8 SECTION 8: BEST PRACTICE FOR FUTURE CONDUCT

(Fourth term of reference: to determine guidelines and best practice with regard to possible future conduct of the S A Reserve Bank with regard to banks in distress)

8.1 Lender-of-last-resort facilities – current best practice

Introduction

This chapter deals with the Panel's fourth term of reference which requests the Panel to *determine guidelines and best practice with regard to possible future conduct of the S A Reserve Bank with regard to banks in distress*. To do that it is first necessary to examine the current practice of major central banks in the provision of assistance to troubled financial institutions, identifying what might be construed as best practice and examine the extent to which such best practice is actually achieved. Current best practice has in fact changed little since those earlier exemplars quoted in Chapter 6. The principles outlined there have withstood the stresses imposed by a number of financial crises around the world in the 1990s. Then the chapter describes current practice by the S A Reserve Bank and concludes that it accords considerably more closely with international practice than was the case at the time of the Bankorp assistance. The treatment of banks in distress cannot be looked at in isolation, however, the subject needs to be considered in the context of the financial and regulatory architecture as a whole. In this context, the chapter concludes by making some recommendations as to further improvements that might be made to the overall architecture to ensure that South African practice continues to comply with the best practice of governments, central banks, and supervisory authorities elsewhere.

8.1.2 Current international practice

8.1.2.1 The need for reticence

There is considerable academic literature on the provision by central banks of lender-of-last-resort facilities, which discusses, in particular, the delicate balance that needs to be struck between avoiding systemic instability on the one hand, and discouraging the disciplining of banks by their creditors on the other hand. This is the so-called moral hazard problem often referred to in the literature on the subject (Freixas and

Giannini,1999). But central banks themselves have been much more reticent and have published little material on their own policies and practices. Observed practice still appears to follow the principles laid down over a hundred years ago by Walter Bagehot (Bagehot, 1873). But central banks are remarkably reluctant to comment, particularly on incidences where their practice in specific cases may have departed from Bagehot's recommendations.

Few central bank laws even provide explicitly for the provision of last-resort facilities, although they rarely exclude them. There are exceptions. The Federal Reserve Act, and the Federal Reserve Board’s Regulation “A”, do specify, in some detail, the manner in which the Federal Reserve Banks should lend to member banks. And some other central bank legislation, for example in Norway and New Zealand, specify a last-resort facility. But many of the older central banks' statutes are silent on the topic. For example, there is nothing in the Bank of England's legislation (although a general statement appeared recently in the October 1997 Memorandum of Understanding between the UK Treasury, the Bank of England, and the Financial Services Authority to the effect that support operations may occur in the exceptional circumstances of a genuine threat to the stability of the financial system). The legislation empowering other major European central banks does not mention lender-of-last-resort functions, nor is there any reference in the legislation empowering the new European Central Bank. One reason for this reticence is a desire to convince markets that the use of last-resort facilities should be, and is, an extremely rare occurrence. To set out the rules for use of last resort-facilities risks an impression that their use will be routine. Some central banks would even deny the possibility of their acting in this way.

However, in recent years, central banks have, in general, become a little less reticent on the subject in response to pressure from governments, the markets, and the financial press, to be more transparent about their operations, modern desiderata being summarised in IMF Code of Good Practice in Transparency in Monetary and Financial Policies.

Many central banks now make an explicit responsibility for the maintenance of financial stability one of their principal objectives. To discharge this responsibility, central banks accept that there should be a system of financial supervision, particularly of commercial banks, and increasingly of other financial intermediaries as well, whether provided by the central bank itself or by other agencies. As well as such precautionary measures, many countries now accept the need for a deposit insurance system to protect the more vulnerable depositors on occasions where banks fail despite the efforts of supervisors and the existence of disclosure requirements. But most central banks also accept that there are circumstances where it would be appropriate for them to intervene to prevent such failure taking place by providing financial assistance of some kind, if only to alleviate the risk of contagion and consequential damage to the workings of the financial system as a whole.

For example, central bank accounts and annual reports now conventionally disclose much more than was the case in previous years. Central banks are often now required to account directly to legislatures as well as to Ministers, and this means that such accountability has to be more public than was previously the case. Central bank financial statements now often follow commercial standards of accounting best practice, and this makes it more difficult to refrain from disclosing use of lender-of-last-resort facilities. Improved accounting standards have also made it more difficult for the recipients of central bank facilities to avoid disclosing that fact. It is also important to reassure the public that central bank facilities are used consistently, and that decisions are made objectively and without acceding to improper pressures.

Nevertheless, many, if not most, central banks are still reluctant to spell out in advance even the general principles under which they might be prepared to make last-resort facilities available to banks, for fear of encouraging imprudent behaviour by banks which would then know that the central bank would be prepared to assist if they ran into problems. Too forthcoming an attitude would also encourage creditors of banks to believe they would always be protected and, therefore, discourage the process of market discipline, still the main deterrent to imprudent behaviour on the part of commercial banks. In addition central banks are also conscious of the fact that it is always difficult to predict what sort of problems banks will encounter that would justify the provision of last-resort facilities. To set out too much in detail in advance would deprive central banks of much-needed flexibility.

8.1.2.2 The basic principles

Some of the basic principles that can be applied have, however, been described, notably by the Governor of the Bank of England. In the 1993 speech quoted in Chapter 6, he set out the principles governing the Bank of England's policy. These principles are still probably the most often quoted example of good practice. He noted that:

- The Bank of England sees as its task the provision of a regime in which the users of financial services can benefit from robust competition among financial firms, which will not happen unless each individual firm takes on some risk.
- Banks can fail and depositors can lose some of their money, otherwise, if depositors were relieved of all responsibility, deposits would simply flow to the highest bidder regardless of risk, which would undermine market disciplines.
- The Bank of England does not see as its job the prevention of each and every bank from failing, but when a bank does seem likely to fail, the central bank must at least consider the option of supporting it.
- In reaching a decision on support, the Bank of England takes care not to be predictable. It is essential that no one should expect support as a matter of course. The size of a bank suffering difficulty is an important factor, but no assistance will be granted automatically.

The major issues that the Bank takes into account in deciding whether to intervene are:

- What effect will the failure of the institution have on the system as a whole?
- What should be done to protect the system from contagion?

The Governor then described the five criteria outlined in Section 6.3.1 above, which he stated governed the Bank of England's actions. These five criteria are generally regarded as the most comprehensive and explicit guide given to date on international best practice and can be summarised as:

- Explore private sector commercial solutions first.
- Avoid at all costs public subsidies to private shareholders.
- In normal circumstances, any support given should aim to provide liquidity, not support insolvent banks.
- Have an exit strategy which enables disengagement at the earliest possible opportunity.

- The provision of systemic support may be kept secret but should be disclosed when the danger has passed.

It was noteworthy that this was the first time the Bank of England had spoken in detail on the subject and the Governor did so, in part at least, to justify actions the Bank of England had taken in the recent past. The Bank of England had, in the previous two years, supported some quite small banks having allowed rather larger institutions to fail without support, and this had raised questions about the Bank of England's policy stance. In one case, Commonwealth Merchant Bank, it was even believed that the bank was solvent, yet the Bank of England had refrained from intervening and the institution was closed. The Governor noted that the Bank of England only provides support to protect the financial system, and thus potential damage to the economy as a whole, and not to protect a particular institution, its creditors or even less its shareholders or managers.

8.1.2.3 Is best practice always achieved?

These principles are extensive, but they do not, however, cover all cases where central banks have felt obliged to extend assistance. In most countries central banks have, on one occasion or another, extended facilities to banks that they believed might be insolvent. The fact that Bagehot does not countenance such behaviour and that central banks rarely admit to the possibility does not, however, mean that such occasions do not happen in practice. In many cases, of course, a central bank may conclude that the stability of the financial system requires that an institution that may not be solvent be nonetheless supported, at least temporarily, until a long term solution to its future can be found, whether by private or public shareholders recapitalising it, or by the authorities winding it down so as to avoid contagion and unacceptable damage to the financial system. It is not just that establishing solvency in such cases is difficult. Even in cases where a bank is clearly, or probably, insolvent there are numerous cases where it is known that central banks or governments have intervened to provide support. In many cases, the banks have been recapitalised by the government, or some public agency, at the taxpayer's expense.

So while it may be stated that best practice is to lend only to solvent institutions, and many central banks are required, by their statutes, to lend only in such situations, in practice many central banks, but normally only with the formal backing of their governments, have found it necessary to go beyond this dictum when they have judged the systemic risk of not intervening to pose unacceptable costs. Research done by the IMF has shown, for example, that at least three-quarters of countries have experienced significant systemic failure in the last two decades. In the majority of these cases, official intervention has resulted in a charge to public funds, and in many of them very large losses indeed have been incurred (Lindgren et. al., 1996). Probably the majority of OECD countries have on one occasion or another intervened to support the financial system from the consequences of the precipitate closure of one or more insolvent banks. Clearly, none of these central banks would now admit to the possibility of doing so in the future, and probably most would not have done so before the occasion arose that demanded such action. Nonetheless, it is clear that while to lend to solvent institutions only may be best practice, that is an ideal that has rarely been lived up to in the past, and assisting insolvent institutions must remain a possibility in the future. It may be inferred that intervention to prevent systemic risk is also good practice. Such a judgement is even more difficult to make than assessing solvency of an individual institution. It is hardly surprising, therefore, that few central banks if any have attempted to define the criteria by which such a judgment would be made. The consequences of dealing with cases of systemic risk are almost always expensive, whether affected institutions are left to exit the system of their own accord or the authorities intervene to prevent failure. That is why much attention has been devoted in South Africa and in most other countries to enhance the capability of the supervisory systems to give governments and central banks the means to prevent crises or at least provide sufficient prior warning of crises to avoid the need to deploy massive use of public funds.

8.2 Current South African practice

8.2.1. Introduction

The practices of the S A Reserve Bank for assisting banks in distress have been the subject of much misunderstanding by the public, the financial press and financial institutions themselves during the past few decades. The reasons for this include:

- The secrecy which traditionally surrounds such practices due to the perceived need to protect the reputation of the bank concerned in the market place.
- Confusion between the various types of assistance which might be extended (in particular the use of the vague terms “lender of last resort” and “lifeboat” that are

open to a variety of interpretations) and the instruments used to extend such assistance.

- A desire on the part of the authorities to avoid a pattern of predictable behaviour for the reasons discussed above.

As in many other countries, a clear written statement covering all aspects of the Bank's policies on assistance to distressed banks of all the various types is not available. The summary set out below has been compiled principally from the 1999 *Annual Report* of the Bank Supervision Department of the S A Reserve Bank, but, as the report stresses, the Department can only give its perception of lender-of-last-resort policy, as this policy is the domain of the Governor and directors of the Bank itself.

8.2.2 1999 Annual Report of the Bank Supervision Department

Towards the end of 1999 a number of the smaller South African banks experienced liquidity problems due, *inter alia*, to the placing under curatorship of New Republic Bank and FBC Fidelity Bank and the feared consequences of expected computer problems owing to the date change from 1999 to 2000 (the Y2K problem). Consequently the question of LOLR assistance by the Bank became a matter of renewed public debate. In an effort to clarify the situation the Registrar of Banks published in the 1999 Annual Report of the Bank Supervision Department a section headed *Role of the S A Reserve Bank as Lender of Last Resort*. The section relevant to the terms of reference of the Panel is discussed below.

Responsibility for LOLR policy

The report of the Bank Supervision Department makes it clear that policy on the Bank's role as LOLR is not the domain of the Registrar of Banks but that of the Governor of the S A Reserve Bank. The policies as set out in the Report are held to be *based on the internationally accepted theoretical approach to the issue*.

The report describes three categories of funding or liquidity support that monetary authorities provide to banks:

- Intra-day or overnight liquidity in order to alleviate short-term cash flow shortages (accommodation system or, in South Africa, the *repo system*).

- LOLR support to banks experiencing funding difficulties on a short-term basis (*LOLR function*).
- Longer-term liquidity support and/or solvency support (the so-called *lifeboat*).

This Report focuses on the second category of liquidity support, i.e. the LOLR function of the Bank as defined above.

Objectives of LOLR support

The report of the Bank Supervision Department defines the objective of the second category of liquidity support as follows:

- Firstly, to provide some breathing space to an institution facing short-term funding problems in order to enable it to implement corrective measures.
- Secondly, to prevent illiquidity from precipitating a situation of insolvency and to prevent the contagion effect of bank runs.

Preconditions for LOLR support

The basic precondition for the provision of LOLR support is the judgement of the S A Reserve Bank that the failure of an illiquid banking institution, if it were to be deprived of liquidity assistance, could damage the stability of the monetary or financial system (that is, systemic risk would result). In addition, a number of preconditions for LOLR support would apply. These preconditions include that:

- The institution has a sufficient margin of solvency. The adequacy of the bank's solvency margin would normally be subject to a "due diligence" review by an accountant appointed by the S A Reserve Bank.
- The LOLR support will be collateralised adequately.
- The institution has sought other reasonably available sources of funding before seeking LOLR assistance.
- The shareholders of the institution have made all reasonable efforts to provide liquidity and/or solvency support as a demonstration of their own commitment to the institution.
- There is no *prima facie* evidence that the management is not fit and proper or that the liquidity problem is due to fraud.
- The institution has developed and is committed to the implementation of a viable plan of appropriate remedial action to deal with its liquidity problems.

Instruments used to provide LOLR support

The report of the Bank Supervision Department goes on to discuss the basic instruments used to provide LOLR support and various other aspects relating to their use. This discussion does not directly relate to the type of assistance provided to Bankorp which would fall into the third category as defined above, i.e. “longer-term solvency support” – the so-called “lifeboat”.

Funding support requiring specific approval from the Minister of Finance

The S A Reserve Bank’s policy relating to solvency support (often referred to in South Africa, misleadingly so in the Panel’s view, as “lifeboats”) is not specifically discussed in the report of the Bank Supervision Department. It does, however, list the following situations which would require the specific prior approval of the Minister of Finance:

- The institution is unable to comply with the preconditions for LOLR support set out above.
- It is considered necessary to give the institution a breathing space longer than that normally provided.
- It is considered necessary to provide funding or solvency support that exceeds the LOLR support criteria set out above.
- The institution concerned cannot provide eligible security as prescribed.

Any funding provided in these circumstances would have to be considered on its merits in the light of the implications for systemic stability. It could be inferred that the assistance given might be extended to solvency assistance if the institution in question was also insolvent and its failure was considered to pose a real threat of systemic risk.

Application of principles in practice

Other than the report of the Bank Supervision Department described above, a written exposition of the S A Reserve Bank’s policy in relation to assistance to distressed banks does not exist. However, senior S A Reserve Bank officials have from time to time expressed agreement with the principles set out by the Governor of the Bank of England, Sir Edward George, and described above.

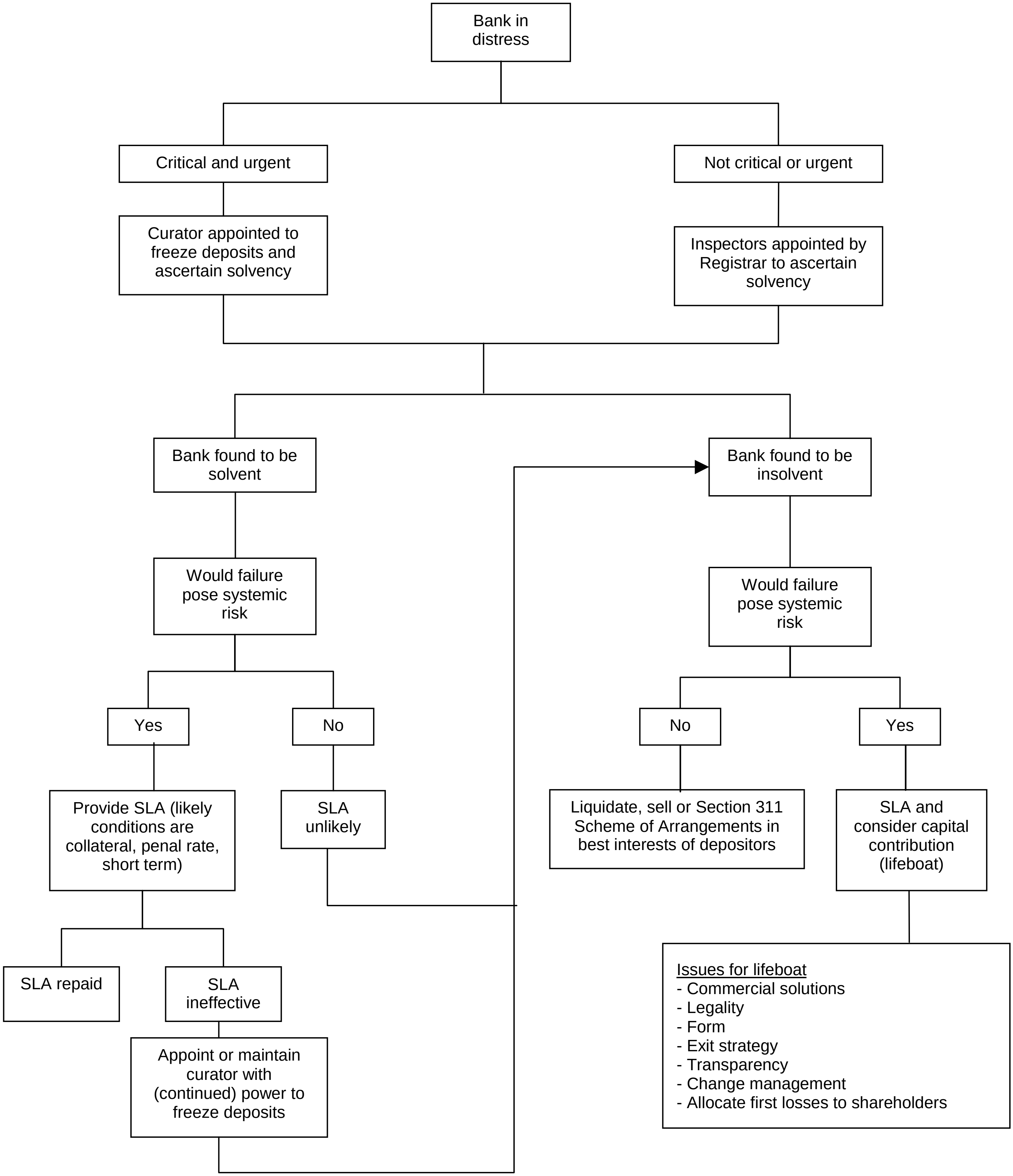
These sentiments appear to have been supported in a speech given by Dr Stals on 15 April 1994, when he said that:

- Neither the central bank nor the Bank Supervision Department can guarantee the safety of deposits placed with financial institutions.
- In the final analysis depositors must carry the full risk and responsibility for their investments.
- The central bank has no obligation to protect depositors against losses, provided the S A Reserve Bank takes due account of the dangers of a breakdown of the total banking system.

The Panel's understanding of the decision-making processes and institutional arrangements involved are described in the chart below.

8.2.3 Current South African practice

This diagram illustrates the current application by the South African authorities of their principles and procedures for the consideration and treatment of distressed banks.



SLA	=	Special liquidity assistance or lender-of-last-resort assistance
Lifeboat	=	Term incorrectly used in South Africa, meaning capital contribution by authorities to insolvent bank (solvency support)
Solvency	=	Less than 4 per cent capital adequacy ratio
Curator	=	Similar function to receiver or judicial manager

8.3 Consistency of South African current practice with international *best practice*

To what extent do these policies and practices comply with the standard identified above? It is worth noting that South Africa has not experienced systemic problems of a kind that many other countries have experienced, for example in Scandinavia, Latin America and East Asia. Support given to banks in the past (as is made clear in earlier chapters of this Report) has involved losses which have ultimately been borne by the taxpayer. Although the S A Reserve Bank is, unusually, wholly owned by private shareholders, its marginal net income is paid to the government so any loss it incurs through support operations diminishes those payments and effectively results in a cost that is born by the taxpayer, as with central banks that are wholly government owned. But these costs have been relatively small compared with the size of the economy or with the government's fiscal expenditures.

The Panel believes the arrangements described above are fully consistent with its understanding of current international best practice described earlier in this chapter. For that reason, the Panel does not feel it necessary to develop new guidelines as suggested in its terms of reference. But the Panel does stress the importance of the authorities adhering to the practices described here.

Moreover, current S A Reserve Bank practice in relation to assistance given to troubled banks is adequately documented. For example, the three principles outlined by Sir Edward George in his 1993 speech, namely the promotion of competition, acceptance that banks can fail, that the central bank's responsibility is not to prevent failure in all cases, and that where it does intervene it does not do so in a predictable manner, are reflected in the report of the Bank Supervision Department and the speech of Dr Stals in 1994, described earlier. As regards Sir Edward's five criteria outlined earlier, it is evident from the procedures described above and from their implementation in recent cases that the Reserve Bank now:

- explores private sector commercial solutions first;
- avoids public subsidies to private shareholders;
- in normal circumstances confines its assistance to the provision of liquidity to solvent banks;
- ensures it has an exit strategy where it intervenes in insolvent banks; and
- retains the right to act confidentially where not to do so would hinder the effectiveness of its actions.

8.3.1 Conclusion

The S A Reserve Bank's current tests are, in general, in line with best practice in most other countries. It is not necessary to devise new guidelines, only to ensure that current policies and procedures continue to be implemented effectively and impartially.

Where South African practice may diverge from best international practice is by being more ready to intervene in banks with small depositors which could have been protected by deposit insurance if such protection existed. There is also some risk of moral hazard in the detailed explanation of policy. These two aspects are considered in detail in the following section.

8.4 The context of central bank assistance: the regulatory and financial policy architecture

8.4.1 Introduction

A framework for financial transfers from the S A Reserve Bank to banks in distress cannot be considered in isolation, however, for the appropriateness of such intervention depends on the wider framework of regulation and responsibility for the system's soundness. Regulation of and intervention in banks is different from regulation of other firms and is justified by the presence of large external costs of a bank's failure (system-wide effects) and the inherent presence of information imperfections (asymmetric information) which prevents depositors and others from making their own efficient estimates of a bank's risk (Freixas and Rochet, 1997: Ch 9).

The developments described in this Report demonstrate that there is a clear need for a transparent and consistent framework for assistance by the S A Reserve Bank to banks in distress. The framework should, and in the Panel's view does, provide guidance on the role and procedures of the Bank in assisting banks in distress.

In general terms the justification for such assistance, whether the provision of liquidity or solvency support, derives from the central bank's responsibility for the soundness of the currency and the banking system as a whole. The current practice of the Bank, which is in line with international practice, is to interpret its responsibility for the banking system as a whole, e.g. by permitting individual bank failures. Therefore its intervention in individual cases of bank distress is determined solely in relation to the potential systemic effects of bank distress. The Panel endorses the consistent application of that approach.

The need for intervention in individual banks to protect the banking system as a whole, and the methods used in any such intervention are affected by the regulatory and financial policy architecture, the framework of rules and institutions within which the banking system operates. The main relevant elements of the financial and regulatory architecture are systems for bank supervision (including bank licensing) and deposit insurance. If a sound system of deposit insurance is in place, assistance that might otherwise be justifiable on the grounds of protecting small depositors, or protecting them to prevent a wider panic and systemic failure, would not be valid. Deposit insurance is likely to increase the incentive for managers to take unwarranted risks with depositors' assets (moral hazard) and therefore depends upon a strong supervision system including effective bank licensing and delicensing arrangements.

The interrelation between central bank financial transfers to distressed banks, deposit insurance, and supervision (including licensing) leads to the consideration of further changes that might be needed to strengthen the system.

8.4.2 Risk, distress, and central bank actions

Before considering what further improvements may be desirable, it is worth reviewing central banks' responsibility for the soundness of the currency or the banking system as a whole. The rationale for intervention and the appropriateness of particular interventions are founded on a distinction between the different possible sources of distress. The risk of distress is due to four possible types of risk (which are, in many instances, interrelated):

- Credit risk
- Liquidity risk
- Market risk
- Operational risk

These risks are present across the range of a bank's operations. Operations involve more than the simple functions of operating the payments system and selling retail deposits which finance the bank's non-marketable loans and its holding of fixedinterest securities. Additionally banks carry out a wide range of market operations in foreign-exchange markets, money markets, and securities markets, including market-based or over-the-counter (tailored) derivatives contracts. The following examples focus on the risks arising from the simplest forms of bank business.

Credit risk: includes the risk that the credit quality of a debtor may deteriorate. The clearest example is the risk of a borrower defaulting on its loan.

Liquidity risk: includes the risk that depositors may withdraw funds in a “bank run”.

Market risk: includes the risk that the value of an asset owned by the bank may lose market value.

Operational risk: includes the risk of faulty management systems within the bank.

In the case of Bankorp’s operations between the early 1980s and at least 1989 the apparent distress that led to requests for assistance stemmed from extremely poor management (operational risk) of:

- the risk of borrowers defaulting (credit risk), and
- a belief that the resulting delinquent loans and the potential deterioration of the bank’s capital had created a risk of a severe run on deposits (liquidity risk).

It is reasonable to conclude that operational risk in the form of poor management played an important role at various stages and was the fundamental cause of Bankorp’s problems. Management failure is, in fact, a widespread cause of bank failure in other countries (Siems, 1992; Barker and Holdsworth, 1993).

In the following paragraphs recommended future policy for financial stability, and specifically for deposit insurance, and supervision are considered in the light of those risks.

8.4.3 Supervision

The supervision of banks includes supervision and regulation at three stages in the life of a bank:

- Licensing of a new bank and periodic re-licensing.

- Supervision of ongoing operations and asset-liability positions including off-balance sheet positions.
- Intervention in a distressed bank including curatorship and de-licensing.

Bank supervision occurs within a global framework, enshrined, for example in the Basel Core Principles for Effective Banking Supervision and related documents of the Bank for International Settlements (Basel Committee on Banking Supervision, 1988, 1996, 1998,1999). The Core Principles relate not just to the supervision of banks with an international reach but also apply to the supervision of smaller national banks. They require supervision of banks' ability to manage risk and the maintenance of adequate capital in relation to the bank's risks in all its operations and positions (risk-weighted capital requirements). One important element in the modern application of the Basel Core Principles is the supervision of management's ability to exercise best practice in managing risk. Another is the requirement for early intervention by supervisors in banks with worsening positions.

For South Africa the Panel recommends the maintenance of best international practice in accordance with the Basel Core Principles and related documents. The criteria for granting bank licences should be consistent with these principles, giving special attention to ownership structure, management quality, management systems, and capital structure.

Current and developing supervision policy in South Africa does broadly meet those requirements (S A Reserve Bank, Bank Supervision Department, 2001). In the mid 1980s when Reserve Bank assistance to Bankorp began, no adequate, explicit principles and procedures for bank supervision existed in South Africa, but subsequently South Africa's supervision principles and practice have developed strongly and in line with international trends. Since the transfer of the responsibility for bank supervision to the Reserve Bank in 1987 and following the Banks Act of 1990, South Africa now has a supervisory regime that is strong by international standards.

The continued development of bank supervision in South Africa requires a choice between alternative institutional arrangements (financial and regulatory architecture). A central question is whether supervision of individual banks should continue to be the responsibility of the Reserve Bank or whether all supervisory functions should be transferred to a new Financial Services Authority with responsibility for supervising banking services and the operations of non-bank financial firms (thereby absorbing the supervisory functions of the Reserve Bank concerning banks, those that the Financial Services Board ("FSB") exercises over non-bank financial firms, and those concerning part-banking conglomerates which are split between the Reserve Bank and the FSB).

South Africa's regulatory architecture is currently being considered by the Policy Board for Financial Services and Regulation. It is the Panel's view that it is undesirable, at least at this stage, for responsibility for prudential supervision of banks to be removed from the S A Reserve Bank. The principal reason is the close relation between supervision and the Bank's lender-of-last-resort function, which is discussed in the following paragraphs.

8.4.4 The relationship between the supervisor and the lender of last resort

There have been suggestions in South Africa that, as in other countries, the supervision of all financial intermediaries be combined within one agency. This development, which began first in Scandinavia some years ago, has taken place in a number of other countries, such as Canada, and much more recently, the UK, Japan, and Australia. In many of these cases, responsibility for the supervision of banks was in the hands of the central bank, and has been removed to the new agency. The result is that the central bank must carry out its responsibilities as lender of last resort without the benefit of the intimate knowledge of individual banks acquired through the supervisory process. If a new agency were set up in South Africa combining the functions of the Bank Supervision Department of the Reserve Bank and those of the FSB, a similar eventuality would occur in South Africa.

Many central bankers have stressed the importance of close working relationships between at least the major banks and the central bank if the latter is to discharge its responsibility for the maintenance of the soundness of the financial system. The Federal Reserve System in the USA is particularly articulate on this subject, arguing that, in its experience, the relationship developed through day-to-day contact with the major banks and its intimate knowledge of the risk profiles of the banks, goes hand in hand with its discount window operations and its ability to respond appropriately at times of distress in the financial system.

One aspect that is of critical importance when changes of responsibilities are contemplated is the maintenance of the effectiveness of the supervisory agency. Not only does a supervisory agency require substantial statutory powers, and to be well-resourced in terms of manpower and skills, but it also needs to have a standing within the system such that it can take sometimes unpopular decisions and generate support from the government, the central bank, and the banking community and indeed the public at large, for its actions. It is clear that the S A Reserve Bank has that status. The FSB is a newer organisation in its present form, and although its effectiveness has improved it has yet to be tested in coping with a major threat to the system. If a combined agency were to be formed it would be critically important that its powers and responsibilities be well-supported by its enabling legislation, and that it should be well-resourced so that it could do its job with technical proficiency and, most important, that it would be able to act decisively when a problem arose. Many supervisory failures can be attributed not so much to inadequate statutory powers, or even to lack of resources, but to an inability to muster support for decisions that often affect powerful vested interests to their detriment.

The second requirement is that such an agency should have a close relationship with the central bank. When a situation arises that threatens the stability of the financial system, it is important that the supervisory agency and the central bank act in close co-ordination. This is an aspect that has concerned all those countries that have made these changes in responsibility. One solution is to set out, in a memorandum of understanding for example, the responsibilities and obligations of the central bank, the supervisory agency, and the government, in a formal way. These responsibilities include the gathering and transmitting of information and the processes of consultation that must precede any action with respect to a distressed institution, often within a compressed time period. The problem that South Africa would face is not a lack of precedents, but that many of these arrangements for co-ordination and information sharing have yet to be tested. It may, therefore, be advisable, so long as the present working arrangements between the S A Reserve Bank and the FSB are satisfactory, to delay more fundamental changes until more international experience has been gained. Let others undertake the experimentation so that South Africa can learn from their experiences. Meanwhile the establishment of a Financial Stability Department within the S A Reserve Bank to monitor financial stability as a whole is a helpful development which will ensure that any future transfer of responsibilities avoids the creation of gaps and conflicting responsibilities.

8.4.5 Deposit insurance

As has been shown in earlier chapters, the South African financial system, while well-developed and now dominated by institutions believed to be sound and well-managed, nonetheless has some of the features of less mature financial systems found in other emerging-market countries. For example, it includes a number of small institutions which provide services to unsophisticated customers. It may be politically and socially unacceptable to impose the kinds of losses on the depositors in such institutions, that the authorities in countries with more resilient systems might be prepared to impose upon the depositors of a failed financial institution. But South Africa is also unusual in another respect. It does not have a deposit insurance system. Deposit insurance, first established in the United Sates in the 1930s but only relatively recently introduced elsewhere, has in the last twenty years or so spread rapidly throughout the world. It now provides a mechanism that, if used advisedly, can significantly alleviate the difficulties of closing a financial institution and thus reduce demands on a central bank's last-resort facility.

No system of deposit insurance, publicly administered but financed by its member banks, exists in South Africa. If it did exist it would reduce the risks created by bank distress in three ways:

- it would reduce the risk of loss borne by small depositors (which is desirable partly because small depositors do not have full information about banks' operations);
- it would do so in a rule-based and pre-announced manner (unlike the implicit deposit insurance practised by the Reserve Bank in the cases examined in Chapter 3, which was ad hoc); and
- it would reduce the risk of deposit runs and therefore reduce systemic risk although other mechanisms are also possible in principle (Diamond and Dybvig 1983).

A sound system of deposit insurance would provide a helpful adjunct to the Bank's tools for intervening in distressed banks. By removing concern for the fate of small depositors, financial assistance through the provision of liquidity or solvency support could be evaluated on the grounds of the financial system's stability alone. And by reducing the risk of systemic failure, the pressure for assistance on those grounds would be reduced.

Moreover, were South Africa to introduce such a system, as has been recommended by the S A Reserve Bank and other observers, failure of a small institution would not have the same impact on society as it would currently. Small depositors who are less able to distinguish the well-run bank from the less prudently managed would be protected from the consequences of their inability to exert discipline on the financial institutions with whom they deposit their savings. This would make it possible for the authorities to refrain from intervention and to allow an institution to fail in the knowledge that small depositors would be protected. By so doing, the need to rescue poorly managed institutions would be reduced, and a more rigorous last-resort facility could be established which could have less regard for the possibility of supporting institutions whose solvency was in doubt, or even those which might be solvent but whose management was not sufficiently prudent to avoid critical liquidity problems.

To illustrate the principle, if a sound system of deposit insurance had existed in the 1980s the assistance given to Bankorp could not have been justified on the grounds that it assisted small depositors and the argument that it was necessary to prevent systemic failure might have been less relevant than otherwise.

However, the design of a sound system of deposit insurance requires the authorities to solve a number of technical issues, for the existence of the system affects the risk-taking behaviour of banks and their profitability, and it can have an uneven effect on member banks. In particular the choice between financing the scheme by flat rate contributions from all member banks or by contributions weighted by the riskiness of the individual bank has to be made.

At present South Africa intends implementing a deposit insurance scheme. A project team comprising members from the National Treasury and the Bank Supervision Department of the S A Reserve Bank was established under the auspices of the Policy Board for Financial Services and Regulation.

The Panel wholly endorses that intention, but considers it necessary to point out that it will be important for a South African deposit insurance scheme to follow best practice elsewhere. The following passage is largely drawn from material published by the IMF and represents the Fund’s view of best practice drawn from its experience in a number of emerging-market countries (Garcia, 1999).

Best practices for a deposit insurance system ("DIS") provide incentives for economic agents to keep the financial system sound. The details of such an incentive-compatible system are summarised in the first column of the table below. Key institutional aspects that contribute to a proper operation of a DIS include:

- The DIS should be explicitly and clearly defined in laws and regulations that are known to, and understood by, the public so that bank customers can protect their interests.
- "Large" deposits should not be covered, in order to reduce the probability of moral hazard.
- Membership should be compulsory; insurance premiums should ideally be risk-adjusted to moderate the subsidy provided by strong to weaker institutions.
- If depositors are to have confidence in the system, the DIS must pay out insured deposits promptly, and it must be adequately funded so that it can resolve failed institutions firmly without delay.
- The DIS should act in the interests of both depositors and the taxpayers who back up the fund. Consequently, it should be accountable to the public, but independent of political interference.
- Since the roles of the lender of last resort, the supervisor, and the DIS are different, they are sometimes housed in three separate agencies. If so, these agencies need to share information and co-ordinate their actions.
- To avoid regulatory capture by the industry it guarantees, it is typically not advisable to place currently practising bankers in charge of decision making. However, bankers should be given the opportunity to serve on an advisory board, where they can offer useful advice.
- Deposit insurance systems are normally financed by levying premiums or assessments on banks in proportion to their deposit base. Except in the case of crises where a number of banks may fail simultaneously, a well-run deposit insurance scheme should be financed entirely within the banking system and payments to depositors of failed institutions should not require the use of public funds.
- If a country operates insurance schemes for financial instruments other than bank deposits (such as capital market investments and insurance policies), such investor compensation schemes should conform to the same standards as deposit insurance.

Best Practices for an Explicit System of Deposit Insurance

	Best Practice	Bad Practice	Practical Issues to be Resolved
1.	Avoid incentive problems.	Agency problems, moral hazard, and adverse selection.	Which incentives are best? How to incorporate them in law and regulation?
2.	Define the system explicitly in law and regulation.	The system is implicit and ambiguous.	How to amend the laws and regulations to ensure transparency and certainty?
3.	Give the supervisor a system of prompt remedial actions.	The supervisor takes no, or late remedial actions.	Should these remedial powers be mandatory or discretionary?
4.	Ensure that the supervisor resolves failed depository institutions promptly.	Forbearance: banks that should be resolved continue to operate.	The types and importance of closure policies. Should the DIS be involved?
5.	Provide low coverage.	There is high, even full coverage.	Which institutions should be in the DIS and which deposits should be covered; what is the appropriate level of coverage; should there be co-insurance?
6.	Make membership compulsory.	The scheme is voluntary.	How to avoid adverse selection?
7.	Risk-adjusted premiums.	Flat-rate premiums.	How to set premiums according to risk?
8.	Pay deposits quickly.	There are delays in payment.	How to effect prompt payment?
9.	Ensure adequate sources of funding to avoid insolvency.	The DIS is under-funded or insolvent.	To choose a funded or *ex post* DIS? What size should the premiums and the accumulated fund be? Should there be back-up funding from the government?
10	Organise good information.	Bad information.	What data do supervisors need?
11.	Make appropriate disclosure.	Little, or misleading disclosure.	What should be disclosed and when?
12.	Create an independent, but accountable DIS agency.	Political interference and lack of accountability.	Designing the DIS and its board of directors to avoid political Interference, but promote accountability.
13.	Have bankers on an advisory board not the main board.	Bankers are in control.	How best to avoid conflicts of interest?

Best Practices for an Explicit System of Deposit Insurance

Best Practice	Bad Practice	Practical Issues to be Resolved
14. Ensure close relations with the lender of last resort and the supervisor.	Relationships are weak.	Poor lender-of-last-resort policies that raise costs to the DIS; sharing information.

8.5 Transparency

It is often held that secrecy is an important aspect of dealing with distressed banks. Three stages in the process need to be considered separately. They are:

- the formulation of principles and procedures;
- operational decisions relating to the provision of assistance to specific institutions; and
- the maintenance of confidentiality after the fact.

8.5.1 Principles and policies

Many central banks still believe that an effective way of dealing with the moral hazard in assisting banks that are distressed is to avoid any policy statements. To lay out in advance facilities for the treatment of such cases would only encourage reckless managements. Indeed, as discussed earlier in this chapter, many European central banks do not specify in advance the basis on which they would extend assistance. However, some central banks believe that a general policy statement is helpful. For example, the Governor of the Bank of England's statement discussed in chapter 6 was motivated by the need to ensure that the limitations on such assistance were appreciated by financial institutions and their creditors. The South African authorities have also given some indication, for example in the 1999 report discussed earlier in this chapter. There is one difference to practice in many other countries in that the Reserve Bank has now spelled out in considerable detail what those tests are. This is now becoming more common, however, as the tendency for central banks to be more transparent is also beginning to be accepted in this field.

But there is perhaps a danger in such transparency. In so far as the recipient bank can demonstrate an adequate solvency margin, there is an implication, at least, that any bank meeting these criteria is likely to receive support. That goes rather further than most central banks would want to suggest, although the Reserve Bank, like other central banks, has made it clear that it reserves the right not to support a bank that may meet all its tests but where the bank's failure would not threaten the system.

Other relevant cases include a recent statement by the Hong Kong Monetary Authority. The Panel believes that the South African statement is helpful provided that it is adhered to rigorously.

8.5.2 Operations

There is more agreement on the need for secrecy in those cases where the bank's distress is not yet known to the market or depositors. Clearly too much transparency in such cases could only precipitate the problem the assistance is designed to avoid. Other cases where the problem is already well known or widely rumoured can often be dealt with more effectively by an open statement of support where that is appropriate.

8.5.3 Disclosure after the event

More problematic in South Africa has been the very limited transparency after resolving the crisis that triggered the support. Partly because modern accounting and disclosure rules for listed companies now make it much more difficult to conceal operations, and partly because central banks are now encouraged (for example, by the IMF's codes) to be much more transparent in general, it is now rare for central bank assistance to distressed banks not to be disclosed after the event. Some central banks may, however, choose to keep details of the terms of the assistance confidential in order to retain greater freedom for their discretion in subsequent cases.

The S A Reserve Bank was for many years bound by its own statute not to disclose matters relating to third parties except where required to do so by the courts. For this reason, the Bankorp assistance was not disclosed for many years, despite the rumours circulating in the market, and despite the desire of ABSA to quash rumours after they had acquired Bankorp. It was only when the Governor was summoned before the Tollgate inquiry that Dr Stals felt free to disclose the details of the operations. He informed the Panel that attempts to persuade the legislature to amend the Reserve Bank Act had been defeated in Parliament. However, in 1997, the Act was amended to allow disclosure of such operations with the consent of the Minister, and after consultation with the party concerned. This amendment is, in the view of the Panel, appropriate. The beneficiary of the assistance clearly has a right to be warned that disclosure is going to happen, but should not be in a position to prevent disclosure when the Reserve Bank, and the Minister, judge it to be in the public interest. Section 33 of the S A Reserve Bank Act is excessively restrictive in another sense. It is arguable that the section prevents public disclosure even in cases where the public interest would dictate otherwise and where the Governor would wish to so act. The Panel considers that any such ambiguity within the section should be cured by way of an amendment.

8.5.4 Record keeping

Whether Reserve Bank assistance is kept secret or disclosed at the time or subsequently, transparency requires that full records are kept of the assistance. Those records should include not only the minimum audit trail of proper accounts and formal minutes, but also written statements by the appropriate officials detailing the objectives of the assistance, the reasons for choosing the methods used, and evaluation of success. Whether the assistance is made public or not, those records should be the basis for properly constituted internal review of the assistance and, if it is made public, would be the basis for public statements. The absence of such records in the Bankorp/ABSA case, while not unusual, contributed to the problems that assistance involved.

Measures to improve greatly record keeping in cases of intervention in distressed banks have now been implemented by the Reserve Bank.

8.5.5 Conflict of interest

From the evidence presented to the Panel it transpired that a meeting between the Governor and other representatives of the Reserve Bank and the then Minister of Finance, Mr B J du Plessis, had been held on 31 July 1991 to discuss whether further financial assistance to Bankorp should be granted. During the negotiations between the Reserve Bank and Bankorp, Mr A S du Plessis, the brother of the then Minister, had been an active member of the Bankorp delegation, as he served in a non-executive capacity on Bankorp's Board.

While the Panel has no evidence that any impropriety took place, nor that any could be inferred, it is not good practice to allow such potential conflict of interest to occur. Impartial independent decision-making by both Reserve Bank and Government officials must not only be done, but be seen to be done.

The Panel recommends that a clear protocol governing the issue of possible conflicts of interest should be compiled and made known to all relevant Reserve Bank and Government officials, as well as the private sector.

8.6 Central bank assistance, financial architecture and South African transformation

This chapter outlines current international principles for assistance to distressed banks and regulatory and financial policy architecture, reviewes current SA Reserve Bank policies in the light of them, and, while judging current Reserve Bank principles positively, discusses possible future developments.

Using international principles as the benchmark should not obscure the fact that South Africa is in a different position from the leading developed economies. An overall socio-economic priority is the promotion of a shift in the ownership and control of economic assets towards the black African majority. In the banking sector that might mean the promotion of new banks owned and managed by new entrepreneurs and providing deposit facilities and loans to black African individuals and businesses. Moreover those developments may be valuable in bringing existing informal finance schemes into the regulated, formal sector.

The application of sound central bank principles themselves may be judged to counter that priority and unintentionally but automatically favour established banks compared to new banks. The provision of assistance only to banks whose distress poses a risk to the banking system as a whole would automatically favour banks that are established and large. A strong regulatory regime imposes compliance costs on banks which might be disproportionately burdensome for small, new banks than for large and established banks. Those problems appear acute in South Africa, but similar issues arise in developing countries throughout the world.

The Panel recommends that the Reserve Bank actively reviews the means by which sound central banking principles can be applied while promoting the socio-economic priority of a shift in the proportion of banks owned and controlled by black Africans and servicing black African business. The Panel believes that such a review should recognise the following principles:

- the promotion of new banking enterprises can make an important contribution to shifting economic power towards black Africans;
- the best international principles of regulation and supervision, and the best practice criteria for assisting distressed banks must be applied consistently to all banks. Laxity in the application of those principles to new black African owned banks cannot secure their sound growth and would not be in the interests of their customers; and
- positive forms of business and management support to new banks that meet certain criteria should be developed, while consistent standards of supervision and criteria for assisting distressed banks are maintained.

8.7 Conclusions

The Panel has concluded that the S A Reserve Bank's practices for dealing with banks in distress are much improved since the time of the Bankorp assistance packages and are now broadly in line with best practice elsewhere. It meets the tests, for example, set out by the Governor of the Bank of England in 1993, and, if followed consistently, should avoid the dangers encountered by many other countries with less robust approaches. The Panel sees no need, therefore for a new set of guidelines to govern practice in this area. Nonetheless, the Panel does consider that there continue to be improvements that need to be made to the overall architecture. Several countries have recognised the inefficiencies that can result from subjecting one financial group of companies or conglomerate to supervision by more than one regulatory authority. However, while the institutional arrangements need to reflect organisational changes, such as the growth of financial conglomerates within the financial sector, care needs to be taken before disturbing the present arrangements which work well. One reform that is now urgent, however, is the development of an effective and well designed deposit insurance facility. The Panel recommends that this should be proceeded with now. It will be important that there be greater transparency of assistance operations once the operational need for secrecy is past. In the Panel's view, the recent amendment to the S A Reserve Bank Act allows for this, and measures to ensure intervention is fully recorded will make transparency possible. Finally the Panel recommends the Reserve Bank actively reviews the means by which central bank principles of bank supervision and assistance to distressed banks relate to South Africa's socio-economic priority of transformation.