REPORT OF THE GOVERNOR'S PANEL OF EXPERTS TO INVESTIGATE THE S A RESERVE BANK'S ROLE WITH REGARD TO THE FINANCIAL ASSISTANCE PACKAGE TO BANKORP LIMITED

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REPORT OF THE GOVERNOR'S PANEL OF EXPERTS TO INVESTIGATE THE S A RESERVE BANK'S ROLE WITH REGARD TO THE FINANCIAL ASSISTANCE PACKAGE TO BANKORP LIMITED

EXECUTIVE SUMMARY

From 1985 to 1992 the South African Reserve Bank provided assistance to Bankorp and, for the period 1992 to 1995, to its new owner, ABSA. After the existence of that assistance belatedly became public knowledge, its nature and validity became the subject of controversy which was not resolved.

Consequently, on 15 June 2000 the Governor of the S A Reserve Bank appointed a *Panel of experts to investigate the S A Reserve Bank's role with regard to the financial assistance package to Bankorp* ("the Panel") and instructed it to determine:

1 whether the S A Reserve Bank, in providing financial assistance to Bankorp, has contravened the provisions of the S A Reserve Bank Act, No 90 of 1989, or any other Act;

2 whether the financial policies and procedures of the S A Reserve Bank with regard to financial assistance have been adhered to in the case of the Bank's assistance to Bankorp;

3 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; and

4 guidelines and best practice with regard to possible future conduct of the S A Reserve Bank with regard to banks in distress.

On 16 February 2001 the Panel's terms of reference were expanded to include:

5 in the event of a finding by the Panel that the assistance to Bankorp by the S A Reserve Bank was *ultra vires* the power of the Bank, the consideration of whether restitution can be claimed, and if so, the manner thereof.

The Panel interpreted these terms of reference to include the agreement between the S A Reserve Bank and ABSA, concluded in 1994 as a result of the acquisition of Bankorp by ABSA in 1992.

Background

Although the assistance granted to Bankorp/ABSA has been the topic of media speculation over many years and had been investigated previously, the Panel found no definitive findings emanating from these previous enquiries. Accordingly, a major objective of the Panel was to produce a comprehensive Report that would bring about closure of this issue.

The Reserve Bank's assistance to Bankorp under review by the Panel commenced in 1985 during a period of political and economic difficulties in South Africa. The assistance was increased in 1986, reviewed and increased in 1990 and again increased in 1991. The assistance was transferred to ABSA when it acquired Bankorp in 1992, and continued until 1995.

In 1985, South Africa's banking system had been suffering the shock of adjusting to international anti-apartheid sanctions, and Reserve Bank policy was conditioned by the political climate of the period. Whatever the motivation, it is noteworthy that, unlike three quarters of International Monetary Fund member countries (including several highly developed countries) in the past thirty years, South Africa actually experienced no major, system-threatening banking failures during this period.

Although the Panel concluded that the decision to provide financial assistance to Bankorp was justified in the interest of protecting the stability of the domestic banking system, its form and structure was seriously flawed when considered as a whole. It does not match present day standards for central bank assistance, but more important, it did not match the standards set by the contemporary practice of other comparable countries' central banks. Most of the individual undesirable features of the assistance given to Bankorp were also found in the Reserve Bank's assistance to other banks, but their combined application to the extent seen in Bankorp is exceptional.

Principal findings

Bankorp in 1985 was a bank that had grown fast, partly by absorbing a number of weak banks. Its request for assistance in 1985 was a symptom of potential solvency problems and those underlying problems worsened during the course of the assistance. The Reserve Bank, however, initially gave assistance of a type that could, at best, address a pure liquidity problem and, even then, did not meet the standards of best practice. Subsequent assistance was of a type relevant for a bank facing a remediable solvency crisis, but for that purpose it did not match international good practice. Overall, the assistance was flawed in the following features of form and structure:

1 The length of time for which assistance, in the form of successive packages, was given.

2 The willingness of the Reserve Bank to accept successive related requests for additional assistance.

3 The continuing secrecy with which the assistance was covered even after the danger of systemic risk had passed, owing to the limiting provisions of section 33 of the S A Reserve Bank Act. However, the secrecy provisions of the S A Reserve Bank Act have been amended in 1997 to allow for some form of disclosure.

4 The use of a simulated transaction to disguise as a loan the Reserve Bank's assistance which was, in substance, solvency support in the form of a grant or donation.

5 The absence of measures to protect the interests of the Reserve Bank and, thereby, the taxpayers, by the Reserve Bank securing a share of the equity of Bankorp in exchange for its capital contribution.

6 The failure to give assistance with conditions that would protect the banking system's depositors while penalising the shareholders and management of Bankorp. In fact, the shareholders of Bankorp benefited from the assistance.

7 The Reserve Bank's assistance had the effect of conferring benefits on Sanlam's policy holders and pension funds and on the minority shareholders of Bankorp rather than solely on its depositors.

8 The failure, for half the duration of the assistance or longer, to monitor effectively the business of the beneficiary, Bankorp.

9 The failure to implement methods used successfully in other countries for alleviating banks' bad debt problems, such as creating a special institution to administer delinquent assets.

10 Under the S A Reserve Bank Act of 1989 the Reserve Bank was obliged to consult the Minister of Finance on certain matters, e.g. assistance to banks in distress. A meeting to seek the approval of the then Minister for the review of assistance to Bankorp was, in fact, held in 1990. That occasioned a further flaw in the design of the assistance packages since the then Minister, Mr B J du Plessis, was the brother of Mr A S du Plessis, a director of Sankorp, a subsidiary of the majority shareholder (Sanlam) of Bankorp, and indeed of Bankorp itself. Owing to a possible conflict of interests, the Minister should have recused himself from any such participation.

Viewed in their totality, these flaws in the Reserve Bank's methods of assistance to Bankorp/ABSA were of a serious nature. In the Panel's opinion the provision of a grant, using a simulated transaction, implies that the Reserve Bank acted outside its statutory powers, for, judged by international standards as required by section 10(1)(s) of the S A Reserve Bank Act of 1989, that action meant that the function being carried out was not such *as central banks customarily may perform*.

The Reserve Bank's assistance conferred benefits on Sanlam's policy holders and pension fund beneficiaries and on the minority shareholders of Bankorp. That is contrary to public perception published in the media, and contrary to the conclusions of the Heath Special Investigative Unit. Those perceptions and conclusions have incorrectly asserted that major benefits were received by the shareholders of ABSA.

The conclusion that the Reserve Bank acted *ultra vires* leads to a consideration of restitution. It is the view of the Panel that, in principle, restitution from the beneficiaries may be sought, but that it may well be difficult and extremely costly to

achieve through litigation, because of the difficulty of determining the exact class of beneficiaries, apportioning the enrichment and the fact that duly appointed officials of the Reserve Bank made the key decisions.

The flaws in the Bankorp/ABSA assistance also informs consideration of the Reserve Bank's current principles and practice. Today, the Reserve Bank's principles and practice relating to distressed banks and to reform in related areas of the financial architecture are comparable to the highest current international standards.

Specific findings

The Panel's conclusions are discussed in chapters 4 to 8 of the Report, but can be summarised as follows:

First term of reference: to determine whether the Reserve Bank, in providing financial assistance to Bankorp, has contravened the provisions of the S A Reserve Bank Act, or any other Act

The first set of agreements concluded between the Reserve Bank and Bankorp in 1985 and 1986 was structured on the basis of a low interest loan. As the S A Reserve Bank Act does not appear to preclude the Bank from charging interest at a rate lower than the market rate the Panel cannot conclude that the S A Reserve Bank acted outside the scope of its powers in concluding these agreements.

However, the agreements of 1990 and 1991 constituted simulated transactions which, in law, amounted to donations of money. There is no legal basis by which the S A Reserve Bank could have entered into such agreements, save if the Bank's actions can be justified under section 10(1)(s) of its Act. This is not the case, as the S A Reserve Bank's assistance did not accord with good international practice and the Bank's assistance was, therefore, *ultra vires*.

The consequence of an unlawful agreement is that it was rendered void *ab initio.* Where one of the parties to the agreement, in the first place, was not authorised to be such a party, the agreement could never have acquired a legal existence.

That being so, the beneficiaries of the assistance packages obtained benefits from the actions of the S A Reserve Bank to which, in law, they may never have been entitled.

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

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

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

The Panel reviewed internationally accepted principles of best practice for dealing with distressed banks and concluded that the methods used to assist Bankorp were flawed, whether providing liquidity support to Bankorp, as in the early stages of its intervention, or providing solvency support in the early 1990s.

Specifically, the Reserve Bank took no equity claim on the future profits of Bankorp, nor did it attempt to protect depositors by removing Bankorp's bad debts to a special institution charged with managing them separately. Nor did it attempt to organise a merger with a sound banking institution.

The assistance was provided over a period that was unusually long by international standards, as the Reserve Bank acceded to successive Bankorp requests for more assistance. Despite those successive requests, the Reserve Bank only assessed adequately the risks pertaining to Bankorp when further assistance was requested in 1990.

The objective of all the international examples of bank assistance practice and principles reviewed by the Panel was to protect the banking system and its

depositors, and a clear recognition of the undesirability of protecting shareholders. 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 and the price they received when taken over by ABSA was raised by the amount of the assistance.

Fifth term of reference: to consider, in the event of a finding by the Panel that the financial assistance to Bankorp by the S A Reserve Bank was *ultra vires* the power of the Bank, whether restitution can be claimed, and if so, the manner thereof

Given the finding that the contracts were illegal, it would not be possible for the S A Reserve Bank to recover any loss under the law of contract. However, another legal avenue is open in such cases, namely on the basis of unjustified enrichment enjoyed by Bankorp/ABSA.

Notwithstanding allegations in the public domain about conspiracies, the Panel did not find any evidence which would have justified such a conclusion. Accordingly, the S A Reserve Bank would not come to court in a position where its previous office bearers were shown to have acted with knowledge of the Bank's lack of legal capacity to enter into such a transaction. Even if this was the case, there would be a compelling argument that public interest favoured restitution to a public institution which had been impoverished and which impoverishment would be for the account of the public.

However, any possible action would be based upon enrichment as opposed to contract where estoppel may be relevant. Thus proof of the existence of a beneficiary would be the critical issue.

The Panel is of the view that ABSA paid for the continued assistance of Bankorp by the Reserve Bank and could not be regarded as beneficiaries of Reserve Bank assistance package. ABSA paid fair value for Bankorp. Due to the complex nature of the impact that the various packages might have had on the value of capital invested in Bankorp, it is difficult for the Panel to assess with accuracy the extent of the benefits derived by Bankorp shareholders. Evidence supports the conclusion that Sanlam, the major Bankorp shareholder was aware that it would have received no value, or less value, for its shareholding absent Reserve Bank assistance.

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

The Panel has concluded that the Reserve Bank's practices for dealing with banks in distress are much improved since the time of the Bankorp assistance packages and are now in line with best practice elsewhere 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 improvements continue to be needed to the overall architecture. Several countries have claimed that inefficiencies can result from subjecting one financial group of companies or conglomerate to supervision by more than one agency. Some have suggested that this could prove to be the case in South Africa. However, while institutional arrangements need to reflect organisational changes, such as the growth of financial conglomerates within the financial sector, the present arrangements work well and considerable care will need to be taken before disturbing them.

However, one reform which should be immediately considered, 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 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. To conclude, the Panel considers that on all the evidence available to it, this Report has brought to light all the material discoverable facts concerning Reserve Bank assistance to Bankorp/ABSA, and that public knowledge of them should end the uncertainty and misinterpretation that has been fuelled by the absence of a rigorous investigation previously.

1 CHAPTER 1: INTRODUCTION

From 1985 to 1992 the South African Reserve Bank provided assistance to Bankorp and, after 1992, to its new owner ABSA. After the existence of that assistance eventually became public knowledge its exact nature and its validity has been the subject of controversy and public criticism.

On 15 June 2000 the Governor of the S A Reserve Bank announced the appointment of *The Governor's Panel of experts to investigate the S A Reserve Bank's role with regard to the financial assistance package to Bankorp* ("the Panel"), consisting of:

- The Hon Mr Justice DM Davis, Judge of the High Court of South Africa (Cape of Good Hope Provincial Division) as Chairperson;
- Prof L Harris, Director: Centre for Financial and Management Studies at SOAS, University of London;
- Mr PC Hayward, Financial Sector Advisor at the Monetary and Exchange Affairs Department, International Monetary Fund, who served on the Panel in a private capacity;
- Mr RM Kgosana, Chairperson of KMMT Inc Chartered Accountants;
- Mr RK Store, Chairperson of Deloitte and Touche Chartered Accountants; and
- Ms S Zilwa, Chairperson of Nkonki Sizwe Ntsaluba Chartered Accountants.

Mr Hayward served on the Panel in his personal capacity. The views expressed in the Panel's Report ("this Report") are entirely those of the Panel and should not be attributed to the International Monetary Fund.

Mr JJ Rossouw of the S A Reserve Bank served as the Panel's secretary.

It was initially envisaged that Mr G Lind, Advisor of the Swedish National Bank would also serve on the Panel, but owing to other commitments he could not accept the appointment to the Panel. However, the Panel did consult with him on its Report.

The deadline for the completion of this Report was initially set as the end of August 2000, but owing to the complexity of the matter under consideration, the time frame for completion was extended by the Governor.

1.1 Terms of reference

The Panel received and accepted as its terms of reference:

To determine:

1 whether the S A Reserve Bank, in providing financial assistance to Bankorp, has contravened the provisions of the S A Reserve Bank Act, No 90 of 1989, or any other Act;

2 whether the financial policies and procedures of the S A Reserve Bank with regard to financial assistance have been adhered to in the case of the Bank's assistance to Bankorp;

3 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; and

4 guidelines and best practice with regard to possible future conduct of the S A Reserve Bank with regard to banks in distress.

On 16 February 2001 the terms of reference of the Panel were expanded to include:

5 in the event of a finding by the Panel that the financial assistance to Bankorp by the S A Reserve Bank was *ultra vires* the power of the Bank, the consideration of whether restitution can be claimed, and if so, the manner thereof.

The Panel interpreted these terms of reference to include the agreement between the S A Reserve Bank and ABSA, concluded in 1994 as a result of the acquisition of Bankorp by ABSA in 1992.

1.2 Work programme

When considering its work programme at the outset, the Panel noted that:

- certain matters included in its terms of reference had been the subject of scrutiny and other investigations over a number of years, e.g. by the Special Investigation Unit, headed at the time by The Hon Mr Justice W H Heath ("Heath Special Investigative Unit") and an enquiry in terms of section 417 of the Companies Act, No 61 of 1973, into the affairs of Tollgate Holdings Ltd;

- despite previous investigations, no definitive or comprehensive set of findings has been made available for public scrutiny;
- although some relevant material was readily available, in other cases substantial research was required;
- international best practice in this area is not well-documented;
- the evaluation of the assistance to Bankorp/ABSA against domestic and international best practice is complicated by the confidentiality surrounding such assistance in most countries, the time lapse since the assistance, and changing standards over time; and
- the assistance to Bankorp/ABSA has been the subject of continued media speculation for almost a decade.

In the consideration of its work programme and the analysis of available documentation, the Panel noted that the assistance granted to Bankorp/ABSA by the S A Reserve Bank has not only been the topic of media speculation over many years, but has also been investigated previously by a number of bodies, e.g. the Heath Special Investigative Unit. The difficulty which has confronted this entire issue has been the plethora of speculation and an absence of any set of clear conclusions based on an evaluation of evidence. The Panel had hoped, when it commenced its work, to have access to a comprehensive report from the Heath Unit on the assistance granted to Bankorp/ABSA following its lengthy period of investigation. However, despite requests by the Panel for a copy of a report by the Heath Unit, all that was made available was a draft summons and a media release, both of which proved to be substantively defective for reasons which will become apparent in further chapters of this Report. The unfortunate effect of these documents was that they created considerable confusion among public commentators, in particular regarding the quantum of any benefit, the identity of any beneficiaries and the considerable legal difficulties in pursuing litigation. Accordingly, one of the major objectives of the Panel was to produce a comprehensive Report and conclusions based on available evidence that would allow clarity and thus closure of this entire issue to be achieved.

This Report is based primarily on an analysis of documents listed in Annexures 4 and 5 to this Report, and interviews conducted by the Panel with:

- Dr CL Stals, Senior Deputy Governor of the S A Reserve Bank, 1981 to 1985, and Governor of the S A Reserve Bank, 1989 to 1999;

- Dr DC Cronjé (Group Chairman), Mr FJ du Toit (Group Executive Director: Finance), Mr JH Shindehütte (Group Executive: Finance) and JN Wepener (General Manager: Group Legal Services) of ABSA;
- Mr AS du Plessis, Executive Director: Sanlam, appearing in his private capacity; and
- Mr G Hoggarth, Senior Economist: Financial Industry and Regulation Division, of the Bank of England.

The Panel met on the following dates:

- from 1 to 3 September 2000 in Pretoria;
- on 27 and 28 October 2000 in Cape Town;
- from 26 to 28 January 2001 in Cape Town;
- from 23 to 25 February 2001 in Cape Town;
- on 27 and 28 April 2001 in London;
- from 8 to 10 June 2001 in Pretoria; and
- on 28 and 29 July 2001 in Cape Town.

1.3 Structure of the Report

CHAPTER ONE is an introduction following the executive summary.

CHAPTER TWO outlines the general economic, social, political and institutional environment at the time of the assistance.

CHAPTER THREE provides a chronology of the events concerning the assistance to Bankorp and its subsequent acquisition by ABSA.

CHAPTER FOUR relates to the Panel's first term of reference and considers the legality of the assistance to Bankorp/ABSA.

CHAPTER FIVE relates to the Panel's second term of reference and reviews the assistance to Bankorp in the context of the contemporary practices of the S A Reserve Bank for assisting banks in distress.

CHAPTER SIX relates to the third term of reference and analyses international practice for assisting banks in distress.

CHAPTER SEVEN relates to the fifth term of reference and considers the question of restitution. A legal opinion on this issue is attached as Annexure 3.

CHAPTER EIGHT, addressing the Panel's fourth term of reference, evaluates the current practice of the SA Reserve Bank in respect of distressed banks and related aspects of South Africa's financial and regulatory architecture.

CHAPTER NINE summarises the Panel's conclusions.

Five **ANNEXURES** accompany this Report.

1.4 Words of thanks

The Panel is greatly indebted to Mr JJ Rossouw for the superb assistance afforded to it throughout its work.

The Panel acknowledges the considerable effort of Mrs HM Nel of the S A Reserve Bank in the preparation of this Report.

2 CHAPTER 2: BACKGROUND INFORMATION

2.1 Synopsis of the political, institutional and economic environment at the time of the S A Reserve Bank's assistance to Bankorp

2.1.1 Introduction

Any attempt to look back from the perspective of 2001 to a period some decades before and evaluate decisions taken during that period is challenging, as such a lapse of time creates an opportunity for the benefit of perfect hindsight.

In South Africa's instance any such reconsideration of events and decisions is even more challenging, as a completely new political, social, institutional and economic order has developed during the last decade. Since democratic elections in 1994, the general environment has improved to such an extent that many people will experience difficulty remembering the previous dispensation. In achieving the objective of pronouncing on the S A Reserve Bank's assistance to Bankorp in the 1980s and early 1990s, it is, therefore, necessary to review the political, institutional and economic environment at the time.

The S A Reserve Bank assisted Bankorp (or one or more of the subsidiaries in the Bankorp Group) over a number of years. The period 1985 to 1992 is of importance for purposes of this Report, as the assistance under consideration was granted, renewed and/or revised on a number of occasions during this period. This synopsis of the prevailing political, institutional and economic environment is, therefore, broadly limited to this period.

2.1.2 Political environment

The assistance to Bankorp in 1985 took place within a particular political context. In 1983 the government of State President P W Botha introduced constitutional reform in the guise of a tricameral parliamentary system. Its racist structure fuelled deep-seated political grievances that, in turn, provided the political impetus for the formation of the United Democratic Front (UDF). The UDF successfully mobilised intense political protest against all forms of apartheid.

Between 1984 (after the implementation of the tricameral constitution) and 1988, more than 3 500 people (the vast majority of them township residents) were killed in political conflict, approximately 45 000 people were detained without trial and work stoppages and strikes increased from 469 in 1984 to 1 148 in 1987 (Political conflict in South Africa - Data trends 1984 to 1988, 1988: various pages). By June 1986 a country-wide state of emergency was declared, press censorship became progressively stricter and the powers of the security forces were extended.

The entire management of government during this period was carried out by means of the National Security Management System (NSMS) headed by the State Security Council in which cabinet members participated and in which regional and local management centres were established. The entire design was to implement a so-called "total strategy", which had as its aim the curbing of what the government at the time referred to as a "total onslaught" launched against the state by the ANC and communist forces. As Seegers states, *every government institution in South Africa is required to participate in the NSMS and this compulsory participation takes place on regional, sub-regional, mini-regional and municipal levels* (Seegers, 1990: 110).

The deep-seated acceptance of this "total onslaught" thesis and the need for a "total strategy" to resist the onslaught, was reflected, for example, in the following introduction to a judgement of The Hon Mr Justice M T Steyn: *South Africa is in the mid 1980s a society in travail … Much of that resistance is violent and is directed not merely at the authorities of government and administration, but also at other individuals and also indiscriminately at the general public* (Bloem v State President 1986(4)SA 1064(O) at 1067).

The revised constitutional structure did not improve South Africa's international acceptability and failed to halt the increasingly strong steps to isolate the country internationally. Following the violent events after the introduction of the tricameral Parliament, the UN Security Council imposed a number of economic sanctions and restrictions on sport and cultural relations. This was followed by the imposition (over a period of time) of economic sanctions on the country by the USA, the European Community (then the EC, now the EU) and Nordic countries. This culminated, *inter alia*, in trade and financial sanctions against South Africa. In the latter instance the sanctions led to massive capital withdrawals and disinvestment. The refusal of key international banks to renew credit lines forced the authorities to announce on 28 August 1985 the temporary closure of the foreign-exchange market and on

1 September 1985 the declaration of a standstill on South Africa's foreign debt repayments. This forced the country to negotiate the rescheduling and orderly repayment of its foreign debt over a prolonged period of time through a series of "standstill arrangements".

In the four years between 1985, when State President PW Botha turned his back on meaningful political reform in his *Rubicon Speech,* and 1989, South Africa experienced a capital outflow of some R 27 000 million (Natrass et. al., 1990: 18).

During this period *a* siege mentality prevailed in South African government and business circles which had a wide influence on the conduct of economic policy. Particularly notable in the present context were the existence of fragility in the financial system and a secretive approach to the conduct of business.

On 8 May 1989 Dr Gerhard de Kock, then Governor of the S A Reserve Bank, warned that *if adequate progress is not made in the field of political and constitutional reform, South Africa's relationships with the rest of the world are unlikely to improve to any significant extent … In that event, South Africa will probably remain a capital-exporting and debt repaying country for years … In such circumstances, the average standard of living in South Africa will at best rise only slowly* (De Kock, 1989b: 7).

Political struggle at home, international pressure and economic difficulty contributed to the announcement on 2 February 1990 of the legalisation of liberation movements, the release of political prisoners and the removal of certain emergency regulations. This paved the way for political change, but the process was not a smooth one and financial markets remained fragile.

A multi-party conference on South Africa's future constitution was proposed in January 1991, but a resumption of violent political conflict in April of that year threatened to derail the process. Formal negotiations did not commence until December 1991 (Codesa 1).

In February 1992 it was announced that the level of support for the negotiation of a democratic constitution would be tested by means of a referendum of South Africa's white population. The referendum was held in March 1992 and confirmed an overwhelming mandate for the continuation of the process of reform.

Codesa 1 was derailed in May 1992 because of an impasse reached about certain constitutional guarantees and by August 1992 an unprecedented level of mass action occurred. The UN intervened by sending a special envoy to the country to re-establish contact between the parties who had participated in Codesa 1.

An internal peace summit was arranged for September 1992, and by April 1993 Codesa 2 was constituted. In June 1993 it was agreed that democratic elections would be held on 27 April 1994.

The announcements of 2 February 1990 and subsequent developments gave rise to a general reappraisal by the international community of its relations with South Africa. During 1991 South Africa was readmitted to international sporting competitions. In July of that year the US administration officially lifted federal sanctions against the country, although a number of states and cities in the USA did not lift their prohibition on investing in South Africa. In October 1991 Japan lifted sanctions, while the Commonwealth lifted its cultural sanctions, but retained sanctions on finance, arms, trade and investment.

In 1992 the EC partially lifted its sanctions, and following the adoption of legislation in September 1993 providing for a transitional administration, the international community lifted the remaining economic sanctions against South Africa. In May 1994 the UN Security Council ended its mandatory arms embargo against the country.

This improvement in international relations was accompanied by the progressive resumption of normal foreign financial relations following the foreign debt standstill of August 1985. South Africa renegotiated the rescheduling and orderly repayment of its foreign debt over a prolonged period of time in terms of a series of standstill arrangements. The first of these rescheduling arrangements (First Interim Arrangements) ended on 30 June 1987. This was followed by the second arrangements (1 July 1987 to 30 June 1990) and the third arrangements (1 July 1990 to 31 December 1993). The final arrangements for the rescheduling of foreign debt in the standstill of August 1985 came into effect on 1 January 1994 and were terminated on 15 August 2001, when the rescheduling of the country's foreign debt came to an end.

2.1.3 Economic environment

2.1.3.1 Economic growth

Despite the international pressure on the domestic economy in the 1980s, periods of surprisingly rapid economic growth were recorded. However, by the early 1990s strain was clearly showing, as is evidenced by three consecutive years of negative economic growth (1990 to 1992). Table 1 depicts real growth in Gross Domestic Product and Gross Domestic Expenditure for the period 1985 to 1992.

Table 1: Economic growth in South Africa

Year	% Change in GDP	% Change in GDE
1985	-1,2	-7,8
1986	0,0	0,7
1987	2,1	3,8
1988	4,2	6,3
1989	2,4	1,2
1990	-0,3	-2,0
1991	-1,0	-0,6
1992	-2,1	-1,9

Source: S A Reserve Bank *Quarterly Bulletin* (various issues)

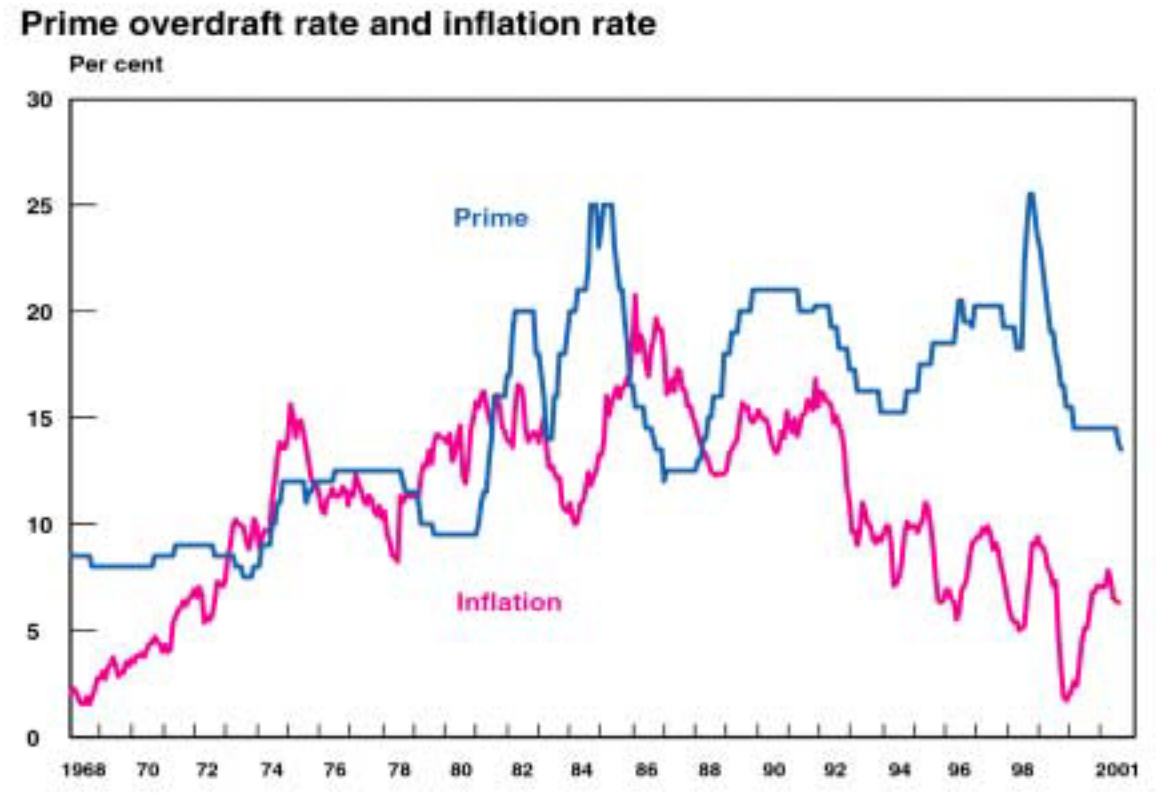
An important reason for the improvement in the level of economic activity in the period 1987 to 1989 was a rise in the extension of bank credit to individuals. This implied that households used credit to protect their standards of living. This practice was clearly not sustainable, and was one of the factors contributing to the introduction of stricter monetary policy in that period.

2.1.3.2 Monetary policy, inflation and interest rates

Graph 1 depicts the prime overdraft rate and the inflation rate over the period 1967 to 2001. However, not obvious from this graph is the important change in the approach to monetary policy that occurred in 1981. Up to 1980 one of the cornerstones of monetary policy was credit ceilings; implying that until 1981 the prime rate was not at

the actual market clearing level. Thereafter monetary policy relied more on an active interest rate policy. Moreover, the regime of credit ceilings imposed limitations on the capacity of banks to extend credit and, therefore, might have prevented banks from undertaking risky loans, but it could also have had the opposite effect. Thereafter monetary policy relied more on an active interest rate policy.

Graph 1



Source: S A Reserve Bank

The change in the monetary policy approach in 1981 also introduced a new competitive environment for banks. This culminated in the cancellation of the cartel agreement between banks with effect from 28 February 1983, when the ROCO (Register of Co-operation) agreement was cancelled.

The introduction of competition between banks in the early 1980s can be one of the explanations why some of the major South African banks ran into serious difficulty by the middle of the 1980s: as in many other countries, not all banking institutions had the same ability to adapt to the new environment, and a competitive environment encouraged reckless lending by some banks.

A further secondary effect of the replacement of direct controls (credit ceilings) with market-oriented monetary policy was that interest rates became much more volatile than before. Not all banks had at that time the necessary internal systems in place to deal with such increased interest rate volatility.

From a lower turning point in 1986/87, interest rates were increased in a number of steps over the ensuing period until 1989. As a result of these increases, Bank rate and the prime lending rate were respectively 7,5 and 8 percentage points higher by August 1989 than at the beginning of 1987, and these rates increased even further by another percentage point on 11 October 1989. Increasing interest rates were the result of a deliberate tightening in monetary policy. This was a reaction to, *inter alia*, rapid credit extension growth. It was necessary to dampen domestic demand to contain inflation and achieve a surplus on the current account of the balance of payments large enough to finance the repayment of foreign debt.

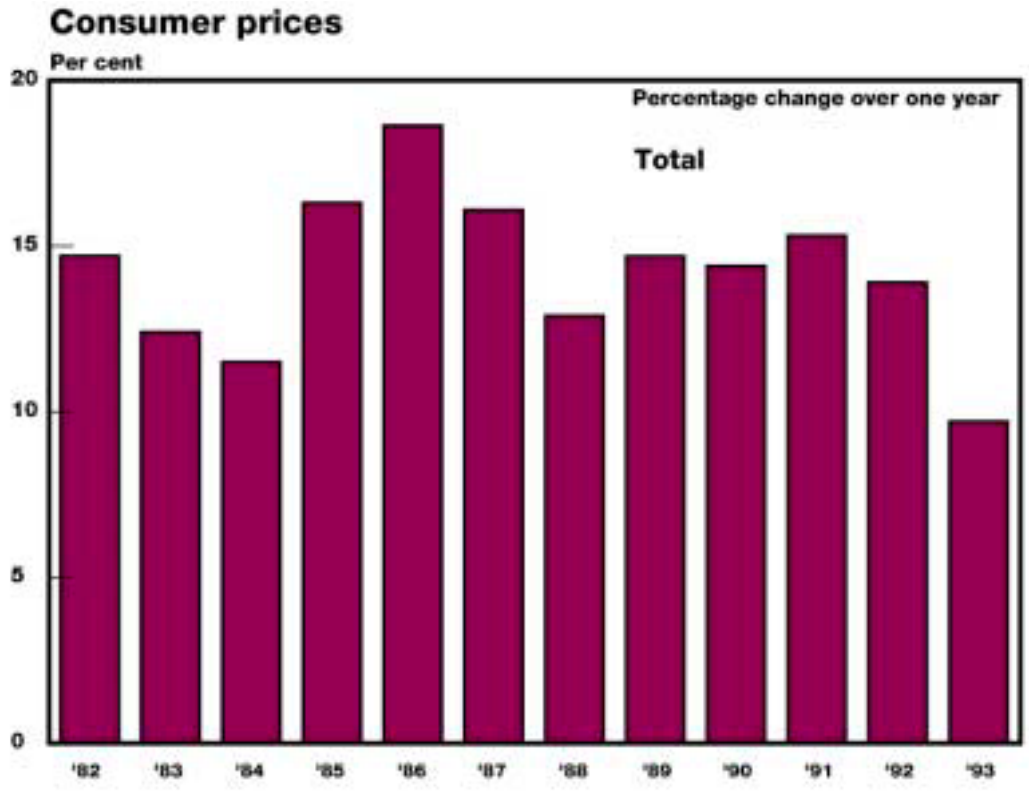
During the period 1985 to 1987 inflation, albeit at a high level, was not regarded as South Africa's main economic problem. An acceleration in the domestic inflation rate during that period was mainly the result of a depreciation in the exchange rate of the rand, which was in turn caused by an outflow of capital from South Africa (see section 2.1.3.3) below. The rate of increase in domestic prices, depicted in graph 2, decelerated from 18,6 per cent in 1986 to 12,9 per cent in 1988, but renewed inflationary pressures emerged towards the end of 1988 and early in 1989. This re-emergence of inflationary pressures contributed to a tightening of monetary policy.

Given the new policy focus, interest rates also stayed at higher levels for longer periods than before, while banks and businesses in general had previously become accustomed only to short periods of high nominal interest rates.

This change in policy introduced to South Africa for the first time in many years the principle of sustained real positive interest rates. However, the downside was that borrowers of funds were not accustomed to paying a real price for funds and a number of households and businesses ran into financial difficulty and defaulted. This permanent change in the prevailing pattern of interest rates was accompanied during the period 1990 to 1992 by a severe recession (three years of negative growth). This combination of a lack of growth and real positive interest rates necessitated difficult adjustments by households, non-financial businesses and banks. They might have

exacerbated the problems of Bankorp in the late 1980s, but the bank's difficulties began before that and resulted from its poor management, strategy, and lending policies as outlined in Chapter 3.

Graph 2



Source: S A Reserve Bank

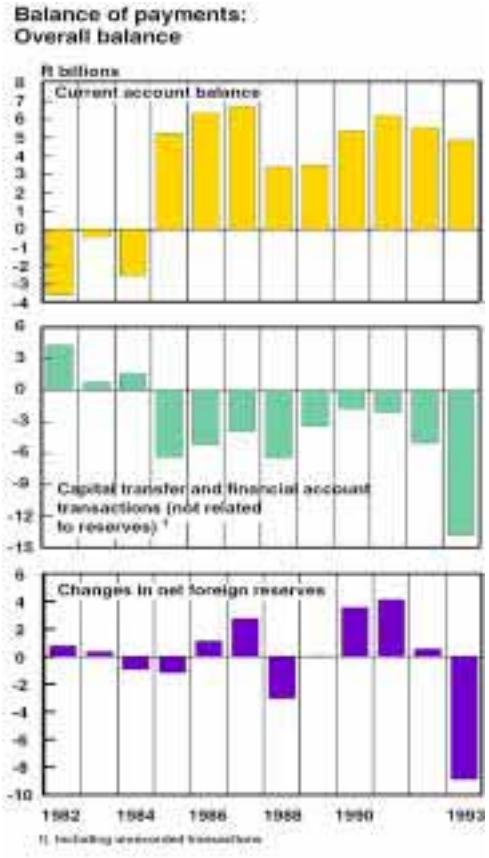
The change in the focus of monetary policy introduced in 1988/89 has remained in place since then, and positive real interest rates, which, as graph 1 shows in *ex post* terms, have existed since 1988/89, are today an accepted feature of South Africa's financial and economic environment.

2.1.3.3 Balance of payments and the exchange rate

A major feature of the period 1985 to 1989/90 was the overriding objective of maintaining a sufficiently large surplus on the current account of the balance of payments. Such a surplus was necessary for ensuring an inflow of foreign exchange large enough to meet the country's foreign debt repayment obligations, arranged by 1990 in terms of the *First* and *Second Interim Debt Arrangements*.

The large outflow of capital from South Africa is depicted in graph 3. Capital became more expensive as a result of this outflow. This contributed to a general pattern of higher domestic interest rates.

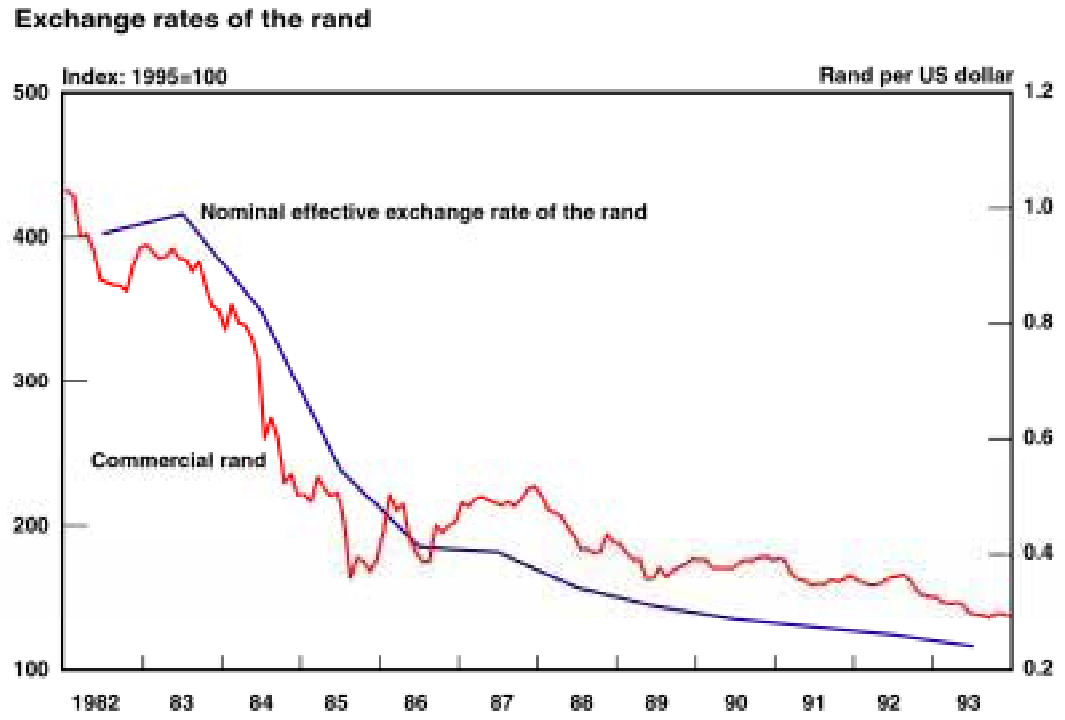
Graph 3



Source: S A Reserve Bank

In an effort to ease the adjustment to the debt standstill and the outflow of capital, the authorities permitted the exchange rate to depreciate. Moreover, exchange control over non-residents was tightened at the time of the announcement of the debt standstill in August/September 1985, as the *financial rand* system was reintroduced: a dual exchange rate system designed to cater for investment flows of non-residents. This system had previously been abolished (in February 1983), but its reintroduction was forced by the events at the time. Graph 4 depicts exchange rate movements.

Graph 4



Source: S A Reserve Bank

The dual exchange rate system, which was one of a number of market impediments that created distortions in the allocation of capital, was finally abolished in March 1995 owing to the considerable improvement in South Africa's international financial relations.

2.1.4 Institutional environment

During the 1980s and early 1990s institutions in South Africa became accustomed to operating under conditions of siege and within an environment of strict exchange control. Moreover, with mounting external pressure, domestic institutions had to adapt to internal policies aimed at structurally adjusting the economy.

In the latter part of the 1980s the S A Reserve Bank voiced concern about the growth in credit, and banks were urged to practise restraint in their financing of consumer goods and the provision of mortgage financing for luxury homes in particular.

An overview of the number of South African banks (known as deposit-taking institutions in 1991) during the late 1980s and early 1990s is given in Table 2.

Table 2: Number of banks and building societies in selected years

Year	Banks(1)	Building societies(2)
1987	52	16
1988	59	16
1989	60	16
1990	54	13
1991	48	8
1992	45	8

(1) Includes 4 discount houses until 1990
(2) Includes equity, permanent, mutual and terminating building societies

Source: Bank Supervision Department, S A Reserve Bank

The figures in table 2 can be put in perspective if the dominating position of the (then) five major banking groups, ABSA, Bankorp, FNB, Nedperm (currently Nedcor) and Standard (in each instance including all subsidiaries and associated banking companies), relative to total assets in the banking industry is highlighted as in table 3 (below). While the five largest banks together accounted for approximately 83 per cent of the banking sector's assets in 1991, Bankorp alone accounted for some 10 per cent.

Table 3: Total assets of banks (deposit-taking institutions) as at 31 December 1991, R million

Total assets	R 257 696	
Five major banks	R 214 624	(83,3%)
Bankorp	R 26 089	(10,1%)

Source: Bank Supervision Department, S A Reserve Bank

At the end of the 1980s there was a change in the S A Reserve Bank's focus on banking supervision. The Governor of the S A Reserve Bank in his annual address to shareholders had made regular references over a number of years to the importance of a stable and sound banking and financial system. The address of 1989, for instance, mentions that the S A Reserve Bank would pay attention to an improvement of the internal management, control and reporting systems of banks.

The address of 1991 mentions that the S A Reserve Bank had taken steps to protect the interests of depositors at three institutions (although it seems that this reference did not include the assistance given to Bankorp that year), and two banks were placed under curatorship and a third one liquidated. It was explained that this action of the S A Reserve Bank was not an unqualified guarantee that the Bank would always protect depositors, countering a perception at the time that the Reserve Bank would automatically help all depositors of banks in distress (a perception that could have induced moral hazard). The policy of the S A Reserve Bank was (and still remains) that depositors would only be helped to the extent necessary to maintain confidence in the banking system and the stability of the banking and financial systems.

2.1.5 Conclusion

As mentioned in the introduction to this review chapter, it is difficult to consider events after the lapse of a decade or more. Domestic conditions and international relations have changed considerably and the South Africa of today is a completely different country from the one of the 1980s and early 1990s.

A number of general conclusions can, however, be drawn:

- it is doubtful whether all domestic banks had the necessary controls and systems in place to deal with increased competition after the change in monetary policy introduced in 1981;
- certain banks experienced difficulty adapting to the declining exchange rate of the rand and increased interest rate volatility in the 1980s;
- capital outflows during the 1980s and early 1990s and the debt standstill forced painful structural adjustments onto the domestic economy; and
- the reintroduction of sustained real positive interest rates since 1988 put many borrowers of funds in distress.

3 CHAPTER 3: CHRONOLOGY OF EVENTS

3.1 Synopsis of the growth of and assistance to Bankorp

3.1.1 Introduction

In order to understand the genesis of the principal matter concerning the Panel — the S A Reserve Bank's assistance to the Bankorp Group between 1985 and 1995 — this chapter begins by outlining the development of Bankorp over the preceding years.

The Bankorp Group began life as Central Acceptances Limited in 1968, with Senbank as a subsidiary. Over the next 10 years the Group grew rapidly, acquiring Bank of Johannesburg, Federale Bank, Mercabank, Santam Bank, Sasbank and Trust Bank. Many of these banks had experienced operating difficulties while Trust Bank, the largest acquisition, had an aggressive lending policy, the effects of which had forced it to apply for and receive assistance from the S A Reserve Bank.

The Group's *Annual Report* for the year ending 30 June 1987 states that Bankorp had become the third-largest banking group in South Africa by 1986 as the result of organic growth. By 1986 the Group's subsidiaries included:

- Trust Bank, a commercial bank;
- Santambank, a general bank;
- Senbank, a merchant bank; and
- Mercabank, an investment and merchant bank.

In addition, Bankorp held a 50 per cent shareholding in Banbol (Pty) Ltd. This shareholding is of importance because Banbol was the company used since 1985 to channel to Bankorp the assistance of the S A Reserve Bank, the principal subject of this Report. Banbol was jointly owned by Bankorp and Boland Bank Limited and because both parties held a 50 per cent shareholding it was not necessary to consolidate the financial statements of Banbol into the accounts of either one of the shareholders in terms of the prevailing accounting practice at the time. Therefore, routing the SA Reserve Bank's assistance to Bankorp through Banbol was a measure contributing to the secrecy of the assistance.

After a change in management in 1990/91, the Group embarked on a restructuring aimed at focused business units within Bankorp. By 30 June 1991 its structure included:

- Trust Bank, a commercial bank;
- Senbank, a corporate and merchant bank;
- Bankfin, a specialist instalment finance bank; and
- Bankorp Treasury and International Banking, a specialised treasury and international banking service unit for the Group.

3.1.2 Bankorp's growth strategy

In the 1980s the Bankorp Group continued to expand rapidly. The mode of expansion changed from growth by acquisition to growth by an aggressive lending policy. This drive for asset growth resulted in a decline in the Group's asset quality and its eventual financial distress leading to the provision of assistance by the S A Reserve Bank described below.

Bankorp's strategy of asset growth has been elucidated in its *Annual Reports* on a number of occasions. Its report published in 1988 mentions that *the Bankorp group decided several years ago to increase its market share by means of organic growth in preference to take-overs and amalgamations. The balance sheet figures serve as proof of the success achieved in this regard. The group's total assets* (including contingencies and repurchase agreements) *increased by R 6 358 million … an increase of 39,6 per cent for the year.* The report for 1989 states that *… having attained the critical mass … to benefit from economies of scale … the objective is to achieve superior returns on assets and shareholders' funds.* However, it continues … *earnings growth did not keep pace with asset growth … .*

Despite receiving S A Reserve Bank assistance, Bankorp grew its assets (excluding contingencies and repurchase agreements) in real terms by 7,41 per cent per annum between 1985 and 1990.

The strategy of superior returns did not materialise and in its *Annual Report* for the financial year ended 30 June 1990, Bankorp reported a loss of R 368,4 million, compared with a profit of R 131,6 million in the previous financial year.

By 1991 Bankorp was the smallest of the five major banking groups, but still substantially larger than the sixth largest banking group at the time (NBS Bank), which had assets amounting to R 8 171 million as at 31 December 1991. Bankorp's growth in assets relative to the total assets of the banking industry is highlighted in table 4.

Table 4: Total bank assets, R million

Year	CPI Index, 1986 = 100	Total industry as at 31 December +	Bankorp as at 30 June ex c and ra*✸	%	Bankorp as at 30 June inc c and ra*
1981	50,5	47 584	4 622,4	9,7	5 010,0
1982	57,9	55 614	6 172,1	11,1	6 721,1
1983	64,9	65 106	6 529,3	10,0	7 701,6
1984	72,5	80 337	8 200,1	10,2	10 744,1
1985	84,4	92 532	10 304,9	11,1	13 611,6
1986	100,0	116 575	10 947,8	9,4	14 436,4
1987	116,2	132 405	13 687,6	10,3	16 069,8
1988	130,9	170 443	19 274,8	11,3	22 427,6
1989	150,2	201 989	27 049,2	13,4	31 582,9
1990	171,9	240 171	30 007,4	12,5	34 785,8
1991	198,1	257 696	28 187,7	10,9	31 841,0
Average annual rate of increase					
1981 to 1985	13,70	18,09	22,19	-	28,39
1985 to 1990	15,29	21,02	23,83	-	26,49
1990 to 1991	15,24	7,30	(6,06)	-	(8,47)
Average annual real rate of increase					
1981 to 1985	-	3,86	7,47	-	12,92
1985 to 1990	-	4,97	7,41	-	4,64
1990 to 1991	-	(6,86)	(18,49)	-	(20,57)

\+ including building societies

* c and ra: assets related to contingencies and repurchase agreements

✸ comparable with figure for total industry, including building societies

% Bankorp (ex c and ra) as percentage of industry

Sources: Bank Supervision Department, S A Reserve Bank
Research Department, S A Reserve Bank
Annual Reports, Bankorp Group (various years)

3.1.3 Concerns about Bankorp's asset growth

During the latter part of the 1980s the S A Reserve Bank voiced concern about the growth in credit extension by banks. Banks were urged to practise restraint in their financing of consumer goods and the provision of mortgage financing for luxury homes in particular.

The S A Reserve Bank addressed letters to Bankorp on at least two occasions in the late 1980s, voicing concerns about the rapid growth in its asset book. On 6 July 1989 the Governor (Dr Gerhard de Kock) wrote to the Chief Executive of Bankorp (Dr CJ van Wyk), conveying the Bank's displeasure about the excessive rate of increase in credit extension by Bankorp in recent months. This letter also mentioned that banks had been requested at meetings held on 9 March 1989 and 5 May 1989 to exercise restraint in their rates of credit extension. Bankorp was the only one of the five major banking groups at the time that did not adhere to the S A Reserve Bank's request for restraint. Bankorp was, therefore, requested in the letter to take immediate steps to curb credit extension. The letter concluded by saying that the co-operation of Bankorp is expected in the matter, particularly in view of the special assistance of the S A Reserve Bank to the Bankorp Group, without the S A Reserve Bank being compelled to penalise the Group for its excessive credit extension.

Moreover, after the appointment of a new Chairperson at Bankorp (Mr D Keys), the then Senior Deputy Governor, Dr A S Jacobs, wrote to Mr Keys on 13 November 1989, voicing concerns about the management of the banks within the Group, including contraventions of the exchange control regulations by Trust Bank; noting the bank's aggressive credit growth; the questionable quality of its credit; the expansion of its balance sheet; and its inability to comply with the requirements of the Banks Act since March 1989. Moreover, conditions at Trust Bank's London office had caused considerable embarrassment to the S A Reserve Bank with the Bank of England.

3.1.4 Bankorp's financial difficulties and the response of its management

Bankorp's strategy of asset growth coincided with a period of restrictive monetary policy from 1987, with concomitant rising interest rates and, for the first time in a number of years, sustained positive real interest rates. Moreover, the domestic

economy suffered a severe recession during the period 1990 to 1992 (three years of negative economic growth).

Borrowers of funds were not accustomed to paying a *real* price for funds and a number of households and businesses ran into financial difficulty and were unable to repay the lenders. The Bankorp Group in particular was affected negatively by the financial difficulties experienced by its customers. As a result of its strategy of asset growth, the Group inevitably ended up with assets of a more dubious nature and suffered financial setbacks as its customers defaulted on commitments. By 1990 it told the Reserve Bank that only about 52 per cent of its assets were profitable.

By that year the Bankorp Group reported that its strategy had been refocused from asset growth to one of containing such growth in favour of improving asset quality. Its *Annual Report* for the year ending 30 June 1991 states that *… total assets, including assets relating to contingencies and reserves, decreased by 8,5 per cent to R 31 841 million … this compares reasonably well with our target of 10 per cent which was set to improve the quality of the assets.*

3.1.5 S A Reserve Bank assistance to Bankorp

Since 1985 there have been a large number of transactions and agreements relating to assistance from the S A Reserve Bank to Bankorp and subsequently to ABSA, which acquired the Bankorp Group in 1992. These can be classified into three sequential assistance packages, referred to below as package A (1985 to 1990), package B (1990 to 1992) and package C (1992 to 1995).

It should be noted, however, that the assistance was advanced to Banbol, a subsidiary in which Bankorp held 50 per cent of the shares. Banbol, in turn, transferred the assistance to Bankorp on the same terms and conditions. This structure was used as it was not necessary for Bankorp at the time to consolidate the financial statements of Banbol. The secrecy of the assistance could, therefore, be protected.

3.1.5.1 Package A

In April 1985 Bankorp approached the S A Reserve Bank with a request to provide the bank with financial assistance of R 300 million in order to assist it in difficulties

encountered pursuant to certain bad investments and other non-performing assets which it had acquired with the takeover of Trust Bank in 1977 and Mercabank in 1984.

The first set of agreements (included in package A) commenced when the SA Reserve Bank, in a letter of 30 May 1985, granted assistance to Banbol (Pty) Ltd in the amount of R 200 million at an interest rate of 3 per cent per annum to assist Bankorp. Repayment of the loan had to commence as quickly as possible and be completed before 31 May 1990. A further condition was that Sanlam (at the time the ultimate majority shareholder in Bankorp) had to cede government bonds to the S A Reserve Bank as security for the loan.

On 18 April 1986 the S A Reserve Bank agreed to increase the financial aid previously granted to Banbol by a further sum of R 100 million to give further assistance to Bankorp (included in package A). The assistance was structured broadly on the same terms, conditions and interest rate as the assistance granted in 1985, again against security provided by Sanlam. It was agreed that the total sum of R 300 million would be repaid in three equal instalments of R 100 million per annum, payable from 1 July 1988 until the full amount of the assistance had been repaid on or before 31 May 1990.

During 1987, the Bankorp Group introduced a major rationalisation programme. To lend support to the programme, the S A Reserve Bank agreed to amend the terms and conditions for the loan and it became repayable in five equal annual instalments of R 60 million each, commencing on 1 April 1990. The other terms and conditions and the interest rate on the loan were not amended.

In November 1989 Sankorp (a 100 per cent subsidiary of Sanlam in which the latter consolidated its strategic investments) underwrote a rights issue of R 350 million by Bankorp, of which it subscribed R 229 million.

In March 1990 the S A Reserve Bank was informed that Bankorp was not in a financial position to commence repayments, and it was agreed that the date for the repayment of the first instalment on the loan would be extended from 1 April 1990 to 1 August 1990.

3.1.5.2 Package B

A further meeting was held on 1 August 1990 between the S A Reserve Bank, Bankorp and Bankorp's controlling shareholder, Sankorp. The S A Reserve Bank was represented by Dr CL Stals (Governor), Dr JA Lombard (Senior Deputy Governor), Dr BP Groenewald (Deputy Governor), Dr JH van Greuning (Registrar of Banks), and Mr SS Walters of the S A Reserve Bank as secretary. Bankorp and Sankorp were represented by Mr MH Daling (Chairperson of Sankorp), Mr PJ Liebenberg (Chief Executive of Bankorp), Mr HJ van der Merwe, Mr PJ Strydom and Mr AS du Plessis.

At the meeting it was explained that the financial position of Bankorp had deteriorated to the extent that the S A Reserve Bank was confronted with a situation where Bankorp no longer met the requirements of the Banks Act. Mr Liebenberg explained that:

- Bankorp had made no operating profit during the 1989/90 financial year;
- excessive asset growth during the year had led to a situation where only 52 per cent of total assets of some R 35 billion of the Bankorp Group was profitable;
- intangible assets were included in the balance sheet;
- Bankorp had been unable to resolve its historical financial problems; and
- provision would have to be made for the writing off of bad and doubtful debts to an estimated amount of R 1 billion.

Mr Liebenberg also mentioned that by placing R 1 billion worth of weak assets and doubtful debts in a risk portfolio, the balance of the asset portfolio could be expected to show a profit.

As a result of Bankorp's financial position, Bankorp and Sankorp requested the S A Reserve Bank to increase the existing loan of R 300 million by a further amount of R 750 million.

On 3 August 1990 an agreement was entered into between the parties in terms of which the S A Reserve Bank provided a package of aid to Bankorp (again via Banbol). The material terms of the agreement which was entered into included:

- The advance of R 300 million in place at the time remained in existence.

- A further amount of R 700 million would be provided and Bankorp had to invest the total amount of R 1 billion with the S A Reserve Bank in cash (to the extent of R 400 million) and in government bonds (to the extent of R 600 million) for a period of five years at a yield of 16 per cent on both elements. These investments served as collateral for the loan.
- As the loan of R 1 billion incurred an interest charge of 1 per cent, a margin of 15 per cent accrued to Bankorp, which would be for its benefit and against which the bad debts in question would be written off over the five-year period.
- Sankorp underwrote a rights issue of R 526 million by Bankorp, of which it subscribed R 419 million.
- Bankorp's cash dividends were limited to minority shareholders for as long as the facility continued. Sankorp was required to invest its share of the dividends in new capital in Bankorp.

In addition, the agreement provided that certain conditions would be applied in the administration of Bankorp. These included the closing of 70 of its branches by 31 December 1990, the reduction of its staff by approximately 3 000 before 31 December 1990, a reduction in total assets by R 5 billion by 30 June 1991, and periodic reporting to the S A Reserve Bank on the extent of bad and doubtful debts. The Managing Director of Bankorp was required to hold quarterly review discussions with the Bank Supervision Department of the S A Reserve Bank.

On 5 September 1991 Mr Liebenberg, acting on behalf of Bankorp, and Dr Stals, acting on behalf of the S A Reserve Bank, and Mr Daling, acting on behalf of Sankorp, entered into an agreement which amended the conditions of the 1990 agreement discussed above. The reason for this amendment was that it transpired that Bankorp's bad and doubtful debts had then amounted to R 1 635 million.

In terms of the amended agreement a further amount of R 500 million (bringing the total advance to R 1 500 million) was to be provided and advanced by the S A Reserve Bank to Bankorp (via Banbol). This amount would be utilised to buy additional government bonds in the amount of R 500 million. In terms of this further agreement Bankorp was to cede all its rights and titles in these additional bonds as security for the further capital amount loaned to it by the S A Reserve Bank, over and above the security for the earlier assistance described above.

Before this agreement was concluded, the financial assistance package was discussed with the Minister of Finance, Mr BJ du Plessis, at a meeting on 31 July 1991, attended by Dr Stals, Dr CJ de Swardt (Deputy Governor) and Adv MCJ van Rensburg (Assistant General Manager of the S A Reserve Bank).

When viewed in its totality the package yielded a net interest margin of 15 per cent and generated a benefit of R 225 million per annum for the five-year period 1991 to 1995, amounting to R 1 125 million in total.

The financial assistance which was provided to Bankorp in terms of the agreement was to be applied towards the writing off by Bankorp of an identified set of bad or doubtful debts as at 30 June 1991, with any further losses to be met from sources other than the Reserve Bank. The agreement contained a repayment provision in favour of the Reserve Bank which would have been triggered if the bad debts written off did not reach the agreed figure, but there was no other provision for any repayment by Bankorp of any or all of the total net interest income which accrued to it during the period of operation of the agreement.

This assistance was subject to a further condition that the majority shareholder (Sankorp) would have to provide the means to cover a substantial part of the total assistance required by Bankorp, i.e. the difference between the debts of R 1 635 million and the S A Reserve Bank's assistance amounting to R 1 125 million.

In 1991 Sankorp entered into an agreement with Bankorp to provide Bankorp an amount of R 510 million in total over ten years. That arrangement was structured in a manner similar to the Reserve Bank assistance, giving Bankorp the benefit of a stream of net interest of R 51 million per annum for ten years.

3.1.5.3 Package C

The acquisition of Bankorp by ABSA, which was effective as at 1 April 1992, was conditional upon the financial assistance from the S A Reserve Bank and Sankorp, arranged under package B prior to the takeover, remaining in place. In other words ABSA was to receive the future stream of net interest previously arranged for Bankorp. As a result of this takeover the agreement was renegotiated between 1992 and 1994. A new agreement was concluded in 1994 with retroactive effect to 1 April

1992. This agreement was similar to the previous agreement (package B), except that:

- ABSA replaced Bankorp as the beneficiary.
- The requirement that Sankorp had to reinvest all dividends was lifted.
- Bankorp was allowed to substitute a new statement of bad and doubtful debts as at 31 March 1992 (details of which had been audited) for the unaudited list of bad and doubtful debts as at 30 June 1991 in its reporting to the S A Reserve Bank.
- The debts of debtors which had been classified as bad or doubtful as at the beginning of June 1990 could, depending on the financial position of the debtors, be increased or decreased in the actual write-off of bad debts against the amounts of financial assistance provided by the S A Reserve Bank, with the proviso that in the case of any debtor a debt written off might not exceed the amount of total indebtedness to Bankorp as at 31 March 1992.
- ABSA's external auditors were required in each financial year during the tenure of the 1991 agreement to audit amounts written off in order to ensure that such write-offs conformed to the stipulated conditions.

In 1995 a further agreement was concluded which amended the 1991 and 1994 agreements. The reason for this was that part of the government bonds that served as security for the S A Reserve Bank's loan to Bankorp/ABSA would mature before the termination of the agreement. Accordingly, the S A Reserve Bank purchased the government bonds from ABSA and required ABSA to deposit the proceeds of R 1 100 million with it and to cede the deposit to the S A Reserve Bank as security for the loan extended to ABSA. ABSA would earn interest on the deposit at a rate exactly equal to the rate of interest it would have received on the government bonds. This agreement terminated on 23 October 1995 when the accumulated total of financial assistance generated in terms of packages B and C amounted to R 1 125 million.

4. CHAPTER 4: LEGALITY OF THE ASSISTANCE TO BANKORP/ABSA

(First term of reference: to determine whether the S A Reserve Bank, in providing financial assistance to Bankorp, has contravened the provisions of the S A Reserve Bank Act, No 90 of 1989, or any other Act)

4.1. Enquiry into the lawfulness of the S A Reserve Bank/Bankorp/ABSA assistance agreements

4.1.1 Introduction

The essential facts are set out in Chapter 3. An examination of the legality of the S A Reserve Bank's assistance requires an analysis of these three sets of agreements, package A, package B and package C, respectively. The differences in the terms and counterparties of the three assistance packages imply that their legal status may differ. Therefore this chapter examines each package in turn.

4.1.2 The legal nature of the powers of the S A Reserve Bank

The key question that then arises concerns the legal nature of the transactions contained in the various sets of agreements. To answer this question, the legal status of the S A Reserve Bank and consequentially its powers to give assistance require examination.

The S A Reserve Bank was established in terms of section 9 of the Currency and Banking Act, No 31 of 1920. Subsequently the Bank was regulated in terms of the S A Reserve Bank Act, No 29 of 1944, which was replaced by the S A Reserve Bank Act, No 90 of 1989 ("the Act").

Section 2 of the Act provides that the Bank is a juristic person. Its powers are derived from statute and thus it has no residual powers derived from the common law. In short the S A Reserve Bank is a creature of statute (Malan, 1997: 307).

4.1.3 The powers of the S A Reserve Bank to act as lender of last resort

In order for any transaction to be lawful, the S A Reserve Bank must have been authorised by the Act to have concluded such a transaction. As a creature of statute, the Bank has only those powers which are vested in it in terms of the enabling legislation. In order for a transaction to which the Bank is a party to be lawful, the Bank must have been authorised by the legislation to have entered into the transaction. This section considers the powers of the S A Reserve Bank to make loans.

Section 10(1) of the Act empowers the Bank to grant loans or advances, provided that unsecured loans and advances may be granted only in the following cases:

- *an unsecured loan… to a company* [which has been formed with the object of making banknotes or coining coins, and with any object incidental thereto (section10(1)(b))] or, *with the approval of the Board, to any company in which the Bank has acquired shares…;*
- *…to an officer or employee of the Bank… .*

The section does not appear to place any restriction upon the rate of interest to be charged by the Bank in respect of a loan or advance. The only caveat to this submission would be that the imposition of a rate of interest at a nominal, low level was not in accordance with customary central banking practice in circumstances of lender of last resort. That is an issue which is examined elsewhere in this Report.

The second question raised in terms of this section concerns the nature of security for the loan. The S A Reserve Bank/Bankorp/ABSA transaction, clearly, did not fall within either of the exceptions of subparagraphs (i) or (ii) of section 10(1)(f) and it follows that, in order for the transaction to have been authorised lawfully by the provisions of section 10(1)(f), it must have required of Bankorp/ABSA that it furnish to the Bank proper and adequate security for the repayment of the loan.

Section 10(1)(f) allows the Bank to grant loans or advances against security, that is it may also grant loans or advances against the tender of, *inter alia,* government bonds as security for the repayment of the loan or advance. The subsection may well permit a loan where the proceeds thereof are employed to purchase the bonds, or other interest-bearing securities, which then constitute the required security for the loan or advance itself. However, that then raises the question as to the nature and purpose

of the transaction and whether it can fairly be classified as a loan. In short, if any of the agreements were of a simulated nature, then the question arises as to whether section 10(1)(f) is applicable.

While it is arguable that the first set of agreements (package A) fell within the scope of section 10(1)(f), in that the Bank imposed a condition of security and further that by 1990 no repayment had actually occurred under package A, the second set of agreements (package B) thereafter governed the entire arrangement. Therefore, it becomes essential to examine the legal basis of the second set of agreements (package B). In 1987 the first agreements (package A) had been amended to provide, *inter alia*, that the loan was to be repaid in five instalments beginning on 1 April 1990. By the time the second set of agreements was concluded, the entire legal arrangement was now governed by the second set.

When package B (and package C) are examined by way of an analysis of the relevant accounts of the Reserve Bank, it would appear that, save for R 400 million which was secured by the deposit with the Reserve Bank itself, the Reserve Bank funds were physically paid to Banbol and employed to purchase government bonds which were immediately ceded by Banbol to the Reserve Bank. At the termination of the applicable loans, set off would then take place such that the bonds held by the Reserve Bank as security would be employed as the means to repay the loans. When the substance of the transactions is examined, it is significant that no cash from the capital of these loans was available to the borrower. The borrower had no rights to employ the capital. Thus the only benefit which flowed to the borrower was the net interest passed on by the Reserve Bank to the borrower.

To the extent that package A stands to be examined, it is important to take account of the fact that these agreements were concluded prior to the application of the S A Reserve Bank Act of 1989. Therefore the question arises as to whether the powers under the S A Reserve Bank Act of 1944 were substantively different. In terms of section 8(1) of the Act of 1944 the Bank may, subject to the provisions of section 9©, grant loans and advances. It further states in section 9(e) that the Bank may not make unsecured loans and advances, except to the Government. The Act of 1944 thus empowered the Bank to grant loans and advances without limitation as to recipient with the exception of the Government, where the loan could be unsecured. Although the Act of 1989 did not make such a differentiation, there appears to be no difference between the two acts which would justify a different conclusion.

The second and third sets of agreements (package B and C) could be legally justified either in terms of section 10(1)(f) or in terms of section 10(1)(s) of the Act of 1989 if the packages are interpreted as loans.

4.1.4 Legal nature of a loan transaction

The question arises whether the agreements in packages A, B and C were in fact loans as purported. Briefly stated a loan is a contract whereby one person delivers some fungible thing to another person who is bound to return the former thing or one of the same kind or quality (Wille et. al., 1992: 576). Depending upon the terms of the contract, interest may be levied (Cactus Investments (Pty) Ltd v CIR 1999 (1) SA 315(SCA) at 319-320).

In essence, if the agreements in the packages A, B and C were to be classified as loans, they would have had to be classified as either a loan for consumption whereby the borrower consumes that which has been borrowed and returns a thing of the same kind or a loan for use whereby he uses the thing borrowed and then returns it at the end of the agreed period. See page 576 in *Wille's Principles of South Africa Law* (1992) and the cases cited.

The parties to the 1991 agreement (package B) refer to an *Assistance Agreement* and of the assistance as constituting a loan by the S A Reserve Bank to Bankorp. The agreement provides for interest accruing to Bankorp. Whilst the agreement might have been worded and constructed in such a way as to convey the impression that the capital amount of R 1 500 million which was advanced by the Bank to Bankorp constituted a loan as it is traditionally understood, on a proper construction of the agreement the transaction which it embodied cannot be said to have constituted a loan. Most important in this regard are the facts that no cash was available to Bankorp/ABSA pursuant to the provisions of these agreements save for the payments of the net interest over the period of the agreements. Further as set out above, repayment of the loans took place by the employment of set off, the bonds having been converted from security for the loans to the means of repayment of the loans.

As the written agreement provided, upon termination of the agreement, the capital amount of the loan was deemed to have been repaid by Bankorp/ABSA to the Bank.

In addition, in the event of the redemption value of the government bonds and investment with the Bank either falling short of or exceeding the capital amount of the loan, such disparity was, to all intents and purposes, to be ignored and the loan was to be treated as having been repaid in its exact amount.

The critical point was that the Reserve Bank then paid over all interest accruing from such bonds (less a charge of 1 per cent) to Bankorp/ABSA. When the transaction is examined as whole, the true nature of the transaction amounted to a donation or grant by the Reserve Bank to Bankorp/ABSA pursuant to the provisions of the agreement, that is, an amount of R 1 125 million. Significantly, in arbitration proceedings relating to whether the S A Reserve Bank's assistance to the Cape Investment Bank (CIB) amounted to a loan (the structure appears to have been similar to that employed in the Bankorp case), the Bank described the loan as a gift, a description which was accepted by the arbitrator, former Chief Justice PJ Rabie.

It is now necessary to establish whether the transactions as set out in the written agreements should be classified as simulated transactions.

The courts in a number of cases have classified a simulated transaction as one in which *the parties to a transaction endeavour to conceal its true character. They call it by a name, or give it a shape, intended not to express but to disguise its true nature.* As the court noted in CCE v Randles Brothers and Hudson Ltd 1941 AD 369 at 395, the parties to such a transaction have as their purpose the concealment of the true nature of the agreement. See also ERF 3183/1 Ladysmith (Pty) Ltd and another v CIR 1996 (3) SA 942 (A).

In the case of packages B and C, the Reserve Bank and Bankorp (and later ABSA) clearly concealed the fact that the monies which passed to Bankorp/ABSA from the Bank constituted a donation rather than a loan. This could not have been contemplated by the Legislature in enacting section 10 of the Act of 1989.

The counter argument is that section 10(1)(f) does not qualify the rate of interest that must be charged upon such loan. Hence a low rate of interest may well be permissible – a point made by the previous Governor of the S A Reserve Bank, Dr Stals, in his evidence to the enquiry in terms of section 417 of the Companies Act into the affairs of Tollgate Holdings Ltd.

Hence if a low rate of interest is permissible, can the same not be said about agreements structured to constitute a gratuitous disposition? The difficulty with the analogy (on the assumption that notional interest rates are permissible) is that if a transaction is, in substance, a donation of money, then it must be classified as such and not as a loan accompanied by a charge of a lower than market-related interest rate. In the view of the Panel, packages B and C amounted to a donation of money by the Reserve Bank; the determination of the quantum thereof depended upon the return on the bonds over the nominal rate of interest charged to Bankorp/ABSA.

4.1.5 S A Reserve Bank powers to make donations

Section 10(1)(s) does not specifically vest the Bank with the power to make donations. The only avenue by which the Bank might conceivably have been so authorised is in terms of the stipulation of section 10(1)(s) that the Bank may *perform such other functions of bankers and financial agents as central banks customarily may perform.*

Read in a restrictive manner, section 10(1)(s) does not extend to test on the basis of some comparator of conduct between central banks as lenders of last resort or lifeboat lenders whether the Bank's conduct was legal. The section deals only with functions of bankers and financial agents conducted by other central bankers and does not cover loans which fall to be governed in terms of section 10(1)(f). Interpreted thus, section 10(1)(s) fails to come to the assistance of the Bank and to render the donation of Bankorp either authorised or lawful. Even if effect is given to the true nature of the transaction, it remains both unauthorised and unlawful.

Assuming that section 10(1)(s) is interpreted to read out the words *bankers and financial agents*, then the test turns on an investigation as to the conduct of central banks in dealing with banks in distress during the relevant period. In his submission to the enquiry in terms of section 417 of the Companies Act into the affairs of Tollgate Holdings Ltd, Dr Stals justified the second set of agreements (package B) and, therefore, by implication the first set (package A) by reference to the practice of central banks as lenders of last resort. For the loans to Bankorp (particularly package B) to fall within the scope of section 10(1)(s), a court will have to be satisfied that the manner in which the assistance was given in the specific circumstances which pertained at the time of the conclusion of the various agreements, can be justified in terms of such international good practice.

To be so satisfied, a court will require convincing evidence of the existence and nature of such practice. As Corbett said in Golden Cape Fruits (Pty) Ltd v Fotoplate (Pty) Ltd 1973 (2) SA 642 ©:

… *the evidence required to establish a trade usage must be clear, convincing and consistent. It must, moreover, amount to something more than mere opinion: instances of the usage having been acted upon should be provided in order to establish the fact of the existence of the usage. No rule can be laid down as to the number of witnesses required. … in the nature of things the Court would not readily act upon the evidence of a single witness, even if uncontradicted* (at 647H).

For this reason, if the S A Reserve Bank's actions are to find justification in terms of section 10(1)(s), the nature of the evidence of how central banks, adopting good practice as it pertained at the time and would have acted in similar circumstances, should be examined. This issue is dealt with in Chapter 6 of this Report.

These agreements, particularly packages B and C which replaced package A, were not authorised by the express provisions of the Act, unless the evidence of comparative good practice by central banks is of sufficient weight to bring the transactions within the scope of section 10(1)(s). If not, the S A Reserve Bank acted *ultra vires* in entering into the agreements which then become unlawful and void *ab initio.* As Chapter 6 concludes that the S A Reserve Bank's assistance did not accord with good international practice, it is concluded that the assistance was *ultra vires*.

Whatever the standing of package B in terms of international practice, since package C was concluded with ABSA which was in a stronger financial position than that of Bankorp, it may be that the manner in which package C was structured would have found less favour with central banks committed to good central bank practice than would package B.

4.1.6 Delegation of powers within the S A Reserve Bank

Following on the conclusion that packages B and C were not authorised by the enabling legislation, the question never arises whether the powers of the Bank to conclude them were properly delegated by the Board to the Governors. No greater powers could have been delegated by the Board to the Governors than the Bank itself had. If the Bank was neither empowered nor authorised to conclude the agreements,

then no power to do so could have been delegated by the Board to the Governors. Any attempt on the part of the Bank to conclude the agreements would necessarily have been *ultra vires* and the agreements themselves would have been unlawful and void *ab initio.*

4.1.7 Conclusion

As the first set of agreements (package A) was structured on the basis of a low interest loan and its Act does not appear to preclude the Bank from charging interest at a rate lower than the market rate, the Panel cannot conclude that the S A Reserve Bank acted outside the scope of its powers in concluding the agreement.

Package B and C constituted simulated transactions which in law amount to donations of money. There is no legal basis by which the S A Reserve Bank could have entered into such agreements, save if the action can be brought under section 10(1)(s) of its Act. As Chapter 6 concludes that the S A Reserve Bank's assistance did not accord with good international practice in several respects, it is concluded that the assistance was *ultra vires*.

The consequence of an unlawful agreement is that it was rendered void *ab initio.* It must surely be the case that it was rendered void *ab initio,* and not merely voidable at the instance of either of the parties, because, where one of the parties to the agreement, in the first place, was not authorised to be such a party, the transaction could never have acquired a legal existence.

That being so, the beneficiaries of the assistance packages obtained benefits from the actions of the S A Reserve Bank to which, in law, they may never have been entitled. This raises the question of restitution which is covered in Chapter 7 of this Report.

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

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

5.1 Introduction

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

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

5.2 Local comparison of assistance at the time

5.2.1 Introduction

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

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

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

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

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

5.2.2 Summary of banks selected for comparison

5.2.2.1 Alpha Bank Limited

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

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

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

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

5.2.2.2 CIB

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

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

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

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

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

5.2.2.3 Pretoria Bank Limited

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

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

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

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

5.2.3 Summary

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

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

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

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

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

5.3 Comparison with principles stated by Dr Stals

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

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

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

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

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

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

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

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

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

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

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

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

5.4 Conclusion

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

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

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

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

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

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

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

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.

7 CHAPTER 7: CONSIDERATION OF RESTITUTION

(Fifth term of reference: to consider in the event of a finding by the Panel that the financial assistance to Bankorp by the S A Reserve Bank was *ultra vires* the power of the Bank, whether restitution can be claimed, and if so, the manner thereof)

7.1 Possible action by the S A Reserve Bank

On the basis of the Panel's finding (Chapter 4) that the agreements concluded from 1990 onwards between the S A Reserve Bank and Bankorp and thereafter ABSA were legally invalid in that the Bank acted outside the scope of its statutory powers, it is necessary to consider the question posed in the fifth term of reference, namely whether restitution can be claimed and, if so, in what manner.

Given the finding that the contracts were illegal, it would not be possible for the S A Reserve Bank to recover any loss under the law of contract. However, another legal avenue is open in such cases, namely on the basis of unjustified enrichment enjoyed by Bankorp/ABSA.

An analysis of the law relating to an enrichment action is both complex and, of necessity, entails a technical legal discussion. Accordingly the technical legal issues are canvassed in a separate Annexure to this Report (Annexure 3).

South African law accepts that performance under an illegal contract can be claimed, even in circumstances where the claimant does not come to court with clean hands, that is without turpitude. Even in such a case, considerations of public policy can justify a decision in favour of the claimant.

Notwithstanding allegations in the public domain about conspiracies, the Panel did not find any evidence which would have justified such a conclusion. Accordingly, the S A Reserve Bank would not come to court in a position where its previous office bearers were shown to have acted with knowledge of the Bank's lack of legal capacity to enter into such a transaction. Even if this was the case, there would be a compelling argument that public interest favoured restitution to a public institution which had been impoverished and which impoverishment would be for the account of the public.

For these reasons, the Panel concludes that, save for the determination as to the identity of the parties who benefited and proof of the amount of such benefits, the Reserve Bank would be legally justified in instituting an enrichment claim for its impoverishment caused by the donation of its funds to Bankorp/ABSA, in terms of which the latter parties had been enriched.

The issue of the nature of the benefits and the identity of any beneficiary is also important in that Sanlam, in documents placed before the Panel, adopted the approach that the Bank would be estopped from denying the validity of their conduct in granting the assistance. Without entering into a comprehensive analysis of the law of estoppel, an essential requirement is that the party pleading estoppel has to show that in acting on the strength of the representation, he altered his position to his prejudice (Autolec Ltd v Du Plessis 1965 (2) SA 243 (O) at 250H). Significantly Sanlam has argued, as set out below, that it did not benefit from the assistance granted to Bankorp. Hence the importance of the nature of any benefit to the evaluation of the validity of an argument based upon estoppel.

However, any possible action would be based upon enrichment as opposed to contract where estoppel may be relevant. Thus proof of the existence of a beneficiary would be the critical issue.

7.2 Quantification of benefits

The question arises as to who benefited from these packages. In its evidence to the Panel, ABSA argued that the price paid by it for the Bankorp shares was enhanced by reason of the Reserve Bank assistance; in other words the price it paid took account of the value of the assistance of the Bank. ABSA was thus not enriched. On the basis of this argument the only possible direct beneficiaries of the assistance were the selling shareholders who benefited by virtue of the price paid to them for their shares.

By contrast Sanlam adopted the approach that it had contributed by the underwriting of rights issues of Bankorp and the taking up of shares pursuant to the assistance and thus had not been enriched. Further they contended that the enrichment, if any, was based upon an interest differential which was not recoverable in terms of an enrichment claim. To the extent that it could be contended that Sanlam benefited from the sale of shares, this could only constitute an “obscure” indirect benefit.

For reasons set out in Chapter 4, the Panel considers that the payment by the Reserve Bank to Bankorp/ABSA amounted to a gratuitous transfer of money, albeit that it was calculated on the basis of an interest differential. To determine whether an enrichment action could be justified, it becomes important to examine, on the basis of the available evidence, the possible benefits and the identity of the beneficiaries from such assistance.

ABSA paid R 1 230 million for the acquisition of all Bankorp ordinary shares in exchange for the allotment by ABSA on a ratio of 100 ABSA shares for every 390 Bankorp shares held.

At the time of the takeover, the cumulative value of the net interest stream (received and receivable) under the assistance packages since 1985 amounted to R 1 295 million. The purpose of the assistance packages was to make good the losses which Bankorp shareholders had incurred on irrecoverable debts. The eligible delinquent debts had been listed and, in fact, it was subsequently discovered that they amounted to less than Bankorp's total holdings of delinquent debts.

At the time of the takeover by ABSA, losses had already been recognised by Bankorp and the effect of the assistance packages was incorporated in the net asset value of Bankorp. A key point is that the value of the assistance packages incorporated into the net asset value was the accounting value of the total net interest stream (grant) already agreed with the Reserve Bank as continuing to 1995. Therefore, if ABSA paid a price equivalent to net asset value, it paid for the expected future interest stream (grant).

Indeed, before concluding the takeover ABSA sought and received assurance from the Reserve Bank, that in the event of a takeover in 1992, the assistance package would continue on the same central financial terms and for the same period as Bankorp had already agreed with the Reserve Bank.

In terms of ABSA's evidence presented, the Panel established that if the assistance package had been terminated at the time of the takeover, either ABSA would have paid a lower price for Bankorp, or there would have been no transaction.

Available information indicates:

Total purchase price paid by ABSA	R 1 230 million
Net asset value of Bankorp	R 1 222 million

The price paid was practically equivalent to Bankorp's calculated net asset value of R 1 222 million. ABSA paid 288,5 cents per Bankorp share in April 1992, whilst Bankorp's last quoted share price on 31 March 1992 was 280 cents.

The Panel is of the view that ABSA paid for the continued assistance of Bankorp by the Reserve Bank and therefore could not be regarded as beneficiaries of the Reserve Bank package.

7.2.1 Bankorp shareholders

The Panel has distinguished between the majority shareholder and the minority shareholders at the time of the takeover. Sanlam, the majority shareholder (which held 88 per cent of the shares at the time of the takeover), was involved in the negotiations regarding the future of Bankorp and was well aware of the consequences of the negotiations; the minority shareholders were a passive party. Therefore, the intention of Sanlam was crucial to a conclusion as to what could have happened to Bankorp without an assistance package.

Dr Stals told the Panel that, in his view, ABSA would not have taken over Bankorp without the assistance package. The majority shareholder of Bankorp would not have any interest in selling at a lower price, hence the continuation of the assistance was a condition of the transaction between Sanlam and ABSA. This evidence supports the conclusion that the major Bankorp shareholder was aware that it would have received no value or less value for their shareholding absent Reserve Bank assistance.

Sanlam, as the major shareholder, was a major beneficiary of the Reserve Bank assistance package. Minority shareholders also benefited.

7.2.2 Quantum of the benefits

Due to the complex nature of the impact the various packages might have had on the value of capital invested in Bankorp, it is difficult for the Panel to assess with

accuracy the quantum of the benefits derived by Bankorp shareholders. However, the value of the net interest stream (grants) which was received by Bankorp from the Reserve Bank was as follows:

	Nominal value (R'000)
1985 to 1986	20 000
1986 to 1990 (R30 million per annum)	150 000
June 1991	150 000
June 1992	225 000
June 1993	225 000
June 1994	225 000
June 1995	225 000
June 1996	75 000
	1 295 000

7

An argument of Sanlam is that, as a condition of the Reserve Bank assistance, they injected additional capital in Bankorp. Owing to this capital injection and the subsequent capitalisation of dividends, Sanlam's shareholding of Bankorp had increased to 88 per cent by 1992. Moreover, Sanlam had to provide a low-interest loan to Bankorp, yielding a net interest of R 51 million per annum for 10 years. The financial effect could be summarised as:

	Nominal value (R'000)
Rights offer in 1990	
(some 80 per cent of R 526 million)	419 000
Net interest stream of R 51 million per annum for 10 years	510 000
Capital injection by Sanlam from 1990	929 000

In these calculations the Panel has not taken account of the rights offer in 1989 because it appears that Sanlam would have made that contribution in any event. It also ignored the R 45 million capitalised dividends, which would not have been received had Bankorp been liquidated in 1990.

At the purchase of Bankorp in 1992, ABSA paid Bankorp shareholders a total amount of R 1 230 million. Of this amount, 88 per cent was paid to Sanlam as the majority shareholder, whilst the minority shareholders received the balance. However, after completion of a due diligence by ABSA and a deterioration in the financial position of Bankorp, Sanlam repaid in total an amount R 151,5 million to ABSA (although minority shareholders made no repayments). Therefore, the net proceeds to Sanlam were:

	Nominal values (R'000)
ABSA's purchase price	1 230 000
Less: payment to minorities	147 600
Initial payment to Sanlam	1 082 400
Less repayment by Sanlam	151 500
Net proceeds to Sanlam	930 900

On these figures, it can be argued that Sanlam received a benefit of approximately R 1,9 million (R 930,9 million less R 929 million) at the time of takeover by ABSA. However, this conclusion ignores the real possibility that Sanlam could have been required to inject further funds to ensure the continued existence of Bankorp without the Reserve Bank assistance. To have walked away and written off its investment in Bankorp would have risked possible litigation from depositors and other adverse consequences from such an action.

The value of the net interest stream (grant) amounted to R 1 295 million and the additional capital Sanlam invested as a condition of the Reserve Bank's assistance package amounted to R 929 million. This indicates Bankorp's required capital injection and, had it not been for the Reserve Bank, Sanlam would have had to inject an additional R 1 295 million to ensure Bankorp's continued existence.

The sums presented here represent the book value of the transactions at the time they occurred. In relation to any claim for restitution these sums would have to be adjusted to allow for the passage of time to the date of restitution.

The Panel is of the view that the difficulties pertaining to the quantification of the enrichment and the identity of the beneficiaries (e.g. as a mutual society at the time,

much of the enrichment would have been enjoyed by Sanlam's policy holders) render problematic the prosecution of an enrichment claim.

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.

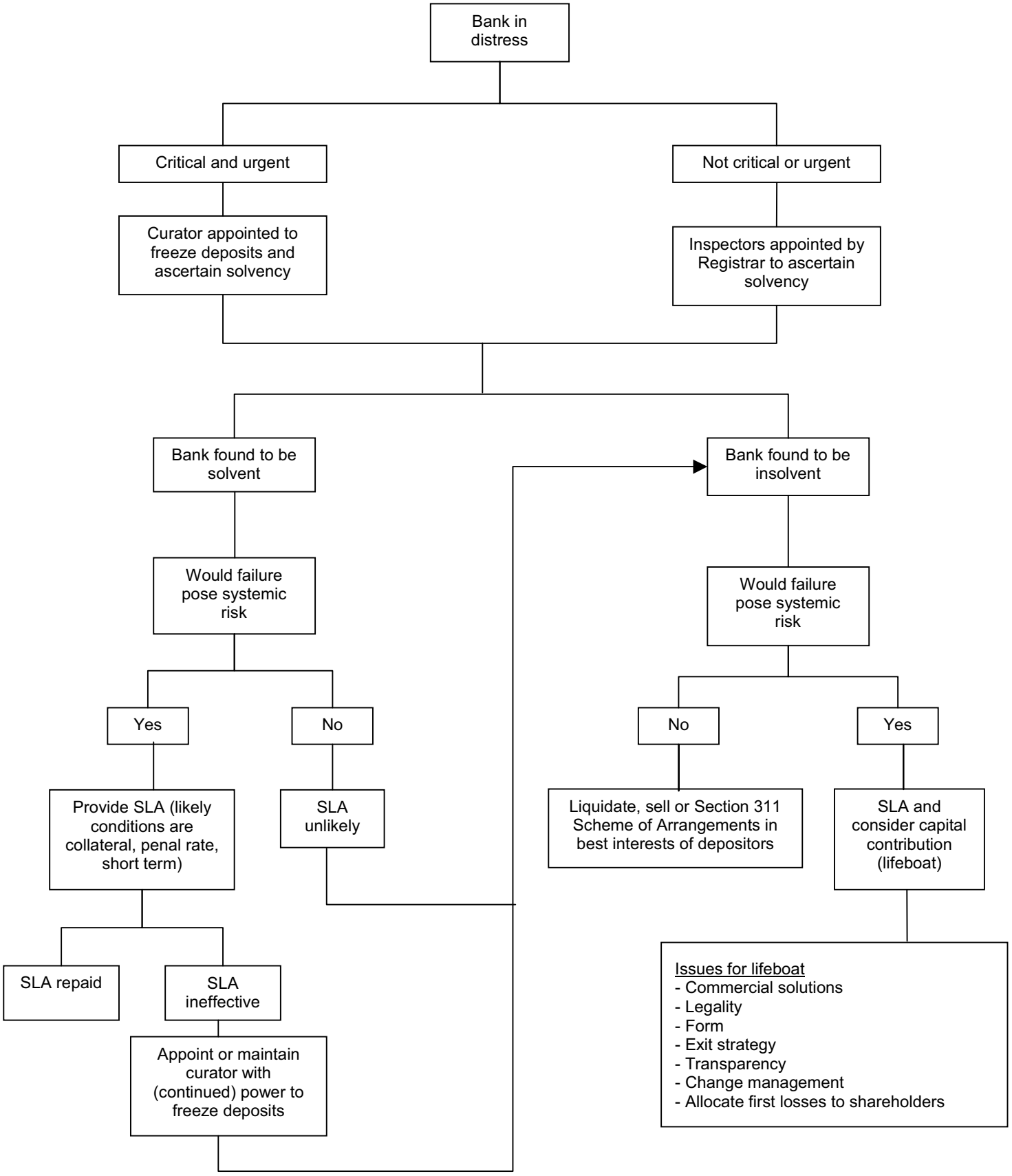
These sentiments appear to have been supported in a speech given by Dr Stals on 15 April 1994, when he said that:

- 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 fixed-

interest 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.

9 CHAPTER 9: CONCLUSIONS

The principal objective of the assistance given to Bankorp by the SA Reserve Bank was to prevent Bankorp's problems causing a general crisis of the banking system. That is a normal objective of central banks and the Reserve Bank gave assistance to other banks with the same objective. It is noteworthy that, unlike three quarters of IMF member countries (including highly developed countries) in the past thirty years, South Africa actually experienced no major, system-threatening banking failures during the period.

However, although the decision to provide financial assistance to Bankorp was, for that reason, justified, the form and structure of Reserve Bank assistance to Bankorp over a decade from 1985 (including its continuation in the form of assistance to ABSA) was seriously flawed, when considered as a whole. It does not match present day standards for central bank assistance and it did not match the standards set by the contemporary practice of other comparable countries' central banks.

Most of the individual undesirable features of the assistance given to Bankorp were also found in the Reserve Bank's assistance to other banks, but their combined application to the extent seen in Bankorp is notable and an important flaw, successive packages of assistance spanning a long period, represents unusually favourable treatment for Bankorp and ABSA.

Central banks normally give assistance to banks to the extent that it is within their legal powers and consistent with their responsibilities for the soundness of the banking system. Such assistance is not automatically available and when it is given, the methods used to assist the bank are designed to meet clear objectives. Assistance may be given in three broad types of cases: solvent banks with liquidity problems; banks that risk insolvency but are able to be restored to a sound position; and banks which are fundamentally insolvent and require orderly liquidation or sale. However, a number of the principles involved were only clarified in the 1990s after the Bankorp decisions were taken.

The Reserve Bank's assistance to Bankorp was marked by a lack of clarity about which type of case was being addressed and a failure to adopt methods appropriate to either the actual or the supposed situation.

Bankorp in 1985 was a bank that had grown fast, partly by absorbing a number of weak banks. Its request for assistance in 1985 was a symptom of potential solvency problems and those underlying problems worsened during the course of the assistance. The Reserve Bank, however, gave assistance (package A) of a type that could at best address a pure liquidity problem and, even as such, did not meet the standards of best practice. Subsequently (package B), the assistance was of a type relevant for a bank facing a remediable solvency crisis, but for that purpose it did not match international good practice. Moreover under package B the Reserve Bank did not address the problem of a bank that was irremediably insolvent as Bankorp might have been. Package C was mainly a continuation of the assistance given in package B in new conditions when, as a result of being bought by ABSA, Bankorp did not represent a systemic risk due to liquidity or solvency.

Overall, the assistance was flawed by the following features of its form and structure:

1 The length of time for which assistance, in the form of successive packages, was given.

2 The willingness of the Reserve Bank to accept successive related requests for additional assistance

3 The continuing secrecy with which the assistance was covered even after the danger of systemic risk had passed, owing to the limiting provisions of section 33 of the S A Reserve Bank Act. However, the secrecy provisions of the S A Reserve Bank Act have been amended in 1997 to allow for some form of disclosure.

4 The use of a simulated transaction to disguise as a loan the Reserve Bank's assistance which was, in fact, a grant (donation).

5 The absence of measures to protect the interests of the Reserve Bank and thereby the taxpayers by the Reserve Bank securing a share of the equity of Bankorp in exchange for the capital contribution made as a grant.

6 The failure to give assistance with conditions that protected the banking system's depositors while penalising the shareholders and management of Bankorp. In fact, shareholders of Bankorp benefited from the assistance.

7 The Reserve Bank's assistance conferred benefits on Sanlam's policy holders and pension funds and on the minority shareholders of Bankorp. That is contrary to public perception published in the media, and contrary to the conclusions of the Heath Investigation. Those perceptions and conclusions have incorrectly asserted that major benefits were received by the shareholders of ABSA.

8 The failure, for half the duration of the assistance or longer, to monitor effectively the business of the beneficiary, Bankorp.

9 The failure to implement methods used successfully in other countries for alleviating banks' bad debt problems, such as creating a special institution to administer delinquent assets.

10 The involvement of the Minister of Finance with a potential conflict of interest. Since the then Minister, Mr B J du Plessis, was the brother of Mr A S du Plessis, a director of Sankorp, a subsidiary of the majority shareholder (Sanlam) of Bankorp, and indeed of Bankorp itself, the Minister should have recused himself in this matter.

In 1985, at the start of the first package of assistance, South Africa's banking system was suffering the shock of adjusting to international anti-apartheid sanctions, and Reserve Bank policy was conditioned by the government's "total strategy" against anti-apartheid forces. Although the problems experienced by Bankorp were not directly linked to those circumstances, the "total strategy" undoubtedly influenced the approach taken by the Governor and senior officers of the Reserve Bank in respect of the problems of Bankorp and other banks.

Moreover it is noteworthy that Reserve Bank assistance was initiated at a time when the Reserve Bank had no bank supervision department. Until 1987 responsibility for bank supervision lay with the Ministry of Finance and was recognised as ineffective. The Reserve Bank's knowledge of the circumstances of banks such as Bankorp would have come through the informal contacts that were, in those days, common sources of information for central bankers.

Under the S A Reserve Bank Act of 1989 the Reserve Bank was obliged to consult the Minister of Finance on certain matters. A meeting to seek the approval of the then Minister for the new assistance being offered to Bankorp was, in fact, held in 1990. That occasioned the above-mentioned flaw in the design of the assistance

packages, for the Minister should have recused himself in this matter owing to family relations.

These flaws in the Reserve Bank's methods of assistance to Bankorp/ABSA are, in total, serious. In the Panel's opinion the provision of a grant, using a simulated transaction, imply that the Reserve Bank acted outside its statutory powers, for, judged by international standards as required by section 10(1)s of the S A Reserve Bank Act of 1989, that action meant that the function being carried out was not such *as central banks customarily may perform* .

The conclusion that the Reserve Bank acted *ultra vires* leads to a consideration of restitution, in which it is the view of the Panel that in principle restitution from the beneficiaries may be sought but that it is impractical to do so.

Noting the flaws in the Bankorp/ABSA assistance also informs a consideration of the Reserve Bank's current principles and practice. Today, the Reserve Bank's principles and practice relating to distressed banks and to reform in related areas of the financial architecture are comparable to the highest current international standards.

The details of these conclusions are summarised in the Report in relation to each of the terms of reference of the Panel. Those summaries are reproduced below:

First term of reference: to determine whether the Reserve Bank, in providing financial assistance to Bankorp, has contravened the provisions of the S A Reserve Bank Act, or any other Act

As the first set of agreements (package A) was structured on the basis of a low interest loan and its Act does not appear to preclude the Bank from charging interest at a rate lower than the market rate, the Panel cannot conclude that the S A Reserve Bank acted outside the scope of its powers in concluding the agreement.

Package B and C constituted simulated transactions which in law amount to donations of money. There is no legal basis by which the S A Reserve Bank could have entered into such agreements, save if the action can be brought under section 10(1)(s) of its Act. As chapter 6 concludes that the S A Reserve Bank's assistance

did not accord with good international practice in several respects, it is concluded that the assistance was *ultra vires*.

The consequence of an unlawful agreement is that it was rendered void *ab initio.* It must surely be the case that it was rendered void *ab initio,* and not merely voidable at the instance of either of the parties, because, where one of the parties to the agreement, in the first place, was not authorised to be such a party, the agreement could never have acquired a legal existence.

That being so, the beneficiaries of the assistance packages obtained benefits from the actions of the S A Reserve Bank to which, in law, they may never have been entitled.

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

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

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

Another way of assessing the extent to which the assistance to Bankorp was consistent with the established policies and procedures of the Reserve Bank is to compare it with Dr Stals' eight principles highlighted at the enquiry into the affairs of Tollgate Holdings Ltd. Dr Stals' principles were, of course, enunciated some years after the first assistance to Bankorp was agreed. Nonetheless they purported to

represent the basis on which this assistance was given. It can be concluded that the assistance was in accordance with these principles to the extent that:

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

However, the assistance was not fully consistent with these principles to the extent that:

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

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

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; its 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 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 adequately assess the risks pertaining to Bankorp.
- 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, but its methods were deficient n

comparison with international best practice. Included in the defects the Panel has noted here, are two that warrant further comment in conclusion:

- A review 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. 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.

Fifth term of reference: to consider in the event of a finding by the Panel that the financial assistance to Bankorp by the S A Reserve Bank was *ultra vires* the power of the Bank, whether restitution can be claimed, and if so, the manner thereof

Given the finding that the contracts were illegal, it would not be possible for the S A Reserve Bank to recover any loss under the law of contract. However, another legal avenue is open in such cases, namely on the basis of unjustified enrichment enjoyed by Bankorp/ABSA.

Notwithstanding allegations in the public domain about conspiracies, the Panel did not find any evidence which would have justified such a conclusion. Accordingly, the Reserve Bank would not come to court in a position where its previous office bearers were shown to have acted with knowledge of the Bank's lack of legal capacity to enter into such a transaction. Even if this was the case, there would be a compelling argument that public interest favoured restitution to a public institution which had been impoverished and which impoverishment would be for the account of the public.

However, any possible action would be based upon enrichment as opposed to contract where estoppel may be relevant. Thus proof of the existence of a beneficiary would be the critical issue.

The Panel is of the view that ABSA paid for the continued assistance of Bankorp by the Reserve Bank and could not be regarded as beneficiaries of Reserve Bank assistance package. The fact that the calculated net asset value and the value of the Reserve Bank assistance package are equivalent, is coincidental. ABSA therefore paid fair value for Bankorp.

Due to the complex nature of the impact that the various packages might have had on the value of capital invested in Bankorp, it is difficult for the Panel to assess with utmost accuracy the quantum of the benefits derived by Bankorp shareholders. Evidence supports the conclusion that the major Bankorp shareholder was aware that it would have received no value or less value for its shareholding absent Reserve Bank assistance. Sanlam, as the major shareholder, was a major beneficiary of the Reserve Bank assistance package.

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

The Panel has concluded that the 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 agency. 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 if measures to ensure intervention is fully recorded, it will make transparency possible. It is however recommended that section 33 of the S A Reserve Bank Act be amended further to allow for public disclosure when such disclosure is manifestly in the public interest. In the view of the Panel the best way in which such a provision could be drafted would be to allow the Governor, with the written consent of the Minister of Finance, to disclose any information referred to in section 33(1)(a) of the Act, when it is deemed to be in the public interest.

Finally the Panel recommends that the Reserve Bank should actively review 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.

To conclude, the Panel believes that this Report has brought to light all the material discoverable facts concerning Reserve Bank assistance to Bankorp/ABSA, and that public knowledge of them should end the uncertainty and misinterpretation that have been fuelled by the absence of previous thorough investigations in the public domain.

10.1 CHRONOLOGY OF EVENTS

Year	Governor	Deputy Governor (responsible for Regulation)	Registrar	Regulatory Events International*	Accounting and Regulatory Events South Africa	Events : Bankorp/Trust Bank/ABSA
1967 to 1975	T W de Jongh 1967-1980	N/A Banking regulation was responsibility of Treasury	JW Louw (1969 to 1981)	Basel Concordat (1975).		Bankorp group consists of: • Senbank • Bank of Johannesburg • Sasbank • Senreg Controlling interest held by Sanlam.
1976						Trustbank over-exposed to property market.
1977						Bankorp Group acquires Trust Bank, which was then headed by Jan Marais.
1978						Bankorp acquires Santam Bank.
1979						
1980				Supervision of banks' forex positions.		
1981	GPC de Kock (1981-1989)		EW van Staden (1982)			
1983			RW Burton (1983-1985)	Basel Concordat amended.		
1984						Bankorp acquires Mercabank.
1985		AS Jacobs (1985-1990)			Foreign banking supervision functions moved to the Bank.	Start of aggressive lending strategies headed by Fred du Plessis (Executive Chairman – Bankorp) and Chris van Wyk (Managing Director – Trust Bank). On 30 May 1985 the Reserve Bank extends low interest loan (3 per cent) of R 200 million to Bankorp. Repayable on or before 31 May 1990.
1986			PJ Badenhorst (1986-1987)	Management of off-balance sheet exposures.	Adoption of UK Capital principles in new regulations. Companies Act regulations changed to eliminate disclosure	Lending book grows by 20 per cent to 40 per cent p.a. Bankorp approached the Bank with a request to increase loan of R 200 million made in April 1985 to R 300 million. After further representations the amount was increased to R 300 million on 18 April 1986.

Year	Governor	Deputy Governor (responsible for Regulation)	Registrar	Regulatory Events International*	Accounting and Regulatory Events South Africa	Events : Bankorp/Trust Bank/ABSA
					exemption for banks.	Full repayment had to be made by 31 May 1990.
1987			CJ de Swardt (1987-1990) (first Registrar who was a Reserve Bank official)		All banking supervision moves to the Bank.	Restructuring by Bankorp. Bank agrees to reschedule loan repayment of five equal instalments of R 60 million each, beginning on 1 April 1990 and ending on 1 April 1994. As a first precursor to the eventual merger of interests into ABSA, UBS Holdings Limited acquired in May 1987, 30 per cent of Volkskas Group Limited, paid for by issuing 10 per cent of its shareholding to Volkskas Group Limited. These two companies became equal joint partners in a new venture, United Bank Limited.
1988				International convergence of capital measurement and capital standards (The Basel Capital Accord). Prevention of the criminal use of the banking system for the purpose of money laundering.		From 1988 onward the Duros Group, through Tollgate, became an aggressive acquirer of companies. It financed these acquisitions through borrowing from Trust Bank and the issue of shares.

Year	Governor	Deputy Governor (responsible for Regulation)	Registrar	Regulatory Events International*	Accounting and Regulatory Events South Africa	Events : Bankorp/Trust Bank/ABSA
1989	C L Stals (1989 – 1999)			Relationship between banking supervisors and external auditors.		In July 1989 the largest single shareholding in Tollgate was registered in the name of Trust Bank Nominees (Pty) Ltd, registered as the holder of 31,5 million shares. There were only two other shareholdings in excess of a million shares at the time, Metropolitan Board Nominees (Pty) Ltd and Southern Life Association Limited. Trust Bank's solvency threatened by debt defaults. Reserve Bank cautions senior management. Sanlam, of its own accord, decided to launch a R 350 million rights issue to recapitalise Bankorp. The issue was not successful and Sanlam took up the majority of the shares.
1990		C J de Swardt (1990 – 1999)	J H van Greuning (1990 – 1994)	Exchanges of information between banking and securities supervisors.		Piet Liebenberg appointed as CEO of Bankorp. Sanlam approaches the Reserve Bank for assistance for Bankorp. Reserve Bank orders investigation of Bankorp by external auditors, which reveals serious situation. The Reserve Bank involved the Minister of Finance, B J du Plessis. He accepts the recommendation to support Bankorp. The Reserve Bank agrees to extend the date on which repayment of the loan commences from 1 April 1990 to 1 August 1990.

Year	Governor	Deputy Governor (responsible for Regulation)	Registrar	Regulatory Events International*	Accounting and Regulatory Events South Africa	Events : Bankorp/Trust Bank/ABSA
						The Reserve Bank, Bankorp and Sankorp meet and agree: • The Reserve Bank provides a further loan of R 700 million (in addition to existing R 300 million) to Bankorp. • The total amount advanced carries an interest rate of 1 per cent pa for 5 years. • Bankorp has to reinvest part of the loan in government bonds (R 600 million) yielding 16 per cent pa for five years, and place the balance on deposit with the Bank (R 400 million) for 5 years. • Various operational constraints. • Only minorities get dividends. Sanlam should launch another rights issue to raise R 526 million. Sanlam ended up taking the majority of the shares. Bankorp made a loss of R 368,4 million during the financial year ended 30 June 1990. Trust Bank increased facilities to Tollgate to R 70 million.
1991				Measuring and controlling large credit exposures. Amendment to the Basel Capital Accord in respect of the inclusion of general provisions/general loan-loss reserves in capital.	New Banks Act incorporating Basel principles comes into effect.	In terms of an agreement dated 26 January 1991, between UBS Holdings Limited, Allied Group Limited, Volkskas Group Limited, Sage Holdings Limited and Sage Financial Services Limited, UBS acquired all the assets of Allied and Volkskas and certain assets of Sage Financial Services with effect from 1 October 1990 and changed its name to Amalgamated Banks of South Africa (later known as ABSA).

Year	Governor	Deputy Governor (responsible for Regulation)	Registrar	Regulatory Events International*	Accounting and Regulatory Events South Africa	Events : Bankorp/Trust Bank/ABSA
						Bankorp's external auditors report that to issue an unqualified opinion for year ended 30 June 1991, a specific provision of R 1 573 million, general provision of some R180 million as well as provisions against high risk accounts amounting to R 616 million (total R 2 369 million) were needed. Bad debts estimated at R 1 930 million. Bankorp has to fund R 800 million of the write-off from own resources. The Bank made available an additional R 500 million to Bankorp, raising its total assistance to R 1,5 billion. A precondition of this help was that Sanlam, as controlling shareholder, had to provide similarly structured, 10 year loan of R 300 million to Bankorp at an interest differential of 17 per cent, the difference between the interest charged on the loan and the rate of reinvestment. The total value of the Bank's assistance equated to R 225 million pa, or a total of R 1 125 million for a 5 year period of the loan (R 1,5 billion at 15 per cent over 5 years). On 3 June 1991 a fax detailing Reserve Bank assistance to Bankorp agreed upon in 1990 was received at a corporate branch in the Volkskas Group. It seems that this fax outlined ideas for discussing further assistance by the Reserve Bank, and was inadvertantly faxed to Volkskas. In terms of an agreement dated 27 September 1991 the subsidiaries of Amalgamated Banks transferred their assets and liabilities to United Bank Limited with effect from 30 September 1991. United Bank

Year	Governor	Deputy Governor (responsible for Regulation)	Registrar	Regulatory Events International*	Accounting and Regulatory Events South Africa	Events : Bankorp/Trust Bank/ABSA
						changed its name to ABSA Bank Limited, and this merging of assets was referred to as ABSA 1.
						ABSA's Chief Executive, Piet Badenhorst approached Sanlam to takeover Bankorp, subject to the continued financial assistance of the Reserve Bank.
1992				Minimum standards for the supervision of international banking groups and their cross-border establishments. A framework for measuring and managing liquidity.		ABSA agrees to pay R 1 230 million for Bankorp. Included in the value of Bankorp assets was a lifeboat from the Reserve Bank amounting to an aggregated benefit of R 1 125 million as is explained in detail in the Report. This was revealed by ABSA's Chairman David Brink in point 1.1 of his October/November 1995 Board statement. ABSA issues shares to Bankorp shareholders for R 11,25 each, which results in a premium of R 9,25 per share. There is no relevance in the issue price; it simply reflects difference in respect of the par value of the shares. Julian Askin of Tollgate liquidates the company. Tollgate owed ABSA R 215 million. ABSA writes off this debt of R 215 million. This was revealed in point 1.3 of David Brink's Board statement of October/November 1995. Note 2 of ABSA's 1993 annual financial statements indicate a write-off against share premium of R 288,8 million for the pre-acquisition bad debts at Bankorp.

Year	Governor	Deputy Governor (responsible for Regulation)	Registrar	Regulatory Events International*	Accounting and Regulatory Events South Africa	Events : Bankorp/Trust Bank/ABSA
1993					AC 120: Disclosure in the financial statements of banks.	Cumulative qualifying write-offs against assistance R 1 098 million.
1994				Risk management guidelines for derivatives. IAS 30: Disclosures in the financial statements of banks and similar financial institutions.		1991 agreement with the Bank amended: • Bankorp becomes "ABSA". • Other consequential amendments. Cumulative qualifying write-offs against assistance R 1 493 million.
1995			C F Wiese (since 1995)	Report by the tripartite group of banking, securities and insurance supervisors on the supervision of financial conglomorates.		Cumulative qualifying write-offs total R 1 953 million (R 800 million more than the Reserve Bank's assistance). ABSA repays R 1 500 million to the Bank. R 300 million (capital in respect of facility of R 51 millon pa) to be repaid to Sanlam in 2001.
1996				Amendment to the Capital Accord to incorporate market risk.		An enquiry in terms of section 417 of the Companies Act into the Tollgate liquidation surfaced on 26 February 1996. Cumulative qualifying write offs against assistance R 2 124 million.
1997				Core principles for effective banking supervision. Basel 25 Core Principles.		Cumulative qualifying write-offs against assistance R 2 259 million.
1998				Framework for evaluation of internal control systems. Risk management for electronic banking and electronic money activities. Operational risk management.	AC 125: Financial instruments - Disclosure and presentation.	In the 1998 report of the external auditors of ABSA to the Reserve Bank, it was shown that the total amount written off against the assistance received was R 2 333 million. The aggregate of the assistance received from the Reserve Bank and Sankorp was R 1 635 million, which meant that qualifying bad debt in an aggregate amount of R 698 million was not covered by the

Year	Governor	Deputy Governor (responsible for Regulation)	Registrar	Regulatory Events International*	Accounting and Regulatory Events South Africa	Events : Bankorp/Trust Bank/ABSA
				IAS 32: Financial instruments - Disclosure and Presentation. IAS 39: Financial instruments:- Recognition and measurement.		assistance and had to be carried by ABSA.
1999	Since 8 August 1999: T T Mboweni	Since 1 July 1999: G Marcus		A new capital adequacy framework. Best practices for credit risk disclosure. Principles for management of credit risk. Sound practices for loan accounting and disclosure. The core principles methodology. A joint report by banking, securities and insurance supervisors on intra-group transactions and exposures principles.		
2000				Basel Committee review of international accounting standards.	AC133: Financial instruments - Recognition and measurement.	

*Except where stated, the papers listed are issued by the Basel Committee on Bank Supervision and can be found on the BIS web site www.bis.org

IMPORTANT NOTE: This table has been assembled from various sources, including a statement by ABSA, newspaper articles and a book "The Infernal Tower".

The contents can be regarded as an indicative guide of events and dates, but are not necessarily complete and factual**.**

ANNEXURE 2

10.2 DEFINITIONS

1 Capital

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

2 Deposit Insurance

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

3 Donation

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

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

Section 417(1) of the Companies Act states:

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

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

5 Lender of last resort

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

6 Lifeboat

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

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

7 Liquidity

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

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

8 Moral hazard

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

9 Regulation

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

10 Simulated transaction

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

11 Solvency

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

12 Special Investigating Unit

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

13 Supervision

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

14 Systemic risk

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

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

15 Tollgate Holdings Ltd

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

ANNEXURE 3

10.3 LEGAL EXPLANATION OF POSSIBLE RESTITUTION ACTION BY THE S A RESERVE BANK

In the event of the Reserve Bank wishing to institute an action to recover monies which it loaned/donated to Bankorp/ABSA, it would be precluded from so proceeding on a contractual action for the reason that the underlying agreement between the parties would be void and unenforceable. Accordingly it would need to proceed by way of an enrichment action.

Briefly, an enrichment action is launched by a party which devolves upon another, at its own expense, a benefit whereby the other party is unjustifiably enriched to recover from that other the benefit itself (or so much as remains of the benefit) or its equivalent in value. The essence of the action is that enrichment of the other party must have been unjustified, that is, must have been *sine causa*. In a case where the enrichment action derives from an agreement which is void and unenforceable (as has been found to be the case with the agreements between the Reserve Bank and Bankorp), the enrichment is necessarily *sine causa* and the action on which the claimant would be required to proceed would either be the *condictio ob turpem vel iniustam causam* or the *condictio indebiti*.

The requirements of the *condictio ob turpem vel iniustam causam* are:

- The ownership of the property must have passed with the transfer.
- The transfer must have taken place in terms of an illegal agreement, that is an agreement whose conclusion, performance or object is prohibited by law or is contrary to good morals or public policy.
- In general terms the plaintiff must be free from turpitude, although this rule has been relaxed *where it is necessary to prevent injustice or to promote public policy*. See Jajbhay v Cassim Ltd 1939 AD 537. See in general JG Lotz in *The Law of South Africa* vol. 9 (first re-issue) at paras 82-83 and DP Visser in *Wille's Principles of South African Law* (8th ed.) at 636 ff.

It would appear that the *condictio ob turpem vel iniustam causam* finds application only in those cases where the agreement is void for illegality. It may be that the concept of illegality in terms of which *condictio ob turpem vel iniustam causam* is

applicable may be considered not relevant in this case, in particular because of the requirement that Bankorp (and later ABSA) must have had knowledge of the illegality at the time of receipt of the loan. It would appear that this may no longer be a requirement of our law. See FNB v Perry NO and others 2001 (unreported decision of the SCA). The point may well be academic because, as Schutz JA said in McCarthy Retail Ltd v Shortdistance Carriers CC 2001 (unreported judgement of the SCA), too much time is spent identifying the correct *condictio* or *actio* rather than analysing the existence of the requirements for an enrichment action (para 10). Thus if this is not the appropriate *condictio*, consideration could be given to the *condictio indebiti* as the appropriate enrichment action.

In terms of the *condictio indebiti*, plaintiff may recover money or other property transferred in intended payment or performance of a non-existent debt. The requirements are as follows:

- Ownership of the property must have been transferred by the act of the parties.
- Transfer must have taken place in circumstances where there was no legal or natural obligation to give it.
- Transfer must have been given in the mistaken belief that the debt was due, involuntary, under duress or by a person of limited capacity to act.
- The *condictio indebiti* is enforceable against the recipient and against nobody else.

Of significance to the present facts may be the finding of the Appellate Division in Willis Faber Enthoven (Pty) Ltd v Receiver of Revenue 1992(4) SA 202 (A) in which it was found that South African law makes no distinction in the application of the *condictio indebiti* between a mistake of law and a mistake of fact. Accordingly a debt paid as a result of a mistake of law can be recovered provided the mistake is found to be excusable in the circumstances of the particular case.

The following caution by Hefer JA (as he then was) at 224 F must be borne in mind, namely *It is not possible nor would it be prudent to define the circumstances in which an error of law can be said to be excusable or, conversely, to supply a compendium of instances where it is not. All that need be said is that, if the payer's conduct is so slack that he does not in the Court's view deserve the protection of the law he should, as a matter of policy, not receive it. There can obviously be no rules of thumb;*

conduct regarded as inexcusably slack in one case need not necessarily be so regarded in others, and ***vice versa****. Much will depend on the relationship between the parties; on the conduct of the defendant who may or may not have been aware that there was no* ***debitum*** *and whose conduct may or may not have contributed to the plaintiff's decision to pay; and on the plaintiff's state of mind and the culpability of his ignorance in making the payment.*

It is not necessary for this Panel to provide a definitive answer as to which of the *condictios* is applicable to the facts of this case. Suffice it to say that there is an enrichment action available to the Reserve Bank, more than that the conclusion that the loan breach the legislation proves to be correct.

This conclusion requires one important qualification. The claimant's right to proceed with the *condictio* would be limited by the *par delictum* rule which literally means "in equal guilt the position of the possessor or defendant is the stronger", that is where the parties are in equal guilt the claimant party will not succeed with the *condictio* for the recovery of the other party's unjustified enrichment. Guilt is construed as turpitude or impropriety and the party guilty of turpitude or impropriety is termed to be *turpis persona*. In South African law however the *par delictum* rule is not applied in all circumstances to defeat a *condictio*. The application of the rule is a question for a decision by the Court exercising its discretion. Following the decision of Jajbhay v Cassim, *supra*, the Courts have relaxed the rule in order "to prevent injustice or to satisfy the requirements of public policy".

Thus on the assumption that the Bank were to proceed with a *condictio* for the recovery of the monies loaned/donated to Bankorp, the latter would inevitably seek to defend itself on the grounds of the *par delictum* rule alleging that the conclusion of the contract and the conduct of the Reserve Bank was tainted by turpitude or impropriety. It would be far less likely that it could sustain an argument that it had not been enriched. If Bankorp was able to prove such turpitude or impropriety the *par delictum* rule could be applied to defeat the claim, save where the Reserve Bank was able to show that either justice or the public interest dictated otherwise. In this case in this context the *dictum* of Diplock LJ in Hardy v Motor Insurers Bureau 1964 (2) QB 745 at 767 is relevant: *The Court's refusal to assert a right even against the person who has committed the anti-social act, will depend not only on the nature of the anti-social act but also on the nature of the right asserted. The Court has to weigh the gravity of the anti-social act and the extent to which it will be encouraged by enforcing the right*

thought to be asserted against the social harm which will be caused if the right is not enforced. In their work *The Law of Restitution* (5th ed.), Goff and Jones at 634 submit that this is the proper test to employ in circumstances where a Court is required to determine whether it is in the public interest or the interests of justice to defeat the claim.

In the context of the facts of the Bankorp loan, it would clearly not be in the public interest nor in the interest of justice to prevent the Reserve Bank (all the other relevant requirements of law having been met) from recovering money which ultimately belongs to a body performing a public function.

There is, however, another aspect to the unlikely success of the invitation of the *par delictum* rule. As Visser submits (Wille et. al. 1991: 636), a better view would be that not all illegal contracts contain an element of turpitude. In the present case there is absolutely no evidence to suggest that the Bank concluded any of the relevant contracts with an element of turpitude. The available evidence indicates that the Bank genuinely and honestly believed that it was so empowered to act. The detailed evidence provided by Dr Stals in the enquiry in terms of section 417 of the Companies Act into the affairs of Tollgate Holdings Ltd provides clear proof for the conclusion that the Reserve Bank acted without any turpitude in this matter. Accordingly the conduct of Bankorp (and later ABSA) is irrelevant and on the basis of the documented evidence available to the Panel, the *par delictum* rule would not be available to the defendant in this case. Thus were the balance of the analysis in this Report to be correct, a claim would be available to the Bank to review the amount of the debt plus interest to the extent allowed by the *in duplum* rule.

ANNEXURE 4

10.4 LIST OF DOCUMENTS CONSIDERED BY THE PANEL

ABSA Bank Ltd v Hoberman and others NNO, Cape Provincial Division, (1996) November 8 and December 19

Amalgamated Banks of South Africa (ABSA) Limited (1992): Circular to shareholders relating to the proposed merger between ABSA and Bankorp; the proposed disposal by ABSA of a 30 per cent interest in Momentum Life Assurers Limited; an increase in the authorised share capital of ABSA; and Notice of a general meeting of shareholders of ABSA, 3 April

Amendment of Regulations framed under Section 36 of the S A Reserve Bank Act, No. 90 of 1989

Banking: The Road to destruction, by the Editor (no date or source)

Bankorp Group - List of top management

Bankorp Group: list of abnormal write-offs, 28 August 1991 (translated from Afrikaans)

Banks Act, No 23 of 1965

Business Day, 28 June 1991: Banking secrets

Business Day, 22 September 1995: Afbank should be saved - curator

Business Day, 26 October 1995: Bailing out Afbank

Business Day, 6 February 1996: Banks fight secrecy in Tollgate case

Business Day, 28 February 1996: ABSA may increase risks with transparency

Business Day, 12 February 1996: ABSA “overcharged Tollgate but did not cause its collapse”

Business Day, 27 February 1996: Bankorp aided for seven years as debts grew

Business Day, 27 February 1996: Stals defends Reserve Bank stance on rescue packages

Business Day, 13 May 1998: Stals asked for Bankorp probe, says Manuel

Business Day, 2 February 1999: Heath “to summons Stals, Liebenberg”

Business Day, 3 February 1999: Heath Unit stalled on banking probe

Business Day, 18 March 1999: Heath Unit oversteps the mark, says ABSA

Business Day, 6 August 1999: A hard road but, looking back, a rewarding one

Business Day, 3 November 1999: Bank to launch lifeboat inquiry

Business Day, 29 November 2000: Court brings Heath's crusade to an end

Business Day, 29 November 2000: Law on Heath unit to change

Business Day, 29 November 2000: Supreme irony

Business Day, 29 November 2000: There are limits to what is permissible

Business Day, 25 January 2001: Panel set to meet again on Bankorp rescue loan

Business Day, 26 January 2001: Clarity on role of Bank Supervision Department

Business Day, 29 January 2001: Bank statement expected today

Business Day, 6 February 2001: Reward sought from SARS for tip, by Bonile Ngqiyaza and SAPA

Business Report, 16 October 1995: Afbank decision still to be made

Business Report, 2 September 1999: Special Report: Banking: The rescue of struggling institutions is not all that phenomenal, but SA has done it better than others: Historical precedent, best practice ... and chance

Business Report, 3 September 1999: Special Report: Banking: The Reserve Bank intervened to ward off potential disaster; and ABSA has never been allowed to forget it: Lifeboat lessons test resolve for future rescues

Commission of Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa by the Honourable Mr Justice HC Nel (November 1997): Extract of certain pages

Draft document for discussion: Letter/Note from the Governor, S A Reserve Bank addressed to Banks, Mutual Banks and Branches of Foreign Banks, dated 2 December 1999, regarding Policy statement on the lender-of-last-resort function of the S A Reserve Bank

Draft document: Core principles for effective banking supervision (Basel Core principles)

Draft document: Policy statement on the role of the S A Reserve Bank as lender of last resort

Draft document: Road map to the Banks Act (Act No 94 of 1990) and consolidated regulations

Evaluation of S A Reserve Bank packages for Bankorp/ABSA in relation to central banking principles, February 2001

Extract from a legal opinion - E Bertelsmann, SC: The Reserve Bank: Various "life boats"

Extracts of certain pages from: Broadway, DJ (1994) *Lessons for management from recent bank failures*. MBA thesis, University of the Witwatersrand

Extracts of certain pages from: *Commissioner's Report: Tollgate Holdings Limited* (in liquidation); Adv J Browde SC, Johannesburg, 2 September 1998

F & T Weekly, 8 May 1998: Heath begins ABSA investigation

Fax from Adam Harris & Associates and an extract re the "lifeboat" afforded by the Reserve Bank to ABSA Bank Limited and its subsidiaries (Tollgate Commission of Enquiry)

Fax from Mr Pieter Strydom from Ernst & Young, addressed to Mr Jannie Rossouw, dated 15 March 2001, regarding Mercabank's management

Fax from Peter Clive Soller (Attorney), addressed to Mr TT Mboweni, Governor of the S A Reserve Bank, dated 31 January 2001 regarding Mr Soller's fax to the SA Revenue Services

Finance Week, 12 November 1999: Three core values for bank clients

Finance Week, 13 February 1992: Legal action against Pickard

Finance Week, 13 February 1992: Reign of silence: Has the Reserve Bank given Bankorp a R1bn lifeboat?

Finance Week, 13 February 1992: Tight lips, open hands

Finance Week, 20 February 1992: Take off the wraps

Finance Week, 20 February 1992: Too big to fail

Finance Week, 27 August 1992: Masterbond and the Bank

Finance Week, 8 January 1998: Watching the watchdog

Finance Week, 26 February 1998: Chris Stals taken to task

Finance Week, 9 November 1998: When a loan isn't

F&T Finance Week, 5 November 1999: Thirty years of banking problems

Financial assistance to Mercabank/Santam Bank by the Reserve Bank - Summary of events: 10 April 1985 to 29 June 1987 (undated document) (translated from Afrikaans)

Financial Mail Supplement, 30 August 1991: A Small world

Financial Mail Supplement, 30 August 1991: In a new frame

Financial Mail, 31 May 1991: The wood for the trees

Financial Mail, 13 September 1991: Behind closed doors

Financial Mail, 19 June 1992: Reserve Bank may face R20m claim

Financial Mail, 26 June 1992: Depositors' luck

Financial Mail, 3 July 1992: Total simulation

Financial Mail, 10 July 1992: Secrecy over claims

Financial Mail, 31 July 1992: Following the paper chase

Financial Mail, 12 March 1993: For whom the bell tolls

Financial Mail, 18 March 1994: Pickard blocks Miba deal

Financial Mail, 25 March 1994: Ham in Pickard's sandwich

Financial Mail, 1 April 1994: Pickard Jnr vs the Bank

Financial Mail, 1 April 1994: Steep curve

Financial Mail, 4 November 1994: Banking: Stals's prime conundrum

Financial Mail, 20 January 1995: Prima Bank/Unibank - In the open

Financial Mail, 3 February 1995: Prima: Where's that missing R5m?

Financial Mail, 3 November 1995: Tollgate: Will there be ABSA-lution?

Financial Mail, 16 February 1996: Beneficiary of secret rescue of ailing bank

Financial Mail, 8 March 1996: Sanlam: Come on, pay up

Financial Mail, 20 March 1998: Mr Askin, we presume

Financial Mail, 15 May 1998: Bankorp ghost haunts Stals

Financial Mail, 11 September 1998: This mustn't be the last word on Tollgate

Financial Mail, 4 December 1998: Here's a conspiracy theory

Financial Mail, 12 February 1999: The lifeboat begins to sink

Financial Times, 3 February 1999: Bank governor may face tribunal over Bankorp

Financial Times, 13 September 1999: Bank corruption probe widens

Financial Times, 2 November 1999: South Africa drops bank fraud inquiry

Focus, November 1999: The Reserve Bank and its naughty children

Government Gazette No. 10564: Regulations framed in terms of the Banks Act, 1965

Government Gazette No. 17115: Banks Act, 1990 (Act No. 94 of 1990): Regulations relating to Banks

IMF Working Paper WP/00/79: Emergency Liquidity Support Facilities by Dong He

IMF Working Paper: Central Banking Department: The Argentine Banking Crisis of 1980, prepared by Tomas JT Balino, 17 November 1987

IMF Working Paper: Monetary and Exchange Affairs Department: Banking Crises in Latin America in the 1990s: Lessons from Argentina, Paraguya, and Venezuela, prepared by Alicia Garcia-Herrero, October 1997

International Monetary Fund: *Occasional Paper 161*: The Nordic Banking Crises: Pitfalls in Financial Liberalization?, by Burkhard Drees and Ceyla Pazarbasioglu (pages 22-35)

International Monetary Fund: *Staff Papers*, Vol. 44, No. 3, September 1997: Determinants of Banking System Fragility: A Case Study of Mexico

Lender of last resort - International discussions

Lender of last resort assistance, Opinion furnished to the S A Reserve Bank by Adv Philip Ginsburg SC, dated 26 May 1998

Letter from Dr CJ de Swardt, Deputy Governor, S A Reserve Bank, dated 18 July 1990, addressed to Mr PJ Liebenberg, Executive Chairperson, Bankorp (translated from Afrikaans)

Letter from Dr CJ de Swardt, Registrar or Bank, S A Reserve Bank, dated 29 June 1987, addressed to Mr CG Erasmus, Managing Director, Bankorp (translated from Afrikaans)

Letter from Dr CL Stals, Governor of the South African Reserve Bank, dated 1991-06-28, addressed to Mr PJ Liebenberg, Bankorp (translated from Afrikaans)

Letter from Dr CL Stals, Senior Deputy Governor, S A Reserve Bank, dated 30 May 1985, addressed to Mr CG Erasmus, Managing Director, Bankorp (translated from Afrikaans)

Letter from Dr DC Cronje, Chairman, ABSA Group, dated 14 March 2001, addressed to Mr JJ Rossouw, Secretary of the Governor's Panel, regarding the financial assistance package to Bankorp

Letter from Dr Gerhard de Kock, Governor, S A Reserve Bank to Mr WP Cooke, Bank of England dated 18 October 1985

Letter from Dr Gerhard de Kock, Governor, S A Reserve Bank to Mr G Blunden, Deputy Governor, Bank of England dated 14 February 1986

Letter from Dr Gerhard de Kock, Governor, S A Reserve Bank, dated 18 April 1986, addressed to Dr LA Porter, Managing Director, Finansbank (translated from Afrikaans)

Letter from Dr Gerhard de Kock, Governor, S A Reserve Bank, dated 18 April 1986, addressed to Mr CG Erasmus, Managing Director, Bankorp (translated from Afrikaans)

Letter from Dr Gerhard de Kock, Governor, S A Reserve Bank, dated 20 June 1986, addressed to Dr P Morkel, Managing Director, Volkskas Group Limited (translated from Afrikaans)

Letter from Dr Gerhard de Kock, Governor, S A Reserve Bank, dated 5 May 1986, addressed to Mr G Liebenberg, Managing Director, Bolank Bank (translated from Afrikaans)

Letter from Dr Gerhard de Kock, Governor, S A Reserve Bank, dated 6 July 1989, addressed to Dr CJ van Wyk, Chief Executive Officer, Bankorp (translated from Afrikaans)

Letter from Dr Gerhard de Kock, Governor, S A Reserve Bank to Mr Paul McGonagle, Senior-Vice President, First National Bank of Chicago dated 31 October 1988

Letter from Dr LA Porter (Managing Director) and Mr HR van der Merwe (Executive Director), Finansbank, addressed to S A Reserve Bank (Ref Dr J Jacobs). [No date on the letter, but it was filed between February and March 1986] (translated from Afrikaans)

Letter from Hongkong Bank (W Purves) to Dr F Leutwiler dated 1 November 1985

Letter from KPMG/Ernst & Young, dated 8 November 1995, addressed to Dr CJ de Swardt, S A Reserve Bank

Letter from KPMG and Ernst & Young Chartered Accountants (SA), dated 21 January 1999, addressed to Dr CJ de Swardt, S A Reserve Bank regarding the Report of the Joint Independent Auditors of ABSA Group Limited to the S A Reserve Bank in connection with exposures in Bankorp Limited and related write-offs

Letter from Mr CG Erasmus, Chairperson, Mercabank, dated 5 December 1986, addressed to Dr AS Jacobs, Senior Deputy Governor, S A Reserve Bank (translated from Afrikaans)

Letter from Mr CG Erasmus, Managing Director, Bankorp, dated 10 April 1985, addressed to Dr Gerhard de Kock, Governor, S A Reserve Bank (translated from Afrikaans)

Letter from Mr CG Erasmus, Managing Director, Bankorp, dated 20 March 1986, addressed to Dr de Kock, Governor, S A Reserve Bank (translated from Afrikaans)

Letter from Mr Harun Ebrahim, Attorney at Law, addressed to the Governor of the S A Reserve Bank, dated 28 March 2001, and Mr JJ Rossouw's reply

Letter from Mr MC Janse van Rensburg, Deputy General Manager, S A Reserve Bank, addressed to Mr J Luttig, Rooth & Wessels, dated 19 March 1998

Letter from Mr J Luttig, partner at Werksmans Attorneys, addressed to Mr Jannie Rossouw, S A Reserve Bank, dated 30 January 2001

Letter from Senior Deputy Governor, S A Reserve Bank, addressed to the Chief Executive Officer, Finance Bank Limited, dated 5 October 1988 (translated from Afrikaans)

Letter from Standstill Co-ordinating Committee to Dr CL Stals, Chairman, dated 1 November 1985

Letter from the Director Corporate Finance, Dr ARP Hamblin, addressed to Dr AS Jacobs and Mr HB Bester dated 4 September 1985

Letter from the Director-General: Finance, Department of Finance to Dr Gerhard de Kock, Governor, S A Reserve Bank dated 27 March 1986

Letter from the Minister of Finance, BJ du Plessis, Ministry of Finance to Dr Gerhard de Kock, Governor, S A Reserve Bank dated 27 March 1986

Letter from the Registrar of Banks (S A Reserve Bank), dated 6 July 1998, addressed to Mr S J Barkhuizen, Heath Special Investigating Unit, East London

Letter from the Registrar of Banks, S A Reserve Bank, dated 31 October 1997, addressed to the Ministry of Finance (Attention: Mr John Solomon)

Letter from the Senior Deputy Governor, S A Reserve Bank, addressed to Mr Derek Keys, Chairperson, Bankorp Group, dated 13 November 1989 (translated from Afrikaans)

Letter from the Senior Deputy Governor, S A Reserve Bank, addressed to Mr BJ du Plessis, Minister of Finance, dated 22 January 1987 (translated form Afrikaans)

Letter, dated 3 August 1990, from S A Reserve Bank to Mr PJ Liebenberg of Bankorp (translated from Afrikaans)

Mail and Guardian, 19 July 1996: Stals's secret hearing

Media release by ABSA regarding tax on Bankorp aid, dated 7 February 2001

Media release by Mr TT Mboweni, Governor of the Reserve Bank, on the findings of the Heath Special Investigating Unit into the financial aid package to Bankorp/ABSA – 3 November 1999

Media Release No 8 of 2001 by the South African Revenue Service re Bankorp/ABSA - taxation issues

Media statement by the Governor's Panel - 29 January 2001

Meeting of the Governor with the management of the Bankorp Group on Wednesday, 1 August 1990 (translated from Afrikaans)

Memo from Mr CF Wiese, Registrar of Banks, dated 22 November 2000, addressed to Mr JJ Rossouw, Secretary of the Governor's Panel, regarding banks that received Reserve Bank assistance

Memorandum - Members of the Standstill Co-ordinating Committee

Memorandum from Mr A Bezuidenhout, Deputy General Manager, Bank Supervision Department, S A Reserve Bank, addressed to Mr JJ Rossouw, dated 15 February 2001 regarding draft documentation for Governor's Panel, and including copies of Memorandums on depositor protection addressed to the Standing Committee for the

Revision of the Banks Act dated 18 September 1996, and the Governors' Committee dated 14 October 1996

Moody's Investors Service - Global Credit Research, South Africa Banking System Outlook, February 2001

Notice of civil proceedings to be instituted in the Special Tribunal: Notice in terms of rule 5 of the rules to regulate the conduct of proceedings in a Special Tribunal made under section 9 of Act 74 of 1996, read with regulation 7 made under section 11 of Act 74 of 1996

Offer by ABSA to acquire all the ordinary shares in the capital of Bankorp for shares in ABSA and incorporating an offer by Sankorp Limited to acquire the entitlements of Bankorp shareholders to such ABSA shares for cash, date of issue: 7 April 1992

One page with four letters from Stals, Murray and two from Faul as well as an article in *Millennium Magazine*, November 1996: Absagate (document incomplete)

Policy statement on the role of the Hong Kong Monetary Authority as lender of last resort - June 1999

Press release by the Heath Special Investigating Unit - no date

Regulations framed in terms of S A Reserve Bank Act, No. 29 of 1944

Report of the Working Group on Strengthening Financial Systems, October 1998

Republic of South Africa, *Debates of Parliament*, Fifth Session, Ninth Parliament, 1 to 4 March 1993

Republic of South Africa, *Interpellations, questions and replies of the National Assembly*, First Session, Second Parliament, 3 to 7 November 1997

Resolution from the Minutes of the Governors' Committee meeting held on Monday, 21 October 1996 in Pretoria, Minutes No 13/1996

S A Reserve Bank Act, No 29 of 1944

S A Reserve Bank Act, No 90 of 1989

S A Reserve Bank: Brief history of banking supervision in the S A Reserve Bank

S A Reserve Bank (1999): Bank Supervision Department: Annual Report

S A Reserve Bank: Extract from Minutes No. 132 - Governors' Committee meeting held on Friday, 14 February 1992 (translated from Afrikaans)

S A Reserve Bank: Extract from the Minutes of a meeting of the Board of directors held on Friday, 27 April 1990

S A Reserve Bank: Extract from the Minutes of a meeting of the Board of directors held on Friday, 15 November 1996

S A Reserve Bank: Extract from the Minutes of a meeting of the Board of directors held on Friday, 27 April 1990

Sanlam's financial exposure and cash flow in respect of Bankorp (on various dates, not adjusted to constant values) - document dated 24 October 2000

Second supplementary opinion - E Bertelsmann, SC: The ABSA Lifeboat and the S A Reserve Bank

Secret Agreement for the Amendment of Assistance Agreements between the S A Reserve Bank, ABSA Bank Limited and Sankorp Limited (19 June 1995) (translated from Afrikaans)

Secret Assistance Agreement between the S A Reserve Bank, ABSA Bank Limited, Sankorp Limited, Banbol (Proprietary) Limited, Bankorp Controlling Limited and Bankorp Limited (31 January 1994) (translated from Afrikaans)

Secret Assistance Agreement between the S A Reserve Bank, Banbol (Proprietary) Limited, Bankorp Limited, Sankorp Limited and Bankorp Controlling Limited (2 September 1991) (translated from Afrikaans) with three Annexures

Share prices: Bankorp and indices for the financial sector as from January 1984 up to June 1992 received from Mr Johan van der Schyff, S A Reserve Bank

Sowetan, 26 January 1999: Heath probe looks into "lifeboats"

Speech given by Sir Edward George, Governor of the Bank of England: The Second Bank of England/LSE Lecture at the London School of Economics on Thursday, 18 November 1993

Statement issued by the S A Reserve Bank, 12 September 1985

Statement issued by the S A Reserve Bank, 29 May 1986

Statement issued by the S A Reserve Bank, 5 September 1985

Submission by Dr CL Stals, Governor of the S A Reserve Bank, to the enquiry in terms of section 417 Companies Act into the affairs of Tollgate Holdings Limited

Summary of expert witnesses (and copy of business cards) Heath Special Investigating Unit

Summary of reports on the International Financial Architecture, October 1998

Sunday Argus Business Report, 28 January 2001: Reserve Bank dawdles where Heath feared to tread

Sunday Times, 15 March 1998: Bank defends itself in face of "lifeboat" allegations

Sunday Times, 31 January 1999: Askin vows to continue "war" with ABSA despite court ruling

Sunday Times, 18 June 2000: Reserve Bank to refloat probe into Bankorp's R1,5bn lifeboat

Tape 1: Interview with Mr Liebenberg 29 June 1997 (translated from Afrikaans): Heath Special Investigating Unit

Tape 2: Interview with Mr Liebenberg 29 June 1997 (translated from Afrikaans): Heath Special Investigating Unit

Tape 3: Interview with Dr Stals 29 June1997 (translated from Afrikaans): Heath Special Investigating Unit

Telefax from the Senior Deputy Governor, S A Reserve Bank to the Minister of Finance, dated 20 December 1989 (translated from Afrikaans)

Telex from Dr Gerhard de Kock, Governor, S A Reserve Bank to Mr Jerry G Franzen, Vice-President and Manager, Europe, Middle East and Africa Div, Texas Commerce Bank dated 23 June 1986

Telex from Mr Stanley Wright from the Office of Dr Fritz Leutwiler, Price Waterhouse and Partners to the Standstill Co-ordinating Committee, dated 6 June 1986

The Banks Act, 1990 (Act No. 94 of 1990, as amended)

The Citizen, 24 November 1997: Reserve Bank to aid Islamic Bank clients

The Economist, 25 March 1995: Please, governor, can you spare a billion?

The Star, 12 August 1997: Prima Bank pay-off revealed

The Star, 3 March 1998: ABSA is in the clear on R6bn Reserve Bank lifeline

The Star, 22 April 1998: ABSA waits for Heath inquiry to clear “slur”

The Star, 7 September 1999: Reserve Bank is more iceberg than lifeboat

The Star, 3 November 1999: Bank acted legally, says Mr Mboweni

ANNEXURE 5

10.5 REFERENCES (OTHER THAN IN LIST OF DOCUMENTS CONSULTED)

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