6 CHAPTER 6: ANALYSIS OF INTERNATIONALLY ACCEPTED PRINCIPLES OF BEST PRACTICE IN ASSISTING BANKS IN DISTRESS AT THE TIME OF BANKORP'S ASSISTANCE

(Third term of reference: to determine whether the S A Reserve Bank's conduct in the provision of financial assistance to Bankorp was in accordance with internationally accepted principles of best practice)

6.1 Introduction

This chapter examines international best practice at the time of the various sets of assistance agreements between the S A Reserve Bank and Bankorp, and an evaluation of such assistance. This examination provides a basis for the legal evaluation referred to in Chapters 4 and 7 of this Report.

Leading international examples of bank rescues that the S A Reserve Bank would have been aware of before it entered into or renewed its transactions with Bankorp are reviewed in this chapter. They provide some benchmarks for evaluating the S A Reserve Bank/Bankorp operation against best international practice. At the time when the Bankorp assistance was initiated the S A Reserve Bank was a long-established central bank that had historically been at the forefront of international developments in monetary policy (having for many years been close to the Bank of England). The main examples reviewed have been selected to identify best international practice in the sense that they focus on leading central banks in developed market economies using principles that accord with their assessment of best practice in a changing environment.

In other words, since the S A Reserve Bank should be compared with the best the Panel does not focus on weak central banks in countries with weak jurisdictions and policies. It is noteworthy that, unlike three-quarters of International Monetary Fund ("IMF") member countries (including highly developed countries), South Africa actually experienced no major, system-threatening banking failures during the past thirty years.

6.2 International policies towards distressed banks from 1973 to 1993

6.2.1 Overview

The Panel examined international best practice from 1973 to 1985, the year that the S A Reserve Bank's assistance packages to Bankorp began, and that consequently already existed as an established standard of international best practice. International best practice in handling bank distress in the subsequent period, 1985 to 1993, during which time assistance to Bankorp and then ABSA was renewed, is also examined. The statement of principles by Sir Edward George, Governor of the Bank of England, published in 1993 and summarising the principles the Bank of England had been using, is also considered. So, too, are the principles published in 1995 by Mr Gerald Corrigan, the former President of the Federal Reserve Bank of New York.

The features of the assistance to Bankorp/ABSA appear unusual and deficient by today's widely accepted standards for actions in respect of bank distress. However, it can be argued that one appropriate standard of comparison is the practices that were customary in South Africa in the same period, for they are relevant to the question of whether Bankorp received special treatment. They are examined in Chapter 5.

Policies that other countries had used in cases of bank distress before and during the S A Reserve Bank's assistance to Bankorp must also inform a retrospective evaluation of the assistance. If the Bank's policy towards Bankorp/ABSA was inferior to international best practice it can be concluded that the S A Reserve Bank engaged in poor policy making and may have exceeded its powers.

6.2.2 Types of central bank assistance, "lender-of-last-resort" and "lifeboat"

To be clear on terminology it is valuable to distinguish between three generally accepted categories of central bank assistance, and the concepts of a "lender of last resort" ("LOLR") operation and a "lifeboat" operation by a central bank.

When the S A Reserve Bank/Bankorp operation came to light, Governor Stals sought to characterise the S A Reserve Bank's role as that of a "lender of last resort" (submission by Dr Stals to an enquiry in terms of section 417 of the Companies Act into the affairs of Tollgate Holdings Ltd). Subsequently the operation has been described as a "lifeboat" operation. However, both terms have been used loosely and without precise definition for the assistance given to Bankorp/ABSA and the Panel believes the vague use of those terms has contributed to confusion over the nature of that assistance.

In order to analyse properly the Reserve Bank’s assistance to Bankorp/ABSA the Panel distinguishes between three fundamental and generally accepted categories of assistance, each of which has a quite precise meaning:

- *Liquidity support:* operations designed to provide liquidity to a bank which faces a liquidity problem but is solvent (a typical operation being a short-term loan against good quality collateral)
- *Solvency support:* operations to re-capitalise a bank that faces a solvency crisis that is capable of being resolved and profitable trading restored on a sustainable basis (which might involve a grant of public funds through the central bank or other agency to protect retail depositors in the process)
- *Insolvency intervention*: operations to assist the orderly liquidation or sale of an insolvent bank (which, too, might involve a grant of public funds through the central bank or other agency to protect retail depositors in the process)

By identifying the defining features of each type of operation, as understood by international bankers, the Panel obtains a set of benchmarks against which it can judge whether the packages of Reserve Bank assistance to Bankorp/ABSA were in line with international standards. The following sections also attempt to relate the more general concepts “lender of last resort” and “lifeboat”, which have been used without precision in discussions of the Bankorp/ABSA assistance, to those three quite precise categories.

6.2.3 *Lender-of-last-resort* operations

“Lender-of-last-resort” assistance often refers to liquidity support alone, and such operations have a long history. Although their role in modern banking dates from Bagehot’s explicit statement of their nature in his 1873 classic *Lombard Street*, authorities, whether in the form of a Central Bank, Treasury, or even monarch (in the case of Prussia in 1763), had undertaken lender-of-last-resort functions for over a century before that. In essence, a central bank acting as lender of last resort provides temporary extra liquidity to banks in order to stem a potential loss of confidence and deposit run. At certain times the objective is to prevent a run that threatens the stability of the banking system as a whole, but a lender of last resort might act to assist a single bank even if no systemic collapse is in prospect.

Since Bagehot the commonly accepted features of a "lender-of-last-resort" operation when, for example, a bank depositors' run is potentially contagious, are:

(i) Liquid funds are provided against good collateral.

(ii) The finance is provided for a defined (short) period.

(iii) The finance is usually provided at a high interest rate.

(iv) The funds are provided only to banks believed to be solvent but facing temporary difficulties and are made available to all such banks that apply for them.

(v) Classic lender-of-last-resort operations are designed to provide banks with immediate liquidity in the form of cash, temporarily shortening the maturity structure of bank assets in order to enable banks to meet depositors' demands to convert liquid liabilities to cash.

A standard technique in lender-of-last-resort facilities is for the central bank to provide funds by discounting or lending against good quality paper, a technique which satisfies conditions (i) and (ii), although the history of central banking shows that there has been considerable flexibility over the definition of "good quality paper".

6.2.4 ***Lifeboat*** **operations: UK Lifeboat 1973-1975**

The term "lifeboat" was not used in relation to cases of bank distress until the operation, begun in December 1973 and directed by the Bank of England, to prevent systemic collapse in the United Kingdom's banking sector. That operation was designed as liquidity support, but at different times and in other countries the term has been used to describe schemes to provide solvency support. Since the S A Reserve Bank's assistance packages to Bankorp have been described as a lifeboat, the features of that initial UK operation comprise an important benchmark.

Partial liberalisation of banking regulation, changes in financial markets, and an economic boom that was marked by a real-estate boom, led to the growth of new “secondary banks” or finance houses in the decade up to late 1973. At the end of 1973 signs of distress in the secondary bank sector heralded the end of that boom and the beginning of what could have become a crisis that could have ultimately threatened the whole banking system.

The lifeboat was initiated by the Bank of England in December 1973 following action to assist one secondary bank (Cedar Holdings). It immediately became clear that other secondary banks were likely to be in need of assistance. An agreement to operate a lifeboat was rapidly formalised to prevent a general collapse of the secondary banking sector and contagion effects on the established commercial banks. The agreement involved the Bank of England and the major commercial banks.

Under the agreement the lifeboat’s “control committee” (comprising the commercial banks and led by the Bank of England) gave authority to lend to a secondary bank that needed support if a request for assistance was approved by the committee. It also had the power to lend to other financial institutions. Ninety per cent of the finance provided to distressed banks was to be contributed by the commercial bank members of the lifeboat.

Initially there was no limit placed on the contributions to be made by the lifeboat’s members but increasing demands on the lifeboat, stimulated by crises in the property market and a stock exchange slide, led to an agreement in August 1974 that the total size of the lifeboat’s operations would not exceed £ 1 200 million. The agreed nature of the lifeboat’s operations included:

(i) Banks receiving aid were expected to remain solvent, and, although funds were to be made available quickly, a rapid evaluation of the bank’s prospects was undertaken (in principle, but not always in practice in the lifeboat’s early days). That evaluation was undertaken with the help of the commercial banks.

(ii) Loans were for a fixed period and carried a penal interest rate (typically at 150 to 200 basis points above the inter-bank rate).

(iii) Collateral was sought from borrowers.

(iv) Banks receiving assistance were required to undertake restructuring of operations and capital (especially after August 1974).

Initially the members envisaged the lifeboat as a recycling operation of liquidity support under which the large, established commercial banks would lend to distressed secondary banks and thereby, in effect, "recycle" deposits that had been transferred to the commercial banks in a "flight to quality". From August 1974 it took on a more direct role in leading the restructuring of the fragile financial sector.

The 1973/74 crisis was not the first time that the Bank of England and commercial banks had combined to prevent a bank's failure; in 1891 the commercial banks had guaranteed the Bank of England's emergency loans to Baring Brothers bank. But it was the first time such partnership had been enshrined in a formal, complex arrangement designed to assist a whole sector. It was the first time the term lifeboat was used and it may be used as a definition of lifeboat arrangements.

6.2.5 Examples of solvency support and insolvency intervention

Subsequently the term lifeboat has been used for a different type of operation, such as Thailand's "April 4 Lifeboat Scheme" established in 1985 which did not involve private banks' participation in funding. That scheme, run by the newly established Financial Institutions Development Fund ("FIDF"), an entity established by the Bank of Thailand, provided soft loans to 13 finance companies and 5 commercial banks. The subsidised credit was intended as solvency support to assist in the recapitalisation of the banks. It is notable that in return for loan finance the FIDF took equity stakes in the assisted banks and finance houses, and their chief executive officers were removed.

A common technique for dealing with asset quality problems is the creation of a privately or publicly owned special purpose vehicle (sometimes known as a "bad bank") to takeover the non-performing assets of distressed banks, enabling the banks to be restored to profitability. In some cases, the transfer has taken place at above market prices, in which case the operation also has the effect of recapitalising the distressed bank. The most often quoted example is the US Resolution Trust Corporation but this was used to acquire the assets of failed, and closed, Savings and Loan Associations. A more conventional, but later, case was the setting up of two separately managed companies to acquire, and work out, the non-perfoming assets of the two large banks rescued by the Swedish authorities in the early 1990s.

In the following paragraphs some of the major international examples of actions by central banks or supervisory authorities in respect of distressed banks are examined. The Panel focuses on selected cases that occurred before the final package of assistance to Bankorp and would have provided a contemporary standard of comparison for the S A Reserve Bank.

From the early 1980s the US experienced a wave of bank failures. One of the most startling was the widespread collapse, spanning almost the whole decade, of the savings and loan (thrift) institutions and their federal deposit insurance body. Another was the collapse in 1984 of the Chicago-based Continental Illinois Bank ("Continental"); the assistance provided was the largest bank bail out the US had experienced and achieved world-wide notice. Assistance was given after the bank had already experienced a run on wholesale deposits, beginning on 8 May 1984, which reduced its assets by US$ 6 billion from US$ 41 billion. The run was prompted by the failure of high-risk assets in which Continental had invested in preceding expansionary years. After the run began, credit was provided by the Federal Reserve. Fifteen private banks were brought into discussion of the assistance package when it was initially seen as a liquidity crisis, but it rapidly became clear that Continental had solvency problems. By 13 August 1984, Continental had received US$ 13,7 billion in rescue funds. As a result the operations and balance sheet of Continental were restructured and the Federal Deposit Insurance Scheme ("FDIC") took a majority equity stake which was subsequently sold.

The attempted rescue of Johnson Matthey Bankers Ltd ("JMB") in September 1984 was prompted by extreme (and initially incorrectly accounted) exposure to bad commercial debts; the capital base of JMB was unable to support that exposure. The Bank of England's attempt to broker a sale of JMB to other banks was unsuccessful and the Bank itself bought the bank (for £1). In order to keep parts of the bank, including its gold bullion operation running, the Bank of England arranged an indemnity fund of £ 150 million to meet JMB losses. The finance for the indemnity fund was provided by the Bank of England, the four leading commercial banks, and other financial institutions. It is noteworthy that in this case the commercial banks were unwilling to participate in the rescue.

The practice of taking equity stakes in return for the protection of depositors was a well-accepted practice long before the mid 1980s. In the UK, the ceiling placed on the size of the 1970s lifeboat meant that when one of the leading secondary banking and finance groups, Slater Walker, became distressed in October 1975, the Bank of England had to provide a line of credit (and provide guarantees) itself. At the failure of the group in September 1977, its constituent bank was taken into the ownership of the Bank of England. Another example is Chile where the new banks that had grown rapidly in the second half of the 1970s, crashed in 1981-1982 and, to protect depositors, were taken into public sector ownership (despite the fact that they were established in a system based upon renunciation of public sector responsibility for banks' security).

There are many other examples of bank failures that have attracted central bank intervention in this period. In Spain, a number of banks had significant solvency problems in the early 1980s. Most were dealt with using the Deposit Guarantee Fund, sometimes known as the "bank hospital", and financed jointly by the central bank (50 per cent) and the commercial banks. The approach used the so-called "accordion" approach. This involved shrinking the bank by writing down its bad assets against its existing capital, acquisition by the Fund, often effectively wiping out existing shareholders, recapitalisation by the Fund, and subsequent sale to new owners. The largest problem was the Rumasa Group, an industrial holding company owning both commercial and banking interests. In this case the process was more protracted, but at an early stage the banks were acquired by the central bank with support from the commercial banks.

In the United States, the savings and loan association affair in the 1980s involved significant amounts of public money, mostly through the setting up of the Resolution Trust Corporation which assumed the insolvent S & Ls (savings and loan banks in the United States) restructuring, and then resale to new investors. At the same time a large number of banks failed, first in the South West, and then later in New England. Unlike the S & L crisis, the central bank was involved here, but only to provide liquidity on orthodox terms. Ultimate resolution of failed banks rested with the FDIC using the deposit insurance fund.

Another case was the failure of Credit Lyonnais in France. However, this bank was already government-owned and its recapitalisation was undertaken through the provision of government funding. In Scandinavia, in the early 1990s, there were a number of major bank failures. Again the major characteristic of their rescue was that bad debts were written down against capital or transferred to a separate asset management company, the banks recapitalised, often using government funds, effectively diluting the interest of the existing shareholders, and then the banks were sold to new owners.

All these cases were sufficiently large to become apparent to the public. Indeed the recapitalisation was almost always done with government funding and with parliamentary approval of some kind. Central bank involvement was usually limited to the provision of short-term liquidity. Sometimes this was in the mistaken belief that the institution was still solvent, and central banks have been criticised for not seeking resolution of the problem more quickly. In the United States this has led to legislation restricting the ability of the federal regulators allowing a weak bank to survive on central bank financing. Recapitalisation has normally involved the stake of existing owners being substantially reduced, if not eliminated entirely. There may well be other instances where central banks have intervened more covertly. If successful, such cases may well have remained undisclosed so it is difficult to know what the terms might have been. Some element of subsidy could well have been involved. However, by this period it would have been difficult for central bank assistance to have continued for long on a large scale without some publicity, even if only after the event.

In 1991, the Bank of England closed the operations of BCCI, a group of banks held through two parent banks registered in Luxembourg and the Cayman Islands, but with management and central treasury operations mainly in London. The BCCI group operated through branches and subsidiaries of the two parent banks in a large number of countries throughout the world, including many African countries (but not South Africa). Because of the structure, no supervisory authority was in a position to exercise effective consolidated supervision over the group as a whole. The supervisory authorities in the principal jurisdictions involved had been attempting to resolve the issue of supervising such a group, but when evidence of massive fraud at the centre of the operation became apparent to the Bank of England, it moved rapidly to close the BCCI's UK business and the two main banks were put into liquidation, a process that has still not been completed. Other supervisory authorities followed suit, although in some countries, where there was a self-standing subsidiary in reasonable condition, the local authorities took it into public ownership or found a buyer to take on the business. Although BCCI was a substantial group with large international operations, it was not felt to pose a systemic risk. The reasons for failure were not felt likely to encourage contagion, and indeed, many of the banks' counterparties in the money markets were already suspicious enough to ensure that their exposure to the banks was kept to a minimum. Although many individual depositors have lost money, to the extent that they were not protected by official deposit insurance schemes in those countries that had them, few other financial institutions suffered loss.

While the practice of leading central banks in cases of bank distress does not resemble the techniques used by the Reserve Bank in packages B and C, there is one example that bears at least a superficial resemblance. Under a Ministerial decree of September 1974, the Bank of Italy has powers to provide resources to cover the losses of a failing bank by lending at 1 per cent. The funds provided are used to buy securities from the Bank of Italy that are deposited with the Bank as collateral for the loan. The transaction does not give rise to any provision of liquidity but to a transfer of income through the spread between the rate of interest on the loan and the yield on the securities purchased with the proceeds of the loan. This is designed to compensate for the shortfall in the capital position of the failed bank.

Despite its superficial similarity, this provision only applies in circumstances quite different from those of Bankorp/ABSA. Unlike the solvency support the SA Reserve Bank provided to Bankorp, the Italian decree relates only to insolvency intervention in cases where the bank is liquidated. The Bank of Italy finance can only be used to make possible the acquisition the business of an insolvent bank by another bank and so protect the failed bank's depositors. Indeed, compulsory liquidation must have been initiated before the transaction can take place, thereby making it possible to separate the fate of the bank and its depositors from that of its shareholders who bear the losses arising from the liquidation. The decree provides that the Bank may make 1 per cent loans for up to two years to *banks that, taking the place of depositors of other banks in compulsory administrative liquidation, find themselves having to amortize the consequent loss in their exposure because it is uncollectible in whole or in part* (Pecchioli, 1987: 262). The procedure is, thus, like that employed in many other countries whereby deposit insurance agencies, for example, may provide capital support to enable a bank to acquire the business of an insolvent bank. In many cases, this procedure is only available if it can be held to cost less than paying off the insured depositors.

6.3 Evaluation of the S A Reserve Bank's assistance packages for Bankorp/ABSA in relation to central bank principles and practice

In this and the following section the Panel evaluates the actions taken and not taken by the SA Reserve Bank in relation to Bankorp/ABSA using international best practice as the comparison. Three international benchmarks are used:

- Principles set out in 1993 by the Governor of the Bank of England, Sir Edward George.
- Principles set out in 1995 by the former President of the Federal Reserve Bank of New York, Mr E Gerald Corrigan.
- The practices of leading central banks in the period before and during the Reserve Bank's assistance to Bankorp/ABSA, as described in Section 6.2.

Although the first two benchmarks were not available to the Reserve Bank before making the substantive agreements with Bankorp/ABSA, the Panel refers to them because Dr Stals has argued that the Bankorp/ABSA assistance conformed with them and because Sir Edward George's statement of principles is now widely recognised as a benchmark.

6.3.1 Evaluation against criteria promulgated by the Governor of the Bank of England in 1993

How do the S A Reserve Bank's actions stand up to the criteria promulgated by the Governor of the Bank of England in 1993?

Sir Edward George's over-riding principle was that support should be directed to safeguarding the financial system, not the institution itself. He then outlined five tests as follows:

- *First we will explore every option for a commercial solution before committing our own funds. Initially we will always look to the major shareholders to provide support. Short of that we will encourage the bank to try to find a buyer, for some or all of itself, even at knock-down prices. Or a bank's major creditors may decide to provide support, to protect their own positions. Or there may be a coherent group of other banks with a common interest in an orderly resolution. It is only when these options have been exhausted that we will consider providing support ourselves – and even then we may decide against it … .*

- *Second, central banks are not in the business of providing public subsidy to private shareholders. If we do provide support, we will try to structure it so that any losses fall first on the shareholders and any benefits come first to us. And any support we provide will be on terms that are as penal as we can make them without precipitating the collapse we are trying to avoid.*
- *Third, we aim to provide liquidity; we will not, in normal circumstances, support a bank that we know at the time to be insolvent. Our own capital is not there to be used as risk capital. But it would be wrong to conclude from this that loans or guarantees never involve any risk … .*
- *Fourth, we look for a clear exit. The company may be required to run down or restructure its operations, under our surveillance, to the point where it can do without our support within a given period. Making the terms as unattractive as possible has the great advantage of encouraging this process. Alternatively the company may be wound down under our management … we aim to protect the system, not to keep in being unviable banking capacity and so interfere in the market process unnecessarily.*
- *Fifth, we usually try to keep the fact that we are providing systemic support secret at the time… . There can certainly be circumstances where the market will be reassured by knowing that we are involved. Very often the opposite is true… . We will as a matter of public accountability always reveal the fact of our support after the event, when the danger has passed. Even then, it will often be difficult to disclose publicly the details of our support. The full details could weaken those banks that had succeeded in dispensing with our support.*

How does the S A Reserve Bank's assistance to Bankorp perform against these tests? First, as noted above, the S A Reserve Bank had grounds to conclude that the failure of Bankorp could have triggered contagion with implications for other banks and indeed for the system as whole. This may be less true of some of the other banks that received assistance at the time, but Bankorp was a large and diversified institution whose failure could clearly have had ramifications throughout the system.

Did the S A Reserve Bank explore commercial alternatives? It is clear that the major shareholder was required to offer support too. It is also possible, although Dr Stals assured the Panel that this was not a factor, that the Bank was concerned not to impose too much of a burden on the policy holders of Sanlam. There appears to have been no attempt to organise a merger or takeover; indeed the reverse, because much of Bankorp's problems seems to have arisen from institutions that it had acquired. Only in the later stages were constraints put on the business of the bank, which for much of the period pursued a policy of aggressive growth amid an attempt to increase its market share. The merger with ABSA, which proved the final solution, was for commercial reasons and was not prompted by the Reserve Bank.

As to the terms, there appear to have been no provisions in packages B and C for any benefits from the assistance to accrue to the S A Reserve Bank, although the assistance was a grant of capital (in the form of a stream of net interest). The Bank did not acquire any right, or claim on future profitability in exchange for its assistance. After taking account of S A Reserve Bank assistance, losses did accrue to the majority shareholders. In addition, Sanlam did make a low interest loan to Bankorp and did support rights issues, although Sanlam may well have believed it had an interest in seeing Bankorp survive thereby avoiding the need to take the losses that would have been triggered by closure. While it is true that attempts to make the assistance more penal might have had the effect of preventing the bank from recovering, nonetheless the agreements could have provided for some recompense conditional on the assistance proving successful in restoring the bank to profitability.

While the earlier assistance packages did provide liquidity, it appears that the objective was all along to contribute capital; and the later packages supplied no liquidity at all, only solvency support. It is not clear if Bankorp was actually insolvent at any stage. But if proper provision has been made at the time its bad debts were recognised, its solvency would certainly have been in doubt. Indeed, there would have been no point to the assistance otherwise.

As to an exit, no doubt the S A Reserve Bank hoped on each occasion that each assistance package would be the last. But until towards the end, when the amounts had become very significant, little attempt was made to ensure that the bank would reform its policies and thus be able to dispense with assistance. Far from finding the central bank's support unattractive, Bankorp seems to have become addicted to it.

Finally, the S A Reserve Bank did maintain a veil of secrecy over the operation, and this was successful in allowing Bankorp to operate without the need to pay the penal rates for its funding which no doubt the market would have demanded if the bank's true condition had become public knowledge. But the S A Reserve Bank could have provided more details once the danger was over. However, until 1997 the S A Reserve Bank Act limited disclosure of assistance to banks in distress. As it was, the

Governor only felt able to provide details for the public record through the medium of an enquiry into the affairs of a different company, Tollgate, under Section 417 of the Companies Act. By that time rumours of the Reserve Bank's assistance had begun to spread in the markets.

6.3.2 Evaluation against criteria promulgated by former President of Reserve Bank of New York

Another experienced central banker, recognised as one of the world's leading experts on bank regulation and supervision, has also set out principles for assistance to banks. Mr Gerald Corrigan, who was President of the Federal Reserve Bank of New York and Chairman of the Basel Committee on Banking Supervision described arrangements for "long fuse" cases, where the authorities have the opportunity to fix the problem before it reaches crisis stage.

He listed seven steps that the authorities should take. They should:

- *Encourage the troubled institution to raise fresh capital*
- *Encourage the troubled institution to reduce or eliminate dividends*
- *Encourage the troubled institution to shrink its balance sheet with a view toward promptly reducing the most sensitive liabilities*
- *Encourage the sale of affiliates or subsidiaries and/or selective lines of business in order to raise capital or reduce points of vulnerability, or both*
- *Actively explore merger possibilities, even those that might entail some governmental financial assistance in the form of capital injections*
- *Encourage if not force changes in management*
- *Maintain strict confidentiality while monitoring the situation on a day-to-day basis* (Corrigan, 1995: 7).

Mr Corrigan made clear that only when all these steps are exhausted would the provision of official financing be contemplated, although the possibility is raised in the fifth point. He also stressed that …*as a matter of strict public policy, shareholders and top management should* <u>*never*</u> *be protected* (Corrigan, 1995: 4).

How consistent with these principles was the Reserve Bank's response to the Bankorp case?

It is not clear when the Reserve Bank began to "encourage" Bankorp to raise more equity. Only in 1989 did Sanlam, the bank's biggest shareholder, underwrite a rights issue. This was four years after the Reserve Bank began to contribute solvency support. In 1990 a further rights issue was underwritten by Sanlam and, as a result of both operations, its equity stake rose to 88 per cent. But as the Reserve Bank took no equity in respect of its contribution, private shareholders as a whole suffered no dilution.

On the second test, Sanlam agreed to take equity in lieu of cash dividends, incidentally increasing its stake, but other shareholders continued to receive cash dividends. Indeed, given the need to maintain secrecy, elimination of dividends would have demonstrated the parlous state the bank was in. However, under package B, Sanlam did provide a grant on terms similar to those provided by the Reserve Bank, thereby effectively diluting its own equity stake somewhat. But this arrangement provided no protection to the Reserve Bank; the beneficiaries were the other shareholders.

As to reduction of the balance sheet, the third test, and sale of affiliates or business lines, the fourth test, there appears to have been little attempt to do this. Part of Bankorp's problems was related to its rapid growth, both by acquisition and organically. There were businesses in the group that could have been sold. Indeed the presence of Bankfin was one of the main reasons that attracted ABSA. It was only in 1991 that the balance sheet began to shrink following the Reserve Bank's insistence. Nor was there any attempt to promote a merger, the fifth test, or even make the assistance conditional on Bankorp itself seeking a partner or strategic investor. Both ABSA and Governor Stals insist that the takeover by ABSA was not prompted at all by the Reserve Bank, although no doubt the latter was relieved when ABSA appeared on the scene. Indeed it was only when ABSA got to hear (following an apparently mis-delivered fax) that Bankorp was in such a bad state that they expressed interest. If Bankorp had attempted to seek a partner earlier, it is conceivable they might have been successful, although that is not self evident; ABSA was itself the product of a difficult merger and the other major banks would not have felt, as ABSA did, the need to acquire the commercial lending business. But clearly no attempt was made.

As to changes in management, the sixth test, certainly there were changes, although not within the time frame of package A. But even subsequently, there is no evidence that the changes were enforced by the Reserve Bank as a condition of package B. Even so, the changes were not wholesale; indeed they could not be without sparking concerns as to the true state of the bank. In many other rescue cases, (this certainly applies in the USA) as a matter of principle, the whole board of directors is replaced.

As to the final test, the Reserve Bank did indeed maintain confidentiality. Whether its monitoring was "on a day-to-day basis" is not entirely clear. Certainly it was considerably more intrusive in package B than in package A. Under package C, Bankorp's problems became subsumed within those of ABSA, which probably did at the time demand considerable monitoring.

6.3.3 Evaluation against best international practice

Evaluation of the finance the S A Reserve Bank provided to Bankorp and ABSA against examples of best international practice described in Section 6.2 requires evaluation of three distinct, but linked, Reserve Bank decisions:

1 The 1985 S A Reserve Bank agreement with Bankorp and subsequent changes in it up to 1990 (package A).

2 The 1990 S A Reserve Bank agreement with Bankorp (formalised 1991) (package B).

3 The 1992 S A Reserve Bank transactions with ABSA that became the basis of a subsequent agreement in 1994 (package C).

Package A, it has been argued, was a "lender of last resort", liquidity support operation arising from fears that delinquent loans would cause losses leading to signals that would trigger a deposit run. It was argued that a run on Bankorp would cause a systemic failure, or, in other words, that Bankorp was "too big to fail".

This finance, structured as a loan, was provided in a manner that did not meet the best practice standards that were then current.

As a pure lender-of-last-resort operation (providing liquidity to a solvent bank) the loan did not satisfy the conditions that:

- it be short term; and
- it be at a "high" interest rate.

The loan losses of Bankorp undoubtedly raised questions about whether this was a pure liquidity support operation (providing liquidity to a solvent bank) or whether there was actual or potential insolvency. The package could in some respects have been viewed as solvency support to an insolvent or potentially insolvent, but saveable, bank. Therefore the transaction had some characteristics of a "lifeboat" to assist insolvent or potentially insolvent institutions. The length of the initially agreed arrangement, and the absence from it of a high interest charge confirm that interpretation. Although the package has subsequently been described as a "lifeboat" it did not have the same characteristics as the UK lifeboat of the 1970s.

The S A Reserve Bank did not require a management restructuring at Bankorp. Correspondence from Bankorp recognised that a change of management was likely to be demanded as a condition for assistance, but in fact none was required by the Bank.

The arrangement did not impose costs on shareholders. Sanlam did inject more equity finance, but that did not involve any dilution of its equity stake; on the contrary it meant that its higher equity stake enabled Sanlam, in principle, to obtain a higher share of the benefits accruing from the subsidies the S A Reserve Bank assistance provided to Bankorp.

Package B was intended solely as solvency support to compensate Bankorp for the costs involved in writing down its delinquent assets. Bankorp was unable to repay its existing debt to the S A Reserve Bank and the extent of its delinquent assets was recognised (although, as subsequently became clear, their full extent was not known). The assistance was a grant from the Bank structured as a simulated transaction in which it appeared as a loan. It did not accord with best practice for solvency support operations because:

- a simulated transaction was used; and
- the S A Reserve Bank took no equity stake or other form of compensation for the grant assistance it gave.

However, one characteristic of "best practice" solvency arrangements was included:

- Reserve Bank assistance was conditional upon an injection of capital by the majority shareholder.

Package C was a continuation of the solvency support arrangement agreed in 1990 (and formalised in 1991). In other words it was a grant hidden in the format of a "simulated transaction". At this stage the benefit was transferred to ABSA, with ABSA's purchase of Bankorp in 1992, although the formal agreement was only signed in 1994.

From 1992 ABSA received a grant for which it did not qualify since ABSA was not suffering liquidity or solvency problems. ABSA chose to buy Bankorp for purely commercial reasons. In determining the price it was willing to pay, ABSA took into account the remaining payments it would receive on transfer of the S A Reserve Bank/Bankorp agreement, although, for unknown reasons, the written agreement to transfer the benefits was not concluded until 1994. Thus, following discussions with the Reserve Bank, ABSA finalised its takeover in 1992 on the assumption that a revised agreement would be satisfactorily negotiated. Because the price was determined in that way the shareholders of Bankorp gained from the prospect of the continuing grant from the S A Reserve Bank. If the premium ABSA paid in respect of the grant was less than the discounted value of the grant, the shareholders of ABSA also gained from it. In this case, since the continuation of the grant was not needed to protect Bankorp depositors after 1992, either Bankorp shareholders alone gained from an unwarranted (future) grant, or both ABSA and Bankorp shareholders gained. These matters are considered further in Section 7.2 of this Report.

6.4 Questions of motivation

Dr Stals has argued that the reason for assistance to Bankorp/ABSA was solely to ensure the stability of the financial system. Such an objective would be in line with one of the core objectives of central banks everywhere. To estimate whether a failure of Bankorp would have caused systemic failure requires a calculation of the extent to which its deposits, loans and transactions created links with the rest of the financial sector (and non-financial sectors) as well as a simple measure of the size of its balance sheet. The Panel does not have such a "network" measure and doubts that the S A Reserve Bank or any other central bank would have been able to carry out such calculations in such circumstances. But in terms of asset size, immediately before its purchase by ABSA, Bankorp was one of South Africa's largest banks and was probably of a similar or higher rank in 1985. That is a strong reason for thinking that a Bankorp failure would have had serious negative implications for the banking system and the economy.

Dr Stals has also argued that the form of assistance was consistent with the practice and principles of central banks elsewhere. The Panel finds that the packages were not in line with contemporary or subsequent international best practice.

The preceding sections summarise the defective nature of the (different) packages provided by the S A Reserve Bank to Bankorp/ABSA, particularly from 1985 to 1990 and 1992 to 1995. The question arises as to why the S A Reserve Bank, which had long been an accomplished central bank with a leadership well versed in both the academic principles and practical arts of central banking, should have structured its assistance in a flawed manner.

Some commentators have implied that, instead of merely aiming to protect the financial system, the S A Reserve Bank conferred benefits on the shareholders of Bankorp and ABSA because the Bank viewed those companies in a specially favourable light for unspecified reasons or because of close personal ties between key players. There were, indeed, social links between several key players, but that was true of many within South African banking circles (mirroring the nature of banking in most other countries). One version of the hypothesis in the public domain is that those close personal ties were linked to other forms of association within the Afrikaner elite such as the Broederbond.

The view that those shareholders were granted especially favourable treatment would be reinforced if the reasoning used by Dr Stals – that Bankorp was, in the standard phrase "too big to fail" (meaning "too big to be allowed to fail") – were inaccurate, but, as pointed out, the Panel believes it was a reasonable judgement for the Reserve Bank to make.

However, the size of Bankorp raises further questions about the role of the S A Reserve Bank. Why was Bankorp allowed to grow to the size it had reached in 1985? The Panel considered possible explanations. If either of the first two were true they would support the idea that the S A Reserve Bank was giving special treatment to the banks in the Bankorp group.

One hypothesis is that the Bankorp group expanded its lending aggressively and without the proper evaluation of risks that a bank owes its shareholders and depositors, and that the S A Reserve Bank had condoned this or permitted it to happen. Clearly the banks that were taken over by Bankorp before 1985 had expanded recklessly, especially Trust Bank which itself had received Reserve Bank assistance as early as 1976. And between 1985 and 1990, Bankorp had again expanded vigorously, acquiring low quality assets.

A second hypothesis is that the S A Reserve Bank condoned the growth of Bankorp in order to enable it to become a bank that was "too big to fail", thus similarly giving favourable treatment to a particular group (and introducing moral hazard in acute form).

A third hypothesis concerning the growth of Bankorp is that the S A Reserve Bank had encouraged Bankorp to assist the banking sector by taking over failing banks in order to prevent instability in the system as a whole.

A fourth hypothesis is that Bankorp's expansion through taking over weak banks was the consequence of the absence of an effective system of bank supervision in the 1970s and early 1980s (it was only in 1987 that the responsibility for banking supervision was transferred from the Ministry of Finance to the Reserve Bank).

The Panel's terms of reference do not require an investigation of the hypotheses listed here concerning the possibility of a special relationship and has no evidence to enable us to reach any conclusion on them.

6.5 Conclusions

The review of internationally accepted principles of best practice leads to the following conclusions:

1 It is important to distinguish between the justification for a central bank intervening in respect of a distressed bank and the modalities of the intervention; between the validity of the ends and the means. In the case of Bankorp/ABSA the Panel finds that intervention with the objective of averting a systemic crisis of the banking sector was justified. However, by the standards of international best practice the methods were flawed. Whether providing liquidity support to Bankorp, as in the early stages of its

intervention, or providing solvency support in the early 1990s, the S A Reserve Bank's methods did not conform with internationally accepted principles for dealing with distressed banks.

2 In so far as the assistance was designed as liquidity support:

- it was not short term; and
- it was not at a high interest rate;

and therefore did not meet international standards.

3 In so far as the assistance was designed as solvency support:

- The assistance was a grant for the direct benefit of shareholders that was disguised as a loan by means of a simulated transaction. The Panel has not found any reputable central bank using such techniques.
- Although it was a grant the Reserve Bank took no equity claim on future profits, as international best practice would require. As it turned out the assistance led to the continued operation of Bankorp, ultimately under the ownership of ABSA, and in the absence of such a claim all the benefits of the assistance accrued to shareholders.
- The Reserve Bank did not attempt to remove bad debts from Bankorp to a special institution charged with managing them separately, as was achieved elsewhere (for example by the publicly owned US Resolution Trust Corporation or by privately owned institutions — so-called "bad banks" — elsewhere).
- The Reserve Bank did not attempt to organise a merger with sound banking institutions, which would have been desirable under international principles; Bankorp's takeover by ABSA was not prompted by the Reserve Bank.
- The assistance was provided over a period that was unusually long by international standards.
- The Reserve Bank did not require replacement of the directors and managerial team of the distressed bank.

4 Looking at the whole period of liquidity support followed by solvency support, several overall features of the assistance methods were flawed by international standards:

- The total period of assistance was extremely long.
- The Reserve Bank accepted successive Bankorp requests for more assistance.

- Despite those successive requests the Reserve Bank did not investigate the problems of Bankorp, or accurately assess the need for solvency support in an adequate or timely manner.
- Similarly the Reserve Bank did not in a timely manner require Bankorp to reduce its balance sheet and did so only late in the process.

5 Dr Stals has argued that the Bankorp/ABSA assistance was normal international practice. The Panel concludes that its objective was in line with international best practice, but its methods were deficient in comparison with such practice. Included in the defects the Panel has noted here, are two that warrant further comment in conclusion:

- A review by Goodhart and Schoenmaker of international experience before and after 1985, involving 104 cases of assistance to distressed banks and 23 countries, reveals no examples where solvency assistance has been given as a grant disguised as a loan by a simulated transaction (Goodhart, 1995: Annexure 3 to Chapter 16 in the book). Although Dr Stals has argued that the Bank of Italy had such powers from 1974 in reality its power was different; a Ministerial Decree of 1974 empowers the Bank of Italy to give a grant in the form of a stream of net interest only in cases where an insolvent bank is being liquidated and the grant is to the bank acquiring the business of the failed bank and is, therefore, for the direct benefit of depositors (not, as in this case, the shareholders of a non-liquidated bank).
- The objective of all the international examples of bank assistance practice and principles reviewed here was to protect the banking system and its depositors. In the UK lifeboat committee there was clear recognition of the undesirability of protecting shareholders and that principle has been set out in central bankers' statements. In the Bankorp/ABSA case no such distinction is apparent. In fact the outcome of the assistance was to benefit shareholders, for the net asset value of Bankorp was raised by the assistance and the price they received when taken over by ABSA reflected that fully.