIES AND PROCEDURES OF THE S A RESERVE BANK

(Second term of reference: to determine whether the financial policies and procedures of the S A Reserve Bank with regard to financial assistance have been adhered to in the case of the Bank's assistance to Bankorp)

5.1 Introduction

For reasons documented elsewhere in this Report, there was reluctance on the part of central bankers (including the S A Reserve Bank) to be explicit in explaining their policies towards distressed banks. Nor was the Panel able to locate any documented internal procedures which, at the time of the relevant assistance packages, were in use by the S A Reserve Bank.

Because of the lack of documented local S A Reserve Bank policies and procedures, the approach in this chapter of this Report has been to establish local practice by reference to assistance extended to other banks in similar circumstances during the same period, on the basis described below. This chapter also considers the assistance in the light of the principles described by Dr Stals to the enquiry in terms of section 417 of the Companies Act into the affairs of Tollgate Holdings Ltd in 1986.

5.2 Local comparison of assistance at the time

5.2.1 Introduction

The banks selected for comparison have been taken from the following list of distressed banks supplied to the Panel by the Office of the Registrar of Banks:

- Bank OVS (and Volkskas Saving Bank Limited in respect of Bank OVS)
- Cape Investment Bank Limited (CIB)
- Finansbank (in respect of Cape of Good Hope Bank)
- Islamic Bank Limited
- Mercabank Limited (Bankorp)
- Pretoria Bank Limited
- Prima Bank Limited

From this list banks have been selected for comparative purposes (although the legality, other features of assistance or compliance with international best practice have not been considered in these instances as these fell outside of the Panel's terms of reference). The selected banks had the following features:

- They are not connected in any way with the ABSA or Bankorp Group.
- The amount of the assistance given was a material amount.

The comparison has been made in order to identify where the Bankorp/ABSA assistance differed from the local precedents.

5.2.2 Summary of banks selected for comparison

5.2.2.1 Alpha Bank Limited

Serious financial problems in Alpha Bank Limited ("Alpha Bank") were confirmed by the external audit in respect of the financial year that ended on 30 June 1990. The external auditors were unable to express an opinion on the financial statements of Alpha Bank. The bank requested the Registrar of Banks ("the Registrar") to appoint a curator, which was done on 21 September 1990.

Most depositors of the bank were local authorities, and the freezing of deposits and the suspension of interest payments by the curator caused serious cash-flow problems within some of the local authorities.

In October 1990, after consultation with the Minister of Finance, the S A Reserve Bank introduced an assistance package for depositors, in terms of which all deposits that had already matured would be repaid before 31 December 1990 and in terms of which all other deposits would be repaid at maturity after the end of December 1990. Interest payments were resumed on 23 October 1990, but at an interest rate of 1 per cent below the prevailing rate on bankers' acceptances.

Net of winding-up dividends, the financial assistance package for depositors amounted to approximately R 150 million. The amount was not repaid by Alpha Bank, and Alpha Bank was later liquidated.

5.2.2.2 CIB

In December 1990, the S A Reserve Bank extended a loan to CIB, in order to allow that bank to make provisions for losses, which provisions would place the external auditors of CIB in a position to issue an unqualified audit report on CIB's financial statements, thereby preventing a loss of depositors' confidence in the bank. The S A Reserve Bank called for a special due diligence audit to be undertaken by the external auditors, as well as by an independent merchant bank in order to confirm the solvency of CIB.

A loan of R 300 million, at an interest rate of 1 per cent per annum, was extended to CIB by the S A Reserve Bank on 10 December 1990. The loan period was 116 days, and the loan was repayable on 30 March 1991. The loan amount had to be deposited with the S A Reserve Bank and earned interest at 17,12 per cent per annum, in order to generate, on a net basis, financial assistance amounting to some R 15,4 million. The deposit was ceded to the S A Reserve Bank as security for the loan.

The intention of the short-term assistance was to allow time for due diligence audits and for CIB to make the necessary arrangements for overcoming its financial problems. Late in December 1990, CIB reached an agreement with Prima Bank Holdings Limited ("PBH"), in terms of which agreement PBH would acquire a controlling interest in CIB.

In early April 1991, the results of the due diligence audits became available and indicated that the financial problems that had already existed before the acquisition of CIB by PBH were of such proportions that, from a business point of view and also in the interest of Prima Bank Limited, it was not advisable to allow CIB to continue with its banking activities. On 11 April 1991, the Registrar applied to the Supreme Court for the winding up of CIB.

The S A Reserve Bank, in consultation with the Minister of Finance, decided to protect the smaller depositors of CIB. All amounts deposited with CIB were repaid, up to a maximum amount of R 5 million per depositor. The Bank became a concurrent creditor for the amount of deposits repaid and, net of the winding-up dividend paid to all creditors, the depositor assistance provided by the Bank amounted to approximately R 48 million, which was not recouped.

5.2.2.3 Pretoria Bank Limited

Pretoria Bank Limited ("Pretoria Bank") experienced serious liquidity problems and, ultimately, also solvency problems during 1991. This was confirmed by a special due diligence audit commissioned by the Registrar of Banks. The Registrar's office directed the attention of the bank's board of directors to their responsibilities in terms of the Companies Act, 1973 (Act No 61 of 1973 – "the Companies Act"). As a result, the directors requested the Registrar to appoint a curator, which was done on 1 July 1991.

Total deposits with the bank amounted to R 208 million, of which R 105 million represented the funds of small investors, R 19 million represented the funds of local authorities and R 84 million represented funds raised by Masterbond as an agent of Pretoria Bank. Given the problems that small depositors and local authorities would experience if deposits with the bank were frozen by the curator and the danger that a freezing of deposits could cause hardship for depositors, the S A Reserve Bank announced on 2 July 1991 that the curator would ensure, with the necessary assistance of the Bank, that depositors could withdraw their funds at maturity and receive interest at the agreed rates.

The curator managed the business of Pretoria Bank for a period of about two years, during which no new business was undertaken. At the end of that period, the remaining assets of the bank were sold to Unibank Limited ("Unibank") by the curator, and Pretoria Bank was deregistered.

The financial assistance provided by the Bank in order to refund depositors amounted to approximately R 160 million. The amount was not repaid by Pretoria Bank and a lesser amount was recovered from the sale of the bank's assets.

5.2.3 Summary

The main comparative features of the cases discussed above can be summarised as follows:

	Alpha Bank	CIB	Pretoria Bank	Bankorp/ ABSA
Was problem external?	No	No	No	No
Assistance package included capital contribution involving donation of taxpayers' funds?	Yes	Yes	Yes	Yes
In secrecy?	No	Partially	No	Yes
Using simulated transactions?	No	Yes	No	Yes
Over an extended period (more than 5 years)?	No	No	No	Yes
Assistance renewed periodically?	No	No	No	Yes
Was there transfer of equity to Government?	No	No	No	No
Was management appropriately penalised?	Yes	Yes	Yes	No
Were shareholders appropriately penalised?	Yes	Yes	Yes	Partially
Was curator appointed?	Yes	No	Yes	No
Was the bank liquidated?	Yes	Yes	Yes	No
Was assistance repaid?	No	No	No	No

This table indicates that there have been cases of financial assistance to distressed banks where the structure and form of the Reserve Bank's assistance had features similar to those of the assistance afforded to Bankorp. However, taken as a whole, the assistance to Bankorp was different in that it had features which together were not present in any other single case.

Of particular significance is the cumulative effect of the following aspects of the transaction:

- The quantum of the assistance
- The extended period of the assistance with periodic renewals
- The fact that although shareholders were called upon to provide assistance in addition to the Reserve Bank's assistance, the shareholders survived intact to share in the future profits of the rescued bank.
- The assistance was continued when Bankorp was acquired by ABSA.

5.3 Comparison with principles stated by Dr Stals

Another way of assessing the extent to which the assistance to Bankorp was consistent with the established policies and procedures of the S A Reserve Bank is to

compare it with Dr Stals' eight principles highlighted at the enquiry into the affairs of Tollgate Holdings Ltd. These were as follows:

- Firstly, financial assistance is applied very sparingly, and as a general rule only when a particular case provides a threat of contagion to the whole banking system.
- Secondly, protection of depositors is a major consideration that must be taken into account, especially by central banks that have to operate in a vacuum where there is no public system of depositor protection.
- Thirdly, confidence in the banking system must be preserved, without providing open-ended support for mismanagement, fraud or internal inefficiencies in banking institutions.
- Fourthly, arising from the foregoing, financial assistance emanating from the central bank/government must, as far as possible, serve to protect depositors and not shareholders of banking institutions.
- Fifthly, in order to assist the banking institution to overcome its problem, the central bank may provide a loan at a nominal rate of interest, or perhaps provide guarantees for raising low interest rate loans from other institutions.
- Sixthly, the assistance must be conditional upon remedial action that will lead to recovery and may often require a change of ownership, of senior management, and even of the structure of the affected institution.
- Seventhly, there must be a possible exit for the central bank from the assistance programme, perhaps only after the credibility, creditworthiness and public trust in the institution have been re-established.
- Eighthly, it may in certain circumstances be necessary to keep the assistance package secret, particularly if disclosure could be counter-productive and defeat the objective of the exercise.

Did the S A Reserve Bank's assistance to Bankorp meet these tests? It can hardly be argued that assistance was provided sparingly. The Bank had provided assistance to a number of institutions during the 1980s, and indeed the assistance to Bankorp/ABSA was outstanding for a long period, from 1985 to 1995. However, Bankorp was one of the six large banks in South Africa at the time, and as is shown in Chapter 2, the South African financial system was vulnerable. It is, of course, impossible to say now whether failure to support Bankorp would have triggered a systemic crisis, but it was clearly reasonable for the S A Reserve Bank to suppose at the time that failure to help Bankorp might have significant contagion effects.

As to the second test, there was, and still is, no formal system of depositor protection in South Africa, although in many cases where banks have failed or have been liquidated, public funds have been made available *ex post* to compensate small depositors. It is likely that Dr Stals was right in saying the absence of a formal system of depositor protection should be a factor influencing a decision as to whether to support a troubled institution. Bankorp at the time of the 1990 and 1991 assistance had some 90 000 depositors. So assistance in this case would appear to have met this test.

On the third test, it appears that the mismanagement in Bankorp and its preceding institutions was indeed long-established. Bad credit decisions seem to have been endemic in Bankorp, and the S A Reserve Bank appears to have had little influence on the management, at least until the later stages. This, in part at least, reflects the absence until 1987 of a formal and robust system of banking supervision, requiring banks to report, in detail, their condition. Indeed, it was only when ABSA bought Bankorp that the weak credit culture typifying the latter was finally eradicated. Indeed, it could be argued that it was the fact that support was given for a long period that allowed the mismanagement to continue. It was only in the later agreements that Bankorp was subjected to significant pressure to reform.

It can be argued on the one hand that it was not just depositors who were protected by the assistance. Shareholders also were allowed to retain their investment despite the S A Reserve Bank's assistance. Indeed the form of the assistance was designed to contribute to the capital base of Bankorp, thus protecting the interest of shareholders, who did not even suffer any dilution. And, at the end of the day, the minority shareholders were bought out by ABSA, whose own shareholders unwittingly voted to acquire Bankorp in ignorance of the S A Reserve Bank's assistance. On the other hand, it can be argued that the majority shareholder, Sanlam, was required to contribute additional capital itself, on more than one occasion, and indeed underwrote the offer by ABSA to the minority shareholders. Sanlam was then still a mutual company; in effect it was the policy holders of Sanlam who were being asked to throw good money after bad. Nonetheless, given the decision to assist Bankorp, the S A Reserve Bank did make attempts to ensure that the cost should fall not entirely on the S A Reserve Bank and the public funds it manages.

Dr Stals' fifth point is that it is appropriate to allow soft loans in certain circumstances. Although some of the earlier assistance did take the form of low interest rate loans against collateral put up by the majority shareholder, the later forms of assistance

were pure solvency support and took the form of a donation. No liquidity was provided, and indeed not needed. Of course, if the assistance had not been forthcoming, it is likely that the bank would have had to publish losses and would then have experienced funding difficulties.

The sixth test, remedial action, was in the end satisfied, but only after assistance had been provided with little conditionality for many years. Finally, the management was changed. The S A Reserve Bank played no role in the acquisition by ABSA which led to a more fundamental change of ownership and management, and ultimately to the disappearance of Bankorp as a separately identifiable financial institution.

As to the seventh test (an exit for the central bank): this was not met for a long time. Because no conditions were applied, the assistance in fact facilitated a continuing stream of acquisitions of weak banks, with the result that the S A Reserve Bank found it impossible to escape from its role as supporter. Furthermore, it was obliged to keep its role secret, and this may have enabled the Bankorp management to avoid public censure. In the end, the S A Reserve Bank only escaped from the role of capital provider when ABSA appeared. This development was fortuitous; the S A Reserve Bank did not actively encourage the transaction, except by agreeing to continue the assistance after the merger.

As to the need for secrecy, it is certainly true that the S A Reserve Bank concealed its role for many years, and that despite the very unfavourable operating environment there was no banking crisis as happened in many other countries with less unfavourable circumstances. It is reasonable to suppose that the S A Reserve Bank would have had good reason to fear that publicity could have led to the contagion they were keen to avoid, and did avoid. Moreover, until 1997 the S A Reserve Bank Act limited the disclosure of assistance.

5.4 Conclusion

The Panel has examined other instances of Reserve Bank assistance to distressed banks that occurred before or during the period in which assistance was given to Bankorp/ABSA. In several cases the structure and form of the Reserve Bank's assistance had features similar to those of the assistance afforded to Bankorp. However, taken as a whole, the assistance to Bankorp was different in that it had features which together were not present in any other single case.

Of particular significance is the cumulative effect of the following aspects of the transaction:

- The quantum of the assistance.
- The extended period of the assistance with periodic renewals.
- The fact that although shareholders were called upon to provide assistance in addition to the Reserve Bank, the shareholders survived intact to share in the future profits of the rescued bank.
- The assistance was continued when Bankorp was acquired by ABSA.

The Panel also compared the Reserve Bank's methods in assisting Bankorp/ABSA with principles stated by Dr Stals. Those principles were, of course, enunciated some years after the first assistance to Bankorp had been agreed upon. Nonetheless they purported to represent the basis on which this assistance was given. It can be concluded that the assistance was in accordance with these principles to the extent that:

- failure of Bankorp could have caused system-wide problems and contagion;
- the absence of deposit protection argued for intervention; and
- the existence of the assistance was kept confidential and thus a run on the bank and contagion effects on other banks were prevented.

The Bankorp/ABSA assistance was not fully consistent with these principles to the extent that:

- mismanagement was not corrected early enough or forcibly enough;
- the assistance protected the interests of shareholders as well as depositors;
- in packages B and C, the assistance did not take the form of a liquidity advance, but was in the form of solvency support;
- effective remedial action was not insisted upon for some years; and
- no effective exit for the S A Reserve Bank was provided for. Acquisition by ABSA was neither anticipated nor instigated by the S A Reserve Bank.