ADDRESSING THE MORAL HAZARD THROUGH EXPLICIT DEPOSIT INSURANCE: A COMPARATIVE APPRAISAL OF THE KENYA DEPOSIT INSURANCE ACT, 2012

by

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ABSTRACT

This thesis appraises the Kenya Deposit Insurance Act, 2012 and evaluates its effectiveness to address moral hazard in banking. While explicit deposit insurance scheme (EDIS) enhance financial system stability by preventing potential bank runs through reimbursement of depositors of failed banks using *ex ante* premiums levied from the banks, they also create moral hazard when banks take excessive risks in the knowledge that their losses will be borne by the EDIS. Kenya's first EDIS under the Deposit Protection Fund Board (DPFB) did not effectively address bank moral hazard. The thesis considers the features the Kenya Deposit Insurance Act has adopted to limit bank risk-taking and mitigate the impact of bank failure by facilitating the orderly exit of failed banks from the financial system. The appraisal of the Act is conducted in the context of the post-GFC reforms that integrate financial regulation for the safety and soundness of individual financial institutions (microprudential regulation) and the systemwide regulation of the risk emanating from the conduct of business of financial institutions for the stability of the financial system (macroprudential regulation). Using the post-GFC reforms in financial regulation, as well as South African and USA bank regulatory and supervisory and deposit insurance and resolution regime perspectives, I recommend reforms to strengthen Kenya's macroprudential financial regulatory framework and to enhance the effectiveness of its EDIS and SRR. Specifically, I recommend reforms *inter alia* to strengthen Kenya's bank supervisory framework through consolidated supervision of financial conglomerates and the incorporation of macroprudential regulation. In addition, I recommend reforms to the Kenya Deposit Insurance Act to *inter alia* prescribe the assessment criteria for risk-based premiums and the criteria for the enforcement of prompt corrective actions and the requirement for financial conglomerates to prepare recovery and resolution plans.

Key words

Explicit deposit insurance, moral hazard, microprudential regulation, macroprudential regulation, Kenya Deposit Insurance Act

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List of abbreviations

AIG	American Insurance Group
CBK	Central Bank of Kenya
IMF	International Monetary Fund
World Bank	International Bank for Reconstruction and Development
IBEA Company	Imperial British East Africa Company
EA Currency Board	East African Currency Board
CDO	Collateralised debt obligation
CDS	Credit Default Swap
CPSS	Committee on Payments and Settlements Systems
Co-Co bonds	Convertible corporate bonds
CFPB	Consumer Financial Protection Board
DPFB	Deposit Protection Fund Board
EDIS	Explicit deposit insurance schemes
ELA	Emergency liquidity assistance
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act, 1991.
FIRREA	Financial Institutions Reform and Recovery Enforcement Act, 1989.
FHFA	Federal Housing Financing Agency
FSOC	Financial Services Oversight Council
FSB	Financial Stability Board
FSF	Financial Stability Forum
GFC	Global Financial Crisis
G-20	Group of Twenty
G-30	Group of Thirty
IADI	International Association of Deposit Insurers
IOSC	International Organisation for Securities Commissions
IAIS	International Association of Insurance Supervisors
KDI Act	Kenya Deposit Insurance Act, 2012

Land Bank	Land and Agriculture Bank
LOLR	Lender of last resort
MBS	Mortgage Backed Securities
OFR	Office of Financial Research
OLA	Orderly Resolution Authority
RA	Resolution Authority
RRPs	Recovery and Resolution Plans
SARB	South African Reserve Bank
SIFI	Systemically Important Financial Institutions
SRR	Special Resolution Regimes
SRB	Special Resolution Bill
The Corporation	Kenya Deposit Insurance Corporation
USA	United States of America
US	United States

TABLE OF CONTENTS

Chapter 1: Introduction

1.1 Introduction 1

1.2 Background to the study 2

1.2.1 Special role of banks in the economy 2

1.2.2 The sui generis nature of bank insolvency 4

1.2.3 The evolution and role of explicit deposit insurance 6

1.2.4 Moral hazard 8

1.2.5 The rise and impact of universal banking on moral hazard 9

1.2.6 The GFC 25

1.2.7 Lessons from the GFC 28

1.2.8 Post-GFC international response 30

1.3 Kenyan context 31

1.3.1 Background to EDIS in Kenya 31

1.3.2 Currency board era with no deposit protection 1895 to 1966 32

1.3.3 Implicit deposit protection from 1966 to 1985 32

1.3.4 Explicit deposit insurance from 1985 to 2012 33

1.4 Research statement 33

1.4.1 Hypothesis 33

1.4.2 Research questions 34

1.4.3 Limitation of the scope of the study 34

1.5 Motivation for the study 35

1.6 Research methodology and selection of comparative jurisdictions 36

1.7 Summary and lay-out of chapters 36

Chapter 2: The international context of bank regulation, deposit insurance and orderly bank resolution

2.1 Introduction 39

2.1.1 General overview 39

2.1.2 Chapter overview 40

2.2 The post-GFC reform of the international financial architecture 41

2.2.1 Group of Twenty countries 41

2.2.2 Post-GFC reforms to international financial regulation 44

2.2.3 The Basel Core principles and Joint Forum Principles for supervision of financial conglomerates 54

2.3 The IADI Core principles of effective deposit insurance systems 61

2.3.1 Overview of post GFC prominence of EDIS 61

2.3.2 The IADI Core principles 62

2.3.3 Addressing moral hazard through the IADI Core principles 62

2.4 The FSB Key attributes of effective resolution regimes for financial Institutions 67

2.4.1 The FSB Key attributes 67

2.5 Implementation of international financial standards 73

2.5.1 Overview of local adaptation of international financial standards 73

2.5.2 Prospects and challenges in the implementation of international financial standards 73

2.6 Chapter summary and conclusions 76

Chapter 3: The regulation and supervision of financial conglomerates in Kenya, South Africa and the United States of America

3.1 Introduction 80

3.2 Regulation of financial conglomerates in Kenya 81

3.2.1 General background 81

3.2.2 Historical context of bank regulation in Kenya 82

3.2.3 Central banking and bank regulation in Kenya 84

3.2.4 Transition to universal banking in Kenya 87

3.2.5 Implementation of international financial standards in Kenya 91

3.2.6 Factors influencing the implementation of financial reforms in Kenya 97

3.3 Regulation of financial conglomerates in South Africa 98

3.3.1 Historical context of bank regulation in South Africa 98

3.3.2 South Africa’s regulation of financial conglomerates 101

3.3.3 Macro-prudential regulation of financial conglomerates 106
3.3.4 Factors influencing implementation of financial reforms in South Africa 110
3.4 Regulation of financial conglomerates in the United States of America 111
3.4.1 Introduction 111
3.4.2 Supervision of financial conglomerates in the USA 113
3.4.3 Financial innovations and deregulation of the 1980s 123
3.4.4 Dodd-Frank Wall Street Reform and Consumer Protection Act 127
3.4.5 Factors influencing implementation of financial standards in the USA 133
3.5 Chapter summary and conclusions 133

Chapter 4: Explicit deposit insurance and special bank resolution in Kenya
4.1 Introduction 137
4.1.1 General overview 137
4.2 Kenyan EDIS under DPFB 139
4.2.1 Mandate and institutional structure of the DPFB 139
4.3 EDIS under the Kenya Deposit Insurance Act, No 10 of 2012 142
4.3.1 The Kenya Deposit Insurance Corporation 142
4.3.2 Public policy objectives, governance and mandate of EDIS 143
4.3.3 Sources and use of funds 148
4.3.4 Coverage and payment of insured depositors 151
4.3.5 Membership of the Deposit Insurance Fund 154
4.3.6 Legal protection of officers and employees of the deposit insurer 155
4.3.7 Cross border cooperation 155
4.3.8 Relationship with safety-net providers 156
4.3.9 Participation in contingency planning and crisis management 157
4.4 Policy framework for bank resolution in Kenya 159
4.4.1 Introduction 159
4.4.2 Control of institutions after notification under section 44 of the KDI Act 164
4.5 The Corporation as Resolution Authority (RA) 170
4.5.1 International standards on resolution powers 170
4.5.2 The Corporation's resolution powers 171

4.6 Factors influencing Kenya’s implementation of international standards 182

4.7 Chapter summary and conclusions 182

Chapter 5: Transition to explicit deposit insurance and special bank resolution in South Africa

5.1 Introduction 185

5.2 Implicit deposit protection in South Africa 186

5.2.1 Administration of implicit deposit protection in South Africa 186

5.2.2 Curatorship of distressed banks in South Africa 191

5.2.3 Investigation of failed banks under section 69A of the Banks Act 201

5.2.4 The winding up or liquidation of insolvent banks 202

5.3 Proposed EDIS and SRR 203

5.3.1 Introduction 203

5.3.2 The proposed EDIS 204

5.4 The proposed bank resolution regime 211

5.4.1 The National Treasury’s resolution policy proposals 211

5.4.2 Key reforms on bank curatorship and liquidation 211

5.4.3 Resolution powers under the envisaged SRA 213

5.5 Addressing moral hazard under the proposed EDIS and envisaged SRR 215

5.5.1 Evaluation of South Africa’s proposed EDIS and resolution regime 215

5.5.2 Implementation of the IADI Core principles 216

5.5.3 Implementation of the FSB Key attributes 216

5.5.4 Factors influencing South Africa’s implementation of IADI Core principles 217

5.6 Chapter summary and conclusions 217

Chapter 6: Explicit deposit insurance and bank resolution in the United States of America

6.1 Introduction 219

6.2 Overview of US bank regulation and introduction of EDIS 220

6.3 The Federal Deposit Insurance Corporation 221

6.3.1 Governance, funding and mandate of the FDIC 221

6.3.2 Scope of cover of insured deposit 222

6.3.3 Challenges to FDIC's mandate 223

6.3.4 Reforms to the FDIC's premium assessment and regulatory enforcement actions 225

6.3.5 Addressing moral hazard through design of deposit insurance in the USA 226

6.4 The US bank resolution regime 227

6.4.1 FDIC as RA 227

6.4.2 The resolution powers 231

6.4.3 Bank liquidation 242

6.4.4 Nexus between the US resolution powers and the FSB Key attributes 243

6.5 Implementation of international financial standards for EDIS and SRR in USA 251

6.6 Chapter summary and conclusions 251

Chapter 7: Conclusions and recommendations

7.1 Objectives of the thesis 254

7.2 Conclusions of the study 254

7.2.1 Conclusions on research questions 254

7.3 Recommendations to reform the Kenyan EDIS and SRR 261

7.3.1 Overview of recommendations 261

7.3.2 General recommendations 261

7.3.3 Specific recommendations to Kenya EDIS and SRR 264

7.4 Suggestions for further research 268

Bibliography

CHAPTER 1: INTRODUCTION

1.1 Introduction

This study is an in inquiry into how the design of the explicit deposit insurance scheme (EDIS) under the Kenya Deposit Insurance Act, 2012 may be enhanced to address the moral hazard in banking more effectively and contribute to Kenya's financial system stability. In this introductory chapter, the special roles that banks play in the economy, as well as the potential moral hazard to which the banking sector is prone, are discussed. In particular, the moral hazard from the practice of universal banking through complex financial conglomerate structures and their offering of complex financial products, that was one of the main factors that led to the 2008 Global Financial Crisis (GFC), are examined.Also discussed are the lessons drawn from the GFC and the post-GFC reforms to international financial standards aimed at limiting moral hazard and the use of public funds to bailout failed banks. Notably, the post-GFC reforms seek to integrate microprudential and macroprudential regulation[1] for financial institutions by aligning bank regulation and supervision,[2] EDIS and special resolution regimes (SRR) to enhance systemic supervision that, *inter alia,* facilitates the orderly exit of failed institutions from the financial system.

Central to the thesis is the evolution of the design of EDIS from being a component of general bank regulation in the pre-GFC framework, to its role as a critical component of an orderly bank resolution regime in the post-GFC framework. Within this broader context, a comparative appraisal of the Kenya Deposit Insurance Act, 2012, is undertaken. In this introduction, I also briefly outline the Kenyan context, the research

[1] While microprudential regulation is focused on the safety and soundness of individual financial institutions, macroprudential regulation seeks to promote the safety of the financial system as a whole by limiting the risks and costs emanating from the collective conduct of business of financial institutions. Unlike the narrow individual focus of microprudential regulation, macroprudential regulation thus has a system wide focus. See SG Hansen, AK Kashyap and JG Stern "A macroprudential approach to financial regulation" (2011) 25:1 *Journal of Economic Perspectives* 5. See also G Galati and R Moesner 'Macroprudential policy- a literature review,' (2011) *BIS Working Paper* No 337, 6.

[2] Although regulation and supervision are sometimes referred to interchangeably they are in fact distinct concepts. See P Cartwright, *Banks, consumers and regulation,* (2004) 5. Thus, while regulation refers to the setting of standards of conduct for licensed institutions and prescribing sanctions for breach, supervision refers to the surveillance of compliance through examinations. See EJ Pan, 'Understanding financial regulation' (2011) *Cardozo School of Law Institute of Advanced Legal Studies Working Paper* No 329, 13. CW Lichtenstein 'Lessons for 21st Century Central Bankers: Differences between Investment and Depository Banking,' in M Giovonoli and D Devos (eds), *The International Monetary and Financial Law: The Global Crisis*, 217.

problem, the research questions, the scope and limitations of the study, the motivation for the study, the research methodology, the selection of the comparative jurisdictions and provides a summary and layout of the chapters of the thesis.

1.2 Background to the study

1.2.1 Special role of banks in the economy

Although banks are incorporated, like other corporations, to serve the interests of their shareholders,[3] they also provide three special services to the economy. These services are, financial intermediation, facilitation of the payments system and implementation of monetary policy.[4] Banks serve as financial intermediaries when they accept deposits from the public, pool them as their own funds, and invest the pooled funds in loans to borrowers.[5] Since the depositors' claims are only against the bank and not its borrowers, intermediation enables banks to keep profits derived from the loans, but exposes depositor funds to risk in the event that the banks fail.[6] By receiving deposits from members of the public with surplus funds to save and lending the deposits to borrowers with viable projects for which they lack financing, banks link savers and borrowers and facilitate the efficient allocation of resources in the economy.[7]

Banks also facilitate the payment for goods and services by settling customer bills through the clearance and settlement of cheques, other bills of exchange or electronic transfers, which promotes trade in goods and services, employment and economic growth.[8] In addition, banks serve as custodians of money and as conduits of money

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[3] Investors incorporate companies, including banks, to enhance their accessibility to increased funding sources in the capital markets, whilst also protecting themselves from the risk of personal bankruptcy. *Salomon v Salomon and Company Ltd* [1897] AC 22, per Lord MacNaughten, 52. See also L Sealy & S Worthington, *Sealy and Worthington's cases and materials on company law,* (2013) 21. In particular, shareholders in banking companies benefit from the use of depositor funds that they may invest in risky ventures in the hope of earning higher profits than the interest they pay for the deposits. The use of the separate legal personality and limited liability status of incorporation may incentivise bank management to gamble with creditors' money in the hope of earning windfall profits while shifting any losses to creditors.

[4] See RS Carnell, JR Macey & GP Miller, *The law of banking and financial institutions,* (2009) 54.

[5] *Ibid.*

[6] Although other financial institutions also facilitate intermediation, consumers prefer to operate their savings and current accounts through banks. See P Cartwright, 'Retail depositors' conduct of business and sanctions', (2009) *Journal of Financial Regulation and Compliance* 302.

[7] Carnell *et al* 54.

[8] *Ibid.*

supply in the economy and thereby implement government monetary policy.[9] Thus, while central banks determine monetary policy by setting the rate at which they lend to banks, it is banks that implement the monetary policy thus set by using the central banks' rate as the basis of determining their own rate of interest on loans they advance to their customers.[10] This facilitates the flow of money in the economy and promotes price level stability that is critical for certainty in business planning.[11] The aforementioned collective services provided by banks have become so critical to national economies that they are considered as public goods.[12] The need to sustain the continued provision of banking services therefore motivates governments to enforce prudential regulation to promote the safety and soundness of banks.[13] Government regulation is also needed because of the adoption of "fractional reserve banking" under which banks invest the bulk of their deposits as loans and retain only a fraction as reserves to meet depositor withdrawal needs.[14] However, fractional reserve banking creates an imbalance between bank liabilities as "liquid cash and repayable on demand"-deposits and bank assets as loans that are recoverable over a longer time and are difficult to liquidate at short notice.[15]

Prudential regulation addresses the imbalance between liquid deposit liabilities and illiquid bank assets through capital and liquidity reserve requirements that obligate banks to maintain reserves at higher levels than the banks would otherwise retain for their depositor withdrawal needs.[16] Capital and liquidity requirements seek to ensure that banks have sufficient funds to meet unexpected depositor withdrawal needs and

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[9] See TC Baxter Jr & D Cross, 'The Federal Reserve's response to the crisis: Doing whatever it takes within its legal authority', in M Giovanoli & D Devos (eds), *International monetary and financial law* (2010) 294.
[10] Carnell *et al* 54.
[11] *Ibid.*
[12] *Ibid.*
[13] *Idem* 732.
[14] Fractional reserve banking is based on

> the notion that depositors will normally withdraw only a small fraction of deposits on any given day, and that this fraction is statistically ascertainable.

However, when unexpected withdrawals exceed the cash on reserve, the bank becomes unable to honour depositor demands, since their deposits would have been lent out in loans. See PA McCoy, 'The moral hazard implications of deposit insurance: Theory and evidence', Seminar on current development in monetary and financial law, (2007) Washington DC, United States of America 5. See also P Howells & K Bain, *The economics of money, banking and finance: A European text,* (2008) 548.
[15] E Hupkes, 'Insolvency – Why a special regime for banks?', (2003) *IMF Current developments in Monetary and Financial Law* 3.
[16] McCoy 15.

so to promote public trust in the financial system.[17] Public trust is essential for the banking business because of the risk that the failure of one bank could lead to panic withdrawals and potentially evolve into a contagion run on even safe and sound banks.[18] Consequently, banking regulation seeks to prevent the risk of contagion[19] and the potential "domino effect" it could have on other banks.[20] This enhances the safety and soundness of banks and protects depositors who, as mere concurrent creditors[21] under normal corporate insolvency regimes, often bear a disproportionate burden in the event of bank failure by losing their total deposits.[22]

1.2.2 The sui generis nature of bank insolvency

While banking regulation promotes the continued provision of banking services, it is paradoxically also recognised that the failure of inefficient banks could be beneficial to the economy by releasing their resources for deployment by the more efficient banks.[23] This is probably why the Basel Committee on Banking Supervision[24] suggests that bank supervision should not aim to prevent bank failureat all costs but to facilitate the orderly exit of insolvent banks from the financial system and mitigate the impact of such failure on depositors and the financial system.[25] However, ordinary corporate

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[17] Hupkes 3.
[18] Carnell *et al* 732.
[19] T Temzelides, 'Are bank runs contagious?', (1997)*Federal Reserve Bank of Philadelphia Business Review* 3. For an analysis of bank contagions from bank over-commitment to risky lending, see P Honohan, 'A model of bank contagion through lending', (1999) *International Review of Economic Finance* 147.
[20] GG Kaufman, 'Bank contagion: Review of the theory and the evidence', (1994) *Journal of Financial Services Research* 123.
[21] Since bank depositors only take their funds to the bank for safe keeping they do not demand any security or other contractual preference in insolvency. For example, under South African insolvency law, depositors are concurrent creditors because they are unsecured and enjoy no preference in insolvency. Consequently, they must prove their claims under section 103(1)(a) of the Insolvency Act 24 of 1936.
[22] Carnell *et al* 732.
[23] See Subcommittee on Financial Institution Supervision, Regulation and Insurance of the Committee on Banking Finance and Urban Affairs of the US House of Representatives, *Inquiry into Continental Illinois Corporation and Continental Illinois National Bank: Hearings before the Subcommittee,* (1984) available at <https://www.fraser.stlouisfed.org>accessed on 11.4.2018. The report argues that "Too-Big-To-Fail" financial institutions (see par 1.2.7 below) increases the moral hazard by enabling inefficient banks to continue in operation and distorts economic rewards and punishment for inefficiency. It recommends the liquidation of inefficient banks as being more advantageous to the economy by releasing their resources to more efficient banks.
[24] The Basel Committee was established in 1974 after the Franklin National Bank crisis in the USA and the failure of the Bankhaus Herstatt Bank of Germany. See M Howard, R Masefield & J Chuah, *Butterworths banking law guide,* (2011) 19 and C Goodhart, *The Basel Committee on banking supervision: A history of the early years 1974–1997*, (2002) 3.
[25] See Basel Committee, *Core principles for effective banking supervision,* (2012) par 24.

insolvency procedures whose main objective, as observed by Finch, is to protect the insolvent company's assets from a "free for all" pursuit of recovery by individual creditors, may not efficiently facilitate the orderly exit of insolvent banks from the financial system.[26] This is inter alia because ordinary corporate insolvency is conducted through lengthy judicial proceedings that rely on creditor meetings to determine depositor rights of recovery.[27]

Consequently, judicial proceedings are costly and unsuitable for bank insolvencies as they could delay the determination of depositor and other creditor rights and disrupt their economic operations for extended periods.[28] In addition, ordinary corporate insolvency procedure treats depositors as concurrent creditors forming part of the lowest tier in creditor hierarchy, who do not enjoy special protection in insolvency procedures.[29] For these reasons, the International Monetary Fund (IMF) and World Bank recommend that depositors ought to be afforded special preference in bank insolvencies because they form the largest category of bank creditors, and place their funds in banks for saving rather than as long term credit to the bank.[30]

Depositors also require special preference in bank insolvencies because their deposits are in the form of liquid cash that is susceptible to quick dissipation by bank employees.[31] Therefore, the fear of losing their savings could motivate depositors to turn to panic withdrawals that would risk creating a contagion of bank runs and lead to instability in the banking sector.[32] All these factors probably entitle depositors to a*sui generis* preferential treatment in bank insolvencies to prevent panic withdrawal of deposits that could otherwise lead to bank runs and threaten financial system stability.[33] Protection of depositors through a special bank insolvency procedure could also enhance public confidence in the financial system.[34]

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[26] V Finch, *Corporate insolvency law, perspectives and principles*, (2009) 7.
[27] Hupkes 3.
[28] *Ibid.*
[29] *Ibid*.
[30] See IMF & World Bank, *An overview of the legal, institutional, and regulatory framework for bank insolvency,* (2009)16.
[31] *Ibid.*
[32] *Ibid.*
[33] *Ibid.*
[34] See RR Bliss & GG Kaufman*, US corporate and bank insolvency regimes: An economic comparison and evaluation*, (2016) Federal Reserve Bank of Chicago working paper 3.

1.2.3 The evolution and role of explicit deposit insurance

Depositor preference in bank insolvencies may be facilitated through EDIS that are established under legislation to confer a statutory right (explicit) to depositors of failed banks to be reimbursed their insured deposits.[35] Thus, EDIS prescribe the timing, scope and features of depositor reimbursement by determining who to pay, when to pay, and how much to pay, in legislation.[36] Explicit deposit "insurance" may be contrasted with implicit deposit "protection" which is presumed to automatically exist in jurisdictions without explicit deposit insurance.[37] Implicit deposit "protection" is provided by government at its discretion (implicit) with decisions as to whether or not to reimburse depositors, and if so, which depositors to reimburse, when to pay them and how much to pay, depending on political expediency.[38] In addition, unlike explicit deposit "insurance" that has a prefunded pool of funds, implicit deposit "protection" is administered by central banks at their discretion along with their other central bank functions.[39] Thus, central banks provide implicit deposit "protection" through their authority as lenders-of-last-resort (LOLR) and as banking supervisors.[40] This entails the use of existing central bank facilities to effect implicit deposit protection, which often means that governments consider it to be more cost effective to administer than to set up a framework for explicit deposit insurance.[41]

However, since it is *ad hoc* and discretionary, implicit deposit protection may not be well enough publicised to depositors to effectively prevent bank runs.[42] As it is financed by the government *after* bank failure, implicit deposit protection also lacks pre-set

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[35] R Ayadi & LM Lastra, 'Proposals to reforming deposit insurance in Europe', (2010) *Journal of Banking Regulation* 230.
[36] *Ibid.*
[37] See A Demirguc-Kunt, E Kane & L Laeven, 'Deposit insurance around the world: A comprehensive analysis and data base', (2015) *Journal of Financial Stability* 155.
[38] *Ibid.*
[39] See M Dobler, S Gray, D Murphy & B Radzewicz-Bak, *The lender of last resort function after the Global Financial Crisis*, (2016) IMF working papers 4.
[40] Central banks act as LOLR when they increase the supply of money to ease a liquidity shortage in the market through open market operations or to provide liquidity to a bank or small group of banks with liquidity problems through the overnight lending or emergency liquidity assistance or "life boat" for longer repayment periods. See also R Smits, 'European supervisors in the credit crisis: Issues of competence and competition', in M Giovanoli & D Devos, (eds) *International monetary and financial law,* (2010) 307, who clarifies that central banks act as LOLR either when they provide funding to individual banks with liquidity problems or as special emergency liquidity assistance (ELA) to a group of banks suffering liquidity shortage due to a systemic lack of liquidity in the financial system.
[41] Ayadi & Lastra 232.
[42] *Ibid.*

mechanisms to address bank moral hazard.[43] This is because it uses public funds to reimburse depositors and to resolve the affairs of failed banks without any structures for recovering the costs of such reimbursement and resolution from banks through *ex ante* premium levies or *ex post* through contributions from the solvent banks.[44] Similarly, implicit deposit protection has no measures to address depositor moral hazard through limitation of the scope of insured deposit.[45] As it relies on central bank discretion, implicit deposit protection is also likely to be administered inconsistently and probably offends the rule of law.[46]

These considerations provide governments with the policy choices of whether to establish EDIS and SRR to provide political legitimacy for the protection of vulnerable depositors or to continue to provide *ad hoc* implicit deposit protection on a discretionary basis.[47] The government of the United States of America (USA)[48] responded to this policy question by establishing the world's oldest EDIS through the Banking Act, 1933,following the Great Depression.[49] The major objective of the US EDIS was to prevent depositors of banks that faced liquidity problems from engaging in panic withdrawal of deposits that would evolve into bank runs, by assuring them of

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[43] Moral hazard arises when a party to a contract takes more risks in anticipation of keeping the profits because the costs of any loss are born by the other party. See International Association of Deposit Insurers (hereafter 'IADI'), *Core principles for effective deposit insurance systems*, (2009) (revised 2014) 10available at <https://iadi.org.core-principles>accessed on 18.6.2017. The IADI was established in 2002 to assist member countries in the design and implementation of effective deposit insurance systems.

[44] See *IADI Core principle* 9.

[45] See *IADI Core principle* 8.

[46] See Dobler *et al*4 and Smits 307. However, while the LOLR provides funds to illiquid banks that are unable to access the private market, it distorts their incentives for risk taking similar to those associated with EDIS. See G Sleet & BD Smith, 'Deposit insurance and lender-of-last-resort functions', (2000) *Journal of Money, Credit and Banking* 519. See also *IADI Core principle* 9 that requires EDIS to be funded by banks.See further P Tucker, *The lender of last resort and modern central banking: Principles and reconstruction*, in *Rethinking the lender of last resort*, (2014) Bank of International Settlements papers 11. The author argues that lenders of last resort have to be credible by meeting their commitments, which credibility is undermined when they exercise their discretion inconsistently. See also HWR Wade and CF Forsyth, *Administrative law*, (2000) 20 where the authors argue that discretion may lead to inconsistencies.

[47] See AJ Levitin, 'In defence of bailouts', (2011) *The Georgetown Law Journal* 481. Levitin argues that because government reimbursement of depositors and other bailout measures result in the distribution of public resources to private firms, it is necessary to establish a statutory framework to structure the rights and obligations of shareholders, depositors and the government rather than reliance on *ad hoc* procedures.

[48] The terms "USA", "US" and "American" are used interchangeably depending on the exigencies of the context.

[49] See CW Calomiris & E White, 'The origins of federal deposit insurance', in C Golgin & GD Libecap (eds),*The regulated economy: A historical approach to political economy,* (1993) 145.

the reimbursement of their deposits.[50] However, EDIS does not automatically address risk-taking by banks, and could even encourage more risk-taking.[51] Wheelock and Kumbhakhar observe that, safe in the knowledge that their depositors will be protected if they fail, banks may also abuse EDIS by taking excessive risk in the hope of keeping the profits if the investments succeed.[52] On the other hand, if the investments fail, the cost of the failure is borne by the deposit insurer that reimburses the failing entity's depositors. [53]To protect bank deposits from being used to cross-finance the risky non-banking business and limit the use of insured bank deposits in excessive risk taking, the Banking Act 1933[54] thus prohibited national banks, under the provisions that are referred to as the Glass-Steagall-provisions, from engaging in the underwriting of, or trading insecurities or in other non-banking business.[55]

1.2.4 Moral hazard

The behaviour by banks of engaging in risky ventures expecting to "privatise profits" by distributing the profits among the shareholders and to "socialise losses"[56] by passing the losses to the deposit insurer, is referred to as "moral hazard."[57] Moral hazard arises when one party to a contract takes risks that such party would otherwise not take if it were to bear the costs of any losses.[58] Notably, EDIS may encourage moral hazard from depositors and from banks. Depositor moral hazard arises when

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[50] EN White, 'State sponsored insurance of bank deposits in the United States 1907 to 1929', (1981) *Journal of Economic History* 539. Although several states had previously introduced deposit insurance within their jurisdictions, the Federal Deposit Insurance Corporation (hereafter 'FDIC') was the first federal agency to establish a national EDIS after the Great Depression of 1930 to 1933.

[51] CW Calomaris, 'Is deposit insurance necessary? A historical perspective', (1990) *The Journal of Economic History* 283.

[52] DC Wheelock & SC Kumbhakhar, 'Which banks choose deposit insurance: Evidence of adverse selection and moral hazard in voluntary insurance systems', (1995) *Journal of Money Credit and Banking* 186.

[53] *Ibid.*

[54] The Banking Act 1933 is also referred to as the Glass-Steagall Act in honor of Senator Carter Glass and Representative Henry B Steagall who sponsored it the US Senate and US House of Representatives respectively. See WF Shughart II 'Public choice perspectives of the Banking Act, 1933,' in C England and TF Huertas, (eds) *The Financial Services Revolution: Policy Directions for the Future*, 1988) Boston: Kluwer Academic Publishers, 87.

[55] See CW Lichtenstein, 'Lessons for 21st Century central bankers: Differences between investment and depository banking', in M Giovanoli &D Devos (eds), *International Monetary and Financial Law*, (2010) 217.

[56] M Carney, 'Statement to International Monetary and Financial Committee', (2013) *IMF* 2, available at <https://www.imf.org/External/AM/2013/imfc/Statement/eng/FSB.pdf>accessed on 31.7.2016. According to Carney, the expectation of government bail-outs encourages financial conglomerates to take excessive risks because while they *privatise profits* the bail-outs enable them to *socialise losses.*

[57] See FS Mishkin, *The economics of money banking and financial markets,* (2016) 296.

[58] See B Ely, 'Regulatory moral hazard: The real moral hazard in federal deposit insurance', (1999) *The Independent Review* 241.

depositors become indifferent to the safety and soundness of the insured banks in which they place their deposits because the EDIS guarantees their reimbursement if the banks fail.[59] Bank moral hazard arises when the bank invests in risky ventures in the knowledge that any losses incurred will be borne by the deposit insurer.[60]

1.2.5 The rise and impact of universal banking on moral hazard

1.2.5.1 Overview of universal banking and moral hazard

Of great significance is the use of deposits to cross-finance investments in non-bank businesses through the practice of "universal banking" that combines the provision of "traditional banking, insurance, securities trading, real estate brokering, and other services under one umbrella."[61] Since universal banks may use deposits to invest in non-bank business through either subsidiaries or investment in the business activities of their clients, the reimbursement of depositors of their banking affiliates by EDIS increases moral hazard because it absolves universal banks from bearing the costs of bank failure.[62]

According to Boyd *et al,* by investing in the business activities of their clients, universal banks seek to benefit from the borrowing clients' business through the interest earnings on the loan as well as the potential profits from the equity investment.[63] This creates a conflict of interest that may prevent the bank from effectively monitoring the borrower's use of the loan and may even motivate the bank to condone the borrower's use of the loan in risky ventures in anticipation of higher profits.[64] Thus, the

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[59] FS Mishkin, 'How big a problem is Too-Big-To-Fail? A review of Gary Stern and Ron Fieldman's Too-Big-To-Fail: The hazards of bank bailouts', (2006) *Journal of Economic Literature* 989. Whilemoral hazard may also arise between the bank and its borrower when the borrower uses a loan for purposes other than those for which it was approved, banks normally limit such moral hazard by disbursing the loans in tranches or through restrictive covenants in the loan agreement the breach of which triggers insolvency proceedings.See E Nier & U Baumann, 'Market discipline, disclosure and moral hazard in banking', (2006) *Journal of Financial Intermediation* 332–361.

[60] See JK Boyd, C Chang & BD Smith, 'Moral hazard under commercial and universal banking', (1998) *Journal of Money, Credit and Banking* 427.

[61] See PS Rose & MH Marquis, *Money and capital markets,* (2009) 754. Over time, universal banking has evolved into what are now referred to as financial conglomerates. See R Cranston, E Avgouleas, K van Zwieten, C Hare & T van Sante, *Principles of banking law*, (2018) 20–32.

[62] See AE Wilmarth Jr, 'The dark side of universal banking: Financial conglomerates and the origins of the sub-prime financial crisis', (2009) *Connecticut Law Review* 967.

[63] Boyd *et al* 427.

[64] *Idem* 428, where Boyd *et al* argue that the conflict of interest dis-incentivises universal banks from effectively monitoring the borrower's use of the loan and probably motivates them to condone the borrower's use of the loan to engage in risky activities that increase prospective profits.

reimbursement of depositors by the EDIS may encourage the universal banks to use depositors' funds to gamble for more profits without the risk of bearing the losses.[65]

1.2.5.2 Rise of universal banking and their financial conglomerate structures

The traditional role of commercial banking was the acceptance of deposits for savings and advancement of loans to customers without the bank's investment of equity in their customers' firms.[66] This traditional role of banks was changed by the rise in universal banking across most of the industrialised countries in the late twentieth centurythat permitted banks to also engage in a range of non-banking businesses.[67] However, the factors that motivated universal banking exercised through financial conglomeration, in Europe differed from those in the USA.[68] While universal banking[69] and the combination of banking and non-bank business had been practiced in Europe since the eighteenth century, the structure of universal banks differed from country to country.[70] For example, in Belgium and Germany, universal banking traditionally combined commercial banking and securities trading that enabled them to invest in the companies they lent to.[71] Accordingly, the expansion of German and Belgian universal banks was into the provision of insurance services to enhance their competitiveness as globalisation intensified.[72]In contrast, the French universal banks that originally combined commercial banking and insurance services, sought to

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[65] According to Cole, McKenzie & White, such institutions use depositors' funds to gamble for resurrection when they hide losses from regulators and gamble in more risky investments hoping to recover their losses and resurrect from insolvency. See RA Cole, JA McKenzie & LJ White, 'Deregulation gone awry: Moral hazard in the savings and loan Industry', in A Cottrell, M Lawlor & J Woo (eds), *The causes and consequences of depository institution failures,* (1995) 29. The authors argue that banks gamble on resurrection when they choose risky asset portfolios hoping for high profits or bonuses knowing that the government, depositors or the deposit insurer will absorb the losses if the gamble fails. See also FM Baldursson & R Portes, 'Gambling for resurrection in Iceland: The rise and fall of the banks', presentation at Central Bank of Iceland (January 2014) 38 and D Kirti, *When gambling for resurrection is too risky*, (2017) IMF working paper 24.

[66] Boyd *et al* 427.

[67] See R Tilly, 'Universal banking in historical perspective', (1998) *Journal of Institutional and Theoretical Economics* 11.

[68] *Ibid.*

[69] See Rose & Marquis 754.

[70] Tilly 11.

[71] *Ibid.*

[72] See F Dierick, *The supervision of mixed financial services groups in Europe*, (2004) The European Central Bank occasional paper series5. See also G De Nicolo, P Bartholomew, J Zaman & M Zephirin, *Bank consolidation, internationalization, and conglomeration: Trends and implications for financial risk*, (2003) The IMF working paper 17.

expand into securities business.[73] In the United Kingdom on the other hand, commercial banks could only underwrite securities through subsidiaries.[74]

The rise in financial conglomerates in the USA, where nationally chartered banks had been prohibited from underwriting securities since 1933,[75] was motivated by increased competition during the 1980s and 1990s,[76] from foreign banks[77] and the rise of "shadow banking".[78] Since most European foreign banks operated as universal banks in their home markets, the US Congress sought to enhance the competitiveness of US banks by deregulating the financial sector in 1999 through the Financial Services Modernization Act (the Gramm-Leach-Bliley Act) and permitting them to establish financial holding companies that combined commercial banking, with securities, insurance and other related financial services.[79] This Act permitted financial holding companies to adopt the financial conglomerates corporate structures that combined a group of two or more companies to "offer at least two distinct forms of financial services."[80] However, the adoption of complex financial conglomerate structures[81] that sought to diversify earnings through economies of scale and scope,[82] and innovative

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[73] Dierick 6.
[74] *Ibid.*
[75] See Lichtenstein 217.
[76] See CW Calomiris, 'Universal banking "American style"', (1998) *Journal of Institutional and Theoretical Economics* 46. See also Carnell *et al* 131. Shadow banking rose in the USA in the 1970s and the 1980s, when investors shifted from banks to new intermediaries comprising hedge funds, investment banks, money market mutual funds, pension funds and insurance companies that offered higher returns in commercial paper markets, hedge funds, private equity and money market mutual funds. See also SL Schwarcz, 'Regulating shadow banking', (2011–2012) *Review of Banking Law and Financial Law* 619.
[77] *Ibid.*
[78] The concept of shadow banking is attributed to P McCulley, who used it to refer to "nonbank investment conduits, vehicles and structures". See P McCulley, 'PIMCO, Teton reflection: PIMCO global central bank focus', (2007) 2, available at <http://media.pimco.com/DocumentGCB%20sept%2007%WEB.pdf>.However, shadow banking is the provision of financial services by money market funds, private equity firms, hedge funds, insurance companies and finance companies, through the issuance of commercial paper, derivatives and other risk shifting instruments.
[79] Financial Services Modernization Act (the Gramm-Leach-Bliley Act) 1999. See LJ White, 'The Gramm-Leach Bliley Act of 1999: A bridge too far? Or not far enough?', (2010) *Suffolk University Law Review* 936.
[80] Ajoint forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions and the International Association of Insurance Supervisors developed *Principles for the supervision of financial conglomerates*, (1999) and revised (2012), available at <https://www.bis.org.publ>accessed on 20.4.2018. See GA Walker, *International banking regulation law, policy and practice*, (2001) 165.
[81] Financial conglomerates may organise their corporations through the integrated, parent-subsidiary, holding company or horizontal corporate structures. See Dierick 5.
[82] Economies of scope arose from the combination of offices and other overlapping resources through centralised production and joint marketing of financial services to the same customers. Economies of scope were achieved through revenue growth from the increased customer segments and the reduction

financial services and products like derivatives,[83] posed a significant challenge to supervision.[84] This was because the pre-GFC regulatory structures focused more on the safety of individual financial institutions than on the systemic risk emanating from their conduct of business.[85]

1.2.5.3 Organisational structure of financial conglomerates

Herring and Santomero describe US financial conglomerates as including “universal banks, multiproduct bank holding companies and other diversified financial firms” that offer a variety of financial services.[86] In a further study of the corporate complexity of twenty nine global financial conglomerates conducted in 2016, Carmassi and Herring[87] found that all of them had banking affiliates on which they relied as a means of attracting public deposits.[88] Out of the twenty nine financial conglomerates, three controlled more than two thousand subsidiaries, nine controlled more than one thousand five hundred subsidiaries, and fourteen controlled more than one thousand subsidiaries.[89] The subsidiaries included banks, securities companies, pension funds, insurance companies, hedge funds, venture capital funds, private equity firms, and other investment firms.[90]

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of information technology costs among the various financial services provided under one roof.In addition, the synergy between the personnel and resources from the affiliated firms could enhance earnings and diversify risks. See AE Wilmarth Jr, ‘The transformation of the US financial services industry 1975-2000: Competition, consolidation and increased risks’, (2002) *University of Illinois Law Review* 215. See also Bank of Japan, *The expansion of corporate groups in the financial services industry: Trends in financial conglomeration in major industrial countries*, (2005) 16.

[83] A derivative is a financial contract whose value is derived from the performance of another primary contract or other underlying market factors like interest rates, currency exchange rates, and commodity, credit, equity or other asset prices. See SL Schwarcz, ‘Derivatives and collateral: Balancing remedies and systemic risk’, (2015) University of *Illinois Law Review*700. See also SL Schwarcz, ‘Markets, systemic risk and the sub-prime mortgage crisis’, (2008) *Southern Methodist University Law Review* 211.

[84] See Group of Thirty,*The structure of financial supervision: Approaches and challenges in the global market place*, (2008) 24.

[85] See SL Schwarcz, ‘Regulating financial change: A functional approach’, (2016) *Minnesota Law Review* 1444–1445.

[86] See RJ Herring & AM Santomero, ‘The corporate structure of financial conglomerates’, (1990) *Journal of Financial Services Research* 471.

[87] J Carmassi &R Herring, ‘The corporate complexity of global systemically important banks’, (2016) *Journal of Financial Services Research* 183.

[88] Indeed, after the GFC, all investment banks in the USA were either acquired by banks or converted into financial holding companies to access insured deposits as a stable source of their funding. See RB Thompson, ‘Market makers and vampire squid: Regulating securities markets after the financial meltdown’, (2011) *Washington University Law Review* 324.

[89] Carmassi & Herring 183.

[90] See Schwarcz (2011–2012) 754.

According to Dierick, most financial conglomerates organise their affiliates through four main corporate structures, namely, the integrated structure, parent-subsidiary structure, holding company structure, and the horizontal structure.[91] The integrated structure is the typical universal banking model that offers commercial banking, insurance, securities, real estate and other financial services from its banking entity, and permits the banking entity to additionally invest in the equity of the industrial or commercial entities it lends to.[92] While integration reduces administrative costs and increases the benefits from diversification, it also increases moral hazard for the deposit insurer by using depositor funds to finance risky non-bank activities. [93]The integrated structure could also increase the financial conglomerate's leverage[94] by applying the bank's capital to cross finance non-bank activities.[95] In addition, it could expose the financial conglomerate to conflicts of interest that arise when conglomerates shift their risk exposures in underperforming securities to their customers.[96]

The parent-subsidiary structure is also centred on the banking firm and incorporates separately capitalised subsidiaries to provide insurance, securities, hedge fund, and

[91] See Dierick 6.
[92] Rose & Marquis 754. The integrated model is also referred to as a bank oriented continental European style universal banking system because it combines non-banking business within the bank and permits bank ownership of a sizeable equity shareholding in the commercial and industrial firms they lend to. See also Mishkin (2016) 303. See further JDL Martinez, 'Supervision of financial conglomerates', (2005)US Federal Reserve Bank System IMF/World Bank seminar 6. The author describes mixed groups as fully integrated universal banks that combine banking, insurance, securities and other commercial or industrial firms, and financial conglomerates as financial holding companies with partial integration that incorporates subsidiaries in at least two financial sectors. Lastly, the banking group structure is described as a bank holding company with subsidiaries in banking, insurance and securities sectors.
[93] J Pogach & H Unal, *The dark-side of bank's non-bank business: Internal dividends in bank holding companies*, (2018) Federal Deposit Insurance Corporation Centre for Financial Research working paper series 3. See also LD Brandeis, *Other peoples' money and how the banks use it,*(1914) 17–19, where the author argues that universal banking enabled bankers to use other people's money in deposits to make profits and control the nation.
[94] Leverage or gearing is the proportion of debt to equity in a firm's capital structure relative to shareholder equity. See E Ferran, *Principles of corporate finance law*, (2008) 63. See also Carnell *et al* 43, where the authors argue that the more debt to equity a company has, the more leveraged it is and the higher its expected return on equity. See also MM Blair, 'Making money: Leverage and private sector money creation', (2013) *Seattle University Law Review* 419. The author argues that while leverage greatly enhances the profitability of financial firms, it shifts the risk of loss to their creditors.
[95] See Dierick 16.See also Martinez 6 andWalker 180.
[96] See G Bagattini, F Fecht & P Weber, 'The fire-sale channels of universal banks in the European sovereign debt crisis', (2018) Paper presented at the 18th*Annual Bank Research Conference, Federal Bank of New York*, September, 2018, 3, available at <https://ssrn.com/abstract=3208722> accessed on 22.7.2018. For example, the authors cite instances during the fiscal crisis suffered by European governments following the GFC, when large banks and bank holding companies with mutual fund affiliates offloaded risky sovereign debt securities to enable them to shift losses from themselves.

other non-bank financial services under separate boards and management organs.[97] Since the parent-subsidiary structure uses the licensed bank to provide banking services and separate subsidiaries to provide the non-bank services, it is often referred to as an operating holding company or banking group structure.[98] While this structure may enable the bank to earn the subsidiary's profits and incur its liabilities,[99] it may also expose the bank to contagion risk arising from any financial or reputational damage suffered by the subsidiary.[100] Thus, the operating holding company structure may increase contagion risk where economic, reputational or financial distress in one group entity may spread to the others and potentially to the financial system.[101] Supervisors are particularly concerned with contagion risk, emanating from unregulated entities within the financial conglomerates, to the safety and soundness of regulated entities.[102] Although regulated entities may be shielded from contagion risk through ring-fencing or fire-walling,[103] conflicts of interest within the operating company or banking group structure may impede its effectiveness.[104]

Financial conglomerates may also organise themselves under a holding company structure that uses the holding company to own the majority shares in banking, securities or insurance or other non-banking subsidiaries.[105] This structure differs from the parent-subsidiary structure because it does not directly offer any services to the

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[97] Dierick 16.
[98] *Ibid.*
[99] Although the parent–subsidiary model may also refer to homogeneous banking conglomerates, banks that establish subsidiaries for foreign operations only qualify to be financial conglomerates if they operate in at least two financial sectors. See Walker 180.
[100] Dierick18.
[101] See Federal Reserve Board, *Bank holding company supervision manual,*(2009) 1019. The cornerstone of bank holding company regulation is to prevent any detrimental effects of their involvement in non-bank activities on the financial system. Thus, a holding company or its unregulated subsidiary that take excessive risks and fails adversely affects the regulated entity. Financial regulation also seeks to prevent holding companies from transferring resources from the regulated firms to the unregulated ones.
[102] Dierick 15.
[103] See JR Walter, 'Firewalls', (1996) *Economic Quarterly* 20. Fire walls are internal corporate mechanisms to prevent contagion between affiliated entities in the financial conglomerate. In the context of banking, firewalls are regulatory restrictions to prevent a banking company from shifting financial losses from its non-bank subsidiary to its insured bank subsidiary and potentially to the federal deposit insurance fund. Ring-fencing is the restriction of banks to deposit-taking, lending, fiduciary services and other activities related to banking and require financial conglomerates to restrict their bank subsidiaries to the traditional banking services. See M Lehmann, *Volcker rule, ring-fencing and separation of bank activities: Comparison of structural reform Acts around the World*, (2014) LSE Law Society and Economy working papers 10. See also AE Wilmarth Jr, 'Narrow banking: An overdue reform that could solve the Too-Big-To-Fail problem and align U.S. and U.K. regulation of financial conglomerates', (2012) *Banking and Financial Services Report* 2.
[104] Carmassi & Herring 183.
[105] See Federal Reserve Board, *Bank holding company manual,* (2009) section 1020.0.

public and uses subsidiaries to which it provides common services like office space, risk management, raising capital, and group wide auditing and compliance services.[106] Such holding company structure is also referred to as the non-operating holding company structure due to its use of subsidiaries to provide services in the various financial sectors.[107] The non-operating holding company structure may combine other specialised holding companies for groups of banks, groups of securities companies or groups of insurance subsidiaries.[108] The structure has the advantage of utilising economies of scale and scope at the holding company level, and may ring-fence[109] the bank from the liabilities of other subsidiaries within the group.[110]

The last financial conglomerate organisational structure is the horizontal structure under which banking, insurance, and securities services are provided through partnerships, joint ventures and "Memoranda of Understanding" between different firms using joint boards of directors.[111] Although the horizontal structure permits participating institutions to retain their independent corporate structures without combinations of capital or management structures, it may influence the use of bank deposits and capital to cross-finance non-bank activities.[112]

1.2.5.4 Basel II Accord and the supervision of financial conglomerates

As noted above,[113] the complexity of financial conglomerate structures and their innovative financial products[114] significantly challenged the pre-GFC regulatory structures that were premised on the *Basel II Accord*.[115] Thus, the supervision of financial conglomerates challenged the effectiveness of each of the three pillars of the *Basel II Accord*, namely the minimum capital adequacy requirements pillar, the supervisory review pillar, and the market discipline pillar.[116]

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[106] *Ibid.*
[107] Dierick 18.
[108] *Ibid.* Thus, holding companies that control banking, insurance and securities companies may be controlled by a second level holding company.
[109] See Lehmann 10 and Wilmarth (2012) 2.
[110] Dierick 18.
[111] *Ibid.*
[112] *Ibid.*
[113] Par 1.2.5.3 above.
[114] *Ibid.*
[115] See Basel Committee, *International convergence of capital measurement and capital standards: A revised framework*, (2004) (hereafter *Basel II Accord*) 7.
[116] *Idem* par 40.

(a) Minimum capital requirements pillar

The minimum capital adequacy requirements pillar required banks to comply with an international capital adequacy ratio of 8 per cent[117] and permitted them to assess their capital requirements using either the standardised approach[118] or the internal ratings-based approach.[119] However, the minimum capital requirements pillar did not prescribe any framework to limit the level of debt that financial conglomerates could take at group level and individual affiliate level.[120] Consequently, financial conglomerates increased their leverage[121] by using their bank regulatory capital and bank deposits to cross-finance their non-bank activities and the capital needs of their non-banking affiliates.[122] Financial conglomerates also adopted double leveraging by using the capital raised for their own group-level regulatory capital requirements to meet the regulatory capital requirements of their banking affiliates.[123]

Double leveraging also arose when the financial conglomerates used capital raised from their financial debt-financing to fund investments in their subsidiaries.[124] While double leveraging enabled financial conglomerates to earn more profits, it also

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[117] Capital was calculated based on regulatory capital and risk weighted capital. Regulatory capital is the list of all elements of bank assets that qualify for regulatory purposes including "Tier 1"or core capital comprising of common stock, retained earnings, capital surplus from sale of common stock and disclosed capital reserves for contingencies, plus "Tier 2" or supplementary capital that consists of loan and lease loss allowances, goodwill undisclosed capital reserves long term subordinated debt and preferred stock with maturity of at least twenty years. See *Basel II Accord* 12. See also SI Greenbaum & AV Thakor, *Contemporary financial intermediation,* (2007) 458.

[118] Greenbaum & Thakor 458.The standardised approach requires all banks to calculate their capital adequacy requirements using a prescribed formula that took account of their risk profile.

[119] See *Basel II Accord* 52. Under the internal ratings-based approach, banks were permitted, subject to regulatory approval, to use internally developed risk assessment models to calculate their risk exposure and minimum capital requirements. Banks may have used the approach to overstate their capital bases and under report their risk levels to enable them to reserve lower capital levels than the regulatory minimum, which increased the build-up of leverage in the build-up to the GFC. See Greenbaum & Thakor 458.

[120] See A Clark & A Large, *Macroprudential policy: Addressing the things we don't know*, (2011) Group of Thirty occasional paper 16.

[121] See the definition of leverage under integrated conglomerate structure in par 1.2.5.3 above.

[122] See WA Boot & L Ratnovovski, *Banking and trading*, (2012) the IMF working paper and Wilmarth (2009) 1002. Since investment banking activities have the potential for super normal profits, financial conglomerates are incentivised to use their banking deposits to subsidise their underwriting of and trading in securities. See JP Choi & C Stefanadis, *Monitoring, cross subsidies, and universal banking*, (2015) Centre for Economic Studies and Ifo Institute working paper 1, available at<www.ssrn.com=Abstractsid2670569>accessed on 18.3.2018. See also Pogach & Unal 3.

[123] See S Bressan, 'The effect of consolidation for the interplay between bank risk and double leverage inside bank holding companies', (2018) *Academy of Accounting and Financial Studies Journal* 3. See also S Bressan, *The funding of subsidiaries equity, "double leverage" and the risk of bank holding companies*, (2015) MODUL University working paper 8 available at <http://www.papers.ssrn.com>, accessed on 18.7.2018.

[124] Bressan (2015) 8.

reduced their capacity to absorb losses and increased their potential to rely on government bail-out for being "Too-Big-To-Fail".[125] It further increased intra-firm moral hazard within financial conglomerates because of the potential to use profits from more efficient subsidiaries to subsidise losses incurred by the inefficient ones or by transferring assets between affiliated firms.[126] Financial conglomerates also exploited regulatory arbitrage[127] by undertaking risky transactions through their unregulated affiliates to circumvent the stricter regulation and supervision of their regulated entities.[128]

The other challenge to the minimum capital requirements pillar was that the *Basel II Accord* permitted banks to adopt either the standardised approach or the internal ratings-based approach in the assessment of their capital adequacy requirements.[129] Greenbaum and Thakor argue that the internal ratings-approach was susceptible to manipulation by banks by means of under-reporting their risk exposures and overstating their capital reserves which then enabled them to build-up excessive leverage that reduced their capacity to absorb losses.[130]

(b) Supervisory review pillar

As indicated above,[131] one of the limitations of the pre-GFC financial regulatory and supervisory structures was their focus on the safety and soundness of individual financial institutions on a solo basis rather than also on the systemic risk the financial

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[125] The concept of "Too-Big-To-Fail" was first raised during the Congressional hearing on the bail-out of Continental Illinois Bank in 1984, after Representative S McKinney (of Connecticut in the USA) inquired whether the government bailed out the bank because it was Too-Big-To-Fail. See *Inquiry into Continental Illinois Corporation and Continental Illinois National Bank,* par 1.2.2 above, 300. A modern account of "Too-Big-To-Fail," and its impact in the USA during the GFC, is given by AR Sorkin, *Too-Big-To-Fail: The inside story of how Wall Street and Washington fought to save the financial system-and themselves*, (2010). See also Boyd *et al* 461.
[126] See Bressan (2018) 3 and Bressan (2015) 8.
[127] Regulatory arbitrage arises when regulated entities exploit legislative or supervisory differences between sectors or jurisdictions to structure their entities. See PC Boyer and H Kempf, *Regulatory arbitrage and the efficiency of banking regulation*, (2016) Baffi Carefin Centre for Applied Research working paper. See V Fleischer, 'Regulatory arbitrage', (2010) *Texas Law Review* 227. See also J Barry, 'Response: Regulatory arbitrage', (2010) *Texas Law Review* 71.
[128] Fleischer argues that financial conglomerates use leverage and high risk activities to pursue short-term profits to satisfy their shareholders. See V Fleischer, *Regulatory arbitrage*, (2010) University of Colorado Legal Studies research paper series 3 available at <http://www.papers.ssrn.com> accessed on 1.11.2018 and Wilmarth (2002) 226.
[129] See *Basel II Accord* 52.
[130] See Greenbaum & Thakor 458 and BE Gup, *The new capital accord,* (2004) 178. Gup argues that capital adequacy requirements are difficult to supervise because capital means different things to accountants, stockholders, lawyers, legislators and regulators.
[131] See *Basel II Accord* par 40.

institutions' conduct of business posed to the financial system.[132] Accordingly, the complexity of financial conglomerate structures[133] and the products and services they offered[134] had to be addressed post-GFC to enhance the consolidated supervision of group-wide operations of financial conglomerates in financial sectors beyond those of their banking subsidiaries.[135] The post-GFC reforms had to address the gaps in the pre-GFC supervisory structures adopted by most governments that included, the institutional approach, functional approach, integrated approach, Twin Peaks model and the US approach.[136]

When evaluated for their capacity to effectively supervise financial conglomerates, most of the structures were found to have limited mechanisms to meet the challenges posed by financial conglomerates:[137] The institutional approach licences financial institutions under a legal framework that regulates financial sectors like banking, insurance and securities in which the financial institutions serve and assign regulators for each of the institutions like banks, insurance companies, and securities companies.[138] The regulators combine safety and soundness (prudential) and conduct of business of firms in their sectors, and regulation is premised on the theory that the financial firms provide services only in the sectors they are licensed for.[139] Accordingly, the institutional approach does not provide mechanisms for consolidated supervision

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[132] KN Johnson, 'Macroprudential regulation: A sustainable approach to regulating financial markets', (2013) *University of Illinois Law Review* 884.
[133] See Dierick 6.
[134] See SL Schwarcz, 'Regulating complexity in financial markets', (2009) *Washington University Law Review* 220. Complexity of financial products impairs the disclosure of their risks and prevents market participants from evaluating the risk they assume. See also ST Omarova, 'License to deal: Mandatory approval of complex financial products', (2012) *Washington University Law Review* 84. Omarova argues for the introduction of a system of mandatory government approval of complex financial products, drawing parallels with similar approvals for new drugs or food products to the market.
[135] See Group of Thirty, *Enhancing financial stability and resilience: Macroprudential policy, tools and systems for the future,* (2010) 16.See also Group of Thirty (2008) 24.
[136] See Group of Thirty (2008) 24. See also HY Jabotinsky, *The structure of financial supervision: A game theoretic approach*, (2013) Hebrew University of Jerusalem, Harry and Michael Sache Institute for Legislative Research and Comparative Law working paper 10, available at <https://ssrn.com/abstracts/id 2007856.pdf> accessed on 21.7.2018. Although each supervisory approach has distinctive features some of the categories may share some features. For a discussion of the interface between commercial bank organisational structure and financial supervisory structure, see VLEC Brea, *The legal structure of commercial banks and financial conglomerates: Does organisational form matter for the design of bank regulation?* (Unpublished European Doctorate in Law and Economics 2017)40.
[137] Group of Thirty (2008) 24 and Group of Thirty (2010)16.
[138] See DT Llewellyn, 'Institutional structure of financial regulation and supervision: The basic issues', *Aligning supervisory structures with country needs,* (2006) 8.
[139] *Ibid.*

of the services that financial conglomerates offer across financial sectors as it assigns separate supervisors for each of the financial sectors.[140]

The functional approach similarly assigns prudential and conduct of business regulation of financial institutions on the basis of the functions they discharge irrespective of the original institutional legal framework under which they are licensed.[141] Accordingly, a bank holding company conglomerate that operates under a banking licence could also be subjected to securities and insurance functional regulators if it undertakes insurance or securities business.[142] Although functional regulation has the advantage of regulating all aspects of the firm, it may engender a silo mentality when each of the regulators acts independently, and often in competition with other regulators, which may delay early identification of systemic risk.[143]

The integrated approach (also referred to as the mega regulator approach)[144] assigns both the prudential and conduct of business regulation over all financial institutions to one financial services agency.[145] Its strength lies in facilitating the consolidated supervision of all affiliates of financial conglomerates and therefore in addressing the limitations of the functional approach.[146] However, the integrated approach has also been criticised for focussing more on the safety and soundness of individual firms than on the conduct of business of the financial institutions and impedes early identification of the systemic risk posed by financial conglomerates.[147] In addition, where the integrated approach assigns the prudential supervision of banks to the single

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[140] See J Carmichael & M Pomerleano, *The development and regulation of non-bank financial institutions*, (2002) 44.
[141] Group of Thirty (2008) 24.
[142] *Ibid.*
[143] Carmichael & Pomerleano 44. The authors argue that both the institutional and functional regulatory models promote regulatory competition and arbitrage by operating on a silo mentality that restricts each regulator to its sector.
[144] See E Botha &D Makina, 'Financial regulation and supervision: Theory and practice in South Africa', (2011) *International Business and Economics Research Journal* 31–32. See also H Falkena, R Bamber, D Llewellyn & T Store, 'Financial regulation in South Africa', in Bank Supervision Department, South African Reserve Bank, Financial Sector Forum (2001) 155–169.
[145] See generally JJ Norton, 'Global financial reform: The single financial regulator model based on the United Kingdom FSA experience- A critical re-evaluation', (2005) *The International Lawyer* 15–62. See also KK Mwenda, *Legal aspects of financial services regulation and the concept of a unified regulator,* (2006) 37.
[146] See Group of Thirty (2010) 16. According to the G-30, most countries were more focused on microprudential regulation and paid little attention to systemic risk through macroprudential regulation.
[147] See Howard *et al* 19.

regulator, it may undermine the central bank's ability to obtain information about individual banks and impede its functions as lender of last resort (LOLR).[148]

The Twin Peaks approach that was conceptualised by Michael Taylor in 1995 assigns the prudential and conduct of business objectives of regulation for all financial sectors to separate agencies (in close cooperation with the central bank as LOLR and custodian of monetary policy).[149] This avoids the regulatory competition and regulatory arbitrage experienced under the functional approach and provides more consolidated supervision for all the individual and systemic activities of financial institutions.[150] Thus, the Twin Peaks framework integrates microprudential regulation for the safety and soundness of individual institutions and macroprudential regulation for the safety of the whole financial system with conduct of business supervision.[151] The conduct of business regulation further enhances public confidence in the financial system by promoting consumer protection through education, dispute resolution, ombudsman services, and compensation.[152]

The special US approach is a dual regulatory structure for the supervision of financial institutions at the state and federal government levels.[153] While each state has banking, insurance and securities regulators, the federal government has supervisors for the banking and securities business, but none for insurance because insurance is considered as a state function.[154] At the federal level, the US Comptroller of the

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[148] See P Tucker, *Basel III, Too-Big-To-Fail and Macroprudential regimes*, (2011) Group of Thirty occasional paper 15.
[149] M Taylor, '"Twin peaks": A regulatory structure for the new century', published by the Centre for the Study of Financial Innovation, (1995) Financial Service Industry - Issue 20 of DSFI series. See also AD Schmulow, *Twin Peaks: A theoretical analysis,* (2015) Centre for International Finance and Regulation research working paper series 6.
[150] Group of Thirty (2008) 24.
[151] For example, under the integrated regulatory approach in the United Kingdom, the heads of the Financial Services Authority, the Treasury and the Bank of England had never met in the ten years preceding the crisis. Therefore, they had neither prepared any coordinated responses to a crisis before the GFC arose "nor practiced how to deal with it." See also J Hindle, 'The future of regulation', (2009) *Journal of Financial Regulation and Compliance* 421.
[152] While consumer education empowers consumers to make informed decisions about the financial services and products they purchase, consumer dispute resolution facilitate the fair settlement of disputes between consumers and their financial institutions. In addition, redress of consumer complaints through a financial service ombudsman, as well as the compensation or reimbursement of consumers for losses arising from their financial institutions' insolvency, failure or inability to meet their obligations, promotes consumer confidence in the financial system. See A Hudson, *The law of finance,* (2009)173. See also M Hapgood, *Paget's law of banking,* (2007) 4-2.
[153] Lichtenstein 217.
[154] The USA has no federal insurance supervisors after the Supreme Court held in *Paul v Virginia* 75 US (8 Wall.) 1868,183 that insurance could not be regulated at federal level. See also SG Calabresi, 'The right to buy health insurance across state lines: Crony capitalism and the Supreme Court', (2013)

Currency regulates national banks,[155] and the Federal Reserve Board[156] regulates bank holding companies,[157] and financial holding companies.[158] The Federal Reserve Board also supervises state chartered banks that are members of the Federal Reserve System.[159] State charted banks that are not members of the Federal Reserve System are either supervised by the Federal Deposit Insurance Corporation (FDIC) if they belong to its deposit insurance scheme[160] or by their state chartering authorities if they do not take federal deposit insurance.[161]

As the supervisor for bank holding companies, the Federal Reserve Board, prior to the Gramm-Leach-Bliley reforms alluded to above,[162] required the prior approval of non-banking activities before the bank holding companies engaged in them and supervised the bank holding company's non-bank subsidiaries irrespective of their functional regulator.[163] For these reasons, the US financial regulatory framework has been described as being complex, confusing, irrational, difficult to administer and impeding on regulatory enforcement.[164] The savings and loan crisis that was experienced in the USA in the 1980s[165] for example, was attributed to this multifunctional regulatory structure that led to regulatory forbearance.[166] By delaying regulatory enforcement on insolvent banks, regulatory forbearance permitted the banks to continue

*University of Cincinnati Law Review*1447. Although *Paul v Virginia* was overruled by *United States v South Eastern Underwriters Association*, 332 US 533 (1944), Congress enacted the McCarran-Ferguson Act to reserve insurance for state regulation. Securities business is regulated at the national level by the Securities Exchange Commission under s 4 of the Securities Exchange Act, 1934. The various states enact their own securities statutes which are informally referred to as "Bluesky" laws. See JR Macey &GP Miller, 'Origin of blue sky laws', (1991) *Texas Law Review* 348.

155 See National Banks Act, 1864.

156 See the Federal Reserve Act, 1913 which established the Federal Reserve System comprising the Board of Governors and the twelve Federal Reserve Banks spread across all the regions of the USA.

157 See s 1842(a) of the Bank Holding Company Act, 1956 that authorises the Federal Reserve Board to supervise bank holding companies and their affiliated entity non-bank business.

158 S 1843(l)(1)–(2) of the Gramm-Leach-Bliley Act prescribes the criteria for bank holding companies to qualify as a financial holding company.

159 Since membership with the Federal Reserve Board is compulsory only for national banks and bank holding companies, state chartered banks may only become members voluntarily. State chartered banks that elect not to be members of the Federal Reserve System are supervised only at state level by the chartering agencies. Carnell *et al* 62.

160 *Ibid.*

161 SK Halpert, 'The separation of banking and commerce reconsidered', (1988) *Journal of Corporation Law* 484.

162 See par 1.2.5.2 above.

163 See s 1843 of the Bank Holding Company Act, 1956.

164 See Carnell *et al* 62.

165 *Idem* 29–30.

166 Regulatory forbearance is the restraint by regulators to close insolvent institutions in the hope that they will recover or on the expectation that another regulator will address the problem. See FS Mishkin, *The economics of money, banking, and financial markets,* (2007) 294.

operationsuntil they depleted their capital.[167] To address this problem, the FDIC was empowered in 1991, to enforce prompt corrective actionson all federally insured banks.[168] Prompt corrective actions prescribed a set of regulatory actions to be enforced on undercapitalised insured banks with declining capital levels.[169] This compelled supervisors to enforce capital requirements by directing banks to promptly restore capital levels and correct other management deficiencies before the banks became insolvent.[170]

The complex structures adopted by financial conglomerates also posed a challenge to EDIS and SRRs[171] that were originally designed[172] to protect depositors of banks that were not engaged in non-banking activities.[173] However, the reimbursement of depositors of failed banking affiliates of financial conglomerates meant that EDIS were to underwrite the activities of non-banking affiliates.[174] In addition, as indicated above,[175] the complexity and interconnectedness of financial conglomerates caused them to be systemically important financial institutions (SIFIs)[176] that were considered as "Too-Big-To-Fail".Due to the potential risk that their failure to disrupt the stability of

[167] See JM Edwards, 'FDICIA and Dodd-Frank: Unlearned lessons about regulatory forbearance', (2011) *Harvard Business Law Review* 281.
[168] S 111 of FDICIA.
[169] See RS Carnell, 'A partial antidote to perverse incentives: The FDIC Improvement Act of 1991', (1993) *Annual Review of Banking Law* 317. Prompt corrective actions are capital-based restrictions and enforcement actions imposed on federally insured banks that obligate supervisors to take progressively severe enforcement actions as the firm's capital levels reduces. Supervisors are compelled to take prescribed enforcement actions on banks based on five categories, namely: well capitalised banks (with a capital ratio at or above 10 per cent); adequately capitalised banks (with a capital ratio of 8 per cent); undercapitalised banks (with capital ratio of below 8 per cent); significantly undercapitalised banks (with capital ratio below 6 per cent); and critically undercapitalised banks (with capital ratio below 2 per cent). As the capital level progressively falls below the minimum capital adequacy ratio of 8 per cent, banking supervisors are compelled to enforce prescribed actions including restricting the permitted products, services and management decisions for the banks. The most severe enforcement actions are directed at critically undercapitalised banks, by prohibiting them, *inter alia,* from advancing loans to highly leveraged borrowers; accessing central bank LOLR discount window facilities; and directing to recapitalise or implement corrective order within 90 days, in default of which they are subject to the appointment of a conservator or receiver.
[170] Prompt corrective actions may also motivate shareholders to monitor the bank's risk profile to avoid being called upon to raise more funds to restore the bank's capital. See PS Rose and SC Hudgins, *Bank management and financial services,* (2010) 501.
[171] See Group of Thirty (2010) 16.
[172] See Lichtenstein 217.
[173] See GGH Garcia, *Deposit insurance: A survey of actual and best practices*, (1999) IMF working paper 19.
[174] Walker 180.
[175] See par 1.2.5.4.(a) above.
[176] SIFIs are institutions whose "size, complexity and systemic interconnectedness" gives rise to the risk that their failure threatens a significant disruption of the financial system. See Mishkin (2016) 265.

the financial system, most government were compelled to bail out SIFIs.[177] Consequently, reforms to strengthen EDIS and SRR were required to facilitate the orderly exit of failed banking affiliates of financial conglomerates from the financial system, without using public funds whilst preserving their vital and critical banking services.[178]

(c) The market discipline pillar

The market discipline pillar of the *Basel II Accord* was premised on the assumption that market players would effectively monitor bank risk-taking through institutional investors, credit rating agencies and external auditing and discipline the banks that contravened capital adequacy requirements.[179] However, when financial conglomerates shifted from raising funds through public deposits to raising funds through the less regulated shadow banking sector by means ofcommercial paper[180] and repurchase agreements (repos),[181] they avoided the scrutiny of regulated markets.[182] The financial conglomerates invested the funds they raised in mortgage backed securities (MBS)[183] and other derivatives on the money markets.[184]In addition, rather than assessing their risk exposure and setting aside capital reserves to absorb potential losses, the banks used credit default swaps (CDSs)[185] to shift their risk of

177 See also Mishkin (2016) 265.
178 See Group of Thirty (2010) 16. See also GGH Garcia, *Deposit insurance and crisis management*, IMF working paper 7.
179 See Nier & Baumann 353.
180 Commercial paper are short term unsecured corporate debt instruments or bonds issued by corporations with strong credit histories to raise funds to finance their operations. See TF Geithner, *Stress test: Reflections on financial crises*, (2014) 228. Geithner was the US Treasury Secretary during the GFC. For a general discussion of the commercial paper market, see D Stojanovic & MD Vaughan, 'The commercial paper market: Who's minding the shop', (1998) *The Regional Economist, Federal Reserve Bank of St Louis*4.
181 Repurchase agreements (repos) are agreements for borrowing funds by sale of government bonds or Treasury bills to a purchaser, on promise to buy them back at a higher sum at an agreed future date (usually within less than two weeks). See Mishkin (2016) 74.
182 See Schwarcz (2011–2012) 754.
183 MBS are created by pooling future mortgage repayments income into securities that are redeemed by receipts from the pool of mortgages. See P Angelides, *Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (hereafter Angelides *Report*) (2011) *US Government Printing Office* 542.
184 Securitisation is the process of pooling debt assets such as mortgages, car loans and credit card debt into a separate legal entity that issues securities for sale to investors. See SL Schwarcz, 'The parts are greater than the whole: How securitization of divisible interests can revolutionize structured finance and open the capital markets to middle-market companies', (1993) *Columbia Business Law Review* 140.
185 CDSs are contracts that protect against loss of default in consideration of fees or premiums to the party offering the protection. See O Juurikkala, 'Financial engineering meets legal alchemy: Decoding the mystery of credit default swaps', (2014) *Fordham Journal of Corporate and Financial Law* 430.

loss to third parties on the derivatives market.[186] Since there were no centralised derivatives exchange to value and enforce the contracts, it was difficult to determine the proper price of the derivatives or to discipline counterparties that failed to honour their obligations.[187] Market discipline, through external auditors that were required to report on the financial status of the financial institutions, and credit rating agencies that were required to report their credit worthiness, also failed.[188] Thus, some external auditors[189] and credit rating agencies[190] were blamed for suffering from conflicts of interest that favoured the companies they audited after being retained as consultants by the same companies.[191]

1.2.5.5Supervisory challenges from financial conglomerates

As observed above,[192] the structure of financial conglomerates included banking subsidiaries that were regulated and supervised,[193] securities companies,[194] pension funds and insurance companies that were regulated but not supervised[195] and shadow banking firms that were not regulated.[196] This enabled financial conglomerates to use their unregulated affiliates to undertake regulated activities and avoid supervisory sanctions.[197]

While banks were supervised through examinations to ensure compliance with regulations, other regulated entities like securities firms and insurance companies

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[186] See definition of derivatives par 1.2.5.2 above.
[187] See VV Acharya, T Cooley, M Richardson & I Walter, *Market failures and regulatory failures: Lessons from past and present financial crises*, (2011) Asian Development Bank Institute working paper 18.
[188] See Angelides *Report* xxiv. See also Financial Services Authority, *The Turner review: A regulatory response to the global banking crisis,* (2009) for a UK perspective on the GFC.
[189] See L Colasacco, 'Where were the accountants? Deepening insolvency as a means of ensuring accountants' presence when corporate turmoil materializes?', (2009) *Fordham Law Review* 79.
[190] Credit rating agencies, which had rated these toxic debt instruments with triple A, thus creating the impression that they presented sound investments, were found to have based their ratings on their own interests to please the debt instrument originators to be retained as consultants. The report found that 83% of the MBSs that Moody's rated at Triple A amounting to 45 000 in total were later downgraded. See Angelides *Report* xxv. It has been argued that the statistical metrics ignored the volatility of asset prices during crises. See P Conti-Brown, 'A proposed fat-tail risk metric: Disclosures, derivatives and the measurement of financial risk', (2010) *Washington University Law Review* 1466.
[191] See VV Acharya *et al*.
[192] Carmassi & Herring 183.
[193] See Lichtenstein 217.
[194] See Thompson 327.
[195] See EJ Pan, *Understanding financial regulation*, (2011) Cardozo School of Law Institute of Advanced Legal Studies working paper 13. The author argues that while financial regulation includes rule making, supervision is surveillance of compliance and enforcement of the rules.
[196] See Schwarcz (2011–2012) 754.
[197] Pan13.

were only regulated through requirements to file returns without any onsite examinations.[198] Similarly, while banking and mortgage company affiliates of financial conglomerates were regulated and supervised, they could avoid regulation pre-GFC by raising funds on the derivatives market through MBSs. Once they had issued the MBSs they could hedge any potential losses by the default in mortgage repayments through CDSs which increased their leverage as the CDSs replaced capital reserves to absorb credit risk.[199] Since the financial conglomerates' shadow banking firms were neither regulated nor supervised, their derivatives dealings were kept out of supervisory surveillance.[200] Accordingly, conglomerate structures gave rise to so-called conglomerate risk,[201] being the risk of loss or financial distress arising from their derivatives trading affiliates, which could spread to other parts of the group.[202]

1.2.6 The GFC

The GFC that disrupted industrialised economies during the period from 2007 to 2009, has been attributed mainly to the failure of the sub-prime mortgage market in the USA.[203] A US Congress Report on the GFC identified its causes as being, lax regulation, deregulation and inappropriate incentives structures that engendered greed, fraud and irrationality.[204] The GFC also highlighted the inadequacy of the pre-GFC international financial regulatory standards that focused on microprudential regulation for the safety and soundness of individual financial institutions rather than also on the systemic risk that the conduct of business of financial conglomerates posed to the financial system.[205] Once financial markets in the USA became

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[198] *Idem* 225.
[199] See Angelides *Report* 540.
[200] See Schwarcz (2009) 220 and Omarova 84.
[201] See Walker 180.
[202] See ME Stucke, 'Lessons from the financial crisis', (2010) *Antitrust Law Journal* 319 for a discussion of the significant conglomerate risks that the combination of Travellers Group with Citicorp exposed Citibank to when they merged in 1998 to create Citigroup.
[203] See AE Wilmarth Jr, 'Turning a blind eye: Why Washington keeps giving in to Wall Street', (2013) *University of Cincinnati Law Review* 1339.
[204] See the Angelides *Report*'s conclusions xxii– xvii that argues that the GFC was caused *inter alia* by: misguided government free market policies that failed to cater for the inherent instability of capitalism, shadow banking and over-reliance on ineffective risk protection models, and conflict of interest prone credit rating agencies.
[205] See Group of Thirty (2010) 15. While microprudential regulation seeks to maintain the safety and soundness of individual firms to reduce their failure, macroprudential regulation seeks to prevent systemic risks by addressing the effects of the conduct of business of individual firms on the financial system. See SG Cecchetti and KL Schoenholtz, *Money, banking and financial markets,* (2016) 305. Pre-GFC most countries had no formal agencies responsible for macroprudential regulation. See Clark &Large 7. See also N Tarashev, C Borio & K Tsatsaronis, 'The systemic importance of financial

deregulated under the Gramm-Leach-Bliley Act, 1999,[206] at a time of low interest rates policy by the Federal Reserve Board, the price of credit fell. This increased borrowing and led to a rise in demand for assets.[207]

In addition, deregulation in the US increased financial institution risk-taking by reducing supervisory oversight,[208] as a result of restricting the Federal Reserve Board's supervisory enforcement powers over functionally regulated affiliates of bank holding companies.[209] Thus, the Gramm-Leach Bliley Act restricted the Federal Reserve Board's supervisory authority to the banking activities of financial holding companies only and limited its supervision of their securities and insurance affiliates to functional regulators.[210] As noted above[211] among the drivers of excessive risk-taking was the rise of shadow banking that provided banks with cheaper sources of short-term funding than the cost of deposits as a funding source.[212] Shadow banking also facilitated liquidity through the new derivatives market[213] that created collateralised debt obligations (CDOs)[214] by pooling future revenue streams of mortgages as MBSs and into a special purpose vehicle[215] and selling them as securities.[216] The originators of the MBSs sought to diversify risks of default by pooling

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institutions', (2009) *BIS Quarterly Review* 75. The authors argue that the interconnections, complexity and size of financial conglomerates pose a systemic risk to economies.

[206] See the Financial Services Modernization Act (the Gramm-Leach-Bliley Act), which deregulated the financial sector in 1999.

[207] See the special US regulatory approach in par 1.2.5.4 above for functional regulators of securities firms and insurance companies in the USA. See also J Taylor, 'Housing and monetary policy', (2007) *Federal Reserve Bank of Kansa City* 463.

[208] See Group of Thirty (2010) 15.

[209] S 1844(c) of Gramm-Leach-Bliley Act, 1999, restricted the Federal Reserve Board's authority to examine non-bank subsidiaries of bank holding companies.

[210] S 1848a(b) of the Gramm-Leach-Bliley Act, 1999. In addition, s 1844(g)1 restricted the Federal Reserve Board from directing bank holding companies to transfer funds from its other regulated entities to recapitalise a bank if their functional regulators objected to such transfer in writing. While these restrictions protected insurance companies and securities firms from the consolidated supervision of the Federal Reserve Board, they permitted the insurance companies and securities firms to benefit from affiliations with banks. See KA Carow & RA Heron, 'Capital market reactions to the passage of the Financial Services Modernization Act of 1999', (2002) *Quarterly Review of Economics and Finance* 465.

[211] See shadow banking under market pillar in par 1.2.5.4 above.

[212] Mishkin (2016) 74.

[213] See F Partnoy & DA Skeel Jr, 'The promise and perils of credit derivatives', (2007) *University of Cincinnati Law Review* 102.

[214] Collateralised debt obligations (CDOs) are securities originated by bundling future receipts on loans to raise funds whose repayment is secured from the loan repayments. See S Johnson and J Kwak, *13 Bankers: Wall Street takeover and the next financial meltdown,* (2010) 123.

[215] A special purpose vehicle is an investment company used by corporations to transact business that is not entered on their balance sheets and which is not subject to any legal capital requirements. See Levitin 481.

[216] SL Schwarcz, 'The future of securitization', (2009) *Connecticut Law Review* 1316.

mortgages from across the USA and from different categories of properties.[217] However, some of the underlying mortgages were of poor quality as the mortgage brokers were motivated to underwrite them because of the potential commissions that they stood to earn rather than because of the quality of mortgages or the creditworthiness of the borrowers.[218] In addition, some of the mortgages had been secured by overvalued houses during the low interest rate era.[219] Nevertheless, the CDOs further provided higher profits to banks through the fees they earned from acting for the issuers and the purchasers, as well as through the banks' investment of their own funds in the derivatives market.[220] While the banks bought CDSs to hedge against losses on the MBSs they held, they also sold CDSs and received premiums from other owners of MBSs against which they undertook to pay for any losses suffered by their counterparties.[221]

Consequently, when widespread mortgage defaults occurred, it led to a contagion of losses across counterparties that dried up liquidity.[222] Since the banks had transferred the risk of default on the MBSs through CDSs to counterparties who promised to reimburse them for any losses they suffered, the banks had not set aside capital reserves to absorb any losses from credit risk in accordance with the *Basel II Accord*.[223] In addition, unlike the other financial markets for payments, futures, or foreign currency exchanges that had clearing houses to enforce obligations between members, the derivatives market had no such clearing house and traded over the counter.[224] Once the Crisis intensified and derivatives investors began to redeem their claims due to fears over the solvency of their counterparties, liquidity dried up.[225] Further, the magnitude and extent of the exposure of counterparties on the over-the-counter derivatives market remained unknown until after the collapse of the insurance giant, AIG, when its derivatives exposure was quantified.[226]

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[217] C Viney & P Phillips, *Financial institutions, instruments and markets,* (2012) 38.
[218] *Ibid.*
[219] See Taylor 465.
[220] S McGee, *Chasing Goldman Sachs: How the masters of the universe melted Wall Street down … and why they'll take us to the Brink Again*, (2010) 56.
[221] *Ibid.*
[222] Levitin 481.
[223] See *Basel II Accord* 12.
[224] See the Angelides *Report* xxv.
[225] For an analysis of the profitability of proprietary trading, see generally WD Cohen, *Money and power: How Goldman Sachs came to rule the world,* (2011).
[226] See the Angelides *Report* xxv.

The assumption of market discipline throughinstitutional investors, credit rating agencies, and external auditing firms that were expected to discipline excessive risk-taking by banks, was rebutted by the activities of market players in derivatives.[227] In addition, as has been observed above,[228] the auditors that were to enforce market discipline through independent financial statements and the credit rating firms[229] that were to assess credit risk and value securities, were also found to have suffered from conflicts of interest.[230] Furthermore, since the creditworthiness of financial institutions was pegged on the performance of their shares on the financial markets, they suffered instability when hedge funds began to bet on the value of their shares, leading to volatility in share prices.[231] This reduced the supply of finance in the repurchase agreements market, which drained it of liquidity that spiralled into the GFC when most banks were unable to raise working capital.[232]

1.2.7 Lessons from the GFC

Among the lessons learned from the GFC was the importance of both macroprudential and microprudential regulatory objectives to financial system stability and the need for international collaboration in financial standard setting and implementation.[233] Thus, it showed the need for new financial regulatory frameworks to limit the risk of bank failures and mitigate the effects of failures that did occur, on depositors and national economies.[234] In addition, the GFC illustrated the need for reforms in international financial regulation to promote financial stability and limit the cross border effects of bank failure through collaboration.[235] Other lessons that were drawn from the GFC are that banks should no longer be bailed out by governments; and that those responsible for, and who benefit from, bank risk-taking should bear the costs of bank failure and prevent the use of public funds to bailout institutions considered as "Too-Big-To-

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[227] All the market institutions that were relied on to discipline banks exploited conflicts of interests to pursue profits that increased shareholder value and ignored the interests of depositors or society as a whole. See Nier & Baumann 361.
[228] Colasacco 79.
[229] Conti-Brown 1466.
[230] Acharya*et al* 18.
[231] See generally L MacDonald, *A colossal failure of common sense: The incredible inside story of the collapse of Lehman Brothers,* (2009).
[232] Viney &Phillips 38.
[233] M Petijean, 'Bank failure and regulation: A critical review', (2013) *Journal of Financial Regulation and Compliance* 16.
[234] Hindle 421.
[235] See E Tafara, Foreword in E Ferran, N Moloney, JG Hill, & JC Coffee Jr, *The regulatory aftermath of the Global Financial Crisis*, (2012) xvi.

Fail."[236] This entails a deliberate regulatory shift from a culture of "bail-out" to a culture of "bail-in" with the aim of instilling greater market discipline in financial conglomerates.[237]

Consequently, a post-GFC regulatory paradigm has evolved that requiresshareholders, uninsured depositors, and unsecured creditorswho share in the profits derived from bank risk-taking to undertake bank bail-ins by sharingin the loss when banks fail, on a *pro rata* basis.[238] In addition, officers and managers responsible for bank failure should be liable to reimburse the deposit insurer for any losses attributable to them.[239] The objective of the post-GFC regulatory reforms is to limit the moral hazard from financial conglomerates whose size, interconnectedness and complexity guarantees them a bail-out when they fail. Thus, the post-GFC international financial regulation agenda addresses bank moral hazard *ex ante* mainly through prudential (micro-and macro-prudential) and conduct of business regulation[240] and mitigates the effects of bank failure *ex post* through EDIS and an orderly resolution regime·.[241] The post-GFC regulatory policy has therefore shifted from microprudential regulation that focuses on the safety and soundness of individual institutions to include macroprudential regulation that also focuses on the impact of, and risk generated by, the conduct of business of intermediaries, markets and products on the stability of the financial system.[242]

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[236] For example, s 203 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 restricts bail-outs through requirements for approval by the Treasury Secretary, the US President and Congressional oversight.

[237] See MH Krimminger, 'Bail-in, not bail-out: Developing SIFI resolution strategies around the globe', available at <https://www.clsbluesky.law.columbia.edu>accessed on 12.4.2018. See also C Aueamnuay, *Resolution tool: Bail-in a paradigm shift in global banking landscape and its legal framework in the European Union (Latest developments since 2014),* (2014) 7.

[238] See Levitin 481. Levitin argues that a statutory SRR limits the moral hazard by holding shareholders, creditors and uninsured depositors liable for any losses from bank failure and thereby limits the amount of public funds used by the government to protect vulnerable depositors.

[239] The *IADI Core principles* 1.

[240] The Basel Committee, *A global regulatory framework for more resilient banks and banking systems,*(2010) (hereafter *Basel III Accord*), available at <https://www.bis.org/bcbs/publ/d.424.htm> accessed on 20.3.2018. See also Tucker (2014) 11.

[241] See *IADI Core principle* 9. See also L Laeven, *Pricing deposit insurance*, (2002) World Bank Policy Research working paper 5. Banks that are charged risk-based premiums would be disciplined to avoid risk taking because they would internalise any the losses they incur. See also FSB*, Reducing the moral hazard posed by systemically important financial institutions: FSB recommendations and timelines,* (2010) 1.

[242] G-20 Leaders' *statement declaration on strengthening the financial system*, available at <https://g29.org> accessed on 30.12.2018.

To address the problem of "Too-Big-To-Fail" that is created by financial conglomerates, international financial reforms post-GFC seek to prevent bank insolvency through prudential and conduct of business regulation, by *inter alia*, requiring banks to prepare recovery plans that outline their strategies to recapitalise and recover financial resilience should they face adversity.[243] Financial conglomerates are further required to prepare resolution plans that outline how, in the event that they nevertheless fail, they will enter an orderly resolution process that facilitates their orderly exit from the financial system without the use of public funds whilst attempting to preserve their vital functions.[244] The rationale for resolution plans stems from the realisation that the lack of data on the failed institution can erode its value due to the time that may pass, while the administrator searches for data to reconstruct its structure and operations.[245] In addition, orderly resolution preserves public confidence in the financial system by addressing the needs of depositors whilst ensuring that the failing bank does not disrupt the stability of the whole financial system.[246]

1.2.8 Post-GFC international response

The scene for the international framework[247] for orderly bank resolution was set by the Basel Committee, through its *Basel Core principles for effective banking supervision* that sought to address the regulation of SIFIs and link it to deposit insurance and bank resolution.[248] Further, the Financial Stability Board (FSB) issued *Key attributes on effective resolution regimes for financial institutions* in 2011*(FSB Key attributes)*.[249] Amongst the twelve *Key attributes* espoused by the FSB is the principle that resolution

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[243] P Volcker, *Report of the Group of Thirty, financial reform- a framework for financial stability,* (2009). The report recommended the enhancement of financial conglomerate supervision, through *inter alia,* integration of microprudential and macroprudential regulation.

[244] See FSB, *Key attributes of effective resolution regimes for financial institutions,* (2014) 3 available at <https://financialstabilityboard.org>accessed on 15.8.2018. Resolution plans are to set out strategies for the resolution of insolvent institutions should they fail to "recover" from their financial distress.

[245] See EHG Hupkes, 'The role of deposit protection and resolution policy in promoting financial stability', (2011) IADI research conference 5. For example, it took a lot of time and resources to investigate structures and operations of Lehman Brothers, when it entered bankruptcy that would have been saved if resolution plans had been filed *ex ante*. See JW Giddens, Trustee for the SIPA Liquidation of Lehman Brothers Inc., *Trustee preliminary investigation report and recommendations,* US Bankruptcy Court, SDNY, Case No 08-01420 (August, 2010).

[246] Tucker (2011) 15.

[247] M Giovanoli, 'The international financial architecture and its reform after the Global Crisis', in Giovanoli and D Devos (eds), *International monetary and financial law,* (2010) 8.

[248] The Basel Committee, *Core principles for effective banking supervision,* (2017) par 51 also provide for effective crisis management and resolution of financial institutions and for a safety net for financial stability and public confidence.

[249] See *FSB Key attributes* and Giovanoli 8.

of financial institutions should be financed through an *ex ante* privately funded EDIS.[250] The FSB further collaborated with the IADI to develop the *IADI Core principles* to guide member countries in the design of an EDIS,[251] and SRR to protect depositors and thereby contribute to financial system stability.[252]

The abovementioned international financial standards collectively seek to reduce the possibility of systemic risk through macroprudential regulation of financial conglomerates because global financial conglomerates can spread such risk across national borders.[253] Over the years, more than 180 countries have established EDIS (with many of them doing so post-GFC) which has shifted the regulatory debate from whether EDIS is more advantageous than implicit deposit protection, to how EDIS can be designed to limit the moral hazard of insured banks.[254] This is why the *FSB Key attributes*, *inter alia*, underwrite a culture of "bail-in within resolution" facilitated through EDIS. As has been pointed out above, despite its advantages, EDIS also has moral hazard implications that raise the post-GFC challenge of how to design the EDIS in a manner that appropriately addresses the moral hazard emanating from SIFIs, and hold them responsible for any losses suffered in the resolution of insured institutions within their group.[255]

1.3 Kenyan context

1.3.1 Background to EDIS in Kenya

Kenya has evolved through a process where there was no deposit protection from 1895 to 1966, to a period with implicit deposit protection from 1966 to 1985, and has an EDIS since 1985 when it was introduced under the Deposit Protection Fund Board

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250 *FSB Key attribute* 6.3.
251 See *IADI Core principles.* See also FSB (2010).
252 *IADI Core principle* 14.
253 See generallyVolcker.
254 While the USA has the oldest EDIS (established in 1933), among the countries that established EDIS post-GFC are Australia (2008), Brunei (2011) and Kosovo (2012). See A Demirguc-Kunt *et al* 183. All the Group of 20 (G-20) member countries had established EDIS by 2014, except China, Saudi Arabia and South Africa. While China implemented an EDIS in May 2015, Saudi Arabia implemented one in 2016, leaving South Africa as the only G-20 member country without an EDIS. The South African government has published a discussion paper for the design of an EDIS and a policy paper on a proposed SRR for implementation after public comments. See South African Reserve Bank, *Designing a deposit insurance scheme for South Africa - a discussion paper,* (2017) 15. See also the National Treasury, *Strengthening South Africa's resolution framework for financial institutions,* (2015) 32.
255 DC Wheelock and SC Kumbhakhar 186.

(DPFB).[256] The DPFB framework was subsequently replaced by a post-GFC framework under the Kenya Deposit Insurance Act in 2012, which forms the basis of this study.[257]

1.3.2 Currency board era with no deposit protection 1895 to 1966

There was no deposit protection in Kenya from 1895, when Great Britain declared a protectorate over Kenya, to 1963 when Kenya attained independence.[258] By 1966 when the Central Bank of Kenya (CBK) was established, Kenya had neither an implicit deposit protection nor an EDIS.[259] During this period, the Kenyan financial system operated a currency board that acted as a money changer to issue local currency only after payment of an equal amount of sovereign gold coins into the Bank of England.[260] Liquidation of insolvent banks was conducted through judicial proceedings that treated depositors on the same basis as ordinary creditors under corporate insolvency law.[261]

1.3.3 Implicit deposit protection from 1966 to 1985

Implicit deposit protection was provided in Kenya from 1966 upon the establishment of the CBK until 1985 when an EDIS was introduced.[262] The motivation for the EDIS was the failure of several financial institutions beginning in 1984 and rising to nine failed institution by 1989.[263] Since the implicit deposit protection system provided no preference to depositors of the failed institutions it left them to prove their rights to recovery under lengthy judicial insolvency proceedings.[264] Consequently, the government introduced an EDIS in 1985 to give depositors a creditor preference in bank insolvencies.[265]

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[256] See Governor M Cheserem's comments in the Central Bank of Kenya, *Bank Supervision Department annual report 1994*, 13.
[257] See Kenya Deposit Insurance Act 12 of 2012.
[258] JB Ojwang, *Constitutional development in Kenya: Institutional adaptation and social change*, (1990) 36.
[259] See Central Bank of Kenya Act 15 of 1966.
[260] A Hazelwood, 'The economics of colonial monetary arrangements', (1954) *Social and Economic Studies* 292.
[261] Judicial insolvency proceedings were carried out under the Companies Act that has been repealed by the Companies Act 17 of 2015.
[262] The Banking Amendment Act 17 of 1985 introduced an EDIS in Kenya after the banking crisis of the 1980s. See Governor Cheserem's comments discussed in par 1.3.1 above. See also R Detho, 'Benefits of deposit insurance in Africa: The Kenya experience', International Association of Deposit Insurers African Regional Conference (2010) Arusha, Tanzania 2.
[263] See Governor Cheserem's comments discussed in par 1.3.1 above. See also Detho 2.
[264] Detho 2.
[265] See Central Bank of Kenya, *Bank Supervision Department Annual Report 1994*, 13.

1.3.4 Explicit deposit insurance from 1985 to 2012

When Kenya introduced the EDIS under the Banking Act in 1985, it was administered by the DPFB, an agency established as a separate juristic person within the CBK.[266] The DPFB was mandated to charge flat rate premiums on member banks and left the liquidation of banks to ordinary bank insolvency.[267] This deprived the DPFB of any statutory autonomy as receiver or liquidator of insolvent banks.[268] Consequently, the government enacted the Kenya Deposit Insurance Act in 2012 to repeal the EDIS under the DPFB[269] and establish a new EDIS and an SRR[270] under the Kenya Deposit Insurance Corporation.[271]

1.4 Research statement

1.4.1 Hypothesis

This thesis focuses on how explicit deposit insurance (as opposed to implicit deposit protection) may be designed as a crucial component within the new regulatory landscape of an orderly bank resolution regime. More specifically, it considers how explicit deposit insurance can be designed to effectively guarantee reimbursement of insured deposits in the event of bank failure, without also promoting the moral hazard from bank risk-taking and from depositor indifference as to the safety of the banks that they place their deposits in.

Therefore, this thesis analyses the design of explicit deposit insurance to serve the narrow objective of protecting depositors of failed banks, while also serving the broader public interest role post-GFC to promote financial system stability through mitigating the moral hazard that leads to bank failures. The main objective of the study is to address this challenge from the perspective of my home jurisdiction Kenya, that adopted an EDIS in 1985 (pre-GFC) and has subsequently replaced it with a newly designed EDIS in 2012 (post-GFC) that has to function within the broader scheme of an orderly resolution regime introduced by the Kenya Deposit Insurance Act, 2012.

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266 S 36(6) of the Banking (Amendment) Act 9 of 1989.
267 S 38(3) of the Banking (Amendment) Act 9 of 1989.
268 The Kenya Deposit Insurance Corporation may be appointed as receiver under s 51 of the Act and as liquidator under s 61 of the Act.
269 S 76(1).
270 S 5(1).
271 S 4(1) of Kenya Deposit Insurance Act 10 of 2012.

1.4.2 Research questions

The research statement raises the following research questions:

(1) What gaps existed in the pre-GFC international financial standards on bank regulation, EDIS and SRR?

(2) What reforms did the post-GFC international financial standards introduce to strengthen bank regulation and supervision, EDIS and SRR for a more resilient financial sector?

(3) What is the significance of effective bank regulation and supervision in explicit deposit insurance and how has Kenya's bank regulatory framework addressed financial conglomerate risk taking as compared to the South African and US bank regulatory frameworks?

(4) How does the design of EDIS and SRR under the Kenya Deposit Insurance Act, 2012, adopt the *IADI Core principles* and the *FSB Key attributes* to address the moral hazard in banking and how may it be reformed to enhance its effectiveness?

(5) How has the apparent implicit deposit protection and bank curatorship in South Africa addressed moral hazard in banking? What are the key features of the proposed EDIS and envisaged Special Resolution Bill in South Africa and do they adopt the *IADI Core principles* and the *FSB Key attributes* in addressing moral hazard in banking?

(6) How does the EDIS and SRR under the FDIC address the moral hazard in banking in the USA?

(7) What conclusions may the study draw and what lessons may Kenya learn from the experience in addressing the moral hazard in banking in South Africa and the USA, to enhance the effectiveness of the Kenyan EDIS?

1.4.3 Limitation of the scope of the study

The study is limited to the role of explicit deposit insurance in the regulation of commercial banks and excludes other depository or financial institutions, except as they relate to universal banking groups. As pointed out above,[272] the thesis does not

[272] Par 1.2.8 above.

seek to provide a general rendition of the advantages and disadvantages of explicit deposit insurance vis-à-vis implicit deposit protection. It is accordingly a narrow study that seeks to contribute to the existing body of literature on explicit deposit insurance that operates as a critical component of an orderly bank resolution regime post-GFC, by highlighting its pertinent role in curbing moral hazard.

1.5 Motivation for the study

My motivation for this study stems from three main areas. The first relates to the Kenya Deposit Insurance Act, 2012 that was enacted after the 2008 GFC. This development motivated me to consider how the Kenya Deposit Insurance Act incorporates the global trends in the reform of bank supervision, deposit insurance and orderly resolution to shift from government bail-out of insolvent banks to bail-in within resolution by shareholders, unsecured creditors and uninsured depositors bearing the cost of bank failure. The second motivation is the paradox of the GFC having been triggered in the subprime lending practice of banks in the USA, where the world's first known EDIS originated, when South Africa, which was then operating an apparent implicit deposit protection system did not experience a similar scale of bank failure during such a time.

In addition, South Africa is currently implementing financial regulatory reforms to enhance the safety of its financial system through the Twin Peaks model, the South African Reserve Bank's discussion paper on EDIS, the proposed Special Resolution Bill, and the *Discussion paper on principles for the effective supervision of financial conglomerates.* These developments particularly motivate the study of South Africa as a comparative jurisdiction, because of the strong institutional framework established by its National Treasury and the South African Reserve Bank for public participation in the discussion and validation of new financial reforms before they are adopted and implemented.

Lastly, I have a personal interest in the study of the role of deposit insurance in bank regulation. I have practised banking law since 1987, and also taught and conducted seminar courses in Banking Law since 1998. In both capacities I have noticed the scarcity of academic materials on deposit insurance as a bank regulatory tool in Kenya, to which I hope to contribute through this study.

1.6 Research methodology and selection of comparative jurisdictions

The study is library-based desk top doctrinal research conducted through an examination of documents, text books, learned articles, and other local, national and international instruments and materials on bank regulation, bank supervision, bank examinations, deposit insurance, the moral hazard and bank resolutions. I selected the Republic of South Africa for the comparative study because it is the leading financial power in Africa and has pioneered the adaptation of international instruments to African contexts as a member of the G-20. It also has an apparent implicit deposit protection system and an advanced bank regulatory regime with robust safety net practices and is in the process of transitioning to an EDIS and SRR, that inform my evaluation of the Kenyan regime.

I further selected the USA for a comparative perspective because it has pioneered explicit deposit insurance and has improved its EDIS from the time it was established in 1933, as well as an established SRR, which developments are useful in the evaluation of the Kenyan EDIS. In addition, globalisation enables banks from other countries to operate in Kenya, and the regulatory experience in USA and South Africa may aid in the evaluation of the Kenyan Act.

1.7 Summary and lay-out of chapters

Chapter One provides the roadmap to the study and discusses the special role of banks in the economy; the problem of moral hazard in the banking sector, and how universal banking became the driver of moral hazard. It considers the gaps in pre-GFC regulatory and supervisory frameworks and the rationale for EDIS in the post-GFC regulatory paradigm and the lessons drawn from the GFC regarding the need to address moral hazard in banking to prevent the use of public funds to bail-out banks. Central to this chapter is the post-GFC evolution and function of deposit insurance as a critical component of an orderly bank resolution regime.

Chapter Two examines the post-GFC international financial standards that integrate mechanisms of bank regulation and supervision, explicit deposit insurance and orderly bank resolution to maintain the safety and soundness of individual financial institutions (microprudential regulation) as well as the stability of the financial system (macroprudential regulation). Accordingly, the chapter considers the post-GFC

international financial regulatory reforms through: the *Basel III Accord*, the *Basel Core principles*, the *Joint Forum Principles*, the *IADI Core principles* and the *FSB Key attributes* as a framework for financial regulation and supervision, explicit deposit insurance and orderly bank resolution. The focus is on shifting from the pre-GFC bail-out of financial conglomerates that were considered "Too-Big-To-Fail", to bail-in by requiring shareholders, uninsured depositors and unsecured creditors to recapitalise their failed banks through conversion of their debts to equity. The chapter further outlines the analytical framework for the factors that may influence the implementation of the international financial standards in the three jurisdictions.

Chapter Three discusses the implementation of international financial standards on the regulation and supervision of financial conglomerates by Kenya, South Africa and the USA. The chapter outlines the local regulatory context in each country and discusses the factors that influence the design of the financial safety net and the adoption of the *Basel III Accord*, the *Basel Core principles* and the *Joint Forum Principles* for the consolidated regulation and supervision of financial conglomerates. The chapter further considers the impact of the factors that influence the implementation of financial reforms to the effectiveness of those reforms in addressing moral hazard in banking.

Chapter Four discusses the introduction of EDIS in Kenya under the DPFB in 1985 pre-GFC, and the post-GFC design of the EDIS and SRR under the Kenya Deposit Insurance Act, 2012. The chapter further evaluates the adaptation of the *IADI Core principles* and the *FSBKey attributes*to the Kenyan context in the design of the EDIS and the SRR under the Kenya Deposit Insurance Act. The chapter will further examine any the potential reforms to enhance the effectiveness of the Act in addressing moral hazard in banking.

Chapter Five discussesthe apparent implicit deposit protection and bank curatorship and liquidation regime in the Republic of South Africa; and the proposed introduction of an EDIS and SRR. It further evaluates how these reforms will address the moral hazard from banks.

Chapter Six discusses the operation of explicit deposit insurance and special bank resolution in the USA and how it has addressed moral hazard from banks. In particular

the chapter discusses the response of the USA to the GFC and its contribution to the reform of prudential regulation and supervision of SIFIs, and to the design of EDIS and SRR to limit the moral hazard from financial conglomerates.

Chapter Seven outlines the conclusions of the study and makes recommendations for the reform of the KDI Act to enhance the capacity of the Kenyan EDIS and SRR, to address moral hazard in banking. In addition, the chapter makes recommendations for further research in areas that may have been encountered in the study but were outside its scope.

CHAPTER 2: THE INTERNATIONAL CONTEXT OF BANK REGULATION, DEPOSIT INSURANCE AND ORDERLY BANK RESOLUTION

2.1 Introduction

2.1.1 General overview

I examined the rise of universal banking in Chapter One,[1] and observed that the financial conglomerate structures they adopted[2] and complex financial products they offered,[3] challenged the pre-Global Financial Crisis (GFC) financial supervisory structures that most countries had adopted.[4] The challenges in the pre-GFC financial supervision were attributed to gaps in the *Basel II Accord*[5] that focused on the safety of individual financial institutions[6] rather than on the systemic risks that the conduct of business of financial conglomerates posed to the financial systems.[7] Also discussed were the gaps in the *Basel II Accord's* three foundational pillars of minimum capital requirements, supervisory review and market discipline.[8]

Of special concern was the need to address the problem of "Too-Big-To-Fail" that is created by the complexity and interconnectedness of financial conglomerates that compels governments to bail them out in order to prevent the disruption that their failure would pose to the financial system.[9] Thus, the GFC highlighted that significant reforms were required to strengthen financial regulation and supervision in order to limit risk-taking and prevent bank failure, and where banks still failed, to facilitate their orderly exit from the financial system without using public funds through explicit deposit insurance schemes (EDIS) and special bank resolution regimes (SRR).[10]

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[1] Ch 1 par 1.2.5.
[2] Ch 1 par 1.2.5.3.
[3] Ch 1 par 1.2.6.
[4] Ch 1 par 1.2.5.5.
[5] See generally Basel Committee, *International convergence on capital measurement and capital standards: A revised framework,* (2004) (hereafter *Basel II Accord*).
[6] Ch 1 par 1.2.5.4.
[7] Ch 1 par 1.2.7.
[8] Ch 1 par 1.2.5.4.
[9] Ch 1 par 1.2.7.
[10] Ch 1 par 1.2.8.

2.1.2 Chapter overview

This chapter examines the post-GFC international financial regulatory reforms spearheaded by the Group of Twenty (G-20)[11] to *ex ante* limit government bail-out of banks that are "Too-Big-To-Fail" through effective bank regulation and supervision.[12] The chapter further discusses the regulatory reforms to strengthen the supervision of financial conglomerates by integrating macro-prudential system-wide regulation with microprudential regulation for the safety and soundness of individual financial institutions and conduct of business regulation to address the systemic risk that financial institutions pose to the financial system.[13] The objective of the chapter is to provide an overview of the post-GFC international regulatory paradigm that seeks to strengthen the supervision of financial conglomerates on a consolidated basis and to end the problem of "Too-Big-To-Fail" through enhanced capital requirements[14] by making them pay for the costs of their failure and imposing responsibility on them for the resolution of their affairs.[15]

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[11] The Group of Twenty Countries (G-20) comprises the USA, the UK, Canada, Germany, France, Italy, Japan, Russia, China, India, Brazil, South Africa, Australia, Argentina, Indonesia, Korea, Mexico, Saudi Arabia, Turkey, and the European Union. It is "an informal forum to promote dialogue between industrial and emerging market countries on key economic stability issues." See G-20 website, available at <https://www.g20.org> accessed on 12.4.2018.

[12] See Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems,* (2010). See also DH Weber, DW Arner, C Gibson &S Baumann, 'Addressing systemic risk: Financial regulatory design', (2014) *Texas International Law Journal*178–183.

[13] See P Tucker, *Basel III, Too-Big-To-Fail and macroprudential regimes*, (2011) Group of Thirty occasional paper 15. See also KN Johnson, 'Macroprudential regulation: A sustainable approach to regulating financial markets', (2013)*University of Illinois Law Review* 884.

[14] See Basel Committee, *Core principles for effective banking supervision* (revised 2012) (hereafter *Basel Core principles*) as pre-conditions for effective banking supervision. In addition, the Basel Committee, the International Organisation of Securities Commissions, (IOSCO), the Committee on Payments and Settlement Systems (CPSS) and the International Association of Insurance Supervisors (IAIS), established a Joint Forum to deal with issues common to the banking securities and insurance sectors and for the effective supervision of financial conglomerates, available at <http://www.bis.org/bcbs/jointforum.htm> accessed on 29.10.2018. Pursuant to their mandate, the Joint Forum developed *Principles for the supervision of financial conglomerates* in 1999 (revised 2012) (hereafter *Joint Forum Principles*) as agreed standards for the supervision of financial conglomerates.

[15] See Tucker (2011) 15.

The chapter further considers reforms to mitigate the effects of bank failure on depositors and the economy through the design of an *ex ante* privately funded EDIS[16] and SRR[17] that facilitates the orderly exit of insolvent banks from the financial system without the use of public funds whilst preserving their critical economic functions. Accordingly, this chapter provides a framework for the design of EDIS as an integral part of macroprudential regulation aimed at limiting moral hazard in banking and asa critical part of an orderly bank resolution regime.[18] Since the international financial standards can only be effective if implemented, the chapter further examines the factors that may influence such implementation and the impact that those factors may have on the effectiveness of the regulatory and supervisory standards thus implemented.

2.2 The post-GFC reform of the international financial architecture

2.2.1 Group of Twenty countries

2.2.1.1 Formation of Group of Twenty

The international community's response to the GFC was alluded to in Chapter One,[19] as well as the international regulatory reforms introduced to address the gaps identified during the crisis.[20] These reforms seek to strengthen financial supervisory standards to limit excessive risk-taking by financial institutions,[21] and enhance cross border collaboration for the supervision and resolution of globally active financial institutions.[22] The reforms were speared by the Group of Twenty (G-20) that had been formed in 1999 along with the Financial Stability Forum (FSF)[23] to address the Asian

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[16] International Association of Deposit Insurers (IADI), *Core principles for effective deposit insurance systems,* (2014) (hereafter *IADI Core principles*) 5. The *IADI Core principles* provide a standard for assessing "the quality of deposit insurance systems and identify gaps for reform".
[17] See Weber *et al* 178–183.
[18] See ch 1 par 1.2.5 on impact of universal banking on moral hazard.
[19] See ch 1 par 1.2.7.
[20] See DW Arner, 'Adaptation and resilience in global financial regulation', (2011) *North Carolina Law Review* 1579.
[21] See J Hindle, 'The future of regulation', (2009) *Journal of Financial Regulation and Compliance* 421.See also M Giovanoli, 'A new architecture for the global financial market: Legal aspects of international financial standard setting', in M Giovanoli (ed), *International monetary law: Issues for the new millennium*, (2000) 59.
[22] C Brummer, 'How international financial law works (and how it doesn't)', (2011) *The Georgetown Law Journal* 257.
[23] See par 2.2.1.2 below.

Crisis that arose from the drastic fall in the value of the Malaysian currency and spread to other East Asian countries.[24] The fall in value of the Malaysian currency was attributed to the region's sudden liberalisation of foreign exchange markets without effective mechanisms to mitigate cross-border capital flows that was exacerbated by stringent International Monetary Fund (IMF) fiscal constraints.[25] Consequently, once international investors started to transfer their funds from the region, it initiated a bank run on the countries' foreign exchange reserves that caused countries which were solvent to seek liquidity assistance from the IMF.[26] The IMF granted the assistance on fiscal conditionalities that constrained those countries' fiscal capacities and transformed their problems from being foreign exchange liquidity shortage to capital solvency problems.[27]

After addressing the problem, the G-20 became dormant until the onset of the GFC, when it was revived to establish a framework for "global financial regulation and mitigation of systemic risk."[28] Partly to address the perceived concerns by some members of the G-20 that the IMF had favoured some of its members at the expense of others in its responses to the Asian Crisis and other crises,[29] the G-20 expanded its mandate to include the maintenance of international financial stability, which had previously been undertaken by the IMF.[30] To further address this perception of bias, the G-20 adopted a "horizontal approach" in the coordination of its intergovernmental responses to global economic crises in contrast to the "vertical approach" previously

[24] See M Giovanoli, 'The international financial architecture and its reform after the Global Crisis', in M Giovanoli & D Devos (eds), *International monetary and financial law*, (2010) 8.
[25] See B Bosworth, 'The Asian financial crisis: What happened and what can we learn from it', (1998) *The Brookings Review* 8.
[26] *Ibid.*
[27] *Ibid.*
[28] See JH Freis Jr, 'The G-20's emphasis on promoting integrity in financial markets', in M Giovanoli & D Devos (eds), *International monetary and financial law,* (2010) 104.
[29] The main concern for emerging market economies was that the IMF had failed to adhere to its key principle that a member's voting power in the Fund and accessibility to its resources was to be determined by the size of that member in the global economy. In particular, the Fund's role in guiding the economic policies in Asia and Latin America that led to financial crises was cited as evidence that the Fund was more concerned with the industrialised economies than the emergent and low income economies. See S Hogan, 'Reforming the IMF', in M Giovanoli & D Devos (eds), *International monetary and financial law*, (2010) 50.
[30] See JT Fried & JA Haley, 'Crisis prevention: Lessons from emerging markets for advanced economies', in M Giovanoli & D Devos (eds), *International monetary and financial law*, (2010) 82.

adopted by the IMF.[31] The "horizontal approach" facilitates a consultative process for the development and implementation of international financial standards, which has been said to transform the standards from a voluntary "soft law" to a "hard" soft law, because of the enforcement strategies adopted by the G-20 that includes incentives like peer pressure, peer reviews, and World Bank and IMF Financial Sector Assessment Programs.[32]

2.2.1.2 International standard setting bodies

At its London meeting in 2009, the G-20 transformed the FSF into the Financial Stability Board (FSB) and expanded its mandate to include the formulation of international financial standards to strengthen financial stability.[33] The FSB is mandated to collaborate with other standard setting bodies,[34] including, *inter alia*, the Basel Committee, in strengthening bank capital standards and the supervision of financial conglomerates, and the IADI, to develop frameworks for effective deposit insurance and orderly bank resolution regimes.[35] Accordingly, the Basel Committee strengthened the *Basel II Accord* by issuing *Basel III* to increase regulatory capital and

[31] See M Giovanoli, 'The international financial architecture and its reform after the Global Crisis', in M Giovanoli & D Devos (eds), *International monetary and financial law*, (2010) 8.

[32] See AC Eernisse, 'Banking on cooperation: The role of the G-20 in improving the international financial architecture', (2012) *Duke Journal of Comparative and International Law* 240. See also PH Verdier, 'The political economy of financial regulation', (2013) *Indiana Law Journal* 1462 where the author credits the GFC for coalescing international cooperation for stronger prudential regulation, and PH Verdier, 'Transnational regulatory networks and their limits', (2009) *Yale Journal of International Law* 126–129.

[33] The FSF was established by the G-20 to coordinate the activities of the Basel Committee on Banking Supervision, the IOSCO, the IAIS and the CPSS, as international financial standard setting bodies. Upon transformation of the FSF into the FSB membership was increased from the G-20 countries to include the international standard setting bodies, the World Bank, the IMF, and the Organization for Economic Cooperation and Development (OECD).See the FSB website available at <https://financialstabilityboard.org> accessed on 12.4.2018. See also M Giovanoli, 'The international financial architecture and its reform after the Global Crisis', in M Giovanoli and D Devos (eds), *International monetary and financial law*, (2010) 4.

[34] The FSB further collaborates with other standard setting bodies on anti-money laundering, anti-terrorist financing, payment and settlement systems, and other regulatory standards on securities, insurance, good governance, accounting and auditing. See <https://www.financialstabilityboard.org>accessed on 19.12.2018 for links to the standard setting bodies..

[35] S Claessens, RJ Herring & D Schoenmaker, 'A safer world financial system: Improving the resolution of systemic institutions: Geneva report on the world economy', *International Centre for Monetary and Banking Studies* (2010) 57. The authors argue that a financial framework that integrates the regulation, supervision and resolution of SIFIs is more effective in addressing the moral hazard they create than a system that separately provides for bank regulation, supervision and resolution.

enhance the resilience of banks.[36] It also revised the *Basel Core principles for effective banking supervision* (*Basel Core principles*)[37] and participated in the revision of the *Joint Forum Principles for the Supervision of Financial Conglomerates (Joint Forum Principles)* aimed at enhancing the supervision of banks and financial conglomerates.[38]

The Basel Committee further collaborated with the IADI in 2009 to develop the *Core principles for effective deposit insurance systems* (*IADI Core principles*) to guide member countries in the design of effective EDIS to address moral hazard in banking.[39] In addition, in 2011the FSB developed *Key attributes of effective resolution regimes for financial institutions* (*FSB Key attributes*), which it updated in 2014,to guide member countries in the design of effective resolution regimes.[40] As part of its mandate to strengthen global financial stability, the FSB monitors implementation and compliance with the IADI *Core principles and FSB Key attributes* through thematic reviews of member countries.[41] Thus, the FSB promotes global financial stability by positioning EDIS as the bridge between bank regulation and supervision on the one hand, and bank resolution on the other hand,[42] and thereby integrating bank regulation and supervision, deposit insurance and orderly bank resolution.[43]

2.2.2 Post-GFC reforms to international financial regulation

2.2.2.1 Objectives of the post-GFC financial regulatory reforms

The post-GFC international financial regulatory reforms seek to strengthen the resilience of banks and banking systems by integrating microprudential regulation that addresses the safety and soundness of individual financial institutions and macroprudential regulation that addresses the systemic risk emanating from their conduct of business.[44] Microprudential regulation is strengthened through enhanced

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[36] See *Basel III* par 4.
[37] See *Basel Core principles* 5.
[38] See *Joint Forumprinciples*1.
[39] See *IADI Core principles* 11.
[40] See *FSB Key attributes* 5.
[41] See FSB,*Framework for strengthening adherence to international standards,* (2010) 2.
[42] Tucker (2011) 18.
[43] See Claessens *et al*57.
[44] See Group of Thirty, *Enhancing financial stability and resilience: Macroprudential policy, tools and systems for the future,* (2010) 16.

quality and quantity of capital under the *Basel III Accord*, and risk-based and consolidated supervision of financial conglomerates under the revised *Basel Core principles* and *Joint Forum Principles*.[45] Macroprudential regulation focuses on strengthened conduct of business regulation and supervision of banks and financial conglomerates as well as the use of EDIS to reimburse insured depositors of failed banks and a SRR to facilitate the orderly exit of failed banks from the financial system without bail-outs, whilst preserving their critical economic functions.[46]

2.2.2.2 Basel III reforms to the minimum capital requirements pillar

The *Basel III Accord* strengthened the minimum capital requirements pillar of the *Basel II Accord*,[47] by enhancing the quality and quantity of capital,[48] and by limiting bank leverage through systemic capital and liquidity surcharges,[49] conservation buffers,[50] and counter-cyclical buffers.[51] As was noted in Chapter One[52] the use of the internal ratings-based methodology under the *Basel II Accord* in the assessment of regulatory capital was abused by banks that over-stated their capital and under-stated their

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[45] See par 2.2.1.2 above.

[46] See SL Schwarcz, 'Beyond bankruptcy: Resolution as a macroprudential regulatory tool', (2018) *Notre Dame Law Review* 19. See also Tucker (2011) 18.

[47] According to Van Vuuren, the objectives of *Basel III* were to strengthen rather than replace Basel II. See GW Van Vuuren, 'Basel III countercyclical capital rules: Implications for South Africa', (2012) *South African Journal of Economic and Management Sciences* 301.

[48] *Basel III* 30.

[49] Capital and liquidity surcharges are risk based capital and liquidity requirements imposed on banks in proportion to the systemic risk posed by their corporate complexity and interconnectedness. See N Tarashev, C Borio, & K Tsatsaronis, 'The systemic importance of financial institutions', (2009) *BIS Quarterly Review* 75.

[50] Capital conservation buffers are capital requirements additional to the regulatory minimum capital requirements to be raised by banks to absorb losses before drawing down regulatory capital. See *Basel III* par 122. The capital conservation buffers were introduced because many banks had paid generous dividends, bonuses and engaged in share buy backs, despite having low capital levels, in the lead up to the GFC, which reduced their ability to withstand the economic stress when it became severe. See *Basel III* par 27.

[51] Capital counter-cyclical buffers are additional capital to the regulatory minimum capital requirements and capital conservation buffers and are imposed during periods of excess aggregate credit growth that have the potential to create a system-wide risk of economic downturn. See *Basel III*para 137 and 138. The counter-cyclical capital buffers sought to address the counter-cyclical irrational behaviour of market participants to become collectively optimistic (leading to market booms) or pessimistic (leading to economic downturn or busts). To enforce counter-cyclical capital buffers, supervisors were authorised to restrict capital distributions of dividends, bonuses or other compensation schemes for institutions that do not meet statutory capital requirements. See *Basel III* par 138. See also M Carney, *Countercyclical capital buffers and Basel IIIin regulatory reforms and the remaining challenges*, (2011) Group of Thirty occasional paper 7 and 9.

[52] See Ch 1 par 1.2.5.4 for the definition of regulatory capital. See also See RS Carnell, JR Macey & GP Miller, *The law of banking and financial institutions,* (2009) 253.

risks.[53] The *Basel III Accord* addressed this problem by deducting goodwill, minority shares and tax deduction allowances from the Tier 2 or supplementary capital.[54] The systemic capital and liquidity surcharges operate like a systemic tax assessed on the complexity and interconnectedness of a SIFI and the systemic risk the SIFI poses to the financial system.[55] This seeks to prevent risky activities and corporate structures that erode capital and increase the risk of systemic failure.[56] Since the surcharges will divert a large portion of funds from bank investments,[57] they will potentially discourage banks from interconnections that increase systemic risk.[58] The capital conservation buffers are levied at 2.5 per cent additional to the 8 per cent minimum capital requirements,[59] and are to be built up as reserves during periods of market boom, by retaining profits and restrictions on share buy backs and bonuses, to be drawn down in periods of economic stress to absorb shocks that follow excessive credit growth.[60] In addition, the counter-cyclical capital buffers are to be assessed at between zero and 2.5 per cent and applied only during a period of excessive growth as reserves to absorb any losses from any potential credit contraction that may follow such excessive credit growth.[61] Other loss absorption measures include convertible contingent (CoCo) bonds,[62] subordinated debt instruments[63] and restrictions on complexity and interconnectedness.[64]

CoCo bonds are hybrid capital securities issued by banks, which automatically convert to equity when their capital erodes below the regulatory levelin order to absorb losses in accordance with their contractual terms.[65] They are designed toshift the cost of bank resolution from the government through bail-out, to private investors whose credit

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[53] See *Basel II Accord* par 31.
[54] *Basel III* par 30.
[55] See Tarashev *et al* 75–87.
[56] SG Cecchetti &KL Schoenholtz, *Money, banking and financial markets* (2011) 409.
[57] *Ibid.*
[58] See Tarashev *el al* 76.
[59] See *Basel III* par 18.
[60] See *Basel III* par 124.
[61] See *Basel III* para 137 and 138.
[62] See S Avdjiev, A Kartasheva and B Bogdanova, 'CoCo: A primer', (2013) *BIS Quarterly Review* 1.
[63] See E Ferran, *Principles of corporate finance law*, (2008) 58.
[64] *Basel III* par 32.
[65] See Claessens *et al* 57. The authors argue that the requirement by the Basel Committee that banks use subordinated debt, and CoCo bonds, along with the liquidity, and capital surcharges may be useful in imposing a price for systemic risk.

under the bond converts to equity.[66] Sub-ordinated debt instrumentsare securities whereof the rights to recovery of the principal debt and sometimes interest are deferred until some or all of the company's other debts have been repaid in return for a higher rate of interest.[67] The *Basel III Accord* also restricts financial conglomerates from transferring capital and liquidity among affiliates to limit double or multiple leveraging.[68] Thus, financial conglomerates are restrained from using proceeds of their debt securities to meet their subsidiaries' regulatory capital requirements.[69] In addition, financial conglomerates may be directed to, change any corporate or ownership structures that promote double or multiple leverage;[70] exclude intra-group capital transfers from their capital adequacy assessments and to provide additional funds as a "source of strength"[71] to their banking subsidiaries.[72]

2.2.2.3 Reforms to the supervisory review pillar

The Basel Committee addressed the weaknesses within the supervisory review pillar of the *Basel II Accord* as identified above,[73] by issuing revised *Basel Core principles* in 2012[74](see Annexure A to the thesis),[75] and the revised *Joint Forum Principles,*[76] also in 2012 (see Annexure B to the thesis).[77] Through the two sets of standards, the Basel Committee seeks to integrate microprudential and macroprudential regulation

[66] See LB Thomas,*Money, banking and financial markets,* (2006) 281. Thomas suggests that SIFIs that seek approval to provide services or products that increase their risk exposure should be required to purchase additional catastrophe insurance against the risk of their insolvency. In the event that the risk insured against occurs, in that capital is reduced below the prescribed levels, they would lodge a claim and use the insurance proceeds to restore their capital to prescribed levels. The catastrophe insurance would operate like a risk-based capital requirement by using the cost of the premiums to dis-incentivise banks from taking excessive risks.
[67] *Basel III* par 32.
[68] *Joint Forum principles* 24.
[69] *Idem* 18.
[70] *Ibid.*
[71] The source of strength doctrine was introduced in the USA under the Bank Holding Company Act 1856 to ensure that bank holding companies enhanced the resilience of their banking affiliate. Thus, bank holding companies that applied for approval to acquire a bank or to engage in a non-bank activity were required to demonstrate their ability to extend their financial, managerial, and operational strength to the bank or other non-bank affiliate. See AB Ashcraft, 'Are bank holding companies a source of strength to their banking subsidiaries?', (2004) *Federal Reserve Bank of New York Staff Reports* 3.
[72] *Idem* 19.
[73] See par 2.2.2.2 above.
[74] See par 2.1.2 above for the objectives of the *Basel Core principles*.
[75] See generally, 1997 *Basel Core principles.*
[76] See par 2.1.2 above for membership and objectives of the *Joint Forum.*
[77] See *Joint Forum Principles* 2.

and supervision within an enhanced financial system safety net.[78] In addition, it seeks to assign financial stability and financial supervision functions between central banks, prudential and conduct of business supervisors as the well as EDIS and SRR for the orderly resolution of failed financial institutions.[79]

(a) The design of the safety net framework

A financial safety net may be defined as the macroeconomic framework that comprises the Ministry of Finance, the central bank, financial supervisors, the deposit insurer, and the resolution authority (RA) with the aim of protecting the stability of the financial system.[80] Thus, financial safety nets seek to promote the stability of financial systems and sustain the provision of banking services for their economies.[81] Ministries of Finance are normally the politically accountable government departments that formulate and implement fiscal and economic policies and are responsible for the stability of the financial system.[82] Central banks are normally responsible for*, inter alia*: determination of monetary policy, being bankers to governments, other banks and lenders of last resort (LOLR)[83] and for the supervision of financial institutions.[84] In addition, central banks normally serve as the clearing house for banks and supervisors of the payments system and as *de facto* supervisors for financial stability.[85]

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[78] See AJ Levitin, 'In defence of bailouts', (2011) *The Georgetown Law Journal* 481. Levitin argues that EDIS and SRR remove discretion in government protection of depositors and intervention in bank resolution.

[79] Verdier (2013)1462.

[80] *IADI Core principle* 4 defines the financial safety net as including prudential regulation, supervision, resolution, LOLR, deposit insurance, and the Ministry of Finance or Treasury. Also see generally, EW Nier, J Osinski, LI Jerome &P Madrid, *Towards effective macroprudenial policy frameworks: An assessment of stylized institutional models*, (2011) The IMF working paper and EW Nier, J Osinski, LI Jerome & P Madrid, *Institutional models for macroprudential policy*, (2011) The IMF discussion note.

[81] *Basel Core principles* par 52 and *Joint Forum Principles* 2.

[82] For an account of the assignment of this function in the USA, the United Kingdom, Germany and Japan see PB Stephan & JA Roin, *International business and economics-law and policy,* (2010) 308–310.

[83] See ch 1 par 1.2.3 for a discussion of LOLR. See also JJ de Jager, 'Central bank, lender of last resort assistance: An illusive concept?', (2010) *De Jure* 232. See S Schich, 'Financial crisis: Deposit insurance and related financial safety net aspects',(2008) *OECD Financial Market Trends* 2.

[84] See M Melecky & AM Podpiera, *Placing bank supervision in the central bank: Implications for financial stability based on evidence from the Global Crisis,* (2015) World Bank policy research paper 3. See also PB Stephan & JA Roin310.

[85] See F Gianviti, 'The objectives of central banks', in M Giovanoli & D Devos, *International monetary and financial law*, (2010) 474.

As alluded to in Chapter One,[86] the GFC raised the need for the integration of EDIS and SSR for orderly bank resolution within the regulatory framework for the supervision of banks.[87] The EDIS and SRR reinforce prudential regulation by preventing the spread of bank runs through guarantees to reimburse depositors of failed banks,[88] and facilitatethe orderly exit of failed institutions from the financial system without using public funds, whilst preserving vital economic functions.[89] Consequently, to implement the post-GFC standards, countries need to design their safety net systems by balancing the mandates of the central bank, the prudential and conduct of business regulators, deposit insurer and RA within the country's financial system context.[90]

(b) Twin Peaks model of financial supervision

As discussed in Chapter One,[91] the pre-GFC supervisory structures were more focused on the safety and soundness of individual financial institutions than on the systemic risk emanating from their conduct of business.[92] In addition, while both the integrated approach and the Twin Peaks approach could provide consolidated supervision of financial institutions through coordination among the functional financial sector supervisors, the Twin Peaks model appears to provide more effective consolidated supervision of financial conglomerates than the integrated approach.[93] Indeed, a post-GFC review of global responses to the Crisis, suggests that financial supervisors in Australia and the Netherlands, which had adopted Twin Peaks models

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[86] See ch 1 par 1.2.8.
[87] See U Vollmer & H Wiese, 'Minimum capital requirements, bank supervision and special resolution schemes: Consequences for bank risk taking', (2009) *Journal of Financial Stability* 487.
[88] See R Gropp & J Vesala, *Deposit insurance and moral hazard: Does the counterfactual matter?*, (2001)The European Central Bank working paper 2.See also AM Santomero, *Deposit insurance: Do we need it and why?*, (1997) Wharton School Financial Institutions Centre, University of Pennsylvania working paper series 2.See also Tucker (2011) 16.
[89] Vollmer & Wiese 487.
[90] Thus, the implementation of international standards is affected by the local political and legal contexts of each country. See Verdier (2009).See also EJ Kane, *Designing financial safety nets to fit country circumstances,* (2001) World Bank policy research working paper 3. The author argues that the ideal design of a financial safety net should be adapted to the context of the financial system and economy in which it is to be incorporated.
[91] See ch 1 par 1.2.5.4 for a reference to pre-GFC financial regulatory and supervisory structures.
[92] See A Godwin, S Kourabas & I Ramsay, 'Twin peaks and financial regulation: The challenges of increasing regulatory overlap and expanding responsibilities', (2016) *The International Lawyer* 273.
[93] See AD Schmulow, *Approaches to financial system regulation: An international comparative survey*, (2015) Centre for International Finance and Regulation research working paper series 1.

before the GFC,[94] were more effective in their response to the GFC than those in other developed economies that adopted different supervisory models.[95] The resilience of the supervisory systems in Australia and the Netherlands has been attributed to the Twin Peaks model they adopted.[96] In contrast, the relatively poor response to the Crisis in the United Kingdom (UK) which had adopted the integrated or mega-regulator model under the Financial Services Authority (FSA), was attributed to the lack of effective coordination between the FSA and the Bank of England.[97] Consequently, the UK reformed its regulatory structure in 2013 by replacing the integrated approach with the Twin Peaks regulatory model.[98]

The combination of responsibilities for monetary policy, LOLR and prudential supervision within the central bank may be justified as a mechanism toenhance its capacity in systemic risk management, crisis preparedness, and crisis resolution.[99] However, there are fears that the combination of these functions within the central bank could also lead to regulatory enforcement delays, in the event of a conflict between the responsibility for monetary policy and that for financial supervision.[100] This could particularly lead to delays in the supervisory enforcement action against non-compliant banks if such action is deemed likely to impede the central bank's monetary policy objectives.[101] In addition, the combination of monetary policy and bank supervision could also expose the central bank's credibilityas regards monetary policy to reputational risk if it is perceived to perform poorly in its prudential supervisory

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[94] See JF Hill, *Why did Australia fare so well in the Global Financial Crisis?,* (2012) University of Sydney legal studies research paper available at <http://ssrn.com/abstract=2063267> accessed on 24.10.2018.
[95] See generally E Tafara, 'Observations about the crisis and reform', in E Ferran, N Maloney, JF Hill, &JC Coffee Jr (eds),*The regulatory aftermath of the Global Financial Crisis* (2012).
[96] See A Godwin & I Ramsay, *Twin Peaks - the legal and regulatory anatomy of Australia's system of financial regulation*, (2015) Centre for International Finance and Regulation research working paper and M Masselink & P Van den Noord, *The Global Financial Crisis and its effects on the Netherlands*, (2009) European Commission policy paper 3.
[97] See Bank of England, *Building the UK financial sector's operational resilience,* (2018) discussion paper 6.
[98] S 1A(1) of the Financial Services Act, 2012. See also UK National Audit Office, *The Financial Conduct Authority and the Prudential Regulation Authority: Regulating financial services*, (2014) 5. See also F Fry, G Williams, N Henderson, G Adams &T Howarth, 'Twin Peaks regulation: Key changes and challenges', (2012) *KPMG Financial Service*s 2.
[99] See Melecky & Podpiera 3.
[100] See Godwin *et al* 228.The authors argue that the combination of functions within a central bank could also lead to reputational risk to its credibility on monetary policy if it is perceived to have poorly performed its supervisory performance.
[101] *Ibid.*

role.[102] These concerns notwithstanding, there is evidence that central banks are more effective in responding to systemic risk if they are also responsible for prudential regulation.[103]

Since EDIS was not universally accepted as a financial regulatory tool before the GFC,[104] implicit deposit protection was provided by central banks in countries without EDIS.[105] Therefore, the introduction of EDIS in such countries would require reforms to the role that the central bank previously played in implicit deposit protection,[106] especially with regard to providing emergency liquidity assistance (ELA) support.[107] Furthermore, the central bank's function as LOLR must be balanced with the EDIS's role in open bank assistance to distressed banks.[108] As indicated in Chapter One,[109] central banks provide generic LOLR services to provide liquidity to solvent individual banks with liquidity shortages,[110] and ELA to banks when there is a systemic liquidity shortage in the financial system.[111] Therefore, whereas the generic LOLR liquidity stabilises individual banks in distress during normal times, the ELA is invoked during

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[102] *Ibid.*

[103] See Tucker (2011)15, for the experience in the UK during the era of the integrated regulatory model under the FSA when prudential regulation and LOLR functions were separated.

[104] For example, Australia, China, Saudi Arabia and South Africa among other countries had no EDIS pre-GFC. See A Demirguc-Kunt, E Kane & L Laeven, 'Deposit insurance around the world: A comprehensive analysis and data base', (2015) *Journal of Financial Stability* 155.

[105] See ch 1 par 1.2.3. See M Dobler, S Gray, D Murphy & B Radzewicz-Bak, *The Lender of Last Resort function after the Global Financial Crisis,*(2016) IMF working papers4.

[106] See CM Kahn &JAC Santos, *Allocating bank regulatory powers: lender of last resort, deposit insurance and supervision,*(2001)BIS working paper 3.

[107] Since EDIS are implemented through separate legislation, that are normally more recent than those establishing central banks, the central banks retain their discretionary authority over LOLR through special ELA or "lifeboat support" to banks during a systemic liquidity shortage in the financial system, unless special amendments are incorporated within the new safety net design to end Too-Big-To-Fail. The concept of "life boat" originates from the name of a committee set up by the Bank of England to provide extended solvency liquidity to insolvent English banks during the banking crisis of 1973 to 1975. To avoid the imminent collapse of deposit taking institutions that risked a rapid escalation into a panic run on other banks, the Bank of England established a committee, subsequently known as the "life boat" committee, to provide solvency assistance to banks. See Bank of England, *Second banking crisis and the Bank of England's support operations,* par 27 available at <www.bankofengland.co.uk>historicpubs>accessed on 5.7.2017.See also R Smits, 'European supervisors in the credit crisis: Issues of competence and competition', in M Giovanoli & D Devos (eds), *International monetary and financial law*, (2010) 307.

[108] The design of the safety net should clearly assign mandates between the deposit insurer and the LOLR to facilitate effective coordination during financial crises. See Schich 2. See also GL Verley, 'Global overview of resolution: A focus on purchase and assumption', Financial Safety-Net Conference(May 2015) Stockholm, Sweden 14.

[109] See ch 1 par 1.2.3.

[110] See G Kanatas, 'Deposit insurance and the discount window: Pricing under asymmetric information', (1986) *The Journal of Finance*438.

[111] See Smits 307.

financial crises.[112] Consequently, Sleet and Smith argue the central bank's LOLR functions ought to be reconciled with those of the deposit insurer as risk minimiser.[113]

The provision of open bank assistance by direct loans to banks, or to facilitate the merger or purchase of insolvent banks should have institutional safeguards to restrict the use of public funds to bail-out institutions considered "Too-Big-To-Fail" except in prescribed exceptional situations in order to prevent systemic risk.[114] The prescription of the central bank's LOLR facility within the safety net statutory framework would also transform it from the previous discretionary practice to a structured and probably more accountable practice.[115] The post-GFC requirement for the legislative prescription of the central bank's LOLR seeks to address the gaps in the pre-GFC legislative frameworks that did not prescribe any parameters for the exercise of the LOLR function, leaving it to the discretion of the central banks.[116] Consequently, the need to capture the LOLR function in legislation in the post-GFC landscape is evident.[117]

To limit the moral hazard from banks, central banks normally restrict LOLR lending to illiquid but solvent banks under stringent surveillance measures and against higher interest rates,[118] and through "constructive ambiguity" under which they remain ambiguous as to whether they will provide liquidity assistance to banks in distress in future.[119] However, since it may be difficult to differentiate illiquid banks from insolvent

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[112] See A Campbell, JR Labrose, DG Mayes & D Singh, 'A new standard for deposit insurance and government guarantees after the crisis', (2009) *Journal of Financial Regulation and Compliance* 211. The authors argue that explicit deposit insurance is only effective during normal times in a healthy financial system when bank failures are rare. A financial safety net is necessary during crises to prevent economy-wide bank failures.

[113] The mandates of EDIS are outlined in *IADI Core principle 2* as consisting of any one or combination of the "pay-box", "pay-box plus", loss minimiser or risk minimiser mandates forexplicit deposit insurance schemes. The *IADI Core principles* are discussed in par 2.4.2.2 below. See also Al Jafari, 'General guidance for effective deposit insurance mandate', paper presented at the IADI Executive Council Meeting November 2006, Rio De Janeiro 7.

[114] See C Sleet& BD Smith, 'Deposit insurance and Lender of Last Resort', (2000) *Journal of Money, Credit and Banking* 521.

[115] See G Gorton & A Metrick, 'The Federal Reserve and panic prevention: The roles of financial regulation and lender of last resort', (2013) *Journal of Economic Perspectives* 58.

[116] *Ibid.*

[117] See C Goodhart, 'Central bank policies in recent years', (2018) *Central of Malta's Quarterly Review*73.

[118] See P Tucker, *The lender of last resort and modern central banking: Principles and reconstruction*, (2014) Rethinking the lender of last resort BIS papers 11.

[119] Constructive ambiguity is adopted by central banks and financial regulators to avoid declaration of explicit commitments to bail-out troubled financial institutions. See H Peter and I Pnermonidis, 'Triggering events for recovery and resolution plans: Towards better financial crisis management',

banks during a crisis, some insolvent banks may still access LOLR facilities.[120] In addition, since constructive ambiguity is discretionary, it may be abandoned during a crisis and may be exploited by institutions that gamble for resurrection by using the LOLR facility to engage in even more risky ventures in the hope of recouping their losses.[121]

As the deposit insurer may be obligated to reimburse the insured deposits of such banks, the safety net ought to be designed in a manner that facilitates coordination between the central bank's LOLR functions and those of the deposit insurer to prevent access to LOLR assistance by insolvent banks that have ceased to be viable.[122] The safety net framework should set criteria for the bail-out of insolvent banks including, requirements for approval by Minister for Finance or other designated agency.[123]

2.2.2.4 Reforms to the market discipline pillar

Under the market discipline pillar, the *Basel II Accord* had relied on market discipline to influence financial institutions in their conduct of business and consumer protection.[124] This policy proved disastrous during the GFC when financial institutions

(2013) *Revue Suisse de droit des affairs et du Marche Financier* 538. See also D Domaniski, R Moessner & W Nelson, *Central banks as lenders of last resort: Experiences during the 2007-10 crisis and lessons for the future,* (2014) Bank of International Settlement papers 41. Constructive ambiguity may also undermine central bank credibility in the event it is compelled to bail-out insolvent SIFIs, which would breed inconsistencies and cause banks to ignore its future announcements.

[120] See Kanatas 438.

[121] See ch 1 par 1.2.5.1. Gambling for resurrection is a higher form of moral hazard from banks when they hide losses from regulators and gamble in more risky investments hoping to recover their losses and resurrect themselves from insolvency. See RA Cole, JA McKenzie & LJ White, 'Deregulation gone awry: Moral hazard in the savings and loan industry', in A Cottrell, M Lawlor and J Woo (eds), *The causes and consequences of depository institution failures,* (1995) 29. See also FM Baldursson & R Portes, *Gambling for resurrection in Iceland: The rise and fall of the banks*, (2018) Centre for Economic Policy research discussion paper and D Kirti, *When gambling for resurrection is too risky*, (2017) The IMF working paper 1.

[122] *IADI Core principles* 36.

[123] For example, in the USA, s141 (G) of the US FDIC Improvement Act 1991 and s 203 of the Wall Street Reform and Consumer Protection (Dodd-Frank) Act, 2010, restrict government bail-out by requiring majority support of the boards of the FDIC and the Federal Reserve Board, as well as approval by the Treasury Secretary and concurrence of the President. The Group of Thirty recommends that central bank statutes should prescribe the "unusual and exigent circumstances" under which they may provide emergency liquidity assistance to financial conglomerates. See Group of Thirty, *Financial reform: A framework for financial stability,* (2009) 36, available at <www.group30.org> accessed on 20.8.2018. See also the FSB*, Reducing the moral hazard posed by systemically important financial institutions: FSB recommendations and timelines,* (2010) 4.

[124] The assumption of the market discipline pillar of the *Basel II Accord* was that the market had better incentives to monitor the financial markets than regulators and thereby failed to adequately provide for effective supervisory discipline of market abuses or for consumer protection. VV Acharya, T Cooley, M

pursued risky sub-prime mortgages and kept profits, and had to turn to the government for bail-out when the market collapsed.[125] To address this problem, the post-GFC reforms require financial conglomerates to be subject to conduct of business regulation and supervision.[126] The design of EDIS and SRR may also enhance market discipline through risk-based premiums and bail-in requirements.[127]

The conduct of business regulation introduced for financial conglomerates post-GFC include requirements for financial conglomerates to develop and adopt prudent risk management processes, to subject themselves to external auditing,[128] and to prepare their financial reports on a consolidated basis.[129] Financial conglomerate boards and management are further required to develop contingency and recovery plans[130] and a robust risk management framework for internal risk control, auditing and compliance systems.[131] Banks are also required to conduct risk assessments before they enter new businesses or offered new services or products,[132] and have to subject their risk management processes to group-wide stress tests to evaluate their robustness.[133] In addition, the post-GFC reforms introduced regulation for derivatives and credit rating agencies that were previously unregulated.[134]

2.2.3 The Basel Core principles and Joint Forum Principles for supervision of financial conglomerates

2.2.3.1 Development of Basel Core principles and Joint Forum Principles

As noted above[135] the Basel Committee developed 25*Core principles for Effective Banking Supervision* in 1997 *(1997 Basel Core principles*) to complement the

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Richardson & I Walter, *Market failures and regulatory failures: Lessons from past and present financial crises*, (2011) Asian Development Bank Institute working paper18.

125 *Ibid*.

126 See Melecky & Podpiera 3.

127 See L Laeven,*Pricing deposit insurance*, (2002) World Bank policy research working paper 5.

128 *Joint Forum Principle* 27.

129 *Basel Core principle* 28. The financial reporting should also include off balance sheet activities under *Joint Forum Principle* 29.

130 *Basel Core principle* 15.

131 *Joint Forum Principles* 21.

132 *Joint Forum Principles* 24.

133 *Idem* 26.

134 See ch 1 par 1.2.5.3. See also SL Schwarcz, ‘Regulating complexity in financial markets’, (2009) Washington *University Law Review* 220 and ST Omarova, ‘License to deal: Mandatory approval of complex financial products’, (2012) *Washington University Law Review* 84.

135 See par 2.1 above.

supervisory review pillar of the *Basel II Accord*.[136] The Basel Committee and other members of the Joint Forum[137] had also developed the *Joint Forum Principles for Effective Supervision of Financial Conglomerates (1999 Joint Forum Principles)* in 1999.[138] Post-GFC, the *1997 Basel Core principles* were revised and increased from 25 to 29 principles, to incorporate developments in the global financial market,[139] and were issued in 2012 as the *Basel Core principles for effective banking supervision.*[140] In addition, the *1999 Joint Forum Principles* were replaced by revised *Joint Forum principles for effective supervision of financial conglomerates,* also in 2012.[141]

2.2.3.2 Enhanced banking supervision under the 2012 revised Basel Core principles

The revised *Basel Core principles* enhance banking supervision through, increased capital requirements for SIFIs, the imposition of risk-based capital requirements, and enhanced enforcement actions through regulatory approvals.[142] The revisions further require banking groups to prepare recovery plans outlining their strategies for recovery from financial distress occasioned by a material change in economic prospects. They also require the preparation of resolution plans to set out the manner in which banks would mitigate the impact of their exit if necessary without disrupting their vital and critical functions.[143] As noted above,[144] the complex structure of financial conglomerates and of the innovative products and services, posed significant challenges to the pre-GFC regulatory frameworks.[145] Therefore, *the Basel Core principles* require financial supervisors to impose regulatory approvals for: ownership structures or corporate affiliation;[146] permissible activities or major acquisitions or investments;[147] transfers of significant ownerships;[148] and the appointment of personnel to bank management and the board of directors.[149] Regulatory approvals

[136] *Ibid.*
[137] *Ibid.*
[138] *Ibid.*
[139] *Basel Core principles* 2.
[140] See Basel Committee, *Core principles for effective banking supervision* (2012).
[141] Joint Forum *Principles for effective supervision of financial conglomerates* (2012).
[142] *Ibid.*
[143] *Ibid.*
[144] See par 2.1.1 above
[145] *Ibid.*
[146] *Basel Core principle* 7.
[147] *Idem* 4
[148] *Idem* 6.
[149] *Idem* 5.

are a useful device to limit bank risk-taking by restricting asset growth, and new lines of business and instruments.[150] The approval process compels financial institutions to fulfil supervisory conditions before approval is granted.[151]

Of great significance is the protection of bank deposits from cross-financing of non-bank activities through the ring-fencing of the banking entity from non-bank affiliates within the group[152] or prescription of regulatory approvals for entry into new products or service areas.[153] The ring-fencing of banking services from other non-bank activities of financial conglomerates aims at protecting depositor funds from being invested in risky non-banking activities by isolating the banking subsidiary from the non-bank affiliates.[154] In the event of the insolvency of the non-bank affiliate, ring-fencing facilitates its liquidation without risking loss of deposits.[155] Ring-fencing also safeguards critical banking and payments services from the risky trading activities of financial conglomerates.[156] Where ring-fencing is effected through the separation of commercial banking from investment banking, it may also be referred to as "narrow banking" since the banking subsidiary is restricted to retail deposit-taking and lending.[157]

Since the *Basel Core principles* do not declare a preference between ring-fencing and total separation of banking and non-bank financial institutions, different countries have

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[150] *Ibid.*

[151] Compare with Group of Thirty (2009) 36, where it is recommended that banks that access the LOLR facility should be separated from affiliations with non-bank financial institutions.

[152] See par 2.2.1.3 above for the definition of ring-fencing. Ring-fencing is adopted to, among other functions, protect a firm from the risks of failure emanating from its affiliates, or from being taken advantage of by its affiliated firmsto protect its assets and business. See SL Schwarcz, 'Ring-fencing', (2013) *Southern California Law Review* 73–74.

[153] See M Lehmann, *Volcker Rule, ring-fencing or separation of bank activities: Comparison of structural reform Acts around the World*, (2014) LSE Law Society and Economy working paper 1. Ring-fencing is implemented in different countries using different concepts. For example, in the USA it is captured under the Volcker rule that prohibits proprietary trading under s 219 of the Dodd-Frank Act. In the UK it is implemented under the Vicker's *Report* ring-fencing rules and the Financial Services Act, 2013. See the Independent Commission on Banking, *Final report recommendations,* (2011) (hereafter Vicker's *Report*).

[154] Basel *Core principle* 6. Ring-fencing shields depositor funds from the risky non-bank activities, so as to protect them from loss in the event the non-bank affiliate fails by enabling it to be wound up without posing a risk of a bank run or other systemic crisis. One of the problems of "Too-Big-To-Fail" arises from the regulatory dilemma of whether to use public funds to bail-out a failing bank or to risk the loss of depositor funds that could trigger a run on other banks.

[155] See Lehmann 1.

[156] AE Wilmarth Jr, 'Narrow banking as a structural remedy for the problem of systemic risk: A comment on Professor Schwarcz's "Ring-fencing"', (2013) *Southern California Law Review Postscript* 1.

[157] *Idem*2.

adopted different measures to protect commercial banking affiliates from the non-bank business of financial conglomerates.[158] However, despite these measures, there are concerns that as long as commercial banks remain affiliated to non-banking subsidiaries within financial conglomerates, partial ring-fencing reforms may not effectively protect bank deposits from risky non-bank investments.[159] The approval requirement for significant ownership of banks or bank involvement in new services or products, [160] seeks to control the acquisition by existing banks of significant shareholding in other banks and the affiliation of existing banks with institutions that provide non-bank services and products.[161] Consequently, the legal framework should set criteria for licencing or designating financial conglomerates, and approval for their organisational structures, boards, management and key personnel.[162] The Basel Committee also imposes risk-based capital adequacy requirements on banks, assessed in proportion to their risk profiles and capacity to absorb losses.[163] This addresses the failure of the *Basel II Accord* to prescribe leverage ratios to limit the excessive build-up of leverage by banks that was witnessed in the lead up to the GFC.[164] Consequently, supervisors should employ resources on a risk-adjusted basis by considering the risk profile and systemic importance of each bank.[165] Banks should also be required to develop and maintain policies for early identification and management of problem assets through adequate provisions and reserves.[166] Banks should further establish risk management processes to identify, evaluate and mitigate the effects of bank failure through contingency and recovery plans.[167]

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[158] See for example L Gambacorta & A van Rixtel, *Structural bank regulation initiatives: Approaches and implications,* (2013) BIS working papers2. The authors discuss the objectives and rationales of the Volcker rule prohibiting proprietary trading in the USA, the Likannen *Report* (E Likannen, *Final report of the High Level Expert Group on reforming the structure of the EU banking sector* (2012)) that requires subsidiarisation of proprietary trading and market-making in the EU and the Vickers *Report* that ring-fences commercial banking in the UK. See also Vicker's *Report* 5 for the objectives and scope of ring-fencing and its impact on the structure of banking groups.

[159] M Ojo, *Volcker/Vickers "hybrid"?: The Likannen report and justification for ring-fencing and separate legal entities*, (2013) Munich Person RePE Archives 5, available at <https://mpra.ub.uni-muenchen.de/44180> accessedon 24.8.2018.

[160] *Basel Core principle* 7.

[161] *Idem* 6.

[162] *Ibid.*

[163] *Basel Core principle* 16.

[164] *Basel III* par 4.

[165] *Basel Core principle* 9.

[166] *Idem*18.

[167] *Idem*15.

Revised *Basel Core principle* 8 requires banking supervisors to identify risky banks early in order to institute their orderly resolution before they cease to be viable so as to protect the financial system from any systemic risks from banks.[168] Supervisors are further required to conduct on-site and off-site prudential examination of banks,[169] and to expeditiously enforce corrective action to prevent threats to the safety and soundness of banks.[170] The Basel Committee's provision for recovery and resolution plans[171] appears to integrate financial regulation, supervision, and deposit insurance within an orderly bank resolution framework to reduce disruption to financial stability.[172]

Although the Committee recommends a well-designed safety net system consisting of the government, the central bank and deposit insurance that will determine the use of public funds in the resolution of distressed banks, it is however submitted that the *Basel Core principles* could be strengthened by specifically addressing the use of government bail-out and by restricting it to the prevention of systemic risk to the financial system.[173]

As indicated above,[174] the complexity in financial conglomerate structures posed challenges to the pre-GFC supervisory structures that focused on the safety and soundness of individual financial institutions.[175] This narrow supervisory focus has been criticised for failing to identify the risk that affiliated institutions posed to their banking groups or the financial system as a whole.[176] The revised *2012 Basel Core principles* seek to enhance consolidated supervision for conduct of business of banking groups by requiring bank supervisors to enforce corrective actions on banks by directing them to restore the safety and soundness at individual bank level and at banking group level.[177] This will facilitate the early identification of risks and enable interventions before banks deplete their capital or cease to be viable.[178] Regulators

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168 *Idem* 8.
169 *Idem* 10.
170 *Idem* 11.
171 Recovery and resolution planning are also discussed in par 2.5.2.3 below.
172 See *Basel Core principles* par 51.
173 *Basel Core principles* par 52.
174 Par 2.2.2.3 above.
175 See Tucker (2011) 15.
176 *Ibid.*
177 *Basel Core principle* 1.
178 *Idem* 8.

are further required to adopt risk-based supervision by assigning supervisory resources in proportion to the risk profile and systemic importance of banks;[179] and to expeditiously enforce corrective actions to address threats to bank safety and soundness.[180] Boards of banks and banking groups are also required to establish robust corporate governance policies and procedures for strategic direction, group and organisational structures.[181]

To address the cross-border effects of bank insolvencies[182] that were experienced during the bankruptcy of Lehman Brothers investment bank in the USA[183] and Northern Rock in the UK,[184] the revised *Basel Core principle* 3 requires home and host supervisors of cross-border banking groups to cooperate and collaborate in their supervision.[185] Cross-border cooperation is also enhanced by the home and host country supervisors applying the same standards to foreign banks as to domestic groups and banking group entities.[186]

2.2.3.3 Joint Forum Principles for effective supervision of financial conglomerates

The revised *Joint Forum Principles* enhance the supervision of financial conglomerates,[187] and complement the revised *Basel Core principles* which were developed to enhance the supervision of banks on a solo and banking group basis.[188] Accordingly, the revised *Joint Forum Principles* set standards for: supervisory powers and functions, corporate governance and structure, supervisory enforcement, capital adequacy and liquidity requirements, and risk management. A major contribution of the revised *Joint Forum Principles* is their requirement for formal assignment of regulatory functions between a group-level supervisor and functional regulators for each financial sector.[189] The group-level supervisor should be empowered to collect

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179 *Idem*9.
180 *Idem*11.
181 *Idem*14.
182 Brummer 258.
183 See JW Giddens (Trustee for the SIPA liquidation of Lehmann Brothers Inc.), *Trustee preliminary investigation report and recommendations,* US Bankruptcy Court, SDNY, Case No 08-01420 (August, 2010).
184 See DT Llewellyn, 'The Northern Rock crisis: A multidimensional problem waiting to happen', in RR Bliss and GG Kaufman (eds), *Financial institutions and markets,* (2009) 102.
185 *Basel Core principle* 3.
186 *Idem* 13.
187 *Joint Forum Principles* 1.
188 See par 2.2.3.2 above.
189 *Joint Forum Principles* 7.

information from financial conglomerates on a group-wide and individual entity basis,[190] under a framework that facilitates supervisory coordination, cooperation, and information sharing.[191] The regulatory framework should also prescribe the criteria for the identification and designation of financial conglomerates and approval of their significant owners.[192]

Financial conglomerates are required to adopt robust governance structures and policies[193] that enhance their strategic management.[194] Thus, the board of directors of the parent holding company should define its risk appetite and develop a strategy to monitor, manage and mitigate the risk it assumes.[195] The board should also ensure compliance with prescribed prudential requirements on a group-wide and solo basis,[196] and develop effective oversight over subsidiaries to balance intra-group conflicts of interests.[197] Although the *Joint Forum Principles* do not recommend any preferred corporate structure for financial conglomerates, they require transparent organisational and management structures that enhance prudent management and facilitate the orderly resolution of sectoral entities without disrupting their critical and essential financial services.[198] In addition, the corporate structures should include mechanisms for identification and assessment of material contagion risk from the affiliated entities, (whether regulated or unregulated) to the financial conglomerate or to other affiliated entities.[199] Supervisory capacity should also be developed to enable supervisors to understand the operations and governance structures of financial conglomerates,[200] and to be authorised to direct such changes to those structures as may be necessary to promote effective supervision.[201] Any material changes to

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[190] For example, after the Federal Reserve Board's supervisory powers over affiliates of bank holding companies were restricted under the Gramm-Leach-Bliley Act, 1999, it left the non-bank subsidiaries of bank holding companies under the supervision of functional regulators only. This undermined the Federal Reserve Board's consolidated group wide supervisory powers over financial conglomerates and their affiliates, and partially led to the GFC. See ch 1 par 1.2.6.

[191] *Joint Forum Principle* 5.

[192] *Idem* 9.

[193] *Idem* 10.

[194] *Basel Core principle* 14.

[195] *Joint Forum Principle* 13.

[196] *Joint Forum Principle* 27.

[197] *Idem* 28.

[198] *Idem* 11.

[199] *Ibid.*

[200] *Joint Forum Principle* 8.

[201] *Ibid.*

existing financial conglomerate structures or significant ownership, should also be subject to supervisory approval.[202]

Since regulation is only effective if it is effectively supervised and enforced,[203] supervisors should be authorised to compel financial conglomerates to comply with prescribed prudential standards by directing them to take corrective actions and by sanctioning non-compliant entities.[204] Therefore, supervisors should be authorised to impose prompt corrective actions upon non-compliant institutions by directing them to cease from unsafe and unsound activities,[205] and to take expeditious corrective actions to restore the safety and soundness of their banking affiliates.[206]

2.3The IADI Core principles of effective deposit insurance systems

2.3.1 Overview of post GFC prominence of EDIS

EDIS gained global prominence in 2002 when the IADI was established to promote the effectiveness of deposit insurance systems in G20-member states.[207] Consequently, in collaboration with the Basel Committee, the IADI developed the IADI *Core principles for effective deposit insurance systems* in 2009.[208] In 2014 the IADI issued revised *IADI Core principles*(see Annexure C to the thesis)to take account of significant developments in the regulatory landscape post-GFC, including *inter alia* the revised *FSB Key attributes*(2014)and the recommendations arising from the FSB's 2012 *Thematic Review on Deposit Insurance.*[209]

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202 *Ibid.*
203 See EJ Pan, 'Challenge of international cooperation and institutional design in financial supervision: Beyond transgovernmental networks', (2010) *Chicago Journal of International Law* 266, where Pan underscores the essence of supervision for effective rules and standards. See also par 2.2.1.3 above.
204 *Joint Forum Principle* 8.
205 *Joint Forum Principle* 9. This principle empowers financial conglomerate supervisors to enforce sanctions that include: restrictions on current or future activities, suspension of dividends to shareholders and direction to restore capital to required capital adequacy levels.
206 Thus, the *Joint Forum Principle* 9 reinforces *Basel Core principle* 11.
207 *Ibid.*
208 *Ibid.*
209 FSB, *Thematic review on deposit insurance systems: Peer review report,* (2012).

2.3.2 The IADI Core principles

The sixteen *IADI Core principles* highlight explicit deposit insurance practices that national governments can adapt to their local contexts.[210] The major objective ofthe *IADI Core principles* is to limit the use of public funds by government to bail-out banks that are considered "Too-Big-To Fail" by requiring them to contribute to an *ex ante* deposit insurance fund.[211] This is to be achieved through the design features of an EDIS,[212] within an orderly bank resolution framework that aims to facilitate the exit of inefficient banks from the financial system while preserving their critical and vital functions.[213] In this regard the *IADI Core principles* recognize that a well-designed financial safety net contributes to the safety of the financial system but, may increase the moral hazard to public funds if designed poorly.[214]

2.3.3 Addressing moral hazard through the IADI Core principles

2.3.3.1 Overview of IADI measures to limit moral hazard

As argued in Chapter One,[215] EDIS enhances public confidence in the financial system by assuring retail depositors of reimbursement of their deposits in failed banks.[216] To address the moral hazard that is inherent in EDIS, its features should be designed to limit moral hazard from depositors and banks in conjunction with the safety net framework.[217]

2.3.3.2 Limitation of moral hazard through design of EDIS

The design of an EDIS may address the moral hazard in various ways: it may address depositor moral hazard through limitation of coverage and requirements for co-

[210] *IADI Core principle* 25.
[211] *Idem* 11.
[212] *Ibid.*
[213] *Idem* 9. See also ch 1 par 1.2.2, where it was argued that the liquidation of inefficient banks is beneficial to the economy because it releases their resources to more efficient banks.
[214] See AD Morrison and L White, *Is deposit insurance a good thing? If so, who should pay for it?,* (2006) Oxford Financial Research Centre working paper 2.
[215] See ch 1 par 1.2.3.
[216] *Ibid.*
[217] *IADI Core principles* 9.

insurance;[218] and that of banks by charging *ex ante* risk-based premiums and requirements for private insurance.[219] The limitation of the moral hazard from depositors by restricting the scope of coverage of the EDIS to unsophisticated and retail depositors, excludes wholesale or large depositors.[220] The wholesale or large depositors are excluded because they are presumed to have the capacity to evaluate the safety and soundness of banks and thus to either avoid unsafe and riskier banks or to use market mechanisms to hedge against losses from bank failure.[221] Thus, by limiting the deposit insurance cover, the EDIS increases market discipline for large depositors.[222] The *IADI Core principles* also enhance market discipline through consumer education that promotes public awareness of the benefits and limitations of deposit insurance.[223]

The *IADI Core principles* further recommend that the EDIS be designed to limit moral hazard from banks through an *ex ante* privately funded pool of insurance funds.[224] In addition, the EDIS should require mandatory membership of all licensed banks.[225] Mandatory membership of all licensed banks prevents the problem of adverse selection, where the stronger and better capitalised banks would opt out of membership and leave the weaker banks that are more likely to fail, to be members.[226] To discourage banks from taking on excessive risks, the *IADI Core principles* recommend that the EDIS should levy risk-based premiums that will cause banks to internalise the costs of the losses resulting from their risk-taking, so that

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[218] VP Iaonnidou & J de Dreu, *The impact of explicit deposit insurance on market discipline*, (2006) Centre for Economic Research discussion paper 3. See also GGH Garcia, *Deposit insurance and crisis management*, (2000) IMF working paper 7.
[219] GGH Garcia, *Deposit insurance: Obtaining the benefits and avoiding the pitfalls*, (1996) IMF working paper 29.
[220] *IADI Core principle* 7.
[221] See Iaonnidou & Dreu 3.
[222] *Ibid.*
[223] *IADI Core principle* 10.
[224] *IADI Core principle* 9. See also Laeven 5. The author recommends that banks be charged market risk-based premiums to limit the moral hazard from banks.
[225] *IADI Core principle* 10.
[226] Adverse selection arises when the party most likely to create the undesirable or adverse outcome is most likely to seek the insurance cover and most likely to be selected. FS Mishkin, *The economics of money banking and financial markets,* (2016) 41. DC Wheelock and SC Kumbhakar, 'Which banks choose deposit insurance: Evidence of adverse selection and moral hazard in voluntary insurance systems', (1995) *Journal of Money Credit and Banking*186.

banks that pose higher systemic risks are charged higher premiums.[227] Conversely, safer banks that enforce good risk management could be rewarded with lower premium levies.[228]

Although Thomas suggests that the moral hazard from depositors be also limited through co-insurance and private insurance by requiring depositors to shoulder part of the insured deposit, it is submitted that both these measures could undermine the essence of EDIS.[229] The experience in the United Kingdom where co-insurance had been introduced in pre-GFC,[230] was blamed for the run on Northern Rock when depositors feared losing their deposits through co-insurance and rushed to withdraw their money.[231] This led England to abandon co-insurance and increase the scope of the insured deposits substantially.[232] The suggestion by Thomas that banks take private deposit co-insurance policies against the risk of their insolvency,[233] is also not practical because one of lessons of the GFC was that only governments can restore public confidence in the banking system during crises.[234] Thus, the *ex ante* funded EDIS that charges risk-based premiums limits the use of public funds to bailout banks and makes the banks pay for their own resolution while they are still operating.[235] The *IADI Core principles* also require the EDIS to provide for timely intervention in distressed banks to resolve them before they cease to be viable.[236] Accordingly, the EDIS should be designed within the context of an overall SRR separate from ordinary

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[227] *IADI Core principle* 9. See also PA McCoy, 'The moral hazard implications of deposit insurance: Theory and evidence', Seminar on current developments in monetary and financial law (2006) Washington DC, USA 21.

[228] See McCoy 21.See also *Basel Core principles* 9, 16 and 18 that complement risk based premiums with the risk based supervision.

[229] See Thomas 281. Thomas suggests the use of co-insurance under which depositors would be obligated to shoulder a proportion of the insured deposit as a contribution for their failure to avoid the risky bank.

[230] S 214 of the Financial Services and Markets Act, 2000.

[231] See EP Ellinger, E Lomnicka &CVM Hare, *Modern banking law,* (2011) 46. See also Llewellyn 102.

[231] *IADI Core principle* 10.

[232] See Part 4 of the Banking Act, 2009 and ss 16 and 17 of the Financial Services Act, 2010.

[233] See Thomas 280–281. However, private deposit insurance could probably not be viable in emerging markets as it would require a strong insurance industry to absorb claims from large banks and would still require further government supervision as the private deposit insurers would probably lack the capacity to reimburse depositors without government facilitation.

[234] During the GFC the use of complex derivatives and reliance on AIG to insure risks of default were blamed for the drying up of liquidity when AIG failed to honour its counterparty obligations on the CDSs.See Acharya *et al* 18.

[235] See T Beck and L Laeven, 'Resolution of failed banks by deposit insurers: Cross-country evidence', in A Demirguc-Kunt and EJ Kunt (eds), (2006) World Bank research working paper 5.

[236] See A Demirguc-Kunt and H Huizinga, *Market discipline and financial safety net design*, (2000) World Bank working paper 3.

insolvency procedures in order to facilitate an expeditious orderly exit of insolvent banks from the financial system.[237]

2.3.3.3 Public policy objectives and mandates of the EDIS

The *IADI Core principles* require the public policy objectives of the EDIS to be declared in legislation[238] under which its mandates and institutional framework should also be prescribed.[239] Such public declaration of the policy objectives of the EDIS seeks to assure the public of the guarantee of reimbursement of the insured sum and serves to prevent their panic withdrawals.[240] The public declaration of policy objectives also educates the public on the limits of the scope of coverage and the risk of loss they assume on amounts of deposits beyond the scope of the insured sum.[241] The *IADI Core principles* further require the public policy objectives of the EDIS to be aligned to its mandates.[242]

The deposit insurer's mandates are the official description of its roles and responsibilities as adapted to the specific contexts of the relevant jurisdictions.[243] The mandates range from the narrow scope of the "pay-box" and "pay-box plus" to the wider scope of "loss minimiser," and "risk minimiser."[244] However, the implementation legislation may assign any one or more of the four broad mandates to the EDIS.[245] The "pay-box" mandate is the narrowest mandate and focuses on the reimbursement of insured depositors of the failed member banks.[246] It also collects premiums from member banks, administers them as pooled funds, and "pays" depositors of failed banks.[247] The "pay-box plus" or the "pay-box extended" mandate discharges the pay-box mandate and in addition, authorises the deposit insurer to co-supervise depository

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[237] *IADI Core principle* 14.
[238] *Idem* 1.
[239] *Idem* 2.
[240] *Ibid.*
[241] *Ibid.*
[242] *Ibid.*
[243] *IADI Core principle* 9.
[244] *IADI Core principle* 2. See also Al Jafari, 'General guidance for effective deposit insurance mandate', paper presented at the IADI Executive Council Meeting (November 2006) Rio De Janeiro, Brazil 7.
[245] *IADI Core principles* 19.
[246] See Verley 14.
[247] See IADI, *General guidance for effective deposit insurance mandate*, (2006) 11 available at <https://www.iadi.org>accessed on 20.4.2017.

institutions, financially supports banks, and participate in the resolution and liquidation of insolvent banks.[248]

The "loss minimiser" mandate authorises the RA to choose the least costly resolution strategies for failed banks.[249] It may be exercised by designated RAs where the deposit insurer is not responsible for bank resolution[250] or by the deposit insurer, where it is also the RA.[251] The least costly resolution strategy is preferred to minimise loss from bank resolution and preserve the banks' assets for the benefit of the institution, its depositors and creditors.[252] Finally, the "risk minimiser" mandate is the broadest mandate and authorises the deposit insurer to participate in risk surveillance of member banks.[253] This includes participation in prudential supervision either alone or in collaboration with the other safety net providers; so as to identify, assess and manage the institution's risk profile in order to facilitate early intervention and minimise the risk of bank failure.[254]

An EDIS with the "risk minimiser" mandate also executes resolution powers and therefore combines the administration of the EDIS and SRR in the same agency.[255] Hupkes argues that the assignment of both the "loss minimiser" and "risk minimiser" mandates to the deposit insurer facilitates early identification of risky banks and triggers enforcement actions to correct the unsafe activities, facilitates bail-in within resolution or triggers orderly resolution whilst facilitating the continuity of critical financial functions.[256] Although the loss minimiser and risk minimiser mandates need

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[248] *Ibid*.
[249] See Beck and Laeven 5.
[250] The Resolution Authority is a function of the *FSB Key attributes* 3. However, since EDIS were developed before the *Key attributes*, the designation of the deposit insurer as the RA has developed into the "loss minimiser" mandate for the EDIS. See also par 2.4.1.2 below.
[251] See BA Bennett, 'Bank regulation and deposit insurance: Controlling the FDIC'S losses', (1984) *Economic Review of the Federal Reserve Bank of San Francisco* 23.
[252] Verley 14.
[253] *Ibid.*
[254] *Ibid.*
[255] *Ibid.*
[256] See EGH Hupkes, 'The role of deposit protection and resolution policy in promoting financial stability', IADI Research Conference (June 2011) Basel, Switzerland 2. See also T Beck, *The incentive compatible design of deposit insurance and bank failure resolution: Concepts and country studies*, (2003) The World Bank development research working paper 2. The author argues that deposit insurance and bank resolution are not only important parts of the safety net, they reinforce each other. A deposit insurance scheme can only be effective if it is reinforced by an efficient and timely bank resolution regime.

not be assigned to the deposit insurer, it has been argued by Beck and Laeven[257] that granting the deposit insurer a greater role in bank supervision and resolution may enhance banking sector stability.[258]

2.3.3.4 Role of deposit insurance in safety net framework

The incorporation of deposit insurance within the financial safety net is important because deposit insurance can only be effective if it is complemented by a strong regulatory enforcement framework.[259] The deposit insurer participation in the safety net framework is vital as it enables the EDIS to limit losses to the deposit insurance fund by preventing banks that have ceased to be viable from continuing to accept deposits.[260] This facilitates coordination with the central bank in the extension of open bank assistance to distressed banks for purposes of limiting the use of public funds on insolvent banks.[261] Such coordination also facilitates timely interventions in problem banks to enforce sound risk management measures and to pursue parties responsible for the bank failure for purposes of recovering any benefits they may have obtained by their actions.[262]

2.4 The FSB Key attributes of effective resolution regimes for financial institutions

2.4.1 The FSB Key attributes

2.4.1.1 An overview of the FSB Key attributes

As alluded to above, the FSB issued the twelve *Key attributes of Effective Resolution Regimes for Financial Institutions* (*FSB Key attributes)* in 2011 and updated it in 2014 to augment the *IADI Core principles* in the resolution of financial conglomerates with complex integrated organisational structures under multi-functional supervisors.[263]

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[257] See Beck and Laeven 5.
[258] *Ibid.*
[259] See also McCoy 3.
[260] *IADI Core principles* 36.
[261] See HJ Kim, HS Shin and J Yun, 'Monetary aggregates and the central bank financial stability mandate', (2013) *International Journal of Central Banking*105, where the authors argue that the assignment of the financial stability mandate to the central bank enables it to more effectively coordinate the monitoring of systemic risks to the financial system.
[262] *IADI Core principle* 12.
[263] See Hupkes 5.

The twelve *FSB Key attributes* (see Annexure D to the thesis),[264] seek to limit the moral hazard from bank failure by facilitating the absorption of bank losses by shareholders, unsecured creditors and uninsured depositors.[265] The *Key attributes* further seek to limit systemic risk posed by financial conglomerates to the stability of the financial system by providing for the orderly resolution of their unviable entities whilst preserving their critical and vital functions.[266]

The *FSB Key attributes*form part of the macroprudential regulation framework that integrates financial supervision, market conduct and consumer protection schemes and that include EDIS and SRR, to address systemic risks that emanate from the activities of financial conglomerates.[267] Therefore, the *FSB Key attributes* significantly enhance the resolution of financial institutions by increasing the options available to governments as opposed to the previous two options, in the pre-GFC landscape, of either entering costly corporate bankruptcy procedures or using public funds to bail-out failing financial institutions.[268]

2.4.1.2 Resolution of financial conglomerates and resolution powers

As alluded to above,[269] a major limitation of the pre-GFC regulatory and resolution frameworks for financial institutions was the use of public funds to bail out institutions that were considered "Too-Big-To-Fail."[270] The *FSB Key attributes* specifically seeks to address the moral hazard from "Too-Big-To-Fail"[271] by requiring SIFIs to internalise the costs of their resolution.[272] Accordingly, the FSB recommends that countries either appoint their deposit insurer as the RA, or designate some other agency as the RA.[273] The resolution legislation should authorise the RA to appoint an administrator to take

[264] See *FSBKey attributes* (2014).
[265] *Ibid*.
[266] *FSB Key attribute* 1.1.
[267] See Vollmer & Wiese 487.
[268] *Ibid.*
[269] Par 2.2.2.3. See also ch 1 para 1.2.7 and 1.2.8.
[270] See ch 1 para 1.2 5 and 1.2 6.
[271] *FSB Key attribute* 1.1.
[272] See Hupkes 2. See also *FSB Key attribute* 3 that outlines the applicable resolution powers as: appointment of a manager to take over the failing firm; transfer of assets and liabilities; and establishment of a bridge bank for the critical and viable operations of the failed firm, and an asset management vehicle for its toxic assets; a bail-in within resolution; and the liquidation and timely depositor pay-off. *FSB Key attribute* 6.4 permits the use of public funds to bail-out banks only for the protection of financial system stability and after following a prescribed approval process from the Government.
[273] FSB *Key attribute* 2.

over the affairs of any bankthat either ceases or becomes likely to cease to be viable.[274] The administrator should also be authorized to either to restore the institution to viability,[275] or continue the viable functions of the institution, and dispose of the non-viable ones.[276]

The *FSB Key attributes* also stipulate various resolution powers to be exercised by the administrator, including the sale and transfer of the failed institution's assets without seeking approval from the shareholders.[277] The administrator may *inter alia* establish a bridge bank to carry out the failed institution's critical and viable functions and a separate special purpose vehicle to manage its toxic non-performing assets while its residual business is wound up and its affairs liquidated.[278] The RA may also facilitate a capital restructuring or "bail-in within resolution"[279] by requiring shareholders, uninsured depositors and unsecured creditors to recapitalize the failed firm and so to restore its viability.[280] The prominence of "bail-in within resolution" underscores the new post-GFC financial regulatory framework that shifts funding for resolution from public funds to the private market through conversion of unsecured creditor rights or uninsured deposits, and other convertible contingent securities into capital.[281]

The abovementioned bail-in powers may be accompanied by other resolution strategies like replacement of senior management; or holding culpable managers liable for resolution costs; or implementation of a capital restoration plan to make the

[274] *Idem* 3.
[275] *Idem* 3.2(ii).
[276] *Idem* 3. The FSB recognises that the *Key attributes* are to be adopted to the contexts of individual jurisdictions. Thus, the administrator may be referred to as a manager or receiver, where a manager is authorised to continue to run the business as a going concern, and a receiver is required to collect the debts and realise the assets of the institution with no authority to continue trading. The two functions may be consolidated by the appointment of the same person as receiver/manager. See JM McGhee, *Snell's equity,* (2010) 575. Other jurisdictions refer to the administrator as conservator and receiver, where the conservator is appointed to preserve the institution's assets, manage them and restore the business to viability, and a receiver is appointed to liquidate the assets of the institution and to resolve its affairs. See WF Todd, 'Bank receiverships and conservatorships', (1994) *Federal Reserve Bank of Cleveland Economic Commentary* 4. See also Verley 12.
[277] *FSB Key attribute* 3.2(iv) read with *FSB Key attribute* 3.4.
[278] *FSB Key attribute* 3.2(vii) read with *FSBKey attribute* 3.4. See also EHG Hupkes, 'Key attributes of effective resolution regimes for financial institutions overview', 2 presentation FSB FinSAC workshop (April 2017) Vienna, Austria.
[279] *FSB Key attribute* 3.2(ix) read with *FSB Key attribute* 3.4. See also MH Krimminger, 'Bail-in, not bail-out: Developing SIFI resolution strategies around the globe', 3 available at <https://www.clsbluesky.law.columbia.edu>accessed on 12.4.2018.
[280] *FSB Key attribute* 3.2 (ix) read with *FSB Key attribute* 3.4.
[281] Krimminger above.

new institution financially viable.[282] Thus, the *FSB Key attributes* further recommend that, whenever liquidation of the failed institution' is the least costly strategy, its depositors should be expeditiously reimbursed or their insured deposits should be transferred to a solvent bank, while the institution's assets and its affairs are being wound up.[283] This incorporates the "pay-box" functions contemplated by the *IADI Core principles* within the orderly bank resolution framework.[284]

2.4.1.3 Private funding of resolution through deposit insurance

Key attribute 6 discourages government bail-out of distressed banks through open bank assistance,[285] and recommends that bail-outs only be provided on a temporary basis conditional upon the costs being recovered from shareholders, unsecured creditors, or from post-resolution contributions from solvent banks.[286] Of greater significance is *Key attribute* 6.3 that incorporates the *IADI Core principles* on *ex ante* funded EDIS[287] within the orderly bank resolution framework, by requiring jurisdictions to establish *ex ante* privately funded EDIS by levying premiums on member banks.[288] Thus, private funding of EDIS limits the use of government funds to bail-out insolvent banks and recommends that the government recovers any costs incurred in the bail-outs (extended under exceptional circumstances only) of SIFIs *ex post* from surviving banks.[289] Accordingly, the *FSB Key attributes* recommend that public funds only be used to bail-out SIFIs upon a determination and approval within the safety net provision[290] that the bail-out is necessary to protect financial system stability, and that no privately funded resolution options are available.[291] In addition, losses and residual costs incurred during the resolution process should be borne by equity holders, unsecured creditors and the financial industry through *ex post* assessments on solvent institutions.[292]

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282 *FSB Key attribute* 3.5.
283 *Idem* 3.2(xiii).
284 Par 2.3.3.3 above.
285 *FSB Key attribute* 6.1.
286 *FSB Key attribute* 6.2.
287 *IADI Core principle* 9.
288 *FSB Key attribute* 6.3.
289 *Ibid.*
290 *FSB Key attribute* 6.
291 *Idem* 6.4.
292 *Ibid.*

The private funding of bank resolution through capital and liquidity surcharges, contingent securities, and sub-ordinated debt,[293] will internalise the cost of bank failure and limit the use of public funds to bail-out failing banks.[294] Thus, the RA's powers can be summarised as: open bank assistance, bridge bank, bail-in, purchase and assumption, and depositor pay-out and liquidation.[295] Although open bank assistance is not expressly recommended in the *FSB Key attributes*, it is implied in the use of the temporary bail-out mechanism.[296]

As discussed above,[297] open bank assistance is normally extended by the central bank as LOLR in certain instances, and in other instances by the EDIS whenever it is less costly to the deposit insurance fund than depositor pay-out.[298] Other resolution options include, the transfer of assets and liabilities by the RA through the disposal of the viable functions of the failed institution to a solvent third party, and either the liquidation of unviable assets of the business or their transfer to a special purpose vehicle or separate asset management vehicle.[299] The transfer of assets and liabilities is also referred to as a "purchase and assumption" transaction under which the failed institution's assets are purchased and its liabilities assumed by the (acquiring) solvent institution.[300]

2.4.1.4 Recovery and resolution plans

The *FSB Key attributes* also incorporate orderly bank resolution within the prudential regulatory and supervisory framework by recommending consolidated supervision of SIFIs to include their holding companies, non-regulated entities significant to group business, and branches of foreign firms.[301] Therefore, banking supervisors are required to oblige SIFIs to internalise the cost of their failure, through the preparation of recovery and resolution plans (RRPs).[302] The recovery plans should expressly

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[293] *Basel III* par 32.
[294] See also Claessens 57.
[295] Hupkes (2017) 2.
[296] *Ibid.*
[297] Group of Thirty (2009) 36.
[298] Verley 13.
[299] *FSB Key attribute* 3.2(viii).
[300] Mishkin 263.
[301] *FSB Key attribute* 1.
[302] *Idem* 11. See also J Amour, *Making bank resolution credible*, (2014) ECGI working paper series in law 14. Amour argues that after the first generation US Federal Deposit Insurance Corporation *ex post*

stipulate the strategies to be adopted by the institution to restore their financial strength and viability in the event of financial stress.[303] The recovery plans should also stipulate the strategies that the SIFIs plan to adopt to protect their systemically important functions from disrupting the financial system or exposing public funds to loss.[304] The resolution plans are therefore to operate like "living wills" by stipulating *ex ante* the strategies that the SIFIs plan to adopt, as well the finances they set aside for, the resolution of their affairs without disrupting the financial system in the event that they become insolvent.[305] Accordingly, the resolution plans provide a blueprint of the strategies to be adopted to resolve the SIFI by outlining their organisational, operational and financial structures, and the different strategies to resolve each unit and isolate the viable units in order to preserve the continuation of systemic financial services.[306]

Thus, recovery and resolution planning facilitates the capital restoration of insolvent banks by outlining strategies through which the banks may recover from financial distress and if recovery fails, the strategies through which they may be resolved without the use of public funds.[307] Banking supervisors are required to enforce the obligation regarding recovery and resolution planning through prior reviews.[308] They should also be authorised to direct the banks to revise recovery and resolution plans that they deem inadequate so as to improve the plans' effectiveness.[309] Although jurisdictions may determine the triggering criteria for the RRPs,[310] the triggering events

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receivership framework under the FDIC Act, recovery and resolution planning is a second generation *ex ante* framework to facilitate orderly bank resolutions without using public funds.

[303] The recovery plans should contain the parent company's analysis of a range of scenarios of severe macroeconomic and financial stress relevant to their contexts, the potential recovery options and the arrangements and conditions for intragroup financial support for the recovery options. See Bank of England/Prudential Authority, *Implementing the recovery and resolution directive,* (2014) consultation paper9.

[304] *FSB Key attribute* 11. See for example under the European Union Bank Recovery and Resolution Directive 2014/59/EU, a recovery plan should describe the entity or entities it relates to and the recovery options it proposes to adopt. See European Banking Authority, *EBA recovery planning: A comparative report on recovery options*, (2017) 9.

[305] See World Bank, *Understanding bank recovery and resolution in the EU: A guidebook to the BRRD,* (2017) 74.

[306] See Peter & Pnermonidis 538.

[307] See R DeYoung, M Kowalink &J Redhill, 'A theory of failed bank resolution: Technological change and political economics', (2013) *Journal of Financial Stability* 624.

[308] See *Basel Core principles* 8 and 15.

[309] *FSB Key attribute* 11.

[310] See Peter & Pnermonidis538. See also Basel Committee, *Resolution policies and frameworks-Progress so far,* (2011) 7.

for recovery plans may also be included within the prompt corrective actions framework[311] with resolution plans being triggered when institutions cease or are likely to cease to be viable.[312]

2.5 Implementation of international financial standards

2.5.1 Overview of local adaptation of international financial standards

Since the benefits of the post-GFC international financial standards discussed above[313] can only be realised if they are implemented, it is pertinent to consider the strategies the FSB has adopted to implement them and the possible country specific factors that would influence such implementation.[314]

2.5.2 Prospects and challenges in the implementation of international financial standards

2.5.2.1 FSB strategies for the implementation of the standards

The FSB adopts a multi-layered approach to implement international financial standards that comprises of direct obligations on member countries and voluntary adoption of such standards by non-member countries.[315] While international financial standards developed by the FSB and other international standard setting bodies,[316] are "soft law" under international law,[317] because they lack a sanctions-based enforcement framework,[318] the G-20 encourages its members to enforce them through official incentives like peer pressure, peer reviews, World Bank and IMF Assessment

[311] Par 2.2.3.4 above and ch 1 par 1.2.5.4.
[312] See Basel *Core principles* 51.
[313] See par 2.2.2 above.
[314] See *Basel Core principles* 6, *Joint Forum Principles* 5, *IADI Core principles* 6 and *FSB Key attributes*, all of which are designed to be adapted to country specific contexts.
[315] Non-member countries of the Basel Committee participate through the *Basel Consultative Group*, the biannual *International Conferences of Banking Supervisors* and *Regional Groups of Banking Supervisors.* See M Howard, R Masefield, & J Chuah, *Butterworths banking law guide,* (2006) 54.
[316] The FSB membership was increased to include, amongst others, the international standard setting bodies, the World Bank, the IMF and the OECD. FSB website available at <https://financialstabilityboard.org>accessed on 15.8.2018.
[317] See Brummer 257. See also AT Guzman, 'A compliance-based theory of international law', (2002) *California Law Review* 1861.
[318] See LLC Lee, 'The Basel accords as soft law: Strengthening international banking supervision', (1998) *Virginia Journal of International Law* 1.

Programs, and blacklisting of non-compliant members.[319] Thus, the black listing of non-compliant member countries as high risk jurisdictions may encourage their compliance in order to protect the reputation, and competitiveness of their institutions in global markets.[320] The adoption of the FSB standards for World Bank and IMF Financial Sector Assessment Programs also enhances their implementation in FSB non-member countries that are members of the World Bank and IMF.[321] However, it has been argued that the FSB's enforcement of international financial standards could be enhanced if it developed its own formal institutional enforcement structures.[322]

2.5.2.2 Challenges to the implementation of the standards

Baxter argues that post-GFC financial reforms are influenced by, *inter alia*: the impact of the Crises; the growth of integration of finance and technology; increased monetarisation of the global economy; and government reaction to developments in the financial markets to protect the public.[323] Masciandano and Romelli add that the major determinants for the assignment of supervisory regulation within the safety net are peer pressure and the degree of central bank independence.[324] Notablyall the international financial standards are designed to be implemented by adaptation to the specific contexts of the various jurisdictions.[325] According to Baxter, the factors that influence the implementation of financial standards may be grouped into public choice theory comprising of, the influence from financial crises, government reactions to financial technology and other financial market developments, and peer pressure, as they all enhance public interests.[326] While the monetarisation of the global economy

[319] M Giovanoli, 'The international financial architecture and its reform after the Global Crisis', in M Giovanoli & D Devos (eds), *International monetary and financial law*, (2010) 32. The G-20 encourages FSB member countries to commit to implement international financial standards through official incentives like peer pressure, peer reviews, and World Bank and IMF financial sector assessment programs because market discipline had been ineffective during the GFC.
[320] See FSB, *Framework for strengthening adherence to international standards,* (2011). See also FSB, *Overview of progress in the implementation of the G20 recommendations for strengthening financial stability,* (2014).
[321] M Giovanoli, 'The international financial architecture and its reform after the Global Crisis', in M Giovanoli & D Devos (eds), *International monetary and financial law*, (2010) 32.
[322] DW Arner & MW Taylor, 'The Global Financial Crisis and the Financial Stability Board: Hardening the soft law of international financial regulation', (2009) *University of New South Wales Law Journal*513.
[323] See LG Baxter, 'Fundamental forces driving United States and international financial regulatory reforms', (2012) *SyungKyunKwan Journal of Science and Technology Law* 105.
[324] See D Masciandaro & D Romelli, 'Central bankers as supervisors: Do crises matter?', (2018) *European Journal of Political Economy* 120–140.
[325] Par 2.5.1 above.
[326] See Baxter 105.

may be characterised as a special-interest group factor, the central bank independence may be characterised as a bureaucratic factor to influence reforms.[327]

The rationale for government policy choices in bank regulation may be found in the public choice theory of public finance that posits that since constitutional governments are elected democratically through majority rule, they implement policies that promote the public interest.[328] The need to validate government policies through public participation however also attracts the formation of special-interest groups to influence government policymaking to their favour.[329] Accordingly, by sponsoring political parties and candidates that support their agenda, special-interest groups may successfully influence government policies and regulations that advance their interests.[330] Hyman argues that implementation of government policy may also be influenced by bureaucracies that administer agencies that often exercise monopolistic power.[331]

Thus, bureaucracies influence the effectiveness of government policy depending on their bureaucratic preferences and the impact of the policy on their institutional interests.[332] For these reasons, it is my argument that most governments are influenced in the implementation of banking reforms by either the public choice theory, the special interest group theory or bureaucratic preferences in government agencies.[333] To test the applicability of these theories that influence implementation of financial reforms, I will examine the implementation of the international financial standards on bank supervision in Kenya, South Africa and the USA in Chapter Three, and the implementation of international financial standards on EDIS and SRR in Kenya in Chapter Four, in South Africa in Chapter Five and in the USA in Chapter Six. In addition, I will consider the extent to which the effectiveness of the standards may

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[327] *Ibid.*
[328] D Hyman, *Public finance: Contemporary application of theory to policy,* (2014) 161.
[329] *Idem* 162.
[330] *Idem* 194. See also GS Becker, 'A theory of competition among pressure groups for political influence', (1983) *Quarterly Journal of Economics*372, where he argues that by spending resources and time on successful political campaigns, interest groups can exert political power without holding political office.
[331] Hyman 196.
[332] See WA Niskanen Jr, 'Bureaucrats and politicians', (1975) *Journal of Law and Economics* 621.
[333] *Ibid.*

depend on the factors that influence their implementation, using the public choice theory and special interest group theory.

2.5.2.3 Public choice and interest group challenges to implementation of standards

The post-GFC reforms under *Basel III* include the enhancement of the quality and quantity of capital through capital conservation and countercyclical capital buffers, and reduction of leverage and liquidity through surcharges and other loss absorption instruments.[334] The public policy challenges to the implementation of these measures may include supervisory capacity to monitor compliance with the regulations, especially in relation to the cost of building supervisory capacity. Special-interest group challenges may also be raised in relation to the cost of the additional capital buffers and surcharges.

The implementation of macroprudential regulation post-GFC may be characterised as being influenced by the public choice theory, and its major challenge may emanate from the institutions that currently exercise the functions to be assigned to the prudential authority, conduct of business authority, EDIS and SRR. Since most of these functions may already be exercised by central banks in jurisdictions without EDIS and SRR, the Global Financial Crisis has already raised their public choice value, which leaves their implementation to be influenced by central banks depending on their bureaucratic influence under existing laws. The nature of the specific powers assigned to the EDIS, in relation to its funding, mandates, and relationship with the RA will be determined by the special-interest group theory in relation to funding, and the bureaucratic theory in relation to mandates. Accordingly, the implementation of the *IADI Core principles* and the *FSB Key attributes* will be determined by both public choice and special interest group theories.

2.6 Chapter summary and conclusions

The objective of this chapter was to set out the international financial regulatory reforms undertaken post-GFC to integrate financial regulation and supervision, deposit insurance and orderly bank resolution[335] as means of ending the use of public

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[334] Par 2.2.2.2 above.
[335] Par 2.2.2.

funds to bail-out financial institutions that are considered "Too-Big-To-Fail."[336] The problem of "Too-Big-To-Fail" was traced to the rise in financial conglomerates and the increase in the complexity of the financial services and products they offered and the organisational structures they adopted.[337] The GFC highlighted the mismatch between the complexity in financial conglomerate corporate structures and the institutional frameworks under which they were supervised.[338]

While financial conglomerates combine groups of two or more financial institutions in the banking, insurance or securities sectors, they were supervised under functional regulatory structures that focused on the safety and soundness of individual financial institutions on a solo basis and that negated the systemic risk posed by their group-wide conduct of business.[339] Thus, in order to holistically address systemic risk and promote financial stability, the post-GFC financial macroprudential regulatory reforms seek to incorporate surveillance on the risk emanating from conduct of business of conglomerates, explicit deposit insurance, and orderly bank resolution.[340] This requires a new financial safety net design that comprises *ex ante* mechanisms to prevent bank failure and where such failure nevertheless occurs, to mitigate its effects *ex post* by facilitating the orderly exit of the failed bank from the system, whilst protecting insured depositors and preserving vital economic functions without the use of public funds.[341]

The *ex ante* supervisory reforms include the *Basel III Accord* that increased the quality and quantity of capital through capital conservation and countercyclical capital buffers, imposed leverage and liquidity requirements and recommended other loss absorbing instruments.[342] The *Basel Core principles* reforms seek *inter alia* to limit the systemic risk that the financial conglomerates' conduct of business may pose to the financial system,[343] and to regulate derivatives markets, credit rating agencies and external

[336] Par 2.3.2.
[337] Par 2.1.1.
[338] Par 2.2.3.2.
[339] *Ibid.*
[340] Par 2.2.2.3.
[341] *Ibid*.
[342] Par 2.2.2.2.
[343] Par 2.2.3.2.

auditing standards to strengthen the market discipline pillar through more effective regulatory enforcement frameworks.[344]

The post-GFC reforms adopt macroprudential regulatory objectives in the design of the financial safety net comprising of the Ministry of Finance, the central banks, explicit deposit insurer, and special bank RA.[345] This integrates explicit deposit insurance and orderly bank resolution within the bank supervisory framework.[346] By incorporating prudential regulation, and conduct of business regulation within existing central banking functions, the Twin Peaks model of financial regulation appears to be the most appropriate model as it provides a suitable *ex ante* framework for limiting the potential for bank failure.[347] In the event that the banks still fail, the regulatory reforms seek to limit or mitigate the effects of such failure, *ex post,* through explicit deposit insurance to reimburse retail depositors,[348] and an orderly bank resolution process to preserve the bank's critical and essential functions even as their non-viable portions are liquidated.[349] This facilitates the orderly exit of inefficient and insolvent institutions from the financial system, while restricting bank risk-taking through the levy of risk-based premiums, limitation of the scope of deposits covered, and holding parties at fault liable.[350]

The FSB *Key attributes* alsoseek to reduce the use of public funds by recommendations for private funding for bank resolutions through an *ex ante* private funded EDIS,the use of bail-in mechanisms,[351] and requirements for RRPS that outline the measures to be adopted to restore their viability or resolve their affairs should they fail to restore their viability.[352] The *FSB Key attribute*s seek to preserve the critical and viable functions of the failed bank *inter alia* through a bridge bank and by establishing a special purpose asset vehicle to manage the non-performing assets of the failed

344 Par 2.2.2.3.
345 *Ibid.*
346 *Ibid.*
347 *Ibid.*
348 Par 2.3.3.2.
349 *Ibid.*
350 Par 2.4.1.2.
351 *Ibid.*
352 *Ibid.*

bank.[353] In addition the RA may also liquidate the failed bank and reimburse depositors if it is the least costly resolution strategy.[354]

To identify which of the determinant factors may have influenced the implementation of the international financial standards in Kenya, South Africa and the USA, the study will examine the implementation of *the Basel III,* the revised *Basel Core principles* and the *Joint Forum Principles* in the three jurisdictions in Chapter Three. This will be followed by an examination of the factors that may have influenced the implementation of the *IADI Core principles* and the *FSB Key attributes* in Kenya, South Africa and the USA in chapters four, five and six respectively. Using the findings from the status and scope of implementation of the post-GFC reforms, the study will make final conclusions and recommendations in chapter seven.

[353] *Ibid.*
[354] *Ibid.*

CHAPTER 3: THE REGULATION AND SUPERVISION OF FINANCIAL CONGLOMERATES IN KENYA, SOUTH AFRICA AND THE UNITED STATES OF AMERICA

3.1 Introduction

It was observed in Chapter One[1] that effective financial regulation and supervision is a pre-requisite for effective explicit deposit insurance schemes (EDIS) and orderly bank resolution regimes.[2] It was further noted[3] that the pre-GFC financial regulation and supervision did not effectively address the systemic risks arising from financial conglomerates because of *inter alia*, its focus on the safety and soundness of individual financial institutions rather than also on their conduct of business.[4] In Chapter Two,[5] I examined the post-GFC international financial reforms to address the gaps in financial supervision, EDIS[6] and special bank resolution regime (SRR) frameworks.[7] It was pointed out that the post-GFC financial regulatory reforms not only seek to promote the safety and soundness of individual financial institutions[8] but also to address the systemic risk that their affiliation within financial conglomerates poses to the financial system.[9]

The post-GFC reforms in international financial regulation integrate prudential and conduct of business regulation and supervision to enhance the resilience of banks, with EDIS and SRR to mitigate the effects of bank failure should it ensue.[10] These reforms thus integrate financial regulation and supervision, EDIS and SRR as a means of promoting financial system stability.[11] In this regard, the Basel Committee enhanced microprudential regulation through increased capital requirements[12] and strengthened

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[1] Ch 1 par 1.2.5.5.
[2] Ch 1 par 1.2.7.
[3] Ch 1 par 1.2.5.2.
[4] Ch 1 par 1.2.5.3.
[5] Ch 2 par 2.2.
[6] Ch 2 par 2.3.
[7] Ch 2 par 2.4.
[8] Ch 2 par 2.2.2.3.
[9] Ch 2 par 2.2.2.4.
[10] See SL Schwarcz, 'Beyond bankruptcy: Resolution as a macroprudential regulatory tool', (2018) *Notre Dame Law Review* 19.
[11] See JC Coffee, 'Law and the market: The impact of enforcement', (2007) 156:2 *University of Pennsylvania Law Review* 261. The author argues that strong enforcement of regulations enhances public confidence in the regulated sector. See also EJ Pan, *Understanding financial regulation*, (2011) Cardozo School of Law Institute of Advanced Legal Studies working paper 13.Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems,* (2010).
[12] Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* (2010).

supervision standards,[13] through macroprudential supervision for financial conglomerates.[14]

This chapter considers the implementation of the aforementioned post-GFC international financial reforms to the regulation and supervision of financial conglomerates in Kenya, South Africa and the United States of America (USA).[15] The chapter is organised to provide a brief outline of the local context of the pre-GFC regulatory and supervisory structure and financial safety net provisions in each country. This is followed by a discussion of how each country has implemented the *Basel III Accord,*[16] the revised *Basel Core principles*, and the revised *Joint Forum Principles*.[17] Also considered are the factors that may have influenced the effectiveness of the regulations implemented for the supervision of financial conglomerates in each of the three countries.

3.2 Regulation of financial conglomerates in Kenya

3.2.1 General background

Kenya is an East African country that was colonised by Britain through the Imperial British East Africa (IBEA) Company in 1888.[18] Upon the IBEA Company's collapse, Britain declared a protectorate over Kenya in 1895.[19] Consequently, British farmers, traders and administrators settled in Kenya and agencies of British banks were established to provide financial services to them.[20] In 1896, the National Bank of India was the first bank to open an agency at Mombasa, followed in 1910 by the Standard Bank of South Africa and the National Bank of South Africa.[21]

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[13] See Basel Committee, *Core principles for effective banking supervision,* (revised 2012) (hereafter *Basel Core principles*) and *Joint Forum Principles for the supervision of financial conglomerates*, (revised 2012) (hereafter *Joint Forum Principles).*
[14] Ch 2 para 2.2.2.2 and 2.2.2.3.
[15] For a comparative analysis of the regulation of bank holding companies in Kenya, South Africa and Nigeria see J Taylor & R Smits, 'Bank holding company regulation in Kenya, Nigeria and South Africa: A comparative inventory and a call for Pan-Africa regulation', (2018) *Journal of Banking Regulation* 175. See also A Hargarter & GW van Vuuren, 'Assembly of a conduct risk regulatory model for developing market banks', (2017) *South African Journal of Economic and Management Science* 3.
[16] Hereafter '*Basel III'*.
[17] See *Joint Forum Principles.*
[18] See C Elkins, *Britain's gulag: The brutal end of empire in Kenya,* (2014) 2.
[19] YP Ghai & JBWP McAuslan, *Public law and political change in Kenya,* (1970) 12.
[20] See RM Maxon, 'The colonial financial system', in WR Ochieng& RM Maxon (eds), *An economic history of Kenya,* (1992) 255.
[21] *Ibid*. Banks from the Netherlands, India, Pakistan and the USA later opened branches in Kenya.

3.2.2 Historical context of bank regulation in Kenya

3.2.2.1 Colonial currency boards

With more banks opening branches in Kenya, a Banking Ordinance was enacted in 1910 to register banking companies.[22] However, bank licencing was only introduced later by the Banking Ordinance, 1956.[23] Britain preferred to establish currency boards in its colonies (rather than introduce central banks),[24] which were administered from London under the Colonial Secretary, the Chancellor of the Exchequer and the Bank of England.[25] Crown agents were appointed to represent the interests of the colonies in London.[26] As alluded to in Chapter One,[27] the Board of Currency Commissioners was established in Kenya in 1905[28] to administer the British Sterling as the reserve currency and the Indian *silver rupee* as the local currency.[29]

The Board could only circulate the Indian rupees locally after it had deposited an equivalent amount in gold sovereign coins at the Bank of England.[30] Two thirds of the gold deposits were permanently retained in an interest free account,[31] with only one third being invested in British government securities.[32] The East African Currency Board (EA Currency Board) was established in 1919 to replace the first currency board and was mandated to introduce a local currency (the *East African Florin*) and redeem

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[22] Banking Ordinance, 1910 only required banks to be registered under the Companies Ordinance under which they were governed. See also EPG Girouard, *Annual report of the East African Protectorate1910–1911*, (1912) 9.
[23] See Banking Ordinance 52 of 1956.
[24] W Narsey, *British imperialism and the making of colonial currency systems,* (2016) 14. Narsey argues that Britain established colonial currency boards to provide easy profits to the Bank of England after it complained of making losses on its financing of government. Therefore, Britain imposed the requirement for currency boards to maintain one hundred per cent Sterling reserves to reward the Bank of England. See also I Greaves, *The colonial sterling balances,* (1954) *Princeton University essays in international finance working paper* 2, available at <htttps://www.princeton.edu/~ies/IES_Essays/E20.pdf> accessed on 21.9.2016. See further A Hazelwood, *The economics of colonial monetary arrangements,* (1954) 298 and RI Nasibi, 'Financial institutions and monetary policy in post independent Kenya', in WR Ochieng & RM Maxon (eds) *An economic history of Kenya,* (1992) 448. Compare with J Williamson, 'Revival of an old idea', in J Williamson (ed), *What role for currency boards*, (1995) 2.
[25] Narsey 15. According to Narsey, the Crown Agents were often explicitly over-ridden by the Colonial Secretary who deferred to the Chancellor of the Exchequer.
[26] See JW Kratz, *The East African Currency Board*, (1966) IMF staff papers 230 available at <http://jstor.org/Stable/3866425> accessed on 19.9.2016.
[27] Ch 1 par 1.3.1.
[28] S 3 of the East Africa and Uganda (Currency) Order-in-Council, 1905.
[29] S 15 of the East Africa and Uganda (Currency) Order-in-Council, 1905.
[30] S 17(1) of the East Africa and Uganda (Currency) Order-in-Council, 1905.
[31] S 17(4) of the East Africa and Uganda (Currency) Order-in-Council, 1905.
[32] S 18(1) of the East Africa and Uganda (Currency) Order-in-Council, 1905.

the Indian *silver rupee from* circulation.[33] However, it had no powers in colonial monetary affairs[34] or to regulate the banks in Kenya and provided neither banking nor foreign exchange services.[35]

3.2.2.2 The banking crisis of 1930

The currency board's lack of bank supervisory authority was displayed when Kenya experienced a banking crisis in 1930.[36] Like other banking crises that arise from a boom-bust cycle,[37] the banking crisis of 1930 in Kenya was attributed to a rise in speculative land prices driven by rising commodity export earnings that followed the First World War.[38] Upon the onset of the Great Depression that dampened global trade, land prices collapsed, leading to widespread loan defaults by farmers who had financed their land purchases through bank loans.[39] As most banks withheld further farm credit, many farmers were forced to abandon their farms for lack of working capital.[40] This compelled the government to intervene because the Kenyan economy depended heavily on agriculture.[41]

Since the EA Currency Board lacked central bank authority to finance government debt, the government could only raise funds to provide long term credit to farmers through borrowing from the London money markets.[42] Using the borrowed funds, the government established the Land and Agricultural Bank (Land Bank)[43] to refinance the farmers' loans through low interest rate mortgages.[44] This government bail-out of the agricultural sector pioneered implicit deposit protection in Kenya.[45] However, the bail-out was unique because, unlike other implicit deposit protection measures that

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[33] Maxon 255.
[34] Narsey 14.
[35] See RMA van Zwanenberg, *Colonial capitalism and labour in Kenya1919–1939*, (1975) 13.
[36] *Ibid*.
[37] See F Boissay, F Collard & F Smets, *Booms and banking crises,* (2016) BIS working papers 545. See also G di Iasio& Z Pozsar, *Crises in the modern financial ecosystem*, (2017) European Systemic Risk Board working paper 4.
[38] See Van Zwanenberg 13.
[39] *Ibid.*
[40] *Ibid.*
[41] Governor Grigg, *Evidence to Hilton Young Commission in Report of the Commission on closer union of the dependencies in Eastern and Central Africa 1929,* (1931) 406–446.
[42] Van Zwanenberg 13.
[43] *Ibid.*
[44] Maxon 256.
[45] See ch 1 par 1.2.3 for a discussion on implicit deposit protection.

focus on the bail-out of banks to protect depositors, the Land Bank focused on the protection of borrowers.[46]

3.2.3 Central banking and bank regulation in Kenya

3.2.3.1 Introduction of central banking in Kenya

Once Britain decided to grant independence to its East African colonies, it authorised the EA Currency Board to issue currency against the securities of the protectorate governments of Kenya, Uganda and Tanzania, act as LOLR, and invest in protectorate government securities.[47] The EA Currency Board continued its operations even after Kenya obtained independence from Britain in 1963.[48] In 1966, after Uganda and Tanzania had established their own central banks, Kenya established the Central Bank of Kenya (CBK) leading to the break-up of the EA Currency Board.[49] The CBK Act granted the CBK full central bank authority,[50] including to act as banker to other banks[51] and as LOLR.[52] Therefore, from inception, the CBK provided implicit deposit protection in Kenya as LOLR, until the introduction of an explicit deposit insurance scheme (EDIS) in 1985.[53]

In 1968, formal bank regulation was introduced in Kenya through the Banking Act, 1968.[54] The Act introduced requirements for local registration and reinforced the licencing requirements (introduced in 1956)[55] for banks and financial institutions[56] and the vetting of bank owners and managers.[57] The Act also imposed minimum capital requirements.[58] The Minister of Finance was designated as the banking regulator,[59] with authority to exempt any institution from the provisions of the Act.[60] The Act further

[46] Van Zwanenberg 24.
[47] See I Livingstone & HW Ord, *Economics for Eastern Africa,* (1991) 380.
[48] T Killick & FM Mwega, *Monetary policy in Kenya, 1967–8*, (1990) ODI working paper 10.
[49] See CBK Act 15 of 1966.
[50] S 4 of the CBK Act.
[51] S 34 of the CBK Act.
[52] S 36 of the CBK Act.
[53] Ch 1 par 1.3.3.
[54] See the Banking Act 56 of 1968.
[55] Par 3.2.2.1 above.
[56] Ss 3 and 4 of the Banking Act 56 of 1968.
[57] S 5(2) of the Banking Act 56 of 1968.
[58] S 7 of the Banking Act 56 of 1968.
[59] Ss 4, 5, and 8 of the Banking Act 56 of 1968.
[60] S 30 of the Banking Act 56 of 1968.

designated the CBK as the banking supervisor.[61] The Banking Act, 1968 promoted African investments in the financial sector[62] by lowering the minimum capital requirements for locally incorporated banks and financial institutions as opposed to those required of foreign registered banks and financial institutions.[63] In addition, locally incorporated financial institutions were exempted from capital and liquidity reserve requirements, and their directors and managers were exempted from vetting for moral and professional fitness.[64] Consequently, there was a rapid increase in locally owned non-bank financial institutions, most of which suffered from poor capitalisation and imprudent management.[65]

3.2.3.2 The banking crises of the 1980s and 1990s

The Banking Act, 1968 has been criticised for establishing a weak enforcement framework by permitting licenced institutions or officers charged with contravening its provisions to plead that they reasonably expected some other officer in the bank to be responsible for compliance with the provisions of the Act.[66] Another concern was that, despite the rapid increase in the number of non-bank financial institutions, the CBK did not build a corresponding supervisory capacity.[67] This led to light touch regulation that failed to address bank risk-taking.[68] Thus, a rapid increase in financial institutions, coupled with ministerial exemptions from certain provisions of the Act,[69] poor capitalisation and imprudent management and weak supervisory enforcement, led to banking crises in the 1980s and 1990s.[70]

During the 1980s and 1990s, Kenya experienced two banking crises, the first one being from 1984 to 1989, when two banks and nine non-bank financial institutions

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[61] Ss 11, 12, 17, 18, 19, 20, 21 and 22 of the Banking Act 56 of 1968.
[62] See generally Government of Kenya, *Sessional paper on African socialism and its application to planning in Kenya*, (1965). See also DN Ndegwa, *Report on the public service structure and remuneration,* (1971) 30available at <http://www.kenyalw.org>CommissionReports>Reports>accessed on 16.5.2016.
[63] S 7(2) of the Banking Act 56 of 1968.
[64] S 7(2)(a) of the Banking Act 56 of 1968.
[65] See M Brownbridge, 'Government policies and the development of banking in Kenya', in M Brownbridge and C Harvey (eds), *Banking in Africa: The impact of financial sector reform since independence,* (1998) 80.
[66] *Ibid.* See also R Upadhyaya & S Johnson, *The transformation of Kenya's banking sector 2000–2012*, (2017) 20.
[67] Brownbridge 80.
[68] *Idem* 96.
[69] *Ibid.*
[70] *Ibid.*

failed, and the second one being from 1994 to 1998, when twenty four non-bank financial institutions failed.[71] The majority of the banks and non-bank financial institutions that failed were locally incorporated entities, with the major causes of their failure having been identified, *inter alia*, as insider loans, mismanagement, political interference, and light touch supervision.[72] The aforesaid banking crises presented a policy challenge to Kenya because it had not suffered any banking crisis since the crisis in the 1930s, after which the Land Bank had been transformed into the Agricultural Finance Corporation which was restricted to serving farmers.[73]

In addition, unlike the 1930s banking crisis, where farmers were the major victims, the victims of the 1980s banking crisis were depositors whose plight equally required government intervention.[74] Since the CBK only operated a discretionary implicit deposit protection system for Kenya[75] the liquidation of the insolvent banks and financial institutions was conducted under ordinary corporate insolvency procedures.[76] These corporate insolvency procedures treated depositors as ordinary creditors and suspended their rights until the bankruptcy court made orders for payment.[77] This led to the amendment in 1985 of the Banking Act, 1968, to address the plight of the unfortunate depositors.[78]

3.2.3.3 Reforms to the Banking Act 1968

The Banking Act 1968 was amended in 1985 to introduce an EDIS to give depositors preference in bank insolvencies and to reimburse depositors of failed banks under the Deposit Protection Fund Board (DPFB).[79] The Act was substantially reviewed

[71] See CBK, Bank Supervision Department, *Annual report,* (1994) 35. See also RW Ngugi & JW Kabubo, 'Financial sector reforms and interest rate liberalization: The Kenya experience', (1998) *African Economic Research Consortium Research Paper* 3.
[72] Brownbridge 95.
[73] See Brownbridge 96.
[74] See T Beck, R Cull, M Fuchs, J Getenga, P Gatere, J Randa & M Trandafir, *Banking sector stability, efficiency and outreach in Kenya*, (2010) The World Bank working paper 6.
[75] Par 3.2.3.1 above. See also ch 1 par 1.2.1 for a discussion of implicit deposit protection.
[76] See CBK, BSD, *Annual report,* (1994) 14.
[77] Corporate insolvency proceedings were conducted under the Companies Act 1945 Cap 486 Laws of Kenya (repealed) and are now conducted under the Insolvency Act 18 of 2015.
[78] See CBK, BSD, *Annual report,* (1994) 14.
[79] Banking Amendment Act 17 of 1985. See also RW Ngugi, 'An empirical analysis of interest rate spread in Kenya', (2001) *African Economic Research Consortium* 12.

in1989,[80] and further amended in 1994,[81] and 2006,[82] to enhance the safety and soundness of banks by increasing the capital adequacy requirements for new banks seeking to register.[83] To address the risk from insider loans, amendments to the Banking Act prohibited the grant of unsecured loans to directors, officers and employees,[84] and required secured loans to directors or managers to be approved by the full board of directors, and a report to be made to the CBK within seven days of the approval.[85] The amendments further imposed criminal sanctions against banks and officers that contravened insider lending laws.[86] In addition, the Minister's regulatory authority was transferred to the CBK, and restrictions were placed on the Minister's powers to exempt banks from provisions of the Act, thus improving the effectiveness of supervision.[87]

3.2.4 Transition to universal banking in Kenya

3.2.4.1 Central Bank of Kenya's policy shift and Kenya Vision 2030

According to the International Monetary Fund (IMF) economic liberation and the higher capital requirements under the *Basel I Accord* are the main motivations for financial conglomeration in emerging markets.[88] In Kenya, the shift to universal banking in 1994 was driven by the CBK's policy for financial diversification in the provision of "foreign exchange, insurance, stock-broking, and credit cards" services.[89] The government's Vision 2030, issued in 2007, reinforced the financial diversification by seeking to consolidate the many smaller banks into a number of stronger ones.[90] Despite these policy statements, the government has been slow to develop a regulatory framework for financial conglomerates,[91] until the publication of the Draft Financial Services Authority Bill, 2016 and the Draft Financial Markets Conduct Authority Bill 2018, that

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80 Banking Amendment Act 9 of 1989.
81 Banking Amendment Act 13 of 1994.
82 Banking Amendment Act 9 of 2006.
83 See the Banking Amendment Act 13 of 1994, which increased capital requirements for all financial institutions, which removed the previous advantages enjoyed by non-bank financial institutions.
84 S 11(1) of the Banking Act.
85 S 11(1)(e) of the Banking Act.
86 S 11(3), (4), (5) and (6) of the Banking Act.
87 S 53 of the Banking Act.
88 IMF, *Financial sector regulation: Issues and gaps – Background,* (2004) 4.
89 CBK, BSD*, Annual report,* (1994) 8. See also FM Mwega, *Financial regulation in Kenya: Balancing inclusive growth with financial stability*, (2014) ODI working paper 29.
90 See Government of the Republic of Kenya, *Kenya vision 2030,* (2007) 15.
91 IMF (2004) 6. See also Upadhyaya & Johnson above.

seek to consolidate Kenya's legal framework for the regulation and supervision of financial conglomerates, as discussed in more detail in par3.2.4.2 below. This lack of a formal framework for consolidated supervision of financial conglomerates may explain the high rate of failure among the initial universal banking groups that suffered financial distress, due to poor management, shortly after incorporation.[92]

Some amendments were however effected to the Banking Act to address concentration risk relating to conglomerates. Notably, in 2006 the Finance Act 9 of 2006 amended the Banking Act to introduce vetting for significant shareholders that own more than five percent of the shares of banks.[93] In 2012 the Finance Act 57 of 2012 amended the Banking Act to introduce the regulation and supervision of banking groups and non-operating holding companies to limit the ownership of a bank's capital by a non-operating holding single person to a maximum of twenty five per cent[94] and to require regulatory approval for any acquisition of more than twenty five per cent of a bank's share capital by a non-operating holding company.[95] The amendments further introduced the regulation of bank affiliations with non-bank subsidiaries within non-operating holding companies under the parent-subsidiary corporate structure.[96] Thus, while section 11 of the Banking Act restricts insider loans to protect deposits, and section 12 of the Banking Act prohibits banks from investing more than twenty five per cent of their capital in non-bank business to protect banks' capital from risky investments, the amendments to the Banking Act seek to limit non-bank holding companies from acquiring more than twenty five per cent of a bank's share capital and access depositor funds that could be used in their non-bank affiliates.

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[92] See para 3.2.3.1 and 3.2.3.2 above. See also Brownbridge 92.

[93] S 9A of the Banking Act. The vetting was extended to significant shareholders of banks that reduce their ownership to less than five per cent of the shares to avoid being vetted by the Finance Act 14 of 2015 that introduced s 9A(3A) of the Banking Act.

[94] S 13(1)(e) of the Banking Act.

[95] Compare with s 12 of the Banking Act, which restricts commercial bank investment in non-banking business.

[96] See s 18 of the Banking Act that authorises the CBK to determine minimum capital requirements for banking groups; s 22 of the Banking Act that requires banking groups to furnish the CBK with information on their affiliates, associates or non-operating companies; s 32B that provides for the examination and control of banking groups and s 33(1A)(1B) and (1C) that sets out the CBK's powers over banking groups.

3.2.4.2 Regulatory structure and the financial safety net

When Kenya enacted the CBK Act 1966 and the Banking Act 1968, it adopted the functional approach of financial supervision[97] under which banks are supervised by the CBK. Subsequently, Kenya enacted statutes for the supervision of other financial institutions in the insurance, securities, pensions and retirement, microfinance and savings-cooperative sectors by functional regulators.[98] Since universal banking facilitates the provision of financial services in more than two sectors,[99] the functional supervisory structure may however not be effective in the supervision of financial conglomerates on a consolidated basis.[100] Nevertheless it could be argued that Kenya has strengthened its regulatory structure and financial safety net[101] when compared to the initial provisions of the Banking Act 1968.[102] Thus, Kenya's financial safety net consisting of the Ministry of Finance and the CBK under the Banking Act 1968,[103] was strengthened by the introduction of DPFB in 1985 to provide explicit deposit insurance,[104] and reformed in 2006 by restricting the Minister's powers to exempt licensed institutions from the provisions of the Act.[105] In addition, the National Treasury has recently published Draft Bills to establish a Financial Services Authority (published in 2016)[106] and a Financial Conduct of Business Authority (published in 2018)[107] to strengthen Kenya's supervisory and safety net structures.

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[97] See JK Gakeri, 'Financial services regulatory modernization in East Africa: The search for a new paradigm for Kenya', (2011) *International Journal of Humanities and Social Science* 162. See also ch 1 par 1.2.5 for the pre-GFC supervisory structures.
[98] The functional regulators include the Insurance Regulatory Board under the Insurance Act 1 of 1985 (as amended), the Capital Markets Authority under the Capital Markets Act 17 of 1989, the Retirement Benefits Authority under the Retirement Benefits Act 3 of 1997, the CBK for microfinance institutions under the Microfinance Act 19 of 2006 and the Sacco Societies Regulatory Authority under the Sacco Societies Act 14 of 2008. See also JK Gakeri, 'Overview of Kenya's institutional structures on securities market regulation (2011) 1:9 *International Journal of Humanities and Social Science,* 134 and JK Gakeri Regulating Kenya's securities Markets: An assessment of the Capital Market's Authority's enforcement jurisprudence (2012) 2:20*International Journal of Humanities and Social Science,265.*
[99] See RJ Herring & AM Santomero, 'The corporate structure of financial conglomerates',(1990) *Journal of Financial Services Research* 471, who argue that financial conglomerates include "universal banks, multiproduct bank holding companies and other diversified financial firms that perform basic banking functions".
[100] See Basel *Core principles, Joint Forum Principles* and *Basel III*.
[101] See ch 2 par 2.2.2.3 for the design of financial safety nets.
[102] Par 3.2.3 above.
[103] *Ibid.*
[104] Banking (Amendment) Act 17 of 1985.
[105] See Banking (Amendment) Act 9 of 2006 and s 47 of the Finance Act 10 of 2006.
[106] See Draft Financial Services Authority Bill, 2016, available at <http://www.treasury.go.ke>accessed on 24.6.2018.
[107] See Draft Financial Conduct of Business Authority Bill, 2018, available at <http://www.treasury.go.ke> accessed on 24.6.2018.

3.2.4.3 Supervision of financial conglomerates in Kenya

Financial conglomerates in Kenya may be structured as non-operating holding companies or as banking groups that use the bank as an operating holding company.[108] While the non-operating holding company structure comprises of banks and other financial institutions as subsidiaries or associated companies, the banking group structure has the bank as the operating holding company that may own non-operating holding companies and other financial institutions as subsidiaries.[109] Koome observes that while an operating holding company is a licensed bank that uses subsidiaries to offer other financial services in a banking group, a non-operating holding company uses subsidiaries to offer banking and other services.[110] As the regulator for banks in Kenya, the CBK is designated as lead supervisor of banking groups,[111] and restricts banks and banking groups from engaging in retail or wholesale trade, except for the recovery of a debt owed to it.[112] Banks are also prohibited from investing more than twenty per cent of their core capital in non-banking activities.[113] In addition, non-operating financial holding companies[114] must seek the CBK's approval before they acquire more than twenty five per cent of a bank's share capital.[115] However, as discussed in more detail in paragraph 3.2.5.2 below, the regulatory framework for the supervision of banking groups and non-operating holding companies is spread over the Banking Act and CBK guidelines and requires to be consolidated to prescribe criteria for the incorporation, licensing and consolidated supervision of both banking groups and non-operating holding companies.[116]

[108] See s 2 of the Banking Act for definitions of non-operating companies and banking groups.
[109] See RM Koome, *Financial conglomerates in Kenya: A regulatory response,* (Unpublished University of Nairobi LLM thesis 2017) 74.
[110] *Ibid.*
[111] S 3 of the Banking Act.
[112] S 12(a) of the Banking Act.
[113] S 12(b) of the Banking Act.
[114] S 2 of the Banking Act.
[115] S 13(1)(e) of the Banking Act.
[116] S 4 of the Banking Act.

3.2.5 Implementation of international financial standards in Kenya

3.2.5.1 Overview

As discussed in Chapter Two,[117] although the Basel Committee encourages the implementation of its standards within agreed timelines, it recognises the need for developing countries to be given more time to build capacity before implementing the standards.[118] This enables non-member developing countries to implement the Basel standards in phases as they build the requisite capacity.[119] Accordingly, Kenya has over the years adopted the *Basel Accords* and *Basel Core principles*[120] and strengthened its EDIS post-GFC gradually as it has built its capacity.[121]

3.2.5.2 Microprudential regulation in Kenya

To implement the *Basel III* provisions on risk-based capital adequacy and liquidity requirements and facilitate the effective supervision of banking groups in Kenya, the CBK issued the *Risk Based Supervisory Framework* (2013) as a guideline for consolidated supervision of banking groups.[122] The framework requires supervisors to consider "all risk exposures of a bank and its subsidiaries, or of a bank belonging to a financial group or conglomerate"[123] in the assessment of minimum capital requirements.[124] The guidelines enhance the capital resilience of banks and improve consolidated supervision of banking groups.[125] In addition, approval for the acquisition

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[117] See ch 2 par 2.5.2.1.
[118] See R Gottschalk, *What financial regulation for stability and financial inclusion in Africa? The views of regulators of Ethiopia, Kenya, and Lesotho*, (2015) ODI research paper 6.
[119] See Alliance for Financial Inclusion, *Kenya's engagement with standard setting bodies and the implications for inclusion*, (2011) 4.
[120] See R Upadhyaya, *The political economy of Basel adoption in Kenya: A case of alignment of donor, government and banking sector interests*, (2017) research paper University of Oxford Global Economic Governance Programme 4–8.
[121] See DK Kinyairo, MM Meeme, JN Maina & JM Maitai, 'Implications of Basel III Accord adherence on financial distress status of commercial banks in Kenya', (2016) *International Journal of Economics, Commerce and Management* 702.
[122] See CBK, *Risk based supervisory framework,* (2013).
[123] See s 18(1) of the Banking Act that authorises the CBK to determine the "method of classifying and assessing assets". See also SI Greenbaum& AV Thakor, *Contemporary financial intermediation,* (2007) 458 and A Blundell-Wignall, P Atkinson & C Roulet, 'Complexity, interconnectedness: Business models and the Basel system', in C Goodhart, D Gabor, J Vestergaad &I Ertuk, *Central banking at a crossroads: Europe and beyond,* (2014) 53.
[124] See JK Susan & T Nasieku, 'Effect of capital on the financial performance of commercial banks in Kenya', (2016) *Asian Journal of Business and Management* 226. The authors argue that Kenyan banking groups maintained higher capital levels from 2010 to 2014 than the prescribed minimum levels.
[125] For example, the Cooperative Bank of Kenya is an operating holding company with subsidiaries in insurance and securities business. See G Springfield, 'The Co-operative Bank of Kenya: Transforming

of more than twenty five per cent of a bank's shares by a non-operating holding company[126] is based on the non-operating holding company's demonstration of its ability to be a "source of strength"[127] to the bank.[128]

The CBK has also issued guidelines in 2013 for the consolidated supervision of non-operating holding companies.[129] To facilitate the monitoring of group-wide risk from non-operating holding companies, the CBK requires them to file consolidated financial statements for the parent company and its subsidiaries as a single group entity.[130] Banking groups are further required to meet the same liquidity and capital requirements as solo institutions.[131] In addition, banking groups are required to meet the *Basel III* capital conservation buffers and capital countercyclical buffer requirements.[132] Also, the CBK retains the authority to designate a non-bank corporation that owns more than twenty five per cent of a bank's shares as a non-operating holding company.[133]

The CBK has further issued guidelines for the supervision of banking groups structured as bank holding companies that establish subsidiaries, agencies, or partnerships to undertake banking, insurance, securities or other financial products.[134] In this respect, banking groups that have been approved to engage in incidental business are required to maintain the confidentiality of consumer data, inform consumers of available alternative services and avoid the coercion of banking consumers to purchase their other services.[135] Further, banks that are approved to

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the lives of millions', April 2014) *International Banker* available at <https://www.internationalbanker.com.banking/co-operative-bank-kenya-transforming-lives-millions> accessed on 7.1.2019. Barclays Bank of Kenya Ltd is also an operating holding company with shares in Barclays Life Assurance Limited and Barclays Bank Insurance Agency Limited. See Barclays Bank of Kenya, 'Barclays Bank of Kenya/Life Assurance', available at <http://www.barclays.cp.ke/life-assurance/index.html>accessed on 20.6.2018.

[126] S 13(1) of the Banking Act.

[127] See ch 2 par 2.2.2.2 for the definition of "source of strength".

[128] S 18(2) of the Banking Act.

[129] CBK, *Guidelines on non-operating holding companies*, (2013) par 1.4.4.

[130] *Idem* par 1.4.5.

[131] *Idem* para 8.1 and 8.2.

[132] See ch 2 par 2.2.2.2.

[133] CBK, *Guidelines on non-operating holding companies,* (2013) par 1.4.15.

[134] CBK, *Guidelines on incidental business activities*, (2013) par 3.3.

[135] *Idem* par 4.2 (iii).

engage in incidental business should disclose the commissions or fees they charge,[136] and establish mechanisms for redressing complaints.[137]

3.2.5.3 Regulatory enforcement

The CBK assesses the safety and soundness of the institutions after onsite and off-site examinations using the "CAMELS" rating methodology, pioneered by the USA, that scores their safety on the five indicators of capital adequacy, asset quality, management, earnings, liquidity and sensitivity to risk, (the first letter of each indicator being used to constitute the acronym "CAMELS").[138] Banks with low scores may be directed to cease and desist from unsound practices before they escalate into more serious problems. [139]As discussed in Chapter One[140] and above,[141] ineffective regulatory enforcement undermines the safety and soundness of financial institutions.[142] Accordingly, the Banking Act has been strengthened to authorise the CBK to direct any undercapitalised bank to undertake a capital restoration plan and any mismanaged bank to undertake a plan to resolve its deficiencies.[143]

Supervisors may enforce regulations through ordinary regulatory enforcement[144] or through prompt corrective actions.[145] Ordinary regulatory enforcement may be effected through moral suasion,[146] supervisory approvals, intervention in bank management, criminal sanctions,[147] and suspension of a banking license.[148] As a last

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[136] *Idem* par 4.2 (i).
[137] *Idem* par 4.2 (ii).
[138] CBK, *Risk based supervisory framework,* (2013) 9 and CBK*, Guidelines on prompt corrective actions,* (2013) par 1.4. The CAMELS scores are rated from 1 to 5 on each category with 1 being the highest and 5 the lowest rating and a combination of scores is calculated to obtain the composite rating. See also Greenbaum & Thakor 456.
[139] CBK, BSD*, Annual report,* (1997) 16.
[140] See ch 1 par 1.2.6.
[141] Par 3.2.3.2 above.
[142] See EJ Pan, 'Challenge of international cooperation and institutional design in financial supervision: Beyond transgovernmental networks', (2010) *Chicago Journal of International Law* 266, where Pan underscores the essence of supervision as a pre-requisite for effective rules and standards. Pan states that without supervision, rules and standards means nothing.
[143] S 33A of the Banking Act.
[144] See also CBK*, Guidelines on enforcement of banking laws and regulations,* (2013) for ordinary regulatory enforcement actions.
[145] See CBK*, Guidelines on prompt corrective action,* (2013).
[146] See CBK, BSD*, Annual report,* (1997) 16.
[147] S 49 of the Banking Act.
[148] S 6(1)(b) of the Banking Act.

resort, a distressed institution may be placed under management[149] and receivership.[150] The CBK uses off-site surveillance to obtain or require information from banks and financial conglomerates relating to their legal, managerial and operational structures and their linkages with banking and non-banking affiliates and the risk profile of the group.[151] The CBK also conducts on-site examinations through audits[152] and inspections of banks, financial conglomerates and their holding companies, subsidiaries, or associates.[153]

On the basis of the aforesaid surveillance and examinations, the CBK may invoke ordinary regulatory enforcement to direct financial conglomerates to change their legal or management structures to structures that enhance effective supervision.[154] The CBK may also direct any non-bank affiliate of a bank that violates the Banking Act to desist from such violations[155] and may give directions to stop any conduct by non-banking entities within a financial conglomerate that threaten the interests of depositors.[156] The CBK may also direct any entity that threatens the interests of depositors to suspend further investments in or transactions with the bank, or to refrain from the exercise of control over the institution.[157]

While the Banking Act does not adopt a prompt corrective action enforcement framework, the Kenya Deposit Insurance Act authorises the Kenya Deposit Insurance Corporation to enforce prompt corrective actions without prescribing any criteria for their enforcement.[158] Consequently, the CBK has developed a supervisory framework for early intervention in institutions that erode their capital base or breach banking laws and prudential guidelines.[159] The CBK's prompt corrective actions framework

[149] The CBK may appoint a manager to take over an institution that has ceased or is likely to cease to be viable under s 34 of the Banking Act, or appoint the Kenya Deposit Insurance Corporation as a receiver under ss 43 and 44 of the Kenya Deposit Insurance Act 10 of 2012.
[150] S 50 of Kenya Deposit Insurance Act.
[151] S 28 of the Banking Act.
[152] S 24 of the Banking Act.
[153] S 32(5) of the Banking Act. Under the Third Schedule of the Banking Act, the CBK, the Capital Markets Authority, the Insurance Regulatory Authority, the Retirement Benefits Authority, the Sacco Societies Regulatory Authority and the Communication Commission of Kenya are the prescribed financial regulators.
[154] S 32B of the Banking Act.
[155] S 33(1A)(a) of the Banking Act.
[156] S 33(1A)(b) of the Banking Act.
[157] S 33(1C)(c) of the Banking Act.
[158] Ss 50 and 54 of the Kenya Deposit Insurance Act.
[159] See CBK, *Guidelines on prompt corrective actions,* (2013) and CBK, BSD, *Annual report,* (2012) 45. See also C Goodhart & M Segoriano, *Optimal bank recovery*, (2015) IMF working paper 4 and DG

classifies banks into the following four categories, namely strong or satisfactory, fair, marginal, and unsatisfactory.[160] The framework further stipulates enforcement actions for each category of banks, including for the highest rated banks, namely, "strong" or "satisfactory banks".[161]

The second category of banks, rated as "fair", is obligated to *inter alia*, develop and implement improved management and business methods,[162] under increased supervisory surveillance.[163] For the third category of banks that are rated as "marginal", the guidelines prescribe the appointment of a "Resolution Specialist" to evaluate their viability,[164] and to develop a strategy to restore their solvency or correct any other deficiencies.[165] In addition, the CBK may appoint a "Management Advisor" to assist marginal banks in the design and implementation of capital restoration plans or plans to correct other deficiencies.[166]

The least capitalised banks are rated as "unsatisfactory" banks and are subject to appointment of a "Resolution Specialist" to undertake a voluntary recapitalisation or restructuring or rectification of any other deficiencies.[167] The CBK may also appoint a "Manager" to evaluate the viability of unsatisfactory banks and recommend within three months on whether they should be recapitalised or liquidated.[168] If the "Manager" recommends a restructuring, the unsatisfactory banks are treated as "fair" banks, and if the recommendation is for them to be liquidated, the CBK appoints the Kenya Deposit Insurance Corporation (KDIC) as liquidator.[169]

Mayes, MJ Nieto & L Wall, *Multiple safety net regulators and agency problems in the EU: Is prompt corrective actions partly the solution?*, Central Bank of Spain working paper 10.

[160] CBK, *Guidelines on prompt corrective actions,* (2013) par 4.0.

[161] *Idem* par 4.1.1.

[162] *Idem* par 4.2.3.

[163] *Idem* par 4.2.2.

[164] *Idem* par 4.3.1.

[165] Under s 33A of the Banking Act, the CBK may, *inter alia*, restrict payment of dividends, bonuses or other executive compensation or engagement in new businesses. Institutions may further be directed to *inter alia* reconstitute their board of directors, remove culpable officers and/or submit a capital restoration plan within forty five days. The CBK may further appoint a Management Advisor to the institution under s 34.

[166] CBK, *Guidelines on prompt corrective actions,* (2013) par 4.4.1.

[167] *Idem* par 4.6.1.3.

[168] *Idem* par 4.6.4.1.

[169] The Kenyan prompt corrective action framework does not impose escalating sanctions and subjects banks with capital above the minimum capital adequacy levels to enforcement actions. It further treats undercapitalised and significantly undercapitalised banks as if they have similar capital ratings. In addition, the framework provides for the appointment of a "Resolution Specialist", a "Management

3.2.5.4 Macroprudential regulatory reforms in Kenya

Like the other countries that have instituted post-GFC regulatory reforms,[170] Kenya seeks to transform its financial sector into a vibrant and globally competitive industry.[171] As indicated above,[172] the National Treasury has pursued this objective by the publication of a draft Financial Services Authority Bill[173] in 2016to standardise conduct in the provision of "financial products and services.[174] The Draft Bill seeks to promote fairness and efficiency in the financial sector through a Financial Services Authority to *inter alia*, designate any group of financial institutions as a financial conglomerate[175] and licence financial conglomerates either as bank holding companies,[176] or non-operating holding companies.[177]

The National Treasury has also published a draft Financial Conduct of Business Authority Bill[178] to promote financial consumer protection from misleading, deceptive, unfair or fraudulent conduct.[179] The Draft Bill proposes to establish a Financial Conduct of Business Authority to regulate and supervise the conduct of business of financial service providers[180] and facilitate collaboration of such Authority with other financial regulators with the aim of promoting financial inclusion and providing financial consumer education.[181]

The Draft Bill seeks to enhance such consumer protection through the establishment of a Financial Sector Ombudsman,[182] a Conduct Compensation Board,[183] a Conduct Compensation Fund[184] and a Financial Services Tribunal.[185] Although the CBK Governor has opposed the draft Financial Conduct of Business Authority Bill as being

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Advisor" and a "Manager", which duplicates resolution functions under s 43 of the Kenya Deposit Insurance Act.
[170] See ch 2 par 2.2.
[171] Par 3.2.4 above.
[172] Par 3.2.5 above.
[173] See the Draft Financial Services Authority Bill, 2016.
[174] See the objects of the Draft Financial Services Authority Bill, 2016.
[175] Cl 80(4).
[176] Cl 82.
[177] Cl 84.
[178] See the Draft Financial Conduct of Business Authority Bill, 2018.
[179] Cl 12.
[180] Cl 14.
[181] Cl 13.
[182] Cl 22.
[183] Cl 142.
[184] Cl 143.
[185] Cl 152.

an attack on the CBK's functions,[186] it is submitted that the new agencies proposed under the two Draft Bills, could enhance Kenya's financial conglomerate supervisory structure and make it more effective.[187] However, as at the time of concluding this study, the Draft Bills have neither been introduced in parliament nor has a public statement been offered as to their official status.

3.2.6 Factors influencing the implementation of financial reforms in Kenya

An analysis of the factors that have significantly influenced the implementation of international financial standards in Kenya,[188] arguably leads to the conclusion that its bank regulatory framework has been influenced by public choice, special interest group and bureaucratic factors.[189] Particularly, special interest group factors influenced the enactment of provisions in the Banking Act, 1968 that favoured locally incorporated financial institutions, as well as the provisions permitting the Minister of Finance to exempt institutions from provisions of the Act.[190] Similar incidences are the introduction of universal banking in 1994[191] without a legal framework to address the resulting increase in risk-taking and the risk it caused to the DPFB by using loans granted by the DPFB to cross-finance non-bank activities.[192] It further appears that whenever special interest group factors have influenced financial reforms in Kenya, bank risk-taking has increased - leading to a banking crisis.[193]

In contrast, public choice factors have influenced the reforms to the Banking Act, 1968 that sought to punish insider trading and to strengthen the regulation of financial conglomerates through the *Risk Based Supervisory Framework*, *Guidelines on Non-Operating Holding Companies* and *Guidelines on Incidental Business* and *Guidelines*

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[186] See O Guguyu and P Olusula, 'Why Central Bank reads mischief in Treasury move to control lending', *The Standard* 3.7.2018 1 available at <https://www.Standardmedia.co.ke/business/article/2001282668/why-centralbank-reads.mischief.in-treasury-s-move-to-control-lending> accessed on .7.1.2019. The main complaint of the Governor of the CBK is that the drafting of the Bill was kept secret from the CBK, which only learned about it when it was posted on the Treasury's website for public comments.
[187] See Group of Thirty, *The structure of financial supervision: Approaches and challenges in the global market place*, (2008) 24.
[188] See Upadhyaya 22–23.
[189] Ch 2 para 2.5.2.2 and 2.5.2.3.
[190] Par 3.2.3.1 above.
[191] Par 3.2.4.1 above.
[192] Par 3.2.4.2 above.
[193] Para 3.2.2.2 and 3.2.3.2 above.

on Prompt Corrective Actions.[194] Consequently, regulatory reforms that have been influenced by public choice factors have tended to limit bank risk-taking and address moral hazard.[195] Since Kenya's current regulatory framework for conglomerates is spread over the Banking Act and several CBK guidelines, its effectiveness in addressing systemic risk could be enhanced through the macroprudential measures proposed in the Draft Financial Services Authority Bill 2016 and the Draft Financial Market Conduct Authority Bill 2018.[196] Accordingly, the CBK's opposition to the enactment of the Draft Financial Market Conduct Authority Bill, which opposition is arguably driven by bureaucratic preference factors, requires to be reconciled with the public interest of protecting Kenya's financial stability.[197]

3.3 Regulation of financial conglomerates in South Africa

3.3.1 Historical context of bank regulation in South Africa

3.3.1.1 General overview

South Africa has attracted large scale foreign direct investment and an experienced pool of corporate and public managers since the late nineteenth century when gold and diamonds were discovered. These developments raised its bureaucratic expertise to levels of an advanced capitalist state.[198]

The development of banking in South Africa is linked to the development of commercial and industrial concerns that followed the discovery of gold and diamonds as aforesaid.[199] Thus, South African banks have evolved to spearhead a strong banking and financial services sector that has expanded to other countries in the region.[200] The evolution of South African banking has been driven by the divestment by some foreign financial institutions from the country in the period before the new

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194 Par 3.2.5.2 above.
195 Para 3.2.4.3, 3.2.5.2, 3.2.5.3 and 3.2.5.4 above.
196 Par 3.2.5.4 above.
197 *Ibid.*
198 I Currie & J de Waal, *The new constitutional and administrative law,*(2001) 43.
199 See S Woolman & J Swanepoel, 'Constitutional history', in S Woolman & M Bishop (eds), *Constitutional law of South Africa*, (2013) 9-9.
200 IMF, *Country report,South Africa: Financial Sector assessment program - Detailed assessment of compliance on Basel Core principles for effective banking supervision* (hereafter *Country report*), (2015) 11 available at <http://imf.org/external/pubs/ft/scr/2015/cr1555.pdf>accessed on 10.12.2018. See also IMF, *Pan African banks: Opportunities and challenges for cross-border oversight*, (2015) 15.

constitutional dispensation took effect in 1994.[201] This led the remaining banks to consolidate into fewer and stronger banks that created a concentrated banking sector which strengthened the stability of its financial system.[202] Accordingly, Van Wyk remarks that over the years the Government of South Africa has designed a robust bank regulatory enforcement framework to maintain the safety and soundness of financial institutions that seeks to protect consumers, sustain public confidence, and maintain the stability of the financial system.[203]

3.3.1.2 Regulatory structure

South Africa introduced formal bank regulation in 1921 under the Currency and Banking Act, 31 of 1920 that established the South African Reserve Bank as the country's central bank.[204] In 1942, the Banking Act 38 of 1942 was enacted as a framework for bank regulation in South Africa[205] and subsequently amended [206] until it was consolidated with the Building Societies Act 82 of 1986 and repealed in 1990 by the Deposit Taking Institutions Act 1990 that was later renamed the Banks Act 94 of 1990.[207] Prior to the move to a Twin Peaks model in 2017, South Africa carried out its financial supervision using the sectoral regulatory approach that designated different functional supervisors for the various financial sectors.[208] Thus, the Registrar of Banks, who was also the Director of the Banking Supervision Department in the South African Reserve Bank (SARB),[209] regulated banks under the Banks Act 94 of

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[201] See Constitution of the Republic of South Africa, 1996. The Constitution of South Africa 1996 was preceded by the Interim Constitution 1994. See Woolman & Swanepoel 2-15 to 2-32.

[202] CO Okeahalam, 'The political economy of bank failure and supervision in the Republic of South Africa', (1998) *African Journal of Political Science* 31.

[203] K Van Wyk, 'Regulation of the financial markets,' in K Van Wyk, Z Botha & I Goodspeed (eds), *Understanding South African financial markets*, (2016) 109.

[204] See South African Reserve Bank, *Commemorative publication,* (2011) 3-4.The Currency and Banking Act 31 of 1920 was replaced by the South African Reserve Bank Act 29 of 1944, which was replaced by the South African Reserve Bank Act 90 of 1989 that is currently in operational as amended from time to time. See also JJ De Jager, 'The South African Reserve Bank: Blowing winds of change', (2013) *SA Merc LJ* 342 and S Mollentze, 'The South African Reserve Bank', in K Van Wyk, Z Botha & I Goodspeed (eds),*Understanding South African financial markets*, (2016) 37.

[205] See the Banking Act 38 of 1942. See also J Moorcroft, *Banking law and practice,* (2006) par 1-3.

[206] See Banking Amendment Act 25 1947, Banking Amendment Act 41 of 1951 and Banks Act 23 of 1965.

[207] Moorcroft (2009) 2-1.

[208] A Godwin, T Howse & I Ramsay, 'Twin Peaks: South Africa's financial sector regulatory framework', (2017) *South African Law Journal* 665.

[209] S 3 of the Banks Act 94 of 1990.

1990.[210] Other non-bank financial institutions were regulated by the Financial Services Board.[211] This approach was changed upon the introduction of the Twin Peaks model of regulation under the Financial Sector Regulation Act 9 of 2017.[212] The Financial Sector Regulation Act explicitly assigns the financial stability function to the SARB, assisted by the two peaks responsible for prudential and market conduct regulation and supervision respectively.[213]

3.3.1.3 Twin Peaks model of financial regulation in South Africa

In designing the Twin Peaks model of financial regulation for South Africa,[214] the government took account of the local banking structure. Such structure resembles a "highly interconnected" and concentrated financial sector, with a small number of large financial groups combining "at least a bank and an insurance company."[215] Under the previous sectoral regulatory model,[216] functional regulators supervised the safety and soundness of the banking, insurance, pensions, securities and other financial

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[210] The Banks Act was first enacted and assented to as the Deposit-taking Institutions Act 94 of 1990. See Moorcroft 2-1. See also P Hawkins and C Torr, 'Banks', in K Van Wyk, Z Botha &I Goodspeed (eds),*Understanding South African financial markets*, 70.

[211] Under the Financial Services Board Act 97 of 1990.

[212] The Financial Sector Regulation Act 9 of 2017 substituted the Registrar of Banks with the Prudential Authority under par 15 of Sch Four issued under s 290.

[213] S 11 of the Financial Services Regulation Act 9 of 2017.

[214] Before implementing the Twin Peaks model, South Africa followed an elaborate consultative process that involved various discussion papers published for public comment. See The National Treasury of the Republic of South Africa, *A safer financial sector to serve South Africa better,*(2011) available at<https://treasury.go.za> accessed 16.5.2016; National Treasury, Discussion paper on *Implementing a Twin Peaks model of financial regulation in South Africa,*(2013) available at <www.treasury.gov.za/twinpeaks/20131211%20-%20Item%203%Roadmap.pdf> accessed on 16.5.2016; The National Treasury Republic of South Africa,*Twin Peaks in South Africa: Response and explanatory document accompanying the second draft of the Financial Sector Regulation Bill,* (2014)also available at <https://treasury.go.za> accessed on 7.6.2017; The National Treasury Republic of South Africa, *Strengthening South Africa's resolution framework for financial institutions*, (2015) also available at <https://treasury.go.za> accessed on 7.·6.2017. Subsequently, it has published the National Treasury Republic of South Africa, *Final Twin Peaks policy, a known and trusted ombud system for all: Consultation policy document,* (2017) available at <https://treasury.go.za> accessed on 4.4.2018. See MG Van Niekerk, *The role of the central bank in promoting and maintaining financial stability in South Africa – A comparative analysis*(Unpublished University of Pretoria LLD thesis 2018) 100–154 for a discussion of the South African Twin Peaks model. See further CM Van Heerden and MG Van Niekerk, 'Twin Peaks in South Africa: A new role for the central bank', (2018) *Law and Financial Markets Review* 1.

[215] A Schmulow, 'Financial regulatory convergence in South Africa: The move towards Twin Peaks', (2017) *African Journal of International and Comparative Law* 393. See also A Godwin, S Kourabas & I Ramsay, 'Twin Peaks and financial regulation: The challenges of increasing regulatory overlap and expanding responsibilities', (2016) *The International Lawyer* 273. For a comparison of Twin Peaks structures in Australia and the Netherlands, see Group of Thirty, *The structure of financial supervision: Approaches and challenges in the global market,* 185–204.

[216] See also National Treasury, *Twin Peaks in South Africa: Response and explanatory document accompanying the second draft of the Financial Sector Regulation Bill*, (2014) 6.

institutions that they were responsible for, in silos.[217] The Financial Sector Regulation Act was subsequently enacted in 2017 as the first step in the implementation of the Twin Peaks regulatory model. It provides a framework, *inter alia*, for the holistic regulation and supervision of financial conglomerates.[218] As such the Financial Sector Regulation Act designates the Prudential Authority as the prudential regulator of financial institutions,[219] and the Financial Sector Conduct Authority as supervisor for market conduct of financial institutions.[220]

The Prudential Authority *inter alia* enforces the Banks Act that specifically regulates banks and banking groups.[221] To establish a more holistic supervision of group-wide activities across the financial affiliates within financial conglomerates, a Draft Discussion Document has recently been published for public participation.[222]

3.3.2 South Africa's regulation of financial conglomerates

3.3.2.1 Microprudential regulation in South Africa

As alluded to in Chapter Two,[223] South Africa is a member of the *Basel Committee on Banking Supervision*,[224] which entitles it to directly participate in the development of the international financial standards.[225] As the Basel Committee encourages members to implement its agreed standards, South Africa has consistently implemented the *Basel I Accord, Basel II Accord* and *Basel III Accord* through the Banks Act[226] and now also through the Financial Sector Regulation Act.[227] Indeed, South Africa was the only Sub-Saharan African country to have implemented the *Basel II* and *III Accords* by 2015.[228] South Africa currently prescribes the regulatory powers of bank supervisors

[217] See E Botha & D Makina, 'Financial regulation and supervision: Theory and practice in South Africa', (2011) *International Business and Economics Research Journal* 31–32. See also H Falkena, R Bamber, D Llewellyn & T Store, *Financial regulation in South Africa* (2001) for a general discussion of pre-GFC financial regulation in South Africa.
[218] S 29 of the Financial Sector Regulation Act.
[219] S 33 of the Financial Sector Regulation Act.
[220] S 57(a) of the Financial Sector Regulation Act.
[221] Moorcroft 5-1.
[222] South African Reserve Bank, Prudential Authority, *Draft discussion document: Financial conglomerate supervisory framework,* (2018) 10 available at <http://www.rebank.cp.za> accessed on 22.7.2018.
[223] See ch 2 par 2.1.
[224] See Basel Committee's website available at <http://www.bis/-org/bcbs> accessed on 19.8.2018.
[225] See ch 2 par 2.5 on implementation of international financial standards.
[226] See the Banks Act.
[227] See the Financial Sector Regulation Act.
[228] See IMF, *Pan African banks: Opportunities and challenges for cross-border oversight*, (2015) 15.

over banks and banking groups in the Banks Act and the Financial Sector Regulation Act.[229]

Under the Bank's Act, South Africa adopts the *Basel Core Principles* setting the licensing criteria on ownership structures[230] and the professional suitability for bank management and board members[231] in line with *Basel Core principle* 5. In addition, by prescribing regulatory approval for transfer of significant ownership,[232] the Banks Act complies with *Basel Core principle 6*, and by prescribing regulatory approval for major acquisitions, and investments by banks, including their corporate affiliations and structures[233] the Act complies with *Basel Core principle 7*.[234]

The Banks Act provides a robust bank regulatory framework which prescribes a three stage approval procedure for authorisation of companies to establish a banking business.[235] If the authorisation to establish a bank is granted, the institution must further apply for registration as a bank within twelve months from the date of such authorisation.[236] Thus, Moorcroft remarks that the banking registration procedure enhances the vetting for suitability of companies that seek to enter the banking business even before they apply for registration as banks.[237] The procedure also promotes dispersed shareholding in banks by requiring potential banks to be public companies, which prevents concentrated shareholding and limits the power of a few

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According to the IMF, while South Africa had implemented both *Basel II* and *Basel III* standards and has implemented more than 80 per cent of the *Basel Core principles*, Kenya (a non-member of the Basel Committee) had implemented parts of the *Basel II* and *Basel III* standards and had implemented between 50 per cent and 80 per cent of the *Basel Core principles* as at 2015. See also FA Akinola, *Implication of financial crises, financial regulation and business cycles for bank lending in South Africa*, (Unpublished University of Stellenbosch D. Phil Thesis 2016) 97. The author argues that having implemented *Basel II* as at 1.1.2008, and the *Basel III* Accord as at 1.1.2013, South Africa became the only country in Sub-Saharan Africa to have implemented the Basel reforms. See also SARB, *Financial review report,*(2008) 18 for the *Basel II* implementation date and SARB BSD *Annual report,* (2014)20 for implementation of *Basel III*.

[229] Banks Act 94 of 1990 and the Financial Sector Regulation Act. See also the *Basel Core principle* 1 that requires jurisdictions to prescribe regulatory powers over banks and banking groups in legislation.

[230] S 37of the Banks Act.

[231] S 60of the Banks Act.

[232] S 54of the Banks Act.

[233] *Ibid*.

[234] In line with *Basel Core principle* 7.

[235] Thus, under s 15 of the Banks Act, the Companies and Intellectual Property Commission is required to register a public company formed to conduct banking business only after the Prudential Authority grants its written approval. An institution so registered must further apply under s 12 for authority to establish a bank, which application may be approved if it *inter alia* serves the public interest.

[236] S 16(1) of the Banks Act.

[237] See Moorcroft par 3-1.

shareholders to determine the bank's risk-taking.[238] The Banks Act further requires the Minister of Finance or the Prudential Authority[239] to approve any acquisition of ownership of more than fifteen per cent of the shares of a bank or its controlling company.[240] Consequently, the Minister of Finance or the Prudential Authority may apply to the High Court for any bank shareholding that exceeds fifteen per cent to be reduced to a lower level, if the higher shareholding is deemed to be detrimental to the interests of the bank.[241]

3.3.2.2 Control of bank subsidiaries and mergers

To bring the operations of financial conglomerates within supervisory surveillance and limit conglomerates from using their banking affiliates' deposits to cross-finance non-bank activities,[242] the Banks Act requires the Prudential Authority[243] to approve a bank's establishment or acquisition of subsidiaries,[244] or investment of more than five per cent of its capital in a joint venture.[245] In addition, the Minister of Finance should approve any compromise, amalgamation, merger or acquisition of a bank,[246] and any transfer of more than twenty five per cent of a bank's assets or liabilities to another bank.[247] Approval may only be granted if it is considered beneficial to the public interest.[248] Abank whose merger with another entity has been approved may be directed to divest from any divergent activities that are undesirable to the business of banking.[249]

238 *Nuwe SA Prinsipale Beleggings (Edms) Bpk v Saambou Holdings Ltd* 1992 (4) SA 696 (W).
239 S 37(2) of the Banks Act.
240 S 37(1) of the Banks Act.
241 S 37(5)(I) of the Banks Act.
242 See E Swanepoel, J Esterhuysen, GW van Vuuren & R Lotriet, 'Banking competition and misconduct: How dire economic conditions affect banking behavior', (2016) *Banks and Bank Systems* 31. See also Financial Stability Board, *Reducing the moral hazard from systemically important financial institutions: FSB recommendations and timelines,* (2010).
243 S 52(1)(d)of the Banks Act.
244 S 52(1)(a) of the Banks Act.
245 S 52(1)(aA) of the Banks Act. The Prudential Authority further monitors bank interests in subsidiaries, trusts and other undertakings by requiring them to file particulars of such undertakings. S 53 of the Banks Act. See also Taylor and Smits 12.
246 S 54(1)(a) of the Banks Act.
247 S 54(1)(b)of the Banks Act.
248 S 54(2)of the Banks Act.
249 S 57(1) of the Banks Act. If the bank fails to give effect to the directives, the Prudential Authority may submit a copy of such order to the Commissioner of Companies who must effect such alteration of the Memorandum of Association as if it was a special resolution submitted by the bank under s 57(3) of the Banks Act.

3.3.2.3 Bank controlling companies

Financial conglomerates are defined as "banking groups that consist of two or more persons, engaged in financial activities, at least one of which is a bank,"[250] or consist of entities that are "so interconnected to the others that financial difficulties in one are likely to affect one or all of the other associate companies in the group"[251] Thus, the holding company of the financial conglomerate is the bank's controlling company, while the subsidiaries of the financial conglomerate are associates of each other, including the bank.[252] Since the holding company controls the activities of its subsidiaries, it could potentially transfer depositor funds from the bank for investment in the other non-bank subsidiaries and thereby create a moral hazard that may threaten depositors' funds.[253] To address this concern, the Banks Act limits investments by bank controlling holding companies,[254] or advancement of credit to undertakings other than banks or in fixed property, to a prescribed percentage of their consolidated share capital.[255] In addition, the Act requires controlling companies to prepare consolidated financial statements of their accounts to facilitate the monitoring of the use of depositor funds on risky investments by bank holding companies.[256]

3.3.2.4 Capital adequacy for financial conglomerates

The importance of capital adequacy and asset risk management to the safety of banks,[257] is recognised by the *Basel II Accord.*[258] However, questions have been raised as to whether the same capital adequacy standards that apply in industrialised countries should be applied in emerging markets.[259] Thus, it has been argued that,

[250] S 1(a) of the Banks Act.
[251] S 1(b) of the Banks Act. Compare with s 160 of the Financial Sector Regulation Act that defines a financial conglomerate as a group of companies that includes both a financial institution and a holding company of a financial institution but need not include all members of the group of companies.
[252] See P Delport, Q Vorster, D Burdette, IM Esser & S Lombard, *Henochsberg on the Companies Act No 271 of 2008,* (2011) par 30:4.
[253] See IMF, *Country report*, 196. The IMF rated South Africa's bank regulatory standards for the corporate governance and risk management as strong. However, it recommended the strengthening of the provisions on supervision of risks from non-bank activities or parent entities of financial groups, particularly those that are not controlled by bank holding companies. IMF, *Country report*, 55.
[254] S 50(1) of the Banks Act.
[255] S 51(2) of the Banks Act.
[256] *Ibid.*
[257] See LM Hooks, *Capital, asset risk and bank failure*, (1994) Group of Thirty Occasional paper 5.
[258] *Basel II Accord* 7.
[259] See J Jacobs & GW van Vuuren, 'The role of cost of capital in regulatory capital discrepancies among developing countries', (2015) *South African Journal of Economic and Management Sciences* 100.

while higher capital adequacy requirements may enhance the resilience of banks to financial distress, the cost of capital is higher in developing countries than in the industrialised countries and therefore developing countries should be permitted to adopt lower capital standards.[260] Indeed, Jacobs and Van Vuuren argue that developing countries should be permitted to adopt only those aspects of the international financial standards that are applicable in their contexts.[261] In adapting the *Basel II Accord* to the South African context,[262] the Banks Act limits the moral hazard from financial conglomerates by requiring them to keep appropriate equity capital and unimpaired reserve funds to match their different asset categories and risk exposures.[263]

To address the lack of liquidity that follows cyclical increases and contractions in economic growth,[264] South Africa has further introducedcapital conservation and counter-cyclical capital buffers,[265] in accordance with the *Basel III Accord*.[266] These buffers seek to prevent the counter-cyclical behaviour of market participants to irrationally become collectively optimistic during market boom cycles or pessimistic during low economic cycles.[267] Thus, South Africa requires its banks to keep capital buffers that are to be retained as capital reserves during boom cycles[268] in order to strengthen the capacity of banks to absorb the shocks and losses that follow excessive credit growth.[269] By requiring banks to keep capital conservation buffers and counter-

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[260] See also J Jacobs & GW van Vuuren, 'Is regulatory capital a legitimate, comparable and objective global standard? Evidence from 51 institutions across 17 countries', (2014) *South African Journal of Economic and Management Sciences* 277. It is noted that the international standard setting bodies permit adaptation of the standards to local contexts. See ch 2 par 2.5.
[261] *Ibid*.
[262] J Esterhuysen, GW van Vuuren & P Styger, 'The effect of stressed conditions on credit risk in Basel II', (2011) *South African Journal of Economic and Management Sciences* 135.
[263] S 70(1)(a) of the Banks Act.
[264] See D Visser & GW van Vuuren, 'Procyclicality in tradeable credit risk: Consequences for South Africa', (2018) *South African Journal of Economic and Management Sciences* 8. The authors argue that for countercyclical capital buffers to be effectively implemented, regulators should cooperate with banks to determine the appropriate implementation parameters. See also J Bernstein, L Raputsoane & E Schaling, *Credit procyclicality and financial regulation*, (2014) Economic Research Southern Africa working paper 12. The authors argue that each country should determine the level of buffers to impose on their banks depending on their research as to the level of fluctuation between economic cycles. See also ch 1 par 1.2.5 for capital adequacy assessment methodologies.
[265] See F Liebenberg, GW van Vuuren & A Heymans, 'Contingent convertible bonds as countercyclical capital measures', (2017) *South African Journal of Economic and Management Sciences* 3.
[266] See GW Van Vuuren, 'Basel III countercyclical capital rules: Implications for South Africa', (2012) *South African Journal of Economic and Management Sciences* 321.
[267] Ch 2 par 2.2.
[268] Reg 38(8)(e)(iv) of the Regulations Relating to Banks, 2012.
[269] See Akinola 18.

cyclical capital buffers, South Africa provides an extra cushion on the minimum capital requirements that enhances the resilience of its banks in volatile times.[270] According to Liebenberg, Van Vuuren, and Heymans, the introduction of convertible corporate bonds (CoCo bonds) in South Africa will strengthen its capital buffers framework for loss absorption mechanisms during times of economic contraction.[271]

Financial conglomerates in South Africa are also required to maintain group-wide capital and reserve funds similar to those required of financial conglomerates' affiliated entities by their functional regulators.[272] In addition, banking groups are required to meet the same risk-based capital and unimpaired reserve requirements on a group-wide basis as those required of banks that do not belong to a banking group.[273] Thus, by assessing capital adequacy requirements on financial conglomerates on a group-wide basis, the Prudential Authority requires them to set aside sufficient capital commensurate to their risk profile in order to meet potential losses.[274]

3.3.3 Macro-prudential regulation of financial conglomerates

3.3.3.1 Designation of SIFIs

South Africa enforces macroprudential regulation through the designation of SIFIs and regulation of financial conglomerates under the Banks Act and the Financial Sector Regulation Act.[275] Under the Financial Sector Regulation Act the systemic risks from financial conglomerates is addressed by authorising the Governor of the SARB to designate any financial institution as a SIFI[276] upon consultation with the Financial Stability Oversight Committee.[277] In making the designation, the Governor is guided by, *inter alia*, the institution's size, level of interconnectedness and complexity of its affairs and complexity and substitutability of its products.[278] Once designated as a SIFI

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[270] See P Burra, PJ de Jongh, H Raubenheimer, GW van Vuuren & H Wiid, 'Implementing the countercyclical capital buffers in South Africa: Practical considerations', (2014) *South African Journal of Economic and Management Sciences* 2.
[271] See Liebenberg *et al* 5.
[272] S 70(1)(b) of the Banks Act.
[273] *Ibid.*
[274] See Van Wyk 113.
[275] See generally GM Foggitt, A Heymans, GW van Vuuren & A Pretorius, 'Measuring systemic risk in the South African banking sector', (2017) *South African Journal of Economic and Management Sciences.*
[276] S 29(1) of the Financial Sector Regulation Act.
[277] S 29(3)(c) of the Financial Sector Regulation Act.
[278] S 29(3) of the Financial Sector Regulation Act.

the institution must meet prescribed prudential standards on solvency and capital requirements,[279] leverage ratios,[280] organisational structures,[281] risk management[282] and recovery and resolution planning.[283]

3.3.3.2 Designation and regulation of financial conglomerates

The Prudential Authority may designate members of a group of companies as a financial conglomerate,[284] if the structure of the group impedes the effective supervision of eligible financial institutions within it.[285] While any financial institution that becomes a member of a financial conglomerates must notify the Prudential Authority of such membership within thirty days,[286] the Prudential Authority may use any other information in its possession to direct financial conglomerate holding companies to be licensed,[287] Similarly, a holding company of a financial conglomerate may be directed to become a non-operating holding company,[288] to facilitate the effective management of the risks its members pose to its banking affiliate.[289] The Prudential Authority may also set prudential standards for holding companies of financial conglomerates.[290] Consequently, the Prudential Authority may direct the holding company to reduce risks from its affiliated companies,[291] or to adopt governance and management arrangements for its subsidiaries that reduce risk,[292] or to restructure to facilitate more effective management or mitigation of such risk.[293] Any members of a financial conglomerate that continue to pose risks to the safety of banking affiliates within the conglomerate may also be restructured to eliminate any

[279] S 30(1)(a) of the Financial Sector Regulation Act.
[280] S 30(1)(b) of the Financial Sector Regulation Act.
[281] S 30(1)(c) of the Financial Sector Regulation Act.
[282] S 30(1)(d) of the Financial Sector Regulation Act.
[283] S 30(1)(g) of the Financial Sector Regulation Act.
[284] S 160(1) of the Financial Sector Regulation Act.
[285] S 160(6) of the Financial Sector Regulation Act.
[286] S 161of the Financial Sector Regulation Act.
[287] S 162(1)(a) of the Financial Sector Regulation Act.
[288] S 163(1)(a) of the Financial Sector Regulation Act.
[289] S 163(2) of the Financial Sector Regulation Act.
[290] S 164(1) of the Financial Sector Regulation Act.
[291] S 164(2)(a) of the Financial Sector Regulation Act.
[292] S 164(2)(b) of the Financial Sector Regulation Act.
[293] S 165(2) of the Financial Sector Regulation Act. However, restructuring may only be directed after due process and if it is the most appropriate remedy to solve the problems of the financial conglomerate.

features that hinder their effective supervision.[294] In addition, financial conglomerates may only acquire or dispose of material assets with regulatory approval.[295]

3.3.3.3 Regulatory enforcement

As indicated above,[296] the Financial Sector Regulation Act affords the SARB an express mandate for financial system stability.[297] The Act mandates both the Prudential Authority and the Financial Sector Conduct Authority to assist the SARB in the monitoring, identification and management of systemic risks to the financial system[298] and in restoring financial stability after the occurrence of systemic events.[299] The Financial Sector Regulation Act further establishes a robust regulatory enforcement framework for institutions or their officers that contravene conditions of their licence, a financial sector law, a regulatory standard, directive or enforceable undertaking, or a court order pursuant to a financial sector law.[300]

The enforcement actions that may be taken include criminal sanctions,[301] written undertakings,[302] suspension of a licence[303] or revocation of the entity's licence.[304] In addition, the Prudential Authority may direct financial institutions or their employees to desist from any unsound action that may impede the institution's non-compliance with the law.[305] Similarly, a holding company of a financial conglomerate or its affiliated financial institution may be directed to desist from any actions that threaten to contravene the law.[306] A financial sector regulator may enforce financial regulations through proceedings in the High Court[307] and may only exempt an institution from the

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[294] S 165 of the Financial Sector Regulation Act.
[295] S 166(1)(a) of the Financial Sector Regulation Act. Approval may be declined under s 166(2) of the Financial Sector Regulation Act if the acquisition or disposal may threaten the safety or soundness of a financial institution within the financial conglomerate, or impede the regulator's ability to determine the financial conglomerate's business services, or risks, or its governance structure and management framework.
[296] Par 3.2.1.2 above.
[297] S 11 of the Financial Sector Regulation Act.
[298] S 26 of the Financial Sector Regulation Act.
[299] S 11(1)(b) of the Financial Sector Regulation Act.
[300] S 120 of the Financial Sector Regulation Act.
[301] Ss 265 and 267 of the Financial Sector Regulation Act.
[302] S 151 of the Financial Sector Regulation Act. Written undertakings entail commitments by the institution to comply with the Prudential Authority's directives on compliance with financial laws.
[303] S 120 of the Financial Sector Regulation Act.
[304] S 121 of the Financial Sector Regulation Act.
[305] S 143(1) of the Financial Sector Regulation Act.
[306] S 143(2)(a). The Prudential Authority may also compel financial conglomerates or their subsidiaries that fail to comply with an enforceable undertaking, or contravene a financial sector law, or commit a financial crime to remedy the non-compliance.
[307] S 152 of the Financial Sector Regulation Act.

provisions of a financial sector law if it is in the public interest and facilitates the achievement of the objects of the Financial Sector Regulation Act.[308] The SARB also imposes the duty on banks' boards of directors and management to develop effective risk management strategies,[309] establish risk and capital management committees[310] and evaluate and mitigate the risks to the bank or its controlling company.[311]

The bank boards are further required to employ compliance officers to ensure compliance with banking laws and regulations.[312] In addition, the Prudential Authority prescribes standards for the governance and management structures of bank controlling holding companies and their subsidiaries.[313] The standards require bank controlling holding companies to file information on their non-financial companies,[314] and to monitor, reduce and manage risks that their subsidiaries pose to the safety of their banking affiliates.[315] These measures thus establish a robust financial conglomerate regulatory framework in South Africa that limits financial conglomerate risk-taking through risk-based capital requirements,[316] capital conservation and capital counter-cyclical buffers,[317] and the designation, licensing and consolidated supervision of financial conglomerates.[318]

As observed above[319] the South African Reserve Bank and the Prudential Authority have recently published a Draft Discussion Document[320] that outlines the proposed regulatory and supervisory approach the Prudential Authority will adopt in the regulation and supervision of financial conglomerates.[321] The Draft Discussion Document outlines the framework to guide the Prudential Authority in the implementation of the foregoing provisions of the Banks Act, 94 of 1990 and the

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308 S 281 of the Financial Sector Regulation Act.
309 See SARB, FSD, *Designing a deposit insurance scheme for South Africa- a discussion paper* (2017) 2.
310 S 64A(2)(a) of the Banks Act.
311 S 64A(2)(c) of the Banks Act.
312 S 60(1B) of the Banks Act.
313 S 164(2)(b) of the Financial Sector Regulation Act.
314 S 164(2)(c) of the Financial Sector Regulation Act.
315 S 164(2)(d) of the Financial Sector Regulation Act.
316 S 70(2)(b) of the Banks Act.
317 Reg 38(s) of the Regulations Relating to Banks, 2012.
318 See s 162 of the Financial Sector Regulation Act.
319 Par 3.3.1.3 above.
320 South African Reserve Bank, Prudential Authority, *Draft discussion document: Financial conglomerate supervisory framework,* (2018)10.
321 *Idem* 5.

Financial Sector Regulation Act, 9 of 2017,[322] as well as provisions of the *Joint Forum Principles*.[323] Consequently, the Draft Discussion Document sets out the scope of supervision for financial conglomerates to include groups designated as financial conglomerates by the Prudential Authority, holding companies of financial conglomerates and unregulated entities that are members of financial conglomerates.[324]

The Draft Discussion Document further outlines the framework for its assessment and approval of shareholders of financial conglomerates,[325] and approval or rejection of acquisitions or establishment of financial conglomerates.[326] In addition, the Document provides for the approach the Prudential Authority will adopt in assessing group-wide capital requirements for financial conglomerates,[327] and for the control of leverage,[328] concentration risk,[329] contagion risk[330] and liquidity risk.[331] Overall, the Draft Discussion Document provides the guiding principles for the Prudential Authority's enforcement of the financial conglomerate regulation and supervision in South Africa.

3.3.4 Factors influencing implementation of financial reforms in South Africa

South Africa's financial regulatory reforms have mainly been influenced by public choice factors. Thus, South Africa has a strong public participation framework that guides its development of financial regulation as was evidenced in the process to enact the Twin Peaks regulatory model through the Financial Sector Regulation Act.[332] In addition, public interest factors influence its enforcement of the Banks Act and Financial Sector Regulation Act, as is evidenced by the requirements that any approval for banking licences, or bank mergers, or other bank related activities be considered *inter alia* on the basis of the public interest they serve.[333] South Africa's

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[322] *Idem* 8.
[323] *Idem* 13.
[324] *Ibid.*
[325] *Ibid.*
[326] *Idem* 16.
[327] *Idem* 17.
[328] *Idem* 22.
[329] *Ibid.*
[330] *Idem* 28.
[331] *Idem* 29.
[332] Par 3.2.1.3 above.
[333] Para 3.3.2 and 3.3.3 above.

focus on the public interest has therefore led to a robust bank regulatory framework that successfully protected its banks from the serious effects of the GFC.[334]

3.4 Regulation of financial conglomerates in the United States of America

3.4.1 Introduction

As indicated in Chapter One,[335] the United States of America (USA) adopts a dual structure of bank regulation at the national or federal and the state regulatory levels.[336] While banking and the securities business are regulated at the federal and state levels,[337] the insurance business is regulated at state level only.[338] Bank regulation at the federal level is conducted by the US Comptroller of the Currency for national banks[339] and the Federal Reserve Board[340] for bank holding companies[341] and financial holding companies.[342] The Federal Reserve Board must also approve any non-bank activities to be undertaken by bank holding companies and enforce

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[334] Par 3.2.1.1 above.

[335] Ch 1 par 1.2.5.3.

[336] See DR Fischel, AM Rosenfield & RS Stillman, 'The regulation of banks and bank holding companies', (1987) *Virginia Law Review* 335. See also GP Miller, 'The future of the dual banking system', (1987) *Brooklyn Law Review* 782.

[337] The US Securities and Exchange Commission (SEC) was established under the Securities Act 1933 to regulate securities, as well as bonds under the Trust Indenture Act 1939, and private equity firms under the Investment Company Act 1940. See also G Gensler, *Testimony before House Sub-Committee on Financial Institutions and Consumer Credit*, 21St July, 1999.

[338] Ch 1 par 1.2.5.3. See also SG Calabresi, 'The right to buy health insurance across state lines: Crony capitalism and the Supreme Court', (2013) *University of Cincinnati Law Review* 1447 for a discussion of the rationale for restricting *insurance* regulation in the USA to states. See RS Carnell, JR Macey & GP Miller, *The law of banking and financial institutions,* (2009) 439–442.

[339] The Office of Comptroller of the Currency was established within the US Treasury Department by the National Banks Act, 1864. See also Carnell *et al* 64.

[340] See the Federal Reserve Act, 1913. The USA had unsuccessfully tried to establish a national central bank twice. The first attempt was initiated in 1791 when Congress chartered the Bank of the United States that operated until 1811. In 1816, Congress granted a twenty year charter to the Second Bank of the United States that operated until 1836 when the charter lapsed and Congress declined to renew it. See Carnell *et al* 2–8. The Federal Reserve Act established a dispersed central banking structure referred to as the Federal Reserve System that comprises of the Federal Reserve Board of Governors and twelve Regional Federal Reserve Banks to overcome opposition to its establishment by states in the West and South for fear of being dominated by North eastern bankers. Thus, the Federal Reserve Board conducts its operations through the twelve regional Federal Reserve Banks that are spread across the United States and are owned by the commercial banks in the regions where they are situated. See WA Lovett, *Banking and financial institutions law,* (1988) 9-11. See also *McCulloch v Maryland* 17 US 4 (Wheat.) 36 (1819) in which the Supreme Court overruled the State of Maryland's attempt to tax and thereby limit the use of national currency notes issued by the Second Bank of the United States.

[341] See s 1842(a) of the Bank Holding Company Act, 1956 that authorises the Federal Reserve Board to supervise bank holding companies and their affiliated entity non-bank business.

[342] S 1483(l)(1) and (2) of the Gramm-Leach-Bliley Act prescribes the criteria for bank holding companies to qualify as a financial holding company.

prudential regulation on their non-bank subsidiaries, irrespective of the functional regulator of the non-banking subsidiary.[343]

In addition, the Federal Deposit Insurance Corporation (FDIC)is empowered to co-supervise all federally insured banks and bank holding companies to minimise the risks to its insurance fund.[344] While the National Credit Union Administration charters and supervises national credit unions and federally insured state credit unions,[345] the Office of Thrift Supervision regulates savings and loans associations, savings banks, and savings and loan holding companies that are not registered as bank holding companies.[346] State chartered banks that are neither members of the Federal Reserve System nor of the federal deposit insurance scheme, are regulated by their state chartering authorities.[347] While state chartered banks that elect to be members of the Federal Reserve System are supervised by the Federal Reserve Board,[348] those that are not members of the Federal Reserve System are supervised by the FDIC, if they opt to take out federal deposit insurance.[349]

As indicated in Chapter One,[350] the USA experienced the devastating effects of the GFC first-hand. In its response to the GFC,[351] the USA enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 that established the Consumer Financial Protection Bureau (CFPB), the Federal Housing Financing Agency (FHFA),

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[343] See s 1483(m) of the Gramm-Leach Bliley Act.

[344] S 38 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) 1991 that empowered the FDIC to inspect and take enforcement actions against insured institutions irrespective of their primary regulators, provided it first gives notice of the required enforcement action to the primary regulator.

[345] See the Federal Credit Unions Act 1934. Credit unions are credit cooperative societies formed by artisans, peasants and small business men that feel excluded from banks and join contributions to finance their mutual needs. See M Kohn, *Financial institutions and markets,* (1994) 316.

[346] See the Federal Home Loan Bank Act, 1932. See also DS Adams, RR Peck, & JW Spencer, 'FIRREA and the new federal home loan bank system', (1992) *Santa Clara Law Review* 17.

[347] State chartered banks may only volunteer to be members of the system because membership of the Federal Reserve System is mandatory only for national banks and bank holding companies. State chartered banks that do not elect to be members of the Federal Reserve System or to take federal deposit insurance are supervised by the chartering agencies. See Carnell *et al* 62.

[348] *Ibid.*

[349] See also L McDonald, *A colossal failure of common sense: The incredible inside story of the collapse of Lehman Brothers,* (2009) 6–7.

[350] Ch 1 par 1.2.6.

[351] See ch 1 par 1.2.6 for causes of the GFC that were traced to the complexity of US financial markets. Therefore, the Dodd-Frank Act is the most elaborate and detailed post-GFC financial regulatory statute that runs to over eight hundred pages and establishes over eleven agencies to implement it. See US Government Accounting Office, *Dodd-Frank: Eleven agencies' estimates of resources for implementing regulatory reform,* Testimony before the House of Representatives Sub-Committee on Oversight and Investigations, Committee on Financial Services, July 14, 2011.

Financial Stability Oversight Council (FSOC), the Office of Financial Research (OFR), and the Orderly Liquidation Authority (OLA), to implement the Act and enhance transparency in financial markets.[352]

3.4.2 Supervision of financial conglomerates in the USA

3.4.2.1 Overview of US financial regulatory structures

The combined offering of banking, insurance and securities services in the USA[353] had for a long time been adopted as an effective intermediation process of pooling savings from investors with surplus funds for lending at a profit.[354] This changed after the 1929 stock crash and the ensuing Great Depression, when investment bankers were blamed for having used bank deposits to speculate in the stock market and for extending bank loans to finance stock market speculation.[355] Thus, combinations between commercial banking and investment banking were blamed for increasing bank risk-taking that exposed depositor funds to loss.[356] In response, the Banking Act 1933 (through the Glass-Steagall provisions) prohibited national banks from engaging in investment banking business.[357] It has been argued that by separating 'commercial banks from the capital markets and by prohibiting non-banks from accepting deposits,' the Glass-Steagall Act stabilised the US banking system.[358]

As indicated above,[359] under the dual bank regulatory structure, the Glass-Steagall Act restrictions on commercial bank combinations with investment banking affected

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[352] See ST Omarova, *One step forward, two steps back: The institutional structure of US financial services regulation after the crisis of 2008*, (2014) Cornell Law School legal studies research paper series 1.

[353] See MJ Roe, 'Political roots of American corporate finance', (1997) *Journal of Applied Corporate Finance* 8-22. Compare with LD Brandeis, *Other people's money and how the bankers use it,* (1914) 3.

[354] EL Symons and JJ White, *Banking law: Teaching materials*, (1984) 32.

[355] For an account of the alleged abuses of investment bank combinations with commercial banks, see DU Fletcher, Chairman Senate Committee on Banking and Currency, *US Senate report on stock exchange practices,* (1934) 156–210.

[356] WF Shughart II, 'Public choice perspectives of the Banking Act, 1933', in C England and TF Huertas (eds), *The financial services revolution: Policy directions for the future,* (1988) 96.

[357] S 368 of the Glass-Steagall Act of 1933. See CW Lichtenstein, 'Lessons for 21st Century central bankers: Differences between investment and depository banking', in M Giovanoli & D Devos (eds), *International monetary and financial law,* (2010) 222, and K Scott, 'Deposit insurance and bank regulation: The policy choices', (1989) *Business Law Review* 272.

[358] See AE Wilmarth Jr, 'The road to repeal of the Glass-Steagall Act', (2017) *Wake Forest Journal of Business and Intellectual Property* 384.

[359] See par 3.4.1 above.

only national banks.[360] Thus, state chartered banks enjoyed a competitive advantage over national banks as they were able to continue their combinations with investment banking and insurance businesses.[361] This led national banks to establish bank holding companies that they used to charter or acquire state chartered banks as subsidiaries that could combine with investment banks and other non-bank businesses.[362] The dual banking structure also led to multiple banking and functional financial regulation that was prone to overlapping examinations and potentially inconsistent and conflicting enforcement measures.[363] The US Congress subsequently responded over the course of the years from 1956 to 1991, by enacting legislation to regulate bank holding companies,[364] establishing a uniform standard for financial institution examinations,[365] and streamlining enforcement actions against financial institutions that contravened banking laws and regulations.[366]

3.4.2.2 The regulation of bank holding companies

The establishment of bank holding companies increased the complexity and diversity of the corporate structures adopted by financial institutions to enable their operations and increased the activities that affiliated financial institutions within the group could engage in.[367] Accordingly, the US Congress enacted the Bank Holding Company Act, 1956 to regulate bank holding companies and designated the Federal Reserve Board as their regulator and supervisor.[368] The Act further required bank holding companies to apply to the Federal Reserve Board for approval before they commenced business, or before they acquired an additional bank, or ownership of more than five per cent of another bank or merged with another bank holding company.[369]

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[360] See SK Halpert, 'The separation of banking and commerce reconsidered', (1988) *Journal of Corporation Law* 484.
[361] See DC Langevoort, 'Statutory obsolescence and the judicial process: The revisionist role of the courts in Federal Banking Regulation', (1987) *Michigan Law Review* 676.
[362] For example, the Transamerica Corporation, a holding company that owned Bank of America, owned 46 banks in five states of the US, and non-banking subsidiaries in insurance, real estate, manufacturing and mining. See Carnell *et al* 22.
[363] *Idem* 332.
[364] Bank Holding Company Act. See also Langevoort 677.
[365] See the Financial Institutions Regulatory and Interest Rate Control Act, 1978.
[366] See the Financial Institution Reform and Recovery Enforcement Act, 1989 (FIRREA), and the FDICIA, 1991.
[367] See M Flood, DY Kennett, RL Lumsdaine & JK Simon, *The complexity of bank holding companies: A topological approach*, (2017) Office of financial research working paper11.
[368] See ST Omarova & ME Tahyar, 'That which we call a bank: Revisiting the history of bank holding company regulation in the United States', (2011–2012) *Review of Banking and Financial Law* 113.
[369] S 1842(a) of the Bank Holding Company Act.

The Bank Holding Company Act also restricted the activities that bank holding companies could engage in either directly or through non-bank subsidiaries, to activities that were so closely related to banking as to be incidental thereto.[370] In addition, the bank holding company's engagement in the incidental non-banking activity had to serve a public interest.[371] Thus, in the case of the *Board of Governors of the Federal Reserve System v First Lincolnwood Corp* the US Supreme Court upheld the Federal Reserve Board's denial of the respondent's application for a bank holding company charter because it had failed to demonstrate its capacity to be a "source of strength" to its subsidiaries and thus it was held that the respondent's activities were not in the public interest.[372]

The Federal Reserve Board may further conduct off-site examination of bank holding companies and their subsidiaries, by requiring them to submit reports regarding their financial conditions and the structures they have established to monitor and control financial and operational risks, including intra-firm transactions with banking subsidiaries.[373] In addition, the Federal Reserve Board may also conduct on-site examination of bank holding companies and their subsidiaries to "ascertain their operations and financial conditions; identify any financial and operational risks within the bank holding company that may threaten the safety and soundness of their depository subsidiaries, and to evaluate the systems for monitoring and controlling such risks."[374]

The International Lending Supervision Act, 1973 further empowered the Federal Reserve Board to prescribe consolidated capital requirements for bank holding companies.[375] In 1982, the Federal Reserve Act, 1913 was amended by introducing sections 23A and 23B that sought to limit intra-firm transactions within bank holding

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[370] S 1843(a)(2) of the Bank Holding Company Act.
[371] S 1843(J)(2)(A) of the Bank Holding Company Act.
[372] *Federal Reserve Board v First Lincolnwood Corp* 439 US 234 (1978). However, in the case of *MCorp Financial Inc. v Board of Governors of the Federal Reserve System* decided by the Federal Court of Appeals (900 Fd 852) (5th Cir. 1990), the court questioned the Federal Reserve Board's enforcement of the "source of strength" policy when it held that the Federal Reserve Board lacked authority to direct subsidiaries of bank holding companies that had a separate legal personality to transfer their shareholders' funds to another company without the shareholders' approval. However, the US Supreme Court vacated (set aside) the decision by upholding the Federal Reserve Board's authority to enforce the "source of strength" directive through its administrative proceedings. See *Board of Governors of the Federal Reserve System v MCorp Financial Inc* 111 S. Ct. 1101 (1991). See also Fischel *et al* 336.
[373] S 1844(c)(1)(A) of the Bank Holding Company Act.
[374] S 1844(c)(2)(A)of the Bank Holding Company Act.
[375] S 3902(1)(A) of the International Lending Supervision Act, 1973.

companies that threaten the safety and soundness of their banking affiliates.[376] In 1991, the Federal Reserve Board was empowered to direct bank holding companies to maintain capital adequacy for each holding company and its depository subsidiaries on a solo and consolidated group basis.[377] Accordingly, banks whose capital fell below prescribed levels could be directed to file a capital restoration plan that committed their parent holding companies to guarantee compliance through the sale of stock or assets.[378]

3.4.2.3 Uniform financial institution rating system

To facilitate more effective supervision of financial institutions and promote coordination and cooperation in their examination, the US Congress established the Financial Institutions Examination Council in 1978. This Council comprises the Comptroller of the Currency as the federal regulator for national banks, the Federal Reserve Board as the regulator for bank holding companies, the FDIC as deposit insurer of all national banks and insured state chartered banks, the National Credit Union Administration as the regulator for credit unions[379] and a State Liaison Committee to incorporate state depository institution regulators.[380]

The Financial Institutions Examination Council established the Uniform Financial Institutions Rating System, commonly referred to as the CAMELS rating system,[381] to guide federal regulators in the examination and rating of financial institutions.[382] Thus, banks are scored on the five indicators of: capital adequacy, asset quality,

[376] After the failure of the Hamilton National Bank in Chattanooga, Tennessee in 1976, attributed to its purchase of low quality mortgages from its parent holding company, the Federal Reserve Act was amended by introducing s 23A to prohibit banks from extending credit, giving guarantees or purchasing any assets from or investing in the securities of an affiliate that exceeds ten per cent of the bank's total assets or twenty per cent of the bank's capital. See also Carnell *et al* 427. Under s 23B of the Federal Reserve Act banks are required to transact with their affiliates at arms' length and are prohibited from being liable for any obligations of their affiliates.
[377] S 1831 of the FDICIA, 1991 that reinforced the Federal Reserve Board's consolidated capital requirements on bank holding companies.
[378] S 1811(e)(2) of the FDICIA authorised regulators to enforce bank holding company guarantees on banks that failed to recapitalise, by compelling the bank holding company to execute its guarantee by transferring capital to its failing bank subsidiary.
[379] See s 3301 of the Financial Institution Regulatory and Interest Rate Control Act, 1978.
[380] Carnell *et al* 632.
[381] As discussed above at par 3.2.5.1, Kenya has introduced a similar CAMELS rating system in its regulatory enforcement framework. CAMELS was developed in the USA to address the problem of its multiple regulatory agencies using different measures to rate the banks they supervised. See Carnell *et al* 632.
[382] See s 3305 of the Financial Institution Regulatory and Interest Rate Control Act, 1978.

management, earnings, liquidity and sensitivity to risk, (added in 1997) on a scale of 1 to 5, with 1 being the highest and 5 the lowest.[383] A composite rating of all the scores is compiled to obtain the overall standing of the bank and the risk it poses to the financial system.[384] While the use of the CAMELS rating system enhanced cooperation in the supervision of financial institutions and standardised their examinations among the multiple agencies, each of the regulatory agencies evaluated its findings in accordance with its own regulatory policies.[385]

3.4.2.4 Enhanced enforcement of financial laws

The major objective of bank supervision is to monitor the compliance levels of regulated institutions and sanction non-compliant institutions through appropriate enforcement actions.[386] As indicated in Chapter One,[387] governments regulate banks to preserve the special services that banks provide to the economy by sanctioning non-compliant banks through the chartering procedures, regulatory approval requirements[388] and other ordinary enforcement actions.[389] To enhance regulatory enforcement, the USA introduced cease and desist orders,[390] and civil monetary penalties.[391] In addition, as discussed in Chapter One,[392] the dual banking structure in the USA fostered regulatory forbearance[393] that led regulators to delay action in the

[383] See FDIC, *Manual of examination policies, basic examination concepts and guidelines*, (1983) par 1.1.
[384] *Ibid.*
[385] See FDIC, *History of the eighties: Lessons for the future,* (1997) 438. See also FDIC, *Deposit insurance in a changing environment*, (1983) Policy paper.
[386] Pan 266.
[387] Carnell *et al* 462.
[388] Approval requirements may be imposed for institutions that seek to open or close branches, hire certain officers, enter mergers or acquisitions, enter a market for new products, or to incorporate foreign subsidiaries. Thus, the approval process ensures that institutions comply with regulations or correct deficiencies before they undertake the regulated activity. Regulators may also enter into written agreements with financial institutions to commit them to take corrective actions to reverse any unsafe and unsound banking practices. Written agreements enhance compliance because they are private and confidential and not only commit the institution's senior management to take agreed corrective actions but also provide a record for future enforcement proceedings. See Carnell *et al* 462.
[389] *Ibid.* Other ordinary enforcement actions include civil litigation and criminal proceedings to sanction institutions that contravene financial laws.
[390] See Financial Institution Supervisory Act, 1966 that introduced cease and desist orders as intermediate sanctions directing financial institutions to restore financial stability before withdrawal of charters and closure.
[391] See the FIRREA.
[392] See ch 1 par 1.2.5.3.
[393] See ch 1 par 1.2.5.4 for the definition of regulatory forbearance as the restraint by regulators to close insolvent institutions in the hope that they will recover or on the expectation that another regulator will address the problem. See also JM Edwards, 'FDICIA and Dodd-Frank: Unlearned lessons about regulatory forbearance', (2011) *Harvard Business Law Review* 281.

hope that the other regulator would act. This problem was subsequently addressed by the introduction of the remedy of prompt corrective actions.[394]

(a) Cease and desist orders

The US Congress introduced cease and desist orders in 1966, as intermediary regulatory sanctions as it considered the previous mandatory sanctions against non-compliant financial institutions as too harsh because it required the withdrawal of the bank charter and closure of the bank concerned.[395] Thus, cease and desist orders enable regulators to direct the financial institutions to correct any unsafe and unsound activities, before the more severe sanction of closure is invoked.[396] Most regulators who had been reluctant to invoke the closure of institutions for being a drastic sanction, preferred cease and desist orders because they facilitated the continued provision of financial services.[397]

The cease and desist orders are directed at institutions whenever the institution, its officers, directors, employees or advisers or consultants engage in unsafe and unsound acts or violate any law, regulation or rule or otherwise breached any regulatory order or conditional approval or written agreement.[398] However, both the institutions and the officers upon whom cease and desist orders are served are entitled to judicial review because the orders restrict the business activities of institutions,[399] and the right of officers and directors to earn a living.[400]

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[394] See s 131 of the FDICIA. See also RS Carnell, 'A partial antidote to perverse incentives: The FDIC Improvement Act of 1991', (1993) *Annual Review of Banking Law* 317.
[395] Previously, the Home Owners Loans Act, 1933 required the Home Loan Bank Board and other federal regulators to withdraw the charters of noncompliant financial institutions without first giving them the opportunity to reform and restore compliance. It is this provision that the Financial Institution Supervisory Act, 1966 amended by introducing cease and desist orders.
[396] See Carnell *et al* 650.
[397] *Ibid.*
[398] *Ibid.*
[399] In *Gulf Federal Savings and Loan Association of Jefferson Parish v Federal Home Loan Bank Board*, 651 F 2d 259 5th Circuit 1981, US 1982, a cease and desist order issued to stop the appellant from charging interest on loans that earned it more profits, was set aside for being outside the mandate of the regulator as it addressed a consumer protection activity that neither violated any law nor was unsafe or unsound. Similarly, in *Larimore v Comptroller of the Currency,* 789 F 2d 1244 7th Circuit 1986, a cease and desist order had been issued to require directors of a failed bank to indemnify it for losses incurred on loans exceeding the bank's lending limits that they approved. The court set aside the orders on grounds that they were akin to money damages.
[400] See *Federal Deposit Insurance Corporation v Mallen*, 486 US 230 (1988), where it was held that a bank officer is entitled to a notice, to be allowed to defend himself and to an expeditious hearing because he had a proprietary interest in his continued employment. See also *Van Dyke v Board of Governors of the Federal Reserve System* 876 F2d 177 (8th Circuit 1989) where the court upheld a cease and desist order to remove a President of a bank due to a cheque kiting scheme between various accounts for

(b) Civil monetary penalties

When the Federal Reserve Board raised their interest rate in 1979 to reduce inflation following a rise in oil prices, savings and loan institutions that had issued long term mortgages at lower fixed interest rates suffered losses because their rising cost of funds were higher than the repayments they earned on their long term mortgages.[401] To recover their losses, some savings and loan institutions engaged in risky investments to earn higher returns, leading to the savings and loan crisis of the 1980s.[402] An inquiry into the savings and loan crisis found that the owners and managers of some of the institutions had perpetuated widespread fraud against their customers and the savings and loans deposit insurer.[403]

In response, the US Congress empowered the Department of Justice to file civil monetary penalty actions against financial institutions for fraudulent acts against their customers,[404] and prescribed a civil action standard of proof based on a balance of probabilities, instead of the higher criminal law standard of proof beyond reasonable doubt.[405] Thus, the Department of Justice uses civil monetary penalties as an alternative, and additional to, criminal prosecutions to sanction financial institutions that criminally violate financial laws, regulations and rules.[406]

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violating his fiduciary duties and committing his bank to pay off his overdrafts. Cheque kiting refers to the dishonest overstatement of a person's credit balances by drawing cheques on an account before cheques deposited on that account mature to create the impression that such person has credit in both accounts. See Oxford University Press, *Oxford dictionary of finance and banking*, (2008) 251.

[401] See A Saunders and MM Cornett, *Financial markets and institutions,* (2009) 419.

[402] See RA Cole, JA McKenzie & LJ White, 'Deregulation gone awry: Moral hazard in the savings and loan industry', in A Cottrell, M Lawlor & J Wood (eds), *The causes and consequences of depository institution failures,* (1995) 29.

[403] The Federal Savings and Loan Insurance Corporation, which had been established to insure savings and loans associations was dissolved and its functions transferred to the FDIC under FIRREA. For an overview of the fraudulent activities of savings and loan owners, see generally National Commission on Financial Institution Reform, Recovery and Enforcement, *Origin and causes of the S & L debacle: A blue print for reform,* (1993). See also MP Battin, *Bank director liability under FIRREA*, (1995) *Fordham Law Review* 2348.

[404] The FDIC, *History of the eighties: Lessons for the future,* (1997) 186.

[405] See BJ Campbell, WO Recker & B Morris, 'Understanding FIRREA: Revived law expands government's enforcement options', (2014) *Journal of Taxation and Regulation of Financial Institutions* 14.

[406] S 951 of the FIRREA. The US Supreme Court has further upheld the authority of states to enforce state laws against national banks. See *Cuomo v Clearing House Association* 129 S. Ct. 2710 (2009). See also AE Wilmarth Jr, 'Cuomo v Clearing House: The Supreme Court responded to the sub-prime financial crisis and delivered a major victory for the dual banking system and consumer protection', in LE Mitchell & AE Wilmarths Jr (eds), *Thepanic of 2008: Causes, consequences and implications for reform,* (2010) 4.

Karpoff, Lee and Martin observe that the use of civil monetary penalties has significantly enhanced compliance with financial laws,[407] because they adopt a lower standard of proof, which incentivises the financial institutions concerned to enter into settlements with the relevant regulators.[408] To further hold banks liable for their losses, the Financial Institution Reform, Recovery and Enforcement Act (FIRREA) requires bank holding companies to reimburse the FDIC for any losses it may suffer from any assistance to an insured bank or depository institution within the bank-holding company that suffers financial distress or is in danger of distress.[409]

(c) Prompt corrective actions

As discussed in Chapter One,[410] prompt corrective actions were introduced by the US in 1991 to promote collaboration in regulatory enforcement after the savings and loan crisis of the 1980s that revealed that some regulators had refrained from taking enforcement action on the assumption that other regulators would take appropriate action.[411] The delay to take enforcement action however led most of the US banks to invest in risky activities that exhausted their capital and increased the risk to the insurance fund.[412] Prompt corrective actions were therefore introduced to facilitate mandatory regulatory intervention in problem banks and the timely closure of insolvent banks.[413]

The prompt corrective actions obligated US regulators to direct banks to restore capital and correct other unsound management principles before they exhausted their capital.[414]The corrective actions focus on capital restoration because they require a bail-in by the institutions' shareholders, as a means of motivating them to monitor the bank's risk-taking. It thus requires them to raise more capital to provide a cushion to absorb losses in the event of failure and to prevent government bail-outs.[415]

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[407] See JM Karpoff, D Scott Lee & GS Martin, 'The cost to firms of cooking the books', (2008) *Journal of Finance and Quantitative Analysis* 582.
[408] See JC Coffee Jr, 'What went wrong? A tragedy in three Acts', (2009) *University of St. Thomas Law Journal* 130.
[409] S 1815(e)(1)(A) of the FIRREA.
[410] Ch 1 par 1.2.5.3.
[411] S 131 of the FDICIA.
[412] BA Bennett, 'Bank regulation and deposit insurance: Controlling the FDIC's losses', (1984) *Economic Review of the Federal Reserve Bank of San Francisco* 23.
[413] S 133 of the FDICIA.
[414] S 131(a) of the FDICIA.
[415] See also PS Rose & SC Hudgins, *Bank management and financial services,* (2010) 501.

Prompt corrective actions have been characterised as a “carrot and stick approach” to reward banks that are more capitalised with less regulatory restrictions and supervisory oversight and impose higher regulatory restrictions to undercapitalised banks.[416] This was to incentivise shareholders to monitor the bank’s risk-taking so as to prevent its erosion of capital that would lead it to become undercapitalized and subject to stricter regulation.[417] To target specific prompt corrective actions to corresponding capital levels, five capital compliance categories were created, that is: well-capitalised, adequately capitalised, under-capitalised, significantly under-capitalised and critically under-capitalised.[418]

Well-capitalised banks met their capital to asset ratios of at least 10%, and required no prompt corrective action, but instead were rewarded with soft supervision allowing them freedom to operate.[419] Adequately capitalized banks have a capital to asset ratio of 8%, which is considered weak and are subject to prompt corrective action of ceasing to accept wholesale deposits from brokerages and pension schemes without prior regulatory approval.[420] Undercapitalised banks have a capital to asset ratio of below 8% and are subject to mandatory and discretionary prompt corrective actions.[421] The mandatory prompt corrective actions direct them to: suspend dividends and management fees; prepare a capital restoration plan; restrict asset growth; require approval for acquisitions, branching and new activities; and to cease accepting brokerage deposits.[422] The discretionary prompt corrective actions direct them to: recapitalise; restrict inter affiliate transactions; restrict deposit interest rates; and take any other action to promptly correct their situation.[423]

Significantly undercapitalised banks have a capital to asset ratio of below 6% and attract the same mandatory prompt corrective actions as undercapitalised banks.[424] They are also subject to discretionary prompt corrective actions directing them to: recapitalise; restrict inter affiliate transactions, restrict deposit interest rates, and to

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[416] A Sunders and MM Cornett, Financial Institutions Management: A risk Management Approach 7e (2011), 586.
[417] *Ibid.*
[418] S 131 (b) (1) of the FDICIA.
[419] S 131 (b) (1) (A) of the FDICIA.
[420] S 131 (b) (1) of the FDICIA.
[421] S 131 (e) of the FDICIA.
[422] S 131 (e) (1) (2) and (3) of the FDICIA.
[423] S 131 (e) (4) of the FDICIA.
[424] S 131 (f) of the FDICIA.

take any other action that would promptly correct their situation.[425] In addition, they are subject to conservatorship or receivership if they fail to submit or implement a capital restoration plan or to recapitalise pursuant to an order.[426] They are further restricted on the interest rates to pay on deposits so as to prevent them from attracting deposits from the public with higher interest rates that would enable them to continue in business and continue to gamble with other peoples' money.[427]

The critically undercapitalized banks have a capital to asset ratio of less than 2%, and face the same mandatory prompt corrective actions as undercapitalised and significantly undercapitalised banks.[428] In addition they are restricted from: advancing loans to highly leveraged borrowers; paying above market interest rates to deposits; payment of excessive compensation to staff or consultants; and barred from accessing discount window lender of last resort facilities.[429] If the critically undercapitalized banks fail to recapitalise or to implement any corrective order within 90 days, they are subject to the appointment of a conservator or receiver.[430]

Accordingly, increasingly more serious prompt corrective actions are imposed on banks that are rated as undercapitalised[431] and significantly undercapitalised.[432] The most severe prompt corrective actions are imposed on the critically undercapitalised banks which have a capital to asset ratio of less than 2 per cent.[433]

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[425] *Ibid.*
[426] *Ibid.*
[427] *Ibid.*
[428] *Ibid.*
[429] *Ibid.*
[430] *Ibid.*
[431] S 131(e)(1), (2), (3) and (4) of the FDICIA. Undercapitalised banks have a capital to asset ratio of below 8 per cent and are subject to mandatory prompt corrective actions to suspend dividends and management fees; prepare a capital restoration plan; restrict asset growth; require approval for acquisitions, branching and new activities; and cease accepting brokerage deposits. They are further subjected to discretionary prompt corrective actions requiring them to: recapitalise; restrict inter affiliate transactions; restrict deposit interest rates; and take any other action that would promptly correct their situation.
[432] S 131(f) of the FDICIA. Significantly undercapitalised banks have a capital to asset ratio of below 6 per cent and are subject to the same mandatory and discretionary prompt corrective actions as the undercapitalised banks. They are further restricted from paying higher interest rates to attract deposits from the public. In addition, they are subject to conservatorship or receivership if they fail to submit or implement a capital restoration plan or to recapitalise pursuant to an order.
[433] S 131(f) of the FDICIA.

According to Kaufman, prompt corrective actions enhanced the effectiveness of US regulatory supervision and enforcement of financial institutions,[434] and significantly reduced the losses to the FDIC by limiting its assistance to insolvent banks.[435] In addition, by imposing serious sanctions on undercapitalised banks, prompt corrective actions forced them to either increase their capital or reduce their level of portfolio risk, which generally enhanced bank safety and soundness.[436]

3.4.3 Financial innovations and deregulation of the 1980s

3.4.3.1 Pre-1980 judicial basis of strict regulatory enforcement

Before the 1980s, the strict enforcement by federal regulators and the courts of the Glass-Steagall Act restrictions on commercial bank combinations with investment banking, appeared to stabilise the US banking industry.[437] Thus, in *Saxon v Georgia Association of Independent Insurance Agents Inc.* independent insurance agents in the state of Georgia petitioned the court to annul the Comptroller's approval of a national bank to engage in insurance agency activities in their state.[438] The Comptroller's approval was set aside by the court on the grounds that insurance agency services were neither incidental to nor necessary for conducting the business of a bank.[439]

Similarly, in the case of the *Investment Co. Institute v Camp*,[440] the Comptroller of the Currency's approval of a New York bank to engage in asset management services through an investment company subsidiary was nullified by the US Supreme Court for violating restrictions on commercial bank combinations with investment banking

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[434] See FS Mishkin, 'Evaluating FDICIA 1996', Brookings Institution National Issues Forum in cooperation with the Chicago Clearing House Association conference on bank reform five years later and five years ahead (December 1996) Washington DC, USA.
[435] See GG Kaufman, 'FDIC losses in bank failure', (2004) *Federal Reserve Bank of Chicago, Economic Perspectives 1.*
[436] R Aggarwall & KT Jacques, 'Assessing the impact of prompt corrective actions on bank capital and risk', (1998) *Federal Reserve Bank of New York Economic Policy Review* 23.
[437] For example, from low bank failures of 31 in the 1950s, 44 in the 1960s, and 79 in the 1970s, bank failures increased annually in the 1980s, rising to 1146 by 1989. See Carnell *et al* 30.
[438] *Saxon v Georgia Association of Independent Insurance Agents Inc.* 399 F.2d 1010 (5th Cir. 1965).
[439] *Idem* 1012.
[440] *Investment Co. Institute v Camp,* 401 US 617 (1971). The Supreme Court enumerated the risks of combining commercial banking and investment banking as including: the use of customer deposits to promote its stake in the fund by extending unsound loans to the companies in which the fund had invested; or the granting of loans to facilitate the purchase of interests in the fund; and/or the diversion of talent and resources from its commercial banking operation to the promotion of the fund.

because it exposed the bank's deposits to the risks that the Glass-Steagall Act sought to prevent.[441] In both cases, the plaintiffs sought interventions to enforce regulatory restrictions on bank engagement in non-bank business as a measure to protect their interest when the statutory regulators became reluctant to enforce the particular regulatory restrictions.[442]

3.4.3.2 Judicial deference to regulatory agency rulings

In 1984, the US Supreme Court decided in *Chevron USA Inc v Natural Resources Defence Council Inc* that courts were to give deference to the rulings of federal regulatory agencies because of the specialised expertise the agencies had in the matters they regulated.[443] The decision emboldened financial regulatory agencies that had previously enforced prohibitions on bank affiliations in non-banking activities to relax their enforcement policy.[444] Consequently, in *J.P. Morgan and Co., Inc., and three others*[445] the Federal Reserve Board expressly recommended that the Glass-Steagall Act be repealed because it impeded the competitiveness of US banks.[446] As the overseas operations of US banks had been adversely affected by the sovereign debt crisis of the 1980s,[447] the repeal of the Glass-Steagall restrictions sought to permit banks to venture into new financial products and services to enhance their competitiveness.[448] However, to offer the complex financial products and services banks used complex corporate structures that blurred any previous distinction

[441] S 16 of the Glass-Steagall Act that prohibited national banks from underwriting or purchasing any issues of securities or stock for its own account; and s 21 that prohibited bank involvement in the "business of issuing, underwriting, selling or distributing securities."
[442] See Halpert 495.
[443] See *Chevron USA Inc v Natural Resources Defence Council Inc* 467 US 837, 842 (1984) 843.
[444] Carnell *et al* 102.
[445] See Federal Reserve Board, *J.P. Morgan and Co., Inc., Federal reserve bulletin* (1987) 810.
[446] *Idem* 815.
[447] See Subcommittee on Financial Institution Supervision, Regulation and Insurance of the Committee on Banking Finance and Urban Affairs of the US House of Representatives, *Inquiry into Continental Illinois Corporation and Continental Illinois National Bank: Hearings before the Subcommittee,* (1984) available at <https://www.fraser.stlouisfed.org>accessed on 11.4.2018. The report discusses the role of sovereign debt financing of petroleum costs on the failure of Continental Illinois and the origin of "Too-Big-To-Fail."
[448] See SL Schwarcz, 'Markets, systemic risk, and the sub-prime mortgage crisis', (2008) *Southern Methodist University Law Review* 211.

between financial institutions,[449] by providing products across financial sectors and thereby increasing risks to the financial system.[450]

As discussed in Chapter One,[451] when the Federal Reserve Board raised its base rate in 1979, while retaining ceilings on the interest rates banks could pay on deposits, it restricted the ability of banks to competitively attract deposit funds.[452] The lower interest rates led most investors to shift the investment of their savings from bank deposits to the new shadow banking financial intermediaries[453] through certificates of deposit (CDs).[454] Funds were also shifted to savings and loan institutions that introduced interest bearing current accounts (also called negotiable order of withdrawal (NOW) accounts) on which they paid interest.[455]

In 1980, Congress repealed interest rate ceilings[456] and permitted banks to offer money market funds that were insured under the federal deposit insurance scheme,[457] which further blurred the previous distinction between financial institutions.[458] Consequently, federal regulators informally adopted a deregulation policy under which they were no longer compelled to strictly enforce the restrictions imposed by the Glass-Steagall Actand Bank Holding Company Act on bank engagement in non-banking business, as they sought to enhance the competitiveness of US banks.[459]

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[449] See SL Schwarcz, 'Regulating financial change: A functional approach', (2016) *Minnesota Law Review*, 1444–1445 and SL Schwarcz, 'Regulating complexity in financial markets', (2009) *Washington University Law Review* 220.
[450] See JA Fanto, 'Breaking up is hard to do: Should financial conglomerates be dismantled?', (2010) *University of Cincinnati Law Review* 533.
[451] Ch 1 par 1.2.5.1.
[452] See Reg Q of the Federal Reserve Regulations.
[453] See SL Schwarcz, 'Regulating shadow banking', (2011–2012) *Review of Banking Law and Financial Law* 619.
[454] Carnell *et al* 25.
[455] AE Wilmarth Jr, 'The transformation of the US financial services industry, 1975–2000: Competition, consolidation and increased risks', (2002) *University of Illinois Law Review* 225–238.
[456] See the Depository Institutions Deregulation and Monetary Control Act, 1980.
[457] S 371a of the Garn-St Germain Act, 1982.
[458] See Carnell *et al* 28. See also CW Calomiris, 'Universal banking "American Style"', (1998) *Journal of Institutional and Theoretical Economics* 46.
[459] In 1996, the Federal Reserve Board issued Federal Regulation 47, 242, in which it resolved to permit bank holding companies to conduct non-banking activities under the Bank Holding Company Act to the fullest extent possible.

3.4.3.3 Deregulation in the USA and the GFC

The US Congress formally deregulated the US financial system through the Financial Services Modernization (Gramm-Leach-Bliley), Act 1999,[460] which repealed the Glass-Steagall Act restrictions on combinations of commercial banking and investment banking and relaxed the Bank Holding Company Act's restrictions on bank holding company engagement in non-bank activities.[461] The Gramm-Leach-Bliley Act introduced the "financial holding company" as a new category of bank holding companies.[462] It relaxed the previous approval requirements for bank holding companies to engage in non-bank activities and required them to merely give the Federal Reserve Board a sixty day notice before commencing a non-bank activity or acquiring shares in a non-banking firm.[463] More significantly, the Act restricted the Federal Reserve Board's authority to supervise non-bank subsidiaries of bank holding companies.[464] These restrictions impeded the Federal Reserve Board's enforcement powers over bank holding companies and their subsidiaries by removing the Board's authority to require capital restorations by bank holding companies or their subsidiaries.[465]

As already alluded to in Chapter One,[466] since the non-bank financial institutions are not supervised through off-site and on-site examinations like banks are,[467] the restriction of the Federal Reserve Board's supervisory authority over non-banking affiliates of bank holding companies permitted them to undertake more risk.[468] In 2007,

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[460] The Financial Services Modernization (Gramm-Leach-Bliley), Act 1999.
[461] See ST Omarova, 'The merchants of Wall Street: Banking commerce and commodities', (2013) *Minnesota Law Review*, 274–289, for the dangers that Gramm-Leach-Bliley Act posed to the US financial system.
[462] S 1843(l)(1)–(2) and s 2903(c)(1) of the Gramm-Leach-Bliley Act. The financial holding company is permitted to engage in a broad spectrum of financial and activities that were incidental or complementary thereto.
[463] S 1843(c)(8) of the Gramm-Leach-Bliley Act.
[464] S 1843(c)(1)(B) of the Gramm-Leach-Bliley Act, which restricted the Federal Reserve Board's supervisory authority over bank holding company affiliates, by requiring the Federal Reserve Board to use the examination reports of functional regulators of the affiliates of bank holding companies. This also opened the Federal Reserve Board's supervisory authority over bank holding companies to judicial challenges by the bank holding companies and their affiliates.
[465] S 1844(5) of the Gramm-Leach-Bliley Act.
[466] Ch 1 par 1.2.5.4.
[467] See Lichtenstein 224.
[468] See D Awrey, 'Complexity, innovation and the regulation of modern financial markets', (2011) *University Wolverhampton selected works of Dan Awrey* 48, where he argues that regulators were not prepared to effectively protect consumers from 'sophisticated new instruments, derived from esoteric financial theory, structured in ways which obscure the attendant risks, and traded in opaque dealer-intermediated markets by opaque finance institutions'.

the USA experienced a financial crisis originating from subprime mortgages that eventually evolved into the GFC[469] leading to the collapse of Lehman Brothers and further leading to all the other investment banks converting to financial holding companies or to their acquisition by bank holding companies.[470]

3.4.4 Dodd-Frank Wall Street Reform and Consumer Protection Act

3.4.4.1 Main objectives of Dodd-Frank

As a response to the GFC, the US Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) in 2010, *inter alia*, to enhance effective regulation and improve transparency in the financial system, end "Too-Big-To-Fail" to protect American taxpayers by ending bailouts, and promote the protection of consumers from abusive financial business services.[471]

3.4.4.2 Dodd-Frank's enhanced supervision for financial conglomerates

As observed above,[472] the Gramm-Leach-Bliley Act restricted the Federal Reserve Board's supervisory enforcement authority over non-bank subsidiaries of bank holding companies and financial holding companies. Dodd-Frank however enhanced effective financial regulation, by establishing a Financial Stability Oversight Council, comprising of all US financial regulators,[473] to identify systemic risk to financial stability in the USA that may arise from the failure of large complex financial institutions.[474] The mandate of the Financial Stability Oversight Council is to designate any large bank holding company or non-bank financial institution as a SIFI, based on the institution's risk exposure, importance in credit provision to low income communities, or other risk factors.[475] Once an institution is designated as a SIFI, the Council imposes higher

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[469] Ch 1 par 1.2.6.

[470] *Ibid*. See also RB Thompson, 'Market makers and vampire squid: Regulating securities markets after the financial meltdown', (2011) *Washington University Law Review* 324.

[471] See objectives of the Dodd-Frank Act.

[472] Par 3.4.3.2 above.

[473] S 111(b) of the Dodd Frank Act. As the FSOC comprises of the various US financial regulators, it also has the mandate to resolve any disputes that may arise among them.

[474] S 112(1) of the Dodd-Frank Act.

[475] S 112(2) of the Dodd-Frank Act. See also D Schwarcz & D Zaring, 'Regulation by threats: Dodd-Frank and the non-bank problem', (2017) *The University of Chicago Law Review* 1834.

capital and liquidity ratios and may direct them to reduce their leverage.[476] Dodd-Frank further requires insured financial institutions that pose a significant risk to the financial system to be subject to an orderly resolution process that minimises the risk and mitigates the moral hazard to the financial system.[477]

Among provisions repealed by the Gramm-Leach-Bliley Act that are restored by Dodd-Frank is the Federal Reserve Board's supervisory enforcement authority over bank holding companies or financial holding companies.[478] Accordingly, Dodd-Frank authorises the Board to direct bank holding companies and financial holding companies to maintain a capital ratio of at least 10 per cent[479] and to extend its examination to their functionally regulated subsidiaries.[480] The Act further authorises the Federal Reserve Board to prescribe short term debt limits,[481] and to prescribe a leverage of a debt to equity ratio of not more than 15 to 1 on bank holding companies.[482] In addition, Dodd-Frank requires regulators to conduct annual stress tests to evaluate whether bank holding companies have adequate capital to absorb losses that could arise from adverse economic conditions.[483]

More significantly, Dodd-Frank authorises the Federal Reserve Board's regulatory oversight over the permissible activities of depository institutions,[484] and the restrictions on bank transactions with affiliates.[485] In this regard, the Act restricts banks' engagement in proprietary trading,[486] by ring-fencing insured banks from affiliating with hedge funds through a provision known as the "Volcker rule".[487] This

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[476] S 115(a)(1) of the Dodd-Frank Act. See Also VV Acharya and M Richardson, 'Implications of the Dodd-Frank Act', (2012) *Annual Review of Financial Economics* 2. See also MM Blair, 'Making money: Leverage and private sector money creation', (2013) *Seattle University Law Review* 419.

[476] See F Dierick, *The supervision of mixed financial services groups in Europe*, (2004) The European Central Bank occasional paper series 16.

[477] S 204(a) of the Dodd-Frank Act.

[478] The Federal Reserve Board's supervisory powers over bank holding companies and their affiliates had been restricted by the Gramm-Leach-Bliley Act.

[479] S 606 of the Dodd-Frank Act.

[480] S 604 of the Dodd-Frank Act.

[481] S 165(g) of the Dodd-Frank Act.

[482] S 165(j) of the Dodd-Frank Act.

[483] S 165(i)(1)(A) of the Dodd-Frank Act.

[484] S 605 of the Dodd-Frank Act.

[485] S 608 of the Dodd-Frank Act.

[486] Proprietary trading arises when financial institutions invest their own funds in the trading activities they conduct for their clients in anticipation of earning profits for their own account. See S McGee, *Chasing Goldman Sachs: How the masters of the universe melted Wall Street and why they'll take us to the brink again*, (2010) 125.

[487] S 619 of the Dodd-Frank Act (also referred to as the Volcker rule, named after Paul Volcker, former Federal Reserve Board Chairman that proposed it) prohibits banks from engaging in proprietary trading

protects insured deposits from being used to cross-finance risky non-bank activities,[488] through a version of the Glass-Steagall Act restrictions.[489] As discussed in Chapter One,[490] one of the major causes of the GFC was the use of complex unregulated derivative instruments traded over the counter by unregulated shadow banking intermediaries, after their risk had been inappropriately rated by credit rating agencies.[491] The Dodd-Frank Act has also introduced regulation for hedge funds,[492] credit rating agencies[493] and auditors[494] to enhance their transparency and independence by reducing conflicts of interests.[495] In addition, Dodd-Frank requires that derivative products be approved,[496] and be traded through a clearing house to enhance transparency,[497]as these measures were lacking pre-GFC.[498]

The Dodd-Frank Act also establishes a Consumer Financial Protection Bureau (CFPB) to enhance conduct of business regulation for financial institutions.[499] The Bureau's mandate is to *inter alia* monitor deceptive or abusive financial service activities[500] and

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or owning any interests in hedge funds or private equity funds. It further imposes higher capital requirements on non-bank financial companies affiliated with banks or bank holding companies that engage in proprietary trading or owns interests in hedge funds or private equity funds.

488 See ch 1 par 1.2.5.2 and ch 2 par 2.2.3.2 for a discussion of ring-fencing. See also M Lehmann, *Volcker rule, ring-fencing and separation of bank activities: Comparison of structural reform Acts around the World*, (2014) LSE Law, Society and Economy working papers 10. See also AE Wilmarth Jr, 'Narrow banking as a structural remedy for the problem of systemic risk: A comment on Professor Schwarcz's "Ring-fencing"', (2014) *Southern California Law Review Postscript* and AE Wilmarth Jr, 'Narrow banking: An overdue reform that could solve the Too-Big-To-Fail problem and align U.S. and U.K. regulation of financial conglomerates', (2012) *Banking and Financial Services Report* 2.

489 Par 3.4.2.1 above.

490 Ch 1 par 1.2.6.

491 See K Johnson, 'Things fall apart: Regulating the credit default swap commons', (2011) *University of Colorado Law Review* 169.

492 Title IV of the Dodd- Frank Act.

493 S 932 of the Dodd-Frank Act.

494 S 939c of the Dodd-Frank Act.

495 For a review of the effect of the Dodd-Frank Act on Credit Default Swaps see RS Bloink, 'Does the Dodd-Frank Wall Street Reform Act rein in credit default swaps? An EU comparative analysis', (2011) *Nebraska Law Review* 587. See also M Klock, 'Lessons learned from Bernie Madoff: Why we should partially privatize the Barney Fifes at SEC', (2010) *Arizona State Law Journal* 809, for a discussion of the auditing function in capital markets and how auditors should be held accountable.

496 S 718 of the Dodd-Frank Act. See generally EA Posner & EG Weyl, 'An FDA for financial innovation: Applying the insurable interest doctrine to 21st Century financial markets', (2012) *North West University Law Review* 1308.

497 S 725 of the Dodd-Frank Act.

498See JL Allen, 'Derivatives clearing houses and systemic risk: A bankruptcy and Dodd-Frank analysis', (2012) *Stanford Law Review* 1085 for a discussion of the role of clearing houses in promoting transparency. See also D Heller & N Vause, *Collateral requirements for mandatory central clearing of over-the-counter derivatives*, (2012) BIS working paper2.

499 S 1011 of the Dodd-Frank Act. The Bureau of Consumer Financial Protection regulates the offering of consumer financial products and services under federal consumer laws.

500 S 1031 of the Dodd-Frank Act.

enforce consumer rights to information.[501] Although the financial industry was opposed to its establishment, the Bureau has provided a further layer of macroprudential regulation in the USA by promoting public confidence in the financial sector through consumer protection.[502]

As indicated above,[503] the Dodd-Frank Act also seeks to end the "Too-Big-To-Fail" problem*,* by limiting the use of public funds to bail out SIFIs.[504] Thus, SIFIs may only be bailed out if two thirds of the FDIC board and the Federal Reserve Board,[505] recommend in writing that the government bails out a distressed SIFI, with which recommendation the Treasury Secretary concurs after consulting the President, subject to informing the Congress within 24 hours.[506] The FDIC is further required to report to Congress within 60 days of its appointment as receiver of the SIFI.[507] These provisions substantially limit the Federal Reserve Board's LOLR functions[508] and realign the US safety net provisions to the financial sector,[509] by subjecting any proposed government bail-out to congressional scrutiny and holding the President politically accountable for the decision.[510]

In addition, the Dodd-Frank Act limits the use of taxpayer funds on bail-outs by requiring bank holding companies to prepare recovery and resolution plans (living wills) for their rapid and orderly resolution in the event of material financial distress or failure.[511] The plans should include information regarding the adequacy of the protection of insured subsidiaries from risks arising from the acts of the holding

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[501] S 1034 of the Dodd-Frank Act.
[502] See AE Wilmarth Jr, 'The financial industry's misguided quest to undermine the Consumer Financial Protection Bureau', (2011–2012) *Review of Banking and Financial Law* 881. See also KN Johnson, 'Macroprudential regulation: A sustainable approach to regulating financial markets', (2013) *University of Illinois Law Review* 884 and P Tucker, *Basel III, Too-Big-To-Fail and macroprudential regimes*, (2011) Group of Thirty, occasional paper15.
[503] Par 3.4.4.1 above.
[504] S 203 of the Dodd-Frank Act.
[505] S 203(a)(1) of the Dodd-Frank Act reiterates the conditions for a bail-out of SIFIs under the FDICIA discussed above.
[506] S 203(c)(2) of the Dodd-Frank Act.
[507] S 203(b) of the Dodd-Frank Act.
[508] Ch 2 par 2.2.2.3.
[509] *Ibid.*
[510] S 203(c)(2) of the Dodd-Frank Act. Compare with AE Wilmarth Jr, 'The Dodd-Frank Act: A flawed and inadequate response to the Too-Big-To-Fail problem', (2011) *Oregon Law Review* 951. Thus, Wilmarth argues that Dodd-Frank should have adopted stronger measures to stop government bail-out of SIFIS and suggests that the current provisions do not go far enough. See also R Dibadji, 'Dodd-Frank: Towards first principles?', (2011) *Chapman Law Review* 79.
[511] S 165(d) (1) of the Dodd-Frank Act.

company's other subsidiaries; a full description of ownership structure, assets, liabilities and obligations of the holding company; and any cross-guarantees tied to different securities, major counterparties and persons to whom any collateral is pledged.[512] To facilitate private funding for orderly resolution, shareholders and creditors are required to bear the losses of the failed financial institution.[513] The Dodd-Frank Act further provides for the removal of management members responsible for the failure,[514] and holds culpable managers, directors and third parties proportionally liable for the costs of the failure in accordance with their responsibility for such failure.[515]

3.4.4.3 Review of Dodd-Frank Act and proposed reforms

Almost ten years after being enacted in 2010, Dodd-Frank has been recognised as having stabilised the US banking system,[516] but has also been criticised for being too complex for effective administration[517] and imposing high compliance costs.[518] It has been observed that although the compliance costs are more burdensome to smaller community banks they are also felt by large financial conglomerates.[519] Financial conglomerates also find the costs of the prohibition of proprietary trading,[520] provisions to end "Too-Big-To-Fail",[521] recovery and resolution planning[522] and the capital, liquidity and leverage requirements to be high.[523] US financial conglomerates oppose

[512] *Ibid*.
[513] S 204(a)(1) of the Dodd-Frank Act.
[514] S 204(a)(2) of the Dodd-Frank Act.
[515] S 204(a)(3) of the Dodd-Frank Act.
[516] See M Tanafon, 'The Financial Choice Act: A different path to reform of Dodd-Frank', (2017–2018) *Review of Banking and Financial Law* 178.
[517] See Acharya & Richardson 2.The authors argue that Dodd-Frank is too complex for effective enforcement.
[518] See NKS Rajoo, 'Reform of the Dodd-Frank and its implications', (2016–2017) *Review of Banking and Financial Law* 595.
[519] See MR Kaufman, 'Too small to succeed: An analysis of the minimal undue regulatory burdens facing community banks in the post Dodd-Frank regulatory environment, and how to further minimize their burden', (2017–2018) *Review of Banking and Financial Law* 445. See also AE Wilmarth Jr, 'A two-tiered system of regulation is needed to preserve the viability of community banks and reduce the risks of megabanks', (2015) *Michigan State Law Review* 276. Wilmarth Jr argues that since community banks did not contribute to the causes of the GFC, they should not be subjected to the high compliance costs under the Dodd-Frank Act. Instead, a new regulatory framework ought to be developed for them.
[520] Rajoo 598.
[521] See Tanafon 181.
[522] See DK Suska, 'Reappraising Dodd Frank's living wills regime', (2016–2017) *Review of Banking and Financial Law* 782.
[523] See S Brouillard, 'Basel III reforms: Analysis and potential impact on US banks', (2016–2017) *Review of Banking and Financial Law* 499.

the Volcker rule[524] for the same reasons they opposed the Glass-Steagall prohibitions namely, that it limits their investment opportunities and impedes competition.[525] As the repeal of Glass-Steagall Act led to the lax regulatory era and the GFC,[526] Rajoo submits that repeal of the Volcker rule may probably lead to another financial crisis.[527] Nevertheless, the US House of Representatives has passed a Financial Choice Act, 2017 (which is still pending debate and passage in the US Senate)[528] to repeal the Volcker rule and to promote economic growth and the competitiveness of US banks.[529]

The Financial Choice Act further seeks to transfer the power to declare a SIFI insolvent from the FDIC as the Orderly Resolution Authority for SIFIs, to the SIFIs themselves, by permitting them to apply to a bankruptcy court for protection for their creditors.[530] While the Act will restrict the FDIC's receivership powers over insured institutions to banks only, it requires the FDIC to continue to insure depository institutions within SIFIs.[531] Although the living wills were introduced by the Dodd-Frank Act to correct market failure and end "Too-Big-To-Fail,"[532] Suska argues that they are costly to prepare and regulators have found the quality of living wills submitted to be either unrealistic or without adequate supporting material.[533] As noted in Chapter One[534] the *Basel II Accord* required banks to assess their capital adequacy using either a standardised approach or the internal ratings-based methodology.[535] US banks have also opposed *Basel III*'s restriction of the use of the internal ratings-based

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[524] Rajoo 600. See par 3.4.4.2. above for a discussion of the Volcker-rule.
[525] See Ch 1 para 1.2.6 and 1.2.7 for a discussion of the GFC and the lessons learned from it respectively.
[526] For an analysis of the impact of Wall Street on the US politics and regulatory agencies, see AE Wilmarth Jr, 'Turning a blind eye: Why Washington keeps giving into Wall Street', (2013) *University of Cincinnati Law Review* 1283.
[527] Rajoo 600.
[528] See US House of Representative Financial Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs (CHOICE) Act, 2017.
[529] Tanafon 185.
[530] See the proposed Financial Institutions Bankruptcy Act that creates a separate chapter for financial institutions under the US Bankruptcy Code.
[531] Tanafon 185.
[532] Suska 792.
[533] *Ibid.* Suska observes for example that JPMorgan Chase requires more than one thousand employees to prepare their annual recovery and resolution plans.
[534] Ch 1 par 1.2.5.4.
[535] The standardised approach required banks to use the same criteria to assess their risks for purposes of calculating their capital adequacy. Under the internal ratings-based methodology banks were allowed to use internal ratings of their risk exposure in the calculation of their capital adequacy. This permitted banks to overstate their capital levels and understate their risk exposures. See ch 1 par 1.2.5.4. *Basel III* addressed this problem by deducting goodwill, minority shares and tax deduction allowances from the Tier 2 or supplementary capital regulatory capital requirements. See *Basel III* par 30.

methodology in assessing the credit, market and operational risks they were exposed to.[536] Tsang warns that most of the restrictions introduced by Dodd-Frank for effective supervision of financial conglomerates in the USA may be repealed and potentially return the USA to the pre-GFC lax regulatory era.[537]

3.4.5 Factors influencing implementation of financial standards in the USA

The US financial regulatory framework shows a pattern of strong regulation influenced by public choice factors immediately following financial crises. This is clear from the enactment of the Banking Act in 1933 after the Great Depression,[538] FIRREA in 1989 and FDICIA in 1991 after the savings and loan crisis,[539] and Dodd-Frank in 2010 after the GFC.[540] However, whenever special interest group factors exert influence leading to relaxed regulatory enforcement or deregulation, bank risk-taking increases, leading to banking crises.[541] Thus, relaxation of regulations in the 1980s led to the savings and loan crisis[542] and the deregulation under the Gramm-Leach-Bliley Act led to the GFC.[543]

3.5 Chapter summary and conclusions

This chapter sought to examine how Kenya, South Africa and the USA implemented the *Basel III Accord,* the revised *Basel Core principles*, and the revised *Joint Forum Principles* in their regulatory framework for financial conglomerates. In relation to Kenya, I have considered the evolution of its bank regulatory structure from the currency board era to the establishment of the CBK in 1966 and the introduction of bank regulation through the enactment of the Banking Act, 1968.[544] Over the years, Kenya has strengthened its banking regulation generally, and the regulation of banking groups or financial conglomerates in particular, by requiring non-operating holding companies to seek approval before acquiring more than twenty five percent

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536 See C Binham, 'Basel puts new banking policy on hold pending review', (April 2017) *Financial Times*.
537 C-Y Tsang, 'The seven sins of the contemporary financial system', (2017–2018) *Review of Banking and Financial Law* 377–396.
538 Par 3.4.2.1 above.
539 Par 3.4.2.4 above.
540 *Ibid.*
541 *Ibid.*
542 *Ibid.*
543 Par 3.4.3.2 above.
544 Par 3.2.3.1 above.

shareholding in banks.[545] In addition, banking groups must maintain risk-adjusted regulatory capital and liquidity requirements based on their risk profiles in terms of *Basel Core principles*,[546] and further maintain capital conservation and countercyclical buffers in terms of *Basel III*.[547]

However, Kenya's financial conglomerate regulatory framework does not sufficiently adopt the *Joint Forum Principles* because it is spread over many provisions in the Banking Act and various CBK guidelines. It does not provide an effective framework for the consolidated supervision of the conduct of business of financial conglomerates by prescribing a criteria for their designation, licencing and supervision. I have also examined the CBK's prompt corrective actions framework and argued that the framework's enforcement criteria is unduly complicated and imposes imprecise sanctions that duplicate functions under the Kenya Deposit Insurance Act.[548]

I have further considered Kenya's proposal to develop a regulatory framework for financial conglomerates through the Draft Financial Services Authority Bill 2016 and the Draft Financial MarketConduct Authority Bill.[549] The Draft Bills would enhance Kenya's compliance with the *Joint Forum Principles* by strengthening Kenya's financial conglomerate supervisory structures through the introduction ofa macroprudential framework for the designation and licencing of financial conglomerates and the subsequent supervision of the conduct of business of such financial conglomerates and the systemic risk they pose.[550] However, both Draft Bills do not prescribe any framework for preparation of recovery and resolution plans (RRPs) by financial conglomerates. It is submitted that the Draft Bills should be consolidated into a single bill that will harmonise their current provisions and incorporate a framework for the obligation to prepare RRPs, before enactment.[551]

South Africa regulates financial conglomerates through a screening procedure for the registration of companies as public companies before their registration as banks.[552] In

[545] Par 3.2.4.3 above.
[546] *Ibid.*
[547] Par 3.2.5.2 above.
[548] Par 3.2.5.3 above.
[549] Par 3.2.5.4 above.
[550] *Ibid.*
[551] *Ibid.*
[552] Par 3.3.2.1 above.

addition, the Banks Act requires banks and banking groups to identify, control and mitigate the risks that the bank or its controlling company are exposed to[553] and to maintain risk-adjusted equity capital and unimpaired reserves.[554] Further, South Africa has introduced the Twin Peaks regulatory model captured in the Financial Sector Regulation Act for enhanced regulation of SIFIs by means of their designation that facilitates their subsequent supervision.[555] The Act empowers the Prudential Authority to align the prescribed capital requirements to the risk profile of the bank or its controlling company.[556] While the prudential supervision of SIFIs, financial conglomerates and holding companies has also been assigned to the Prudential Authority, the SARB has been assigned express responsibility for maintaining financial stability and is further mandated to monitor and manage systemic risk from financial conglomerates.[557] The financial regulatory structure in South Africa sufficiently incorporates *Basel Core principles*, *Basel III* and *Joint Forum Principles* under a robust regulatory enforcement system.

The USA had addressed the moral hazard from financial conglomerates through the Glass-Steagall Act[558] and the Bank Holding Company Act, which had introduced most of the features that mirror the *Basel Core principles* and *Joint Forum Principles* in the USA decades before the GFC.[559] However, the deregulation of the US financial markets in the 1980s culminating in the enactment of the Gramm-Leach-Bliley Act in 1999, overrode all these measures for effective supervision of financial conglomerates, leading to aggressive risk taking by financial institutions that resulted in the GFC.[560] The enactment of the Dodd-Frank Act restored the consolidated supervision of financial conglomerates and incorporated the *Basel Core principles, Basel III* and *Joint Forum Principles* in the USA. Therefore, Dodd-Frank improved accountability and transparency in the financial system by regulating non-bank subsidiaries of financial holding companies, including their previously unregulated shadow banking subsidiaries[561] Dodd-Frank further introduced requirements for

[553] Par 3.3.2 above.
[554] Par 3.3.3 above.
[555] *Ibid.*
[556] *Ibid.*
[557] *Ibid.*
[558] Par 3.4.2.1 above.
[559] Ch 1 par 1.2.6.
[560] Par 3.4.2.1 above. See also ch 1 para 1.2.5.2 and 1.2.6.
[561] Par 3.4.4.2 above.

financial holding companies to prepare restoration and recovery plans (RRPs) and be subjected to stress testing to evaluate their capital adequacy.[562] However, the enactment of the Financial Choice Act 2017 by the US House of Representatives may undermine the progress made under Dodd-Frank and return the US to the pre-GFC financial regulatory era which was characterised by deregulation and lax regulation.[563]

I have also observed that while regulations in all three countries that were influenced by public choice factors have tended to effectively address moral hazard in banking, regulations that were influenced by special interest group factors have tended to permit increased risk-taking and resulted in banking crises in Kenya and the USA. The main argument of this chapter is that a strong financial regulatory framework not only prevents bank failure but also enhances the effectiveness of EDIS and SRR that seek to mitigate the effects of bank failure.[564] Using the regulatory frameworks discussed above, I will consider the design of the EDIS and SRR frameworks in Kenya in Chapter Four, in South Africa in Chapter Five and in the USA in Chapter Six and draw final conclusions to the study in Chapter Seven.

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562 *Ibid.*
563 Par 3.4.4.3 above.
564 Par 3.1.1 above.

CHAPTER 4: EXPLICIT DEPOSIT INSURANCE AND SPECIAL BANK RESOLUTION IN KENYA

4.1 Introduction

4.1.1 General overview

The significance of explicit deposit insurance (EDIS) in protecting depositors from the impact of bank failure was highlighted during the GFC.[1] As part of the post–GFC international financial reforms, countries that did not have an EDIS introduced it in their jurisdictions,[2] while those that already had EDIS reformed their systems to strengthen their effectiveness.[3] As discussed in Chapter One,[4] Kenya established an EDIS in 1985 under the Deposit Protection Fund Board (DPFB) following a series of bank failures.[5] Post-GFC, Kenya reformed its EDIS through the Kenya Deposit Insurance Act (the KDI Act)[6] by strengthening its institutional structure and mandates.[7] Thus, the KDI Act established the Kenya Deposit Insurance Corporation (the Corporation) as an agency independent from the CBK.[8] By providing financial consumer protection to depositors, the KDI Act further implemented article 46 of the Constitution of Kenya, 2010 that had introduced consumer protection as a fundamental constitutional right.[9]

The main objective of this study is to investigate how the design of EDIS may be enhanced to more effectively address the moral hazard in banking and improve financial system stability in Kenya.[10] As discussed in Chapter Two,[11] among the post-GFC international financial reforms was the development by the International

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[1] See A Demirguc-Kunt, EJ Kane & L Laeven, 'Deport insurance around the world', (2015) *Journal of Financial Stability* 155.
[2] See ch 1 par 1.2.8 for a reference to jurisdictions that adopted EDIS post-GFC.
[3] A Demirguc-Kunt *et al* 3.
[4] See ch 1 para 1.3.2 and 1.3.3.
[5] See the Banking (Amendment) Act 17 of 1985, which amended the Banking Act 56 of 1968 to establish an EDIS following the banking crisis of the 1980s in Kenya. See also ch 3 par 3.2.3.2 as regards the banking crises of the 1980s. See further CBK, *Bank supervision department annual report,* (1994) 13 and R Detho, 'Benefits of deposit insurance in Africa: The Kenya experience', 2 International Association of Deposit Insurers African Regional Conference (July 2010) Arusha, Tanzania, 2.
[6] Kenya Deposit Insurance Act 10 of 2012 (hereafter KDI Act).
[7] S 5 of the KDI Act.
[8] See also ss 43 and 44(2) in relation to the appointment of the Corporation as a receiver to take over the affairs of the bank from its board and s 54 as regards its appointment as liquidator to wind up the unviable parts of the bank.
[9] See Art 46 of the Constitution of Kenya, 2010, which, *inter alia*, guarantees consumers fundamental rights to goods and services of reasonable quality.
[10] See opening statement in ch 1 par 1.1.
[11] See ch 2 par 2.4.

Association of Deposit Insurers (IADI) of the *Core principles for effective deposit insurance systems* (*IADI Core principles*) in 2009 (revised in 2014) to strengthen the effectiveness of EDIS in addressing moral hazard in insured institutions. In addition to its provisions on deposit insurance, the *IADI Core principles* provided for a special bank resolution regime (SRR) before the Financial Stability Board (FSB) developed *Key attributes for effective resolution regimes for financial institutions* (*FSB Key attributes*) which were issued in 2011 (revised in 2014).[12] Consequently, the *IADI Core principles* on SRR overlap to some extent with the *FSB Key attributes* provisions on SRR. The overlapping provisions relate to, the establishment of an *ex ante* EDIS privately funded from premium levies on member banks;[13] the provision for effective failure resolution[14] the designation of a resolution authority (RA);[15] the recovery of costs of resolution;[16] and to cross-border cooperation.[17]

This chapter appraises the KDI Act and its implementation of the *IADI Core principles*[18] in the design of its EDIS and the FSB *Key attributes* in the design of its SRR[19] to address moral hazard in Kenyan banking. The chapter will first outline the structure and mandates of the EDIS under the DPFB as a means to identify the gaps that the KDI Act were to address. I will further consider the features that the KDI Act has adopted to implement *the IADI Core principles* in the design of the EDIS and the *FSB Key attributes* in the design of the SRR to address the identified gaps under the DPFB. I will specifically focus on how the structures were enhanced to curb moral hazard in Kenyan banking.

Among the key features of the *IADI Core principles* to be considered in the design of the EDIS under the KDI Act, are the provisions relating to the scope of coverage of the insured deposits to limit depositor moral hazard and the provisions to charge *ex ante* risk-based premiums to limit bank moral hazard.[20] Other important design features include the assignment of mandates to the EDIS, particularly those of "loss minimiser",

[12] Ch 2 par 2.5.
[13] See *IADI Core principles* 2 and 9 and FSB *Key attribute* 6.
[14] *IADI Core principle* 14 and FSB *Key attribute* 3.
[15] *IADI Core principle* 2 and FSB *Key attribute* 2.
[16] *IADI Core principles* 12 and 16 and *FSB Key attribute* 3.
[17] *IADI Core principle* 5 and *FSB Key attributes* 9 and 12.
[18] See ch 2 par 2.4.2.3.
[19] Ch 2 par 2.4.
[20] See ch 2 par 2.3.3.2.

and "risk minimizer"[21] and the role of the EDIS within the financial safety net system and its relationship with the central bank as LOLR on open bank assistance to bail-out SIFIs.[22]

Within the context of bank resolution, the KDI Act incorporates aspects of the *FSB Key attributes* on limiting bank bail-outs through the exercise of open bank assistance, bail-in, and "purchase and assumption transactions" hence the chapter will examine the extent to which the KDI Act provisions may require reforms.[23] Lastly, ananalys is of the factors that have influenced Kenya's implementation of the *IADI Core principles* and the *FSB Key attributes* to form part of the Kenyan regulatory landscape will be carried out by using the public choice, special-interest group and bureaucratic preference theories of policy formulation as outlined in Chapter Two.[24]

4.2 Kenyan EDIS under DPFB

4.2.1 Mandate and institutional structure of the DPFB

4.2.1.1 Mandate of DPFB

Although the EDIS under the DPFB was designated as "deposit protection" rather than "deposit insurance,"[25] it was in fact a "deposit insurance" scheme.[26] This is because it was established under legislation, namely the Banking Act,[27] with *ex ante* funding through premiums charged on banks. It also provided limited coverage of the insured deposits.[28] However, the DPFB had no mandate to minimise risk to its insurance fund through enforcement actions against the insured banks and depended on the CBK to supervise banks and enforce any regulatory breaches.[29] The DPFB's lack of risk minimisation precluded it from intervening in insured institutions, which enabled insolvent banks to continue to receive open bank assistance and emergency liquidity

[21] See ch 2 par 2.3.3.3.
[22] See ch 2 par 2.3.2.3.
[23] See ch 2 par 2.4.
[24] See ch 2 par 2.5.1.2.
[25] S 37 of the Banking Act 9 of 1989.
[26] See *IADI Core principles* 11.
[27] S 38 of the Banking Act.
[28] *Ibid.*
[29] See M Brownbridge, 'Government policies and the development of banking in Kenya', in M Brownbridge & C Harvey (eds), *Banking in Africa: The impact of financial sector reform since independence,* (1998) 92.

assistance (ELA)[30] from the CBK, while still engaging in risky activities.[31] In addition, the DPFB charged flat rate premiums on the basis of the average total deposit liabilities of banks,[32] without regard to the risk profiles of the banks. This approach did not sufficiently limit the moral hazard from the risky banks.[33] However, the coverage of insured deposits up to a limit of Ksh.100 000 limited the moral hazard from depositors to some extent by covering unsophisticated depositors but excluding sophisticated depositors.[34]

4.2.1.2 Institutional structure of DPFB under the CBK

Although the DPFB was established as a body corporate with a separate legal personality, it operated as a department of the CBK.[35] The majority of the DPFB's board of Directors were appointed from the ranks of the CBK or member banks. The CBK's Governor was appointed as the DPFB's Chairman and the Deputy Governor as the DPFB's Deputy Chairman. The Treasury Secretary was an *ex officio* member of the board and the Minister of Finance appointed two members to represent the interests of member banks.[36] Since the Governor of the DPFB was also Chairman of the CBK's board, the DPFB lacked the institutional and operational independence to carry out its mandate.[37] Although Demirguc-Kunt *et al* argue that it does not matter whether the EDIS is independently established or hosted at the Ministry of Finance or the central bank (because it will still be technically legally separate),[38] it is submitted that the hosting of the DPFB at the CBK may have affected its capacity to effectively discharge its mandates.[39]

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[30] See ch 2 par 2.3.2.3.
[31] See Brownbridge 92.
[32] S 38(3) of the Banking Act.
[33] See *IADICore principles* 11.
[34] S 39 of the Banking Act.
[35] S 36(6) of the Banking Act.
[36] S 36(4) of the Banking Act. The CBK Act was amended in 2015 to provide for an independent non-executive board chairman. See s 11(2) of CBK Act 14 of 2015.
[37] See T Beck, R Cull, M Fuchs, J Getenga, P Gatere, J Randa & M Trandafir, *Banking sector stability, efficiency and outreach in Kenya*, (2010) World Bank research working paper7. The authors observe that the DPFB was institutionally reliant on the CBK and had no role in the supervisory process. See also S Malikha, *An investigation into the role of deposit insurance in Kenya's banking sector stability*, (Unpublished University of Nairobi, MBA Project 2008) 29. The author argues that the dominance of the CBK over the DPFB undermined its independence.
[38] Demirguc-Kunt *et al* 156.
[39] See the Justice Bosire, *Report of the Judicial Commission of Inquiry into the Goldenberg Affair*, (2005) which inquired into the Goldenberg matter and the activities of banks during the banking crises of the 1990s. It found that the weak institutional structures of the DPFB and the CBK were abused by

The effectiveness of the EDIS under the DPFB was also affected by the weak regulatory and supervisory enforcement framework in Kenya at the time.[40] This was not surprising because, as observed by McCoy, EDIS can only be effective in countries with strong institutional frameworks against bank risk-taking,[41] which are manifested through strong financial regulation and supervision.[42] In the case of the DPFB, its introduction during a time of weak bank supervision in Kenya affected its effectiveness.[43] As discussed in Chapter Three,[44] most of the reforms to strengthen bank regulation in Kenya were undertaken *after* the EDIS had been introduced.[45]

The hosting of the DPFB under the CBK also created confusion as to whether its corporate title was the Deposit Protection Fund Board, or the Deposit Protection Fund. Thus, in *John Gichoki Ndenge v Kiambu Dandora Farmers Co. Ltd and the Deposit Protection Fund as Liquidator of Post Bank Credit (in Liquidation),*[46] the plaintiff's claim against the Deposit Protection Fund (DPF) was struck out because he had sued the DPF, which had no legal personality, instead of the DPFB that had the capacity to sue or be sued under the Banking Act.[47] A similar decision was reached in *Deposit Protection Fund as Liquidator for Euro Bank (in Liquidation) v Rose Njeri Macharia and Guardian Bank Ltd*, where a suit had been filed by the DPF instead of the DPFB.[48] The latter suit was also struck out by the court because the DPF was a non-existent

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politicians to influence the extension of LOLR loans and DPFB open bank assistance to insolvent banks that used the funds to advance insider loans. See also SK Mureithi, *The sufficiency of the Deposit Protection Fund's investment options to generate insurance funds for depositors*, (Unpublished Kenyatta University MBA Research Project 2008) 30.

[40] See ch 3 par 3.2.3.2.

[41] See PA McCoy, 'The moral hazard implications of deposit insurance: Theory and evidence', Presentation at seminar on current developments in monetary and financial law, October 2006Washington DC, USA.

[42] See ch 1 par 1.2.1.3. See also P Cartwright, *Banks consumers and regulation,* (2005) 5 and EJ Pan, *Understanding financial regulation*, (2011) Cardozo School of Law Institute of Advanced Legal Studies working paper 13. The author argues that financial regulation should include rule making, supervision of compliance with those rules and enforcement of the compliance. See also CW Lichtenstein, 'Lessons for 21st Century central bankers: Differences between investment and depository banking', in M Giovanoli & D Devos (eds), *International monetary and financial law* (2010) 217.

[43] See EJ Pan, 'Challenge of international cooperation and institutional design in financial supervision: Beyond transgovernmental networks', (2010) *Chicago Journal of International Law* 266.

[44] Ch 3 par 3.2.2.1.

[45] See par 4.1.1 above.

[46] *John GichokiNdenge v KiambuDandora Farmers Co. Ltd and the Deposit Protection Fund as Liquidator of Post Bank Credit (in Liquidation)* HCCC No. 481 of 2006 (2008) eKLR.

[47] *Ibid.*

[48] *Ibid.*

corporate person, which lacked *locus standi*.[49] An appeal to the Court of Appeal was dismissed.[50]

The bank resolution regime under the DPFB adapted ordinary corporate insolvency proceedings, which are judicial in nature, to bank insolvencies by designating the DPFB as receiver, manager or receiver/manager or liquidator for insolvent insured institutions.[51] When acting as such, the DPFB operated under the insolvency provisions administered under the High Court's judicial management procedure.[52] Thus, the DPFB exercised its authority over insolvent banks under the supervision of the CBK and the High Court.[53] Nevertheless, the assignment of bank liquidation functions to the DPFB was considered a major reform to the ordinary corporate insolvency procedures in Kenya.[54]

4.3 EDIS under the Kenya Deposit Insurance Act, No 10 of 2012

4.3.1 The Kenya Deposit Insurance Corporation

To address the abovementioned gaps within the EDIS under the DPFB, Kenya enacted the KDI Act to strengthen its regulatory framework to also address the moral hazard in banking.[55] The KDI Act (originally enacted in 2012) was strengthened through an amendment in 2013,[56] after consultations with the IADI, which

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[49] *Deposit Protection Fund as Liquidator for Euro Bank (in Liquidation) v Rose Njeri Macharia and Guardian Bank Ltd*, HCCC No. 399 of 2005.

[50] See *Deposit Protection Fund Board on behalf of Euro Bank Ltd (in Liquidation) v Rosemary Njeri Macharia and Guardian Bank Ltd,* Court of Appeal Civil Appeal No. 64 of 2007.

[51] S 34(2) of the Banking Act.

[52] Under ss 35(4), 35(12) and 35(13) of the Banking Act. The High Court exercised its judicial management over company insolvencies through ss 212 to 243 of the Companies Act, 1945 on winding up and ss 345 to 364 on the functions of receivers and managers (now repealed and replaced by Companies Act 17 2015). See ch 1 par 1.3.2 for reference on the role of receivers and managers in Kenya as adopted from English doctrines of equity under which a receiver is appointed when the intention is to "collect the debts and realise the assets" of the institution, with no authority to carry on the business. See JM McGhee, *Snell's equity*, (2010) 575. In contrast, a manager is appointed when the intention is not to close the business and is authorised to continue trading. The same person could be appointed as a receiver/manager to undertake both functions.Liquidators were also appointed under the same principles to wind up the affairs of insolvent corporations. See also V Finch, *Corporate insolvency law: Principles and perspectives* (2009) 21.

[53] S 35(10) of the Banking Act.

[54] See T Beck & L Laeven, *Resolution of failed banks by deposit insurers: Cross country evidence*, (2006) World Bank research working paper 11.

[55] S 5 of the KDI Act.

[56] KDI (Amendment) Act 39 of 2013. See also the CBK, *Financial stability report,* (2014) 41.

amendments became law in 2014.[57] The KDI Act established a more effective EDIS and SRR, than those which operated under the DPFB, through an independent legal and institutional framework constituted under the Corporation.[58] The KDI Act authorised the Corporation to own property[59] and hire its own staff.[60] The KDI Act further repealed sections of the Banking Act relating to the powers of the DPFB[61] and those relating to the CBK's powers over the liquidation of financial institutions.[62] However, the CBK's powers to intervene in bank management by appointing the Corporation as a manager for financial institutions in distress were retained in the Banking Act.[63] The next section examines the design of the EDIS under the KDI Act and considers whether such design adequately addressed the gaps in the system that operated under the DPFB and whether it appropriately implemented the *IADI Core principles* to limit moral hazard *ex ante* and the *FSB Key attributes* in mitigating the effects of bank moral hazard *ex post*.[64]

4.3.2 Public policy objectives, governance and mandate of EDIS

4.3.2.1 Public policy objectives

As indicated in Chapter Two,[65] the *IADI Core principles* require jurisdictions to declare the public policy objectives of their EDIS and to prescribe its mandates and institutional framework in legislation.[66] The declaration of policy objectives of an EDIS promotes the main function thereof, namely to assure depositors of reimbursement of their insured deposits to prevent panic withdrawals.[67] The public declaration of policy objectives further educates the public on the scope of insured deposits and the

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[57] See commencement date of the KDI Act 10 of 2012. The KDI Act was further amended by the Microfinance Amendment Act 41 of 2013, to extend deposit insurance cover to registered microfinance institutions.
[58] S 5 of the KDI Act.
[59] S 4(2)(b) of the KDI Act.
[60] S 11 of the KDI Act.
[61] See s 75 of the KDI Act which repealed ss 34(2)(a), 34(3), 34(4), 34(5), 34(6), 35, 36, 37, 38, 39, 40, 41A and 42 of the Banking Act.
[62] S 35(10) of the Banking Act.
[63] See s 34(1) and 34(2)(b), (c), (d), (e), (f), (g) and (h) of the Banking Act. See alsoch 3 par 3.2.3.2 on retention of the CBK's powers to appoint a manager under the Banking Act which may conflict with the Corporation's powers under the KDI Act.
[64] See *IADI Core principles* 10.
[65] Ch 2 par 2.3.2.
[66] *IADI Core principle* 2.
[67] *Ibid.*

potential risk they assume on the amounts of deposits that exceed the sum insured.[68] The KDI Act declares the public policy objectives of the EDIS as the provision of deposit insurance for customers of member banks and the receivership, liquidation and winding up of institutions over which the Corporation has been appointed as receiver or liquidator.[69] The Corporation discharges these objectives through its powers to levy contributions from member institutions,[70] administer the scheme[71] and reimburse depositors of failed member institutions.[72] Consequently, the KDI Act adopts the *IADI Core principle* 1 that recommends that public policy objectives of an EDIS be formally specified and publicly disclosed.[73]

4.3.2.2 Governance and administration of fund

As indicated above, one of the shortcomings of the DPFB's framework, that hosted it within the CBK, was its lack of operational autonomy.[74] This shortcoming was addressed by KDI Act's establishment of the EDIS under the autonomous Corporation.[75] The Corporation is a body corporate with powers to sue and be sued, acquire and own property and borrow,[76] with a significant measure of independence in its governance.[77] The Corporation's board consists of nine members, comprising of the Principal Secretary for the Ministry of Finance, the Attorney General, the Governor of the CBK, six members appointed by the Minister from the private sector, and a Board Secretary.[78]

While three of the six members appointed by the Minister represent members of financial institutions,[79] the other three members are drawn from the general public and should be qualified in law, insurance, banking, economics, commerce, accounting or

[68] *Ibid.*
[69] S 5(1) of the KDI Act. See also J Malala, 'Bank crises management: Which way for Kenya?', 8 paper presented at the Annual Banking Law Update (ABLU) hosted by the University of Johannesburg (October 2016) Johannesburg, South Africa.
[70] S 5(2)(b) of the KDI Act.
[71] S 5(1) of the KDI Act.
[72] S 23(a) of the KDI Act.
[73] *IADI Core principle* 1.
[74] See par 4.2 above.
[75] S 4(1) of the KDI Act.
[76] S 5(2) of the KDI Act.
[77] Par 4.2 above.
[78] S 7(1) of the KDI Act.
[79] S 7(1)(d) of the KDI Act.

other related disciplines.[80] The chairperson of the board is appointed from among the three members drawn from the general public.[81] There have been concerns that the three members of the board that represent financial institutions may be perceived to have conflicts of interest.[82] To address these concerns, the KDI Act disqualifies any director, chief executive officer or manager of an institution that has been placed under receivership, or liquidation, from such membership.[83] In addition, any board members that have an interest in a matter before the board are required to disclose such interest before every meeting and to abstain from any discussion or voting on the matter.[84]

The KDI Act has also established effective criteria for the selection of qualified persons to the governing board, which criteria have enhanced the governance of the EDIS.[85] These provisions are in line with *IADI Core principle* 3 that requires the deposit insurer to be independent from external influence in the discharge of its mandate.[86] The KDI Act also insulates the Corporation from political influence by expressly providing for the Corporation's autonomy as receiver[87] and as liquidator.[88] To promote accountability, the Corporation is required to prepare annual budgets[89] and it is subject to annual audits.[90] These measures render the governance of the Kenyan EDIS operationally independent, transparent and accountable in terms of the *IADI Core principle 3*. The governance structure also addresses the gaps identified in the DPFB's structure.[91]

4.3.2.3 Mandate and powers of the fund

The *IADI Core principles* require that the public policy objectives of the EDIS be aligned to its mandates.[92] As discussed in Chapter Two,[93] the mandates of EDIS are

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[80] S 7(3) of the KDI Act.
[81] S 7(1)(a) of the KDI Act.
[82] See Malikha 29 who argues that representatives of financial institutions should be appointed to an advisory board rather than to the main DPFB board. See also Mureithi 30.
[83] Reg 2(1)(e) of the Regulations as to Conduct of Business and Affairs of the Board.
[84] Reg 7(1) of the Regulations as to Conduct of Business and Affairs of the Board.
[85] S 7(3) of the KDI Act.
[86] *IADI Core principle* 3.1.
[87] S 51 of the KDI Act.
[88] S 61 of the KDI Act.
[89] S 18(3) of the KDI Act.
[90] S 19(2) of the KDI Act.
[91] Par 4.2.1 above.
[92] *IADI Core principle* 2.
[93] Ch 2 par 2.4.3.3.

the official prescription of its roles and responsibilities.[94] Such mandates range from the narrow mandates of "pay-box" and "pay-box plus" to the wider mandates of "loss minimiser" and "risk minimiser."[95] Although the "loss minimiser" and "risk minimiser" mandates need not be assigned to the deposit insurer, it has been observed that such assignment enhances banking sector stability.[96] This is because a deposit insurer with "risk minimiser" and "loss minimiser" mandates is enabled to identify risky banks early which identification triggers early enforcement actions.[97] Indeed, Beck argues that deposit insurance and bank resolution are important parts of the safety net because they reinforce each other, as the effectiveness of an EDIS depends on the efficiency and timeliness of bank resolution.[98]

The KDI Act prescribes the objects and functions of the Corporation as being, to: establish an EDIS and an SRR for insolvent institutions;[99] to levy, administer and apply the funds in accordance with the Act;[100] and to promote sound risk management by institutions to maintain the stability of the financial system.[101] The Corporation is further required to provide incentives to promote sound risk management by member institutions, and to promote financial system stability.[102] To carry out these functions, the Corporation is empowered to, *inter alia*, invest the contributions and enter into transactions that enhance the management of the Fund,[103] reimburse insured depositors of failed banks;[104] and to avert risk to member institutions, the financial system or loss to the Corporation, through acquisition of assets of the insolvent institution.[105] The Corporation is also empowered to advance loans to financial institutions through open bank assistance,[106] or the acquisition of the assets and

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[94] *IADI Core principle* 9.
[95] See ch 2 par 2.4.3.3 for reference to EDIS mandates. See also *IADI Core principle* 2. See further Al-Jafari, 'General guidance for effective deposit insurance mandate', paper presented at the IADI Executive Council meeting (November 2006) Rio De Janeiro, Brazil 7.
[96] See Beck & Laeven 5.
[97] See EGH Hupkes, 'The role of deposit protection and resolution policy in promoting financial stability', 2 IADI research conference (June 2011) Basel, Switzerland.
[98] See T Beck, *The incentive compatible design of deposit insurance and bank failure resolution: Concepts and country studies*, (2003) The World Bank development research working paper 2.
[99] S 5(1) of the KDI Act.
[100] S 5(2) of the KDI Act.
[101] S 6(b) of the KDI Act.
[102] S 5(2) of the KDI Act.
[103] S 6(a) of the KDI Act.
[104] S 23 of the KDI Act.
[105] S 6(b)(i) of the KDI Act.
[106] S 6(b)(ii) of the KDI Act.

capital instruments of failed institutions.[107] Since the use of public funds to avert risk to member institutions (contagion) or the financial system (systemic risk) involves bail-out of the failed institutions and creates the "Too-Big-To-Fail" dilemma, the KDI Act requires the Corporation to exercise the powers to avert systemic risk only with the approval of the Treasury Secretary.[108]

From all these functions and powers, it appears that the Corporation exercises the broadest mandate of "risk minimiser" through the authority to "avert risk to member institutions and the financial system."[109] It also discharges the "loss minimiser" mandate through the adoption of the least costly resolution strategy for insolvent institutions.[110] Consequently, the Corporation combines the "risk minimiser" mandate in administering the EDIS and the "loss minimiser" role in conducting resolution as receiver and liquidator,[111] which enables the Corporation to participate in the safety net provision.[112]

Since the CBK is the banking supervisor, it is empowered to appoint the Corporation as receiver of distressed banks, which raises the question as to whether the CBK is the RA that appoints the Corporation as administrator in terms of the *FSB Key attribute* 3 or whether the Corporation is the RA whose powers are triggered by the CBK's appointment.[113] It is submitted that the Corporation is the RA under the KDI Act, which designates it as the sole body to discharge the functions of receiver or liquidator under the Act.[114] The designation of the CBK as regulator to appoint the Corporation as RA may be justified on grounds of promoting accountability in the resolution process by separating the CBK's mandate to appoint the RA, from the Corporation's RA mandate to exercise resolution powers.[115] Thus, the Corporation's mandates support its public policy objectives of protecting depositors of failed institutions and the maintenance of

[107] S 6(b)(iii) of the KDI Act.
[108] Proviso to s 6(b) of the KDI Act.
[109] S 6(b) of the KDI Act.
[110] S 50(7)(a) of the KDI Act.
[111] See Beck 2.
[112] S 6(b) of the KDI Act.
[113] See CM Kahn & JAC Santos, *Allocating bank regulatory powers: Lender of last resort, deposit insurance and supervision*, (2001) BIS working paper 3.
[114] S 5 of the KDI Act sets out the objective of the Corporation as to *inter alia* receive, liquidate and wind up institutions. The Corporation may be appointed as a receiver under s 43 of the KDI Act.
[115] See *IADI Core principle* 3 that requires EDIS to be accountable. See also par 4.4.2.3 above.

the stability of the financial system in terms of the *IADI Core principle* 2 that requires mandates of EDIS to support public policy objectives.

4.3.3 Sources and use of funds

4.3.3.1 Operational funds of the EDIS

According to Bretschneider and Benna,[116] the funding of an EDIS is its most significant design feature and thus the critical determinant of the effectiveness of an EDIS in reimbursing depositors.[117] The KDI Act has addressed this critical feature by establishing an operational fund for the administrative expenses of the Corporation[118] and a Deposit Insurance Fund (the Fund) into which the Corporation pools premiums and other monies for the reimbursement of depositors.[119]

The operational fund of the Corporation consists of, *inter alia*, monies donated or lent to the corporation,[120] earnings on its investments[121] and appropriations in aid from Parliament.[122] The appropriations from parliament provide an important supplement to the Corporation's other sources of funds for the resolution of systemic banks.[123] The Corporation is restricted from charging its operational expenses to the Deposit Insurance Fund,[124] unless its board determines that its operational funds are not sufficient to meet its expenses.[125] Upon such a determination, the board may transfer the required funds from the Deposit Insurance Fund to the operational fund.[126] It is submitted that the criteria for the transfer of monies from the Deposit Insurance Fund to meet the Corporation's operational expenses is not satisfactory because it does not require independent approval. Consequently, the board's authority is susceptible to similar abuse as that which transpired during the banking crisis of the 1990s.[127] Since

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[116] B Bretschneider & R Benna, 'Risk-based premium modes for deposit insurance systems' in JP Notte, I Sfandyar& Z Khan, *Deposit insurance systems: Addressing emerging challenges in funding, investment, risk-based contributions and stress testing*, (2017) 141.
[117] *Ibid.*
[118] S 16 of the KDI Act.
[119] S 20 of the KDI Act.
[120] S 16(1)(b) of the KDI Act.
[121] S 16(1)(c) of the KDI Act.
[122] S 16(2) of the KDI Act.
[123] EN White, *State sponsored insurance of bank deposits in the United States* 1907–1929, (1981) 538.
[124] *Ibid.*
[125] S 16(4) of the KDI Act.
[126] *Ibid.*
[127] See par 4.2.1.1 above.

the size of the Deposit Insurance Fund should be protected to enable it to meet depositor withdrawal needs, the board's authority to transfer funds from it to the operational fund, for disbursements which do not enjoy statutory protection, may affect the Corporation's capacity to discharge its mandates, especially the reimbursement of depositors.[128] To address these concerns, it is submitted that the KDI Act should make the conditions for the board's transfer of funds from the Deposit Insurance Fund more onerous by requiring ministerial approval and annual reports that explain the grounds for such transfers to be submitted to parliament.

4.3.3.2 The Deposit Insurance Fund of the EDIS

The Fund represents the pool of premiums and other monies that are earmarked for the reimbursement of depositors of failed banks,[129] and consists of money transferred from the DPFB,[130] contributions by financial institutions,[131] loans from the CBK[132] and money appropriated by Parliament to meet shortfalls.[133] As indicated by Demirguc-Kunt *et al* the legislative authority for lines of credit from the central bank and government appropriations are a statutory guarantee or "government backstop" to augment any shortfall in an *ex ante* fund.[134] To prevent the Corporation's overreliance on loans and to motivate it to harness and prudently manage its finances,[135] the KDI Act limits the Corporation's authority to borrow to a maximum of twenty five per cent of the Fund.[136]

The main source of the Fund is the premiums charged from member banks. These are levied using two methods, namely, an annual flat rate to institutions that are safe and sound[137] and a risk-based premium charged to institutions which pose risk that threatens their safety or the interest of their depositors.[138] The KDI Act prescribes the rate of levying the flat rates to be not less than Ksh 300 000 (approximately US$ 3000) nor more that 0.4 % of the average of the institution's previous year's total deposit

[128] See ss 51 and 61 of the KDI Act that provide for the independence of the Corporation in discharging its functions as receiver and liquidator respectively.
[129] S 20 of the KDI Act.
[130] S 20(3)(a) of the KDI Act.
[131] S 20(3)(b) of the KDI Act.
[132] S 20(3)(c) of the KDI Act.
[133] S 20(4) of the KDI Act.
[134] Demirguc-Kunt*et al* 170.
[135] S 21(1) of the KDI Act.
[136] S 21(2) of the KDI Act.
[137] S 27(1) of the KDI Act.
[138] S 27(4) of the KDI Act.

liabilities.[139] This limits the flat rate premiums to the deposit liabilities of institutions that are considered to be safe and sound.[140] Although the risk-based premiums are charged to the riskier banks to penalise their risky behaviour and limit the moral hazard it creates,[141] the KDI Act does not prescribe a framework or assessment methodology for charging such risk-based premiums. In addition, the KDI Act does not clarify whether it is the Corporation or the Treasury Secretary that should determine the risk-based premiums payable.[142] Consequently, the Corporation levies these risk-based premiums on an *ad hoc* basis, upon discovery of an institution's engagement in risky activities.[143] It is however submitted that, for risk-based premiums to effectively discourage risk-taking, a clear assessment methodology should be developed that prescribes explicit triggering criteria.[144]

Once the Corporation has pooled its funds, it may only invest in government securities, unless the Treasury Secretary approves its investment of funds in other securities or currencies.[145] Ministerial approval may be rationalised as a mechanism to protect the Corporation's funds from the volatility in capital markets, which justified the prohibition of the DPFB from investing in capital markets.[146] Payments from the Fund may only be used to reimburse insured depositors,[147] assist banks with liquidity problems[148] and facilitate the resolution of failed banks.[149]

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[139] S 27(2) of the KDI Act.
[140] *Ibid.*
[141] See Bretschneider & Benna 48, where it is argued that risk-based premiums motivate banks to significantly reduce risk. Compare with MSM Peria & SL Schmukler, 'Do depositors punish banks for bad behavior? Market based discipline, deposit insurance and banking crises', (2001) *Journal of Finance* 1030, who argue that risk-based premiums are only effective in jurisdictions with strong regulatory enforcement and market discipline. In addition, since risk-based premiums rely on past behavior of banks they may not accurately predict future bank risk-taking. Despite these limitations, charging risk-based premiums is an effective tool to prevent moral hazard.
[142] See Bretschneider & Benna 49 who argue that it does not matter who between the EDIS or the Minister for Finance determines the methodology of charging risk-based premiums.
[143] See McCoy 19.
[144] See Bretschneider & Benna 49 who argue that the risk-based premium assessment methodology should be transparent, significantly differentiate the premium categories and keep the ratings for premium levies confidential.
[145] S 22.
[146] Mureithi 5. Essential criteria 6 of the *IADI Core principle 9* requires EDIS to adopt effective risk management measures that preserve its capital and liquidity. See also CBK, *Financial stability report*, (2014) 48.
[147] See generally GL Verley, 'Global overview of resolution: A focus on purchase and assumption', Financial Safety-net Conference (May 2015) Stockholm, Sweden.
[148] S 6 of KDI Act.
[149] *Ibid.*

The design of the EDIS under the KDI Act implements *IADI Core principle* 9 by providing *ex ante* readily available funds to promptly reimburse deposit claims.[150] It also provides liquidity financing to needy banks[151] and incorporates the *FSB Key attribute* 6.5, that requires bank resolutions to be financed by an *ex ante* deposit insurance scheme paid for by banks.[152]

4.3.4 Coverage and payment of insured depositors

4.3.4.1 Scope of coverage

The KDI Act limits the scope of cover of insured deposits under the EDIS to "insured deposits", which are the aggregate balance of deposits in accounts, including "a bank draft, certified cheque or payment instruction or other liability or financial instrument."[153] However, "deposits not payable in Kenya,"[154] "bearer certificates of deposit, or any money payable under a repurchase agreement, any inter-bank transaction or other transaction" do not qualify as insurable deposits.[155] Although the Act does not provide a rationale for the excluded deposits, it should be noted that the insured deposits may only be held by unsophisticated depositors who may require consumer protection.[156] In contrast, the excluded deposits generally appear to belong to more sophisticated depositors who are presumed to be able to afford the means of protecting their investments.[157] Thus, the scope of insured deposits is limited to unsophisticated depositors which serves to obligate depositors of larger sums to share in the costs of bank failure, by either absorbing the loss or by protecting themselves through market discipline.[158]

The KDI Act limits the insured deposit to the aggregate credit balance on a customer's account or accounts to a maximum of Ksh. 100,000, (approximately $US 1000) or

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[150] *IADI Core principle* 15.
[151] *IADI Core principle* 13.
[152] *FSB Key attributes* 6.5
[153] S 2.
[154] Although the KDI Act does not explain what "deposits not payable in Kenya" means, these could include deposits of foreign subsidiaries of Kenyan banks or deposits of foreign banks whose Kenyan subsidiaries have insured deposits. It is submitted that the KDI Act should clarify the meaning of this phrase in light of current financial technology that facilitates payments of deposits across countries.
[155] *Ibid.*
[156] *IADI Core principle* 7. See also ch 2 par 2.3.3.2.
[157] *Ibid.*
[158] See *IADI Core principle* 7.

such higher sum as the Corporation may determine.[159] This sum is similar to the amount previously insured by the DPFB.[160] Accordingly, since depositor reimbursement should be effected expeditiously, after the Corporation reimburses the Ksh 100 000, any excess credit could be claimed through other resolution options, like the transfer of deposits to a bridge institution or to another solvent institution, which extends the scope of cover beyond the insured sum.[161] However, if bail-in is adopted, the uninsured excess credit is converted into equity thus causing the depositor to share in the losses of the failed bank.[162] Similarly, if the institution is liquidated, the uninsured deposit is subject to creditor hierarchy rights in liquidation that cause the depositor to share in any shortfall of assets to meet all claims *pro rata*.[163] This framework complies with *IADI Core principle* 8 that requires deposit insurance schemes to limit coverage to smaller depositors and leave the fate of large depositors to market discipline.[164]

To encourage the culture of savings and address the hardship that would be suffered by special purpose investment vehicles that deposit funds pooled from diverse investors in banks, the KDI Act insures separate individual deposits in valid trusts, joint accounts and business accounts.[165] Consequently, a deposit held by a trustee for a beneficiary is deemed to be separate not only from that beneficiary's deposit held in his own name, but also separate from any deposit held for that beneficiary's benefit in any other trust or joint account.[166] The insured deposit within trust accounts is the balance of each beneficiary's trust deposit, which is deemed to be separate from any other deposits the beneficiary may have in a separate account with the same institution.[167] The reason for this provision is to encourage bank intermediation that helps customers to pool their savings through trusts that enable them to invest in

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[159] S 28(1) of the KDI Act. The Corporation has proposed to increase the insured amount from the current Ksh 100 000 to more than Ksh 200 000, to take account of inflation from the time that the DPFB set the coverage at Ksh 100 000 in 1985. See P Alushula, 'New law to see depositors of collapsed banks get more cash', *The Standard* 16.6.2017 43. See also B Ngugi, 'Risk cutter puts banks under watch', *Daily Nation* 24.10.2017 38. However, at the time of concluding the study on 12.12.2018, no formal legislative instruments have been issued to effect the proposal.
[160] See par 4.2.1.1 above.
[161] See ch 2 par 2.4.1.3 for resolution options.
[162] *Ibid.*
[163] *Ibid.*
[164] *IADI Core principles* 27.
[165] S 29(1)(a) of the KDI Act.
[166] S 29(1)(c) of the KDI Act.
[167] S 29(1)(b) of the KDI Act.

ventures that they would not individually have been able to afford to invest in. It further recognises that the trust funds may have been pooled from unsophisticated employees or other members of the public into pension funds, retirement schemes and other collective investment vehicles and that it thus requires protection.[168] This protection of deposits in trusts is limited to deposits that are in designated trustee accounts that specify the beneficiaries.[169] In addition, the trustee should have maintained prescribed trust records and filed certificates authenticating their accuracy with the Corporation.[170] This prevents abuse of the trustee accounts by persons establishing trusts for purposes only of increasing deposit insurance coverage for the beneficiaries.[171] Similarly, deposits in accounts held for businesses as sole proprietorships or partnerships[172] or for professional practices are also deemed to be separate from the deposits of the beneficiaries in their own names.[173] However, the financial institution must have clearly designated such accounts in its records, with appropriate particulars of the business concerned.[174]

4.3.4.2 Payment of insured depositors

As discussed in Chapter Two,[175] the essence of EDIS is to assure depositors of financial institutions in distress of reimbursement of their claims in order to prevent bank runs that could develop into a contagion.[176] This is why *IADI Core principle*15 requires that EDIS should be well funded to promptly reimburse depositors of failed institutions thereby enhancing public confidence in the financial system.[177] The KDI Act requires the Corporation, upon being appointed as receiver,[178] to invite claims to facilitate the reimbursement of insured depositors.[179]

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[168] S 29(1)(c) of the KDI Act.
[169] S 29(2)(a)(i) of the KDI Act.
[170] S 29(2)(b) of the KDI Act.
[171] S 29(3) of the KDI Act.
[172] S 29(5)(a) of the KDI Act.
[173] S 29(5)(b) of the KDI Act.
[174] *Ibid.*
[175] See ch 2 par 2.3.3.1.
[176] See also ch 1 para 1.2.2 and 1.2.3.
[177] See *IADI Core principle* 15 that requires jurisdictions to establish clear criteria for the prompt reimbursement of failed institutions.
[178] The CBK may appoint the Corporation a receiver of an institution under s 43 of the KDI Act, discussed under par 4.4.2.3 below.
[179] S 33(2) of the KDI Act.

One challenge in reimbursing depositors of failed banks in Kenya as experienced by the DPFB was the failure of the majority of insured depositors of failed institutions to lodge claims.[180] According to Mbaabu, despite media publicity that advised depositors of failed institutions to lodge claims for reimbursement, a "significant number of depositors still failed to lodge claims until they were barred by statutory limitation."[181] It is arguable that this challenge may still be faced by the Corporation. Nevertheless, upon receipt of claims, the Corporation may decline to pay the claim if the depositor contributed to the insolvency of the institution as a director, manager or officer.[182] The Corporation may also set off any loans or debts owed by the depositor to the institution.[183] To further mitigate its costs, the Corporation subrogates[184] to the rights of the reimbursed depositors in the assets of the insolvent institution.[185] These measures enable the Corporation to recover its costs of resolution and mitigate losses to the Fund.[186] These measures accordingly implement the *IADI Core principle* 12 that requires an EDIS to seek legal redress against those responsible for an institution's failure.[187]

4.3.5 Membership of the Deposit Insurance Fund

The KDI Act prescribes a mandatory membership of its EDIS for all "banks, financial institutions, mortgage finance companies, microfinance banks or any other deposit taking entities",[188] licensed by the CBK.[189] The names of all insured members are required to be published to notify the public of the available insured institutions.[190] Mandatory membership prevents the stronger banks from opting out of the EDIS,

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[180] Compare with GN Mbaabu, *Strategy implementation at the Deposit Protection Fund board, Kenya* (Unpublished University of Nairobi MBA Project 2012) 28.
[181] *Ibid.*
[182] S 33(5) of the KDI Act.
[183] S 33(7) of the KDI Act.
[184] S 35(1) of the KDI Act defines subrogation as the assumption by the Corporation of all the rights and interests of the reimbursed depositor in the failed institution, for which it can maintain an action in its own name or that of the depositor. See also *IADI Core principles* that define it as "the substitution of one party in the rights of another over a lawful claim or remedy*".* See *IADI Core principles* 10.
[185] S 35(1) of the KDI Act.
[186] See Mbaabu 29, where the author found the major challenge of subrogation to be the difficulty for the DPFB to recover loans secured by rural based family land.
[187] *IADI Core principles* 35.
[188] S 2 of the KDI Act.
[189] S 24(1) of the KDI Act.
[190] S 24(3) of the KDI Act.

which would leave only the weakly capitalised and riskier banks as members.[191] Arguably, if the EDIS comprised of only the weaker banks, it would be exposed to greater risk of loss because of the potential claims arising from the potentially higher risk of failure by the weaker and riskier banks. Accordingly, the mandatory membership enables the stronger, better capitalised banks to spread the risk of failure among a diversified group of banks.[192] In addition, it cushions the smaller and weaker banks from the perception that they are in greater need of the deposit insurance than the larger ones.[193] These provisions implement *IADI Core principle* 7, which requires mandatory membership of all banks.[194]

4.3.6 Legal protection of officers and employees of the deposit insurer

The Corporation's directors, officers and employees are protected from personal liability for any *bona fide* act done or omitted in the execution of their statutory duties.[195] However, the Corporation is vicariously liable for any injury suffered from the exercise of its statutory powers and for the tortious or contractual liability of its directors, officers and employees.[196] The legal protection of directors, officers and employees of the Corporation seeks to encourage them to discharge their functions without fear and thereby complies with *IADI Core principle* 11, which recommends such protection.[197]

4.3.7 Cross-border cooperation

The Corporation is empowered to share any law enforcement information with law enforcement agencies for investigation or enforcement.[198] Similarly, it may share information with other monetary or financial regulatory authorities or fiscal, tax or fraud investigation agencies within or outside Kenya, provided that there are reciprocal arrangements for those outside Kenya.[199] The Corporation's collaborations and

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[191] See FS Mishkin, *The economics of money, banking, and financial markets,* (2016) 41. Adverse selection arises when a party that is most likely to create the undesirable or adverse outcome is most likely to seek the insurance cover and becomes the most likely to be selected.
[192] *Ibid.*
[193] *Ibid.*
[194] *IADI Core principles* 26.
[195] S 13(1) of the KDI Act.
[196] S 13(2) of the KDI Act.
[197] *IADI Core principles* 34.
[198] S 71(1) of the KDI Act.
[199] S 71(2) of the KDI Act.

coordination with foreign deposit insurers in relation to foreign banks implements *IADI Core principle* 5, which encourages such endeavors.

4.3.8 Relationship with safety-net providers

As observed in Chapter Two,[200] the design of the safety net is critical for the effective enforcement of macroprudential regulation.[201] The deposit insurer participates in the safety net provision through the "risk minimiser" and loss "minimiser mandates." However, the assignment of the "risk minimiser" function to the EDIS may engender potential conflicts with the central bank's discharge of prudential regulation and LOLR functions.[202] To mediate this relationship between the Corporation and the CBK, the KDI Act requires the CBK to expeditiously inform the Corporation of any material changes to the deposit liabilities or other conditions of institutions that may significantly affect the risk to the Fund.[203] The CBK is also required to provide the Corporation with any rating or assessment of the financial condition, safety and soundness of an institution that may enable the Corporation to better manage the risk to its fund.[204]

These provisions facilitate co-operation and co-ordination between the Corporation and the CBK for early identification of risk that may then trigger enforcement action against problem banks. It also leverages the benefits of the CBK's function as banking supervisor through off-site examinations by means of the filing of information and reports[205] and on-site bank examinations, inspections[206] and audits.[207] Therefore, the KDI Act provides synergy between the functions of the Corporation and the CBK and facilitates a coordinated response to bank risk-taking. The Corporation is likewise required to submit to the CBK any information it obtains after inspecting the operation, safety and soundness of insured institutions, their subsidiaries or associates.[208] The sharing of information with the CBK implements the *IADI Core principle* 4, which

[200] See ch 2 para 2.2.2.3 and 2.3.3.4.
[201] See ch 2 par 2.2.2.3.
[202] *Ibid.*
[203] S 40(4) of the KDI Act.
[204] S 40(6) of the KDI Act.
[205] Ss 27 to 31 of the Banking Act.
[206] S 32 of the Banking Act.
[207] S 24 of the Banking Act.
[208] S 40(8) of the Banking Act.

recommends a formal and comprehensive framework for the coordination of activities and information sharing between the deposit insurer and other safety net providers.[209]

4.3.9 Participation in contingency planning and crisis management

The *IADI Core principles* require EDIS to participate in contingency planning and crisis management to enhance its capacity to promote financial stability.[210] Participation in contingency planning also enables the EDIS to detect risks early and to expeditiously intervene in institutions.[211] Early intervention in problem institutions prevents them from gambling on resurrection, which may exhaust their capital and net-worth and increase losses to the deposit insurance fund.[212] The KDI Act addresses this problem by requiring the Corporation to enter into agreements with the CBK or other regulators in Kenya or abroad,[213] to facilitate its role to avert risk to member institutions.[214] Consequently, the KDI Act facilitates collaboration between the Corporation as "risk minimiser" and the CBK as the primary supervisor for banks under the Banking Act.

The CBK as primary supervisor of banks, conducts off-site and on-site inspections that enable it to enforce compliance of banking laws against non-compliant banks.[215] Consequently, whenever the Corporation requires information for its deposit insurance purposes, it may request the CBK to inspect insured institutions and furnish it with the necessary information.[216] To prevent regulatory forbearance,[217] which may arise when the CBK delays to inspect an institution, the Corporation may examine insured

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[209] *IADI Core principles* 23.
[210] *IADI Core principle* 6.
[211] *IADI Core principle* 13.
[212] See ch 2 par 2.3.2.2. Gambling for resurrection is a moral hazard from insolvent banks that take excessive risks in the hope of earning high profits in the knowledge that if their gambles fail, the government will bail them out. See RA Cole, JA McKenzie & LJ White, 'Deregulation gone awry: Moral hazard in the savings and loan industry,' in A Cottrell, M Lawlor & J Woo (eds), *The causes and consequences of depository institution failures,* (1995) 29.
[213] S 6 of KDI Act.
[214] S 6(c) of the KDI Act.
[215] S 38 of the Banking Act.
[216] *Ibid.*
[217] Regulatory forbearance arises when regulators delay of forbear to act, hoping that the regulated entity will improve its situation, or where there are two or more regulators covering the entity that another regulator will act. See ch 2 par 2.2.2.3. See also JM Edwards, 'FDICIA and Dodd-Frank: Unlearned lessons about regulatory forbearance', (2011) *Harvard Business Law Review* 281.

institutions,[218] at the institutions' own cost.[219] Upon such examination, the Corporation is obliged to furnish the results thereof to the CBK.[220]

The Corporation may also recommend to the CBK in writing that enforcement action be taken against a non-compliant institution.[221] If the CBK fails or delays to take such enforcement action within thirty days from the date of the Corporation's request, the Corporation is obliged to serve the institution and the CBK with a notice to terminate the institution's insurance cover.[222] At the expiry of the notice, the Corporation may terminate the institution's insurance cover.[223] Although this procedure enables the Corporation to minimise the risk to the Fund, it is arguably only invoked as a last resort and may be averted either if the CBK takes the appropriate enforcement actions or if the institution takes corrective actions upon receipt of the notice to terminate insurance cover.

The KDI Act also empowers the Corporation to enforce prompt corrective actions to resolve problems in institutions that threaten the interests of depositors and the banking sector.[224] However, the KDI Act prescribes neither the specific prompt corrective actions to be enforced nor the framework for their implementation. Accordingly, the Corporation may only rely on the CBK's prompt corrective actions framework as discussed in Chapter Three.[225] This gives the CBK the primary authority to enforce prompt corrective actions under the Banking Act, with the Corporation being granted supplementary authority to enforce them after consulting the CBK.

Under the Banking Act, the CBK may intervene in institutions that are managed imprudently by, *inter alia,* restricting the institution's payment of dividends[226] or conversion of profits to capital[227] or requiring the dismissal of culpable officers.[228] In addition, the CBK may direct such institutions to, *inter alia,* reconstitute their boards,[229]

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[218] S 39(1) of the KDI Act.
[219] S 39(6) of the KDI Act.
[220] S 39(5) of the KDI Act.
[221] S 41(1) of the KDI Act.
[222] S 41(2) of the KDI Act.
[223] S 41(3) of the KDI Act.
[224] S 42 of the KDI Act.
[225] See ch 3 par 3.2.3.3. See also CBK, *Guidelines on prompt corrective actions,* (2013).
[226] S 33A(a) of the Banking Act.
[227] S 33A(b) of the Banking Act.
[228] S 33A(c) of the Banking Act.
[229] S 33A(d) of the Banking Act.

terminate further growth in assets or liabilities[230] or prepare and implement a capital restoration plan[231] or plan to resolve other deficiencies.[232] Thus, the KDI Act facilitates the Corporation's execution of its "risk minimiser" mandate, promotes information sharing with the CBK and shifts the costs of surveillance to the banking institutions. The KDI Act probably minimises regulatory forbearance by authoring the Corporation to examine banks and to terminate deposit insurance if the CBK delays to inspect or take enforcement action against a non-compliant bank. This framework implements *IADI Core principle* 4 that recommends collaboration between the EDIS and other safety net providers.

4.4 Policy framework for bank resolution in Kenya

4.4.1 Introduction

4.4.1.1 Overview of the role of depositor preference in special bank resolution

As discussed in Chapter One,[233] an EDIS establishes depositor preference in bank insolvencies, unlike ordinary corporate insolvency that mainly seeks to protect the assets of the insolvent company from a "free-for-all" pursuit of recovery by individual creditors.[234] Ordinary corporate insolvency also follows creditor hierarchy laws that rank depositors among unsecured, and thus concurrent, creditors who may only recover funds if there are residual assets remaining after paying secured creditors.[235] To prevent depositors from resorting to panic withdrawals from problem banks, that would create a contagion of bank runs, depositor preference assures depositors of reimbursement of their deposits in failed banks.[236] Depositor preference is further important because depositors represent the largest group of creditors of banks, whose deposits in cash constitute the largest liquid bank liabilities, unlike bank assets that consist of the loans they advance.[237]

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[230] S 33A(j) of the Banking Act.
[231] S 33A(g) of the Banking Act.
[232] *Ibid.*
[233] See ch 1 par 1.2.3.
[234] Finch 21.
[235] EGH Hupkes, 'Insolvency – why a special regime for banks?', (2003) *Current developments in monetary and financial law* 3.
[236] *Ibid.*
[237] *Ibid.*

4.4.1.2 KDI Act's special bank resolution framework

The KDI Act establishes the EDIS in Kenya and combines it with an SRR for insolvent banks and designates the Corporation as the RA.[238] Prior to the enactment of the KDI Act, the CBK was authorised to appoint the DPFB as manager for institutions in financial distress under the Banking Act.[239] Once appointed, the DBFB took over the affairs of the institution from its board of directors[240] and from any other receiver or receiver/manager that may have previously been appointed.[241] In addition, the CBK could have appointed the DPFB as liquidator,[242] who then proceeded with its functions in terms of the Companies Act.[243] As observed above,[244] although the KDI Act repealed provisions relating to the DPFB,[245] the provisions relating to the CBK's authority under the Banking Act to appoint the Corporation as manager of financial institutions in distress, were retained.[246]

Consequently, the CBK's powers to appoint the Corporation as receiver under the KDI Act are additional to the CBK's powers to appoint the Corporation as manager under the Banking Act. As observed above,[247] while receivers were appointed under the Companies Act to collect the debts and realise the assets of the insolvent company under English doctrines of equity without authority to continue its business; managers are appointed to continue the company's business.[248] It should be noted that although receiverships were replaced by administration when the Companies Act was repealed and its insolvency provisions enacted in the Insolvency Act, 18 of 2015 that replaced receivers and managers with administrators, the KDI Act has not yet been amended to reflect this change.[249]

Accordingly the CBK may appoint the Corporation as receiver of institutions under the KDI Act if, *inter alia*, the institution's assets are less than its liabilities, or the institution

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[238] S 5 of the KDI Act.
[239] S 34(2)(a) of the Banking Act.
[240] S 34(2)(a) of the Banking Act.
[241] S 34(1)(b) of the Banking Act. See par 4.2.1.2 above for definitions of receiver/managers.
[242] S 35 of the Banking Act.
[243] S 36 of the Banking Act.
[244] Par 4.3.1 above.
[245] S 75 of the KDI Act.
[246] See par 4.3.1 above for the sections of the Banking Act that were repealed by the KDI Act.
[247] Par 4.2.1.4 above.
[248] McGhee 575.
[249] Part VIII of the Insolvency Act.

conducts its business in an unsafe manner, or it willfully violates a regulatory order.[250] The CBK may also appoint the Corporation as liquidator of an institution if the institution is deemed to be unable to pay its debts, or a winding up order is made against it, or if it engages in a breach of Kenyan or other applicable law.[251] In addition, the CBK may in writing notify the Corporation of an institution that has ceased or is about to cease to be viable, upon which the Corporation is obligated to take any prescribed enforcement actions under the relevant section 44 of the KDI Act.[252]

As the sole agency to be appointed by the CBK as receiver or liquidator of insured institutions, the Corporation discharges the "loss minimiser" mandate[253] over insolvent institutions.[254] This model of combining the administration of the EDIS and the RA in the Corporation improved on the DPFB's model that conducted bank resolution under general corporate insolvency law.[255] Consequently, the KDI Act has established an SRR and designated the Corporation as the RA to "receive, liquidate and wind up" institutions that have ceased or are likely to cease to be viable,[256] over which it "is appointed as receiver."[257] This framework is in line with *FSB Key attribute* 3 that requires jurisdictions to establish RAs and empower them to appoint an administrator to take over the business affairs of institutions that cease to be viable from their board of directors.[258]

4.4.1.3 Appointment of the Corporation as manager or receiver

The CBK may trigger resolution powers by appointing the Corporation, in any one of three ways, namely as a manager under s 34 of the Banking Act,[259] or as receiver under the KDI Act[260] or by notifying the Corporation of an institution that has ceased or is likely to cease to be viable, upon which the Corporation exercises powers under section 44 of the KDI Act as discussed.[261]

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[250] S 43 of the KDI Act.
[251] S 54 of the KDI Act.
[252] S 44 of the KDI Act.
[253] Ch 2 par 2.3.3.3 and par 4.3.2.3 above.
[254] Par 4.3.2.3 above.
[255] Par 4.2.1.2 above.
[256] FSB *Key attribute* 3.
[257] S 5(1) of the KDI Act.
[258] See ch 2 par 2.4.1.2.
[259] S 34(2)(b) of the Banking Act.
[260] S 43 of the KDI Act.
[261] S 44 of the KDI Act.

(a) Appointment of the Corporation as manager under the Banking Act

The CBK may appoint the Corporation as manager of an institution under the Banking Act,[262] if the institution fails to meet its financial obligations, [263] a petition is filed or a resolution proposed to wind up the institution,[264] its assets are placed under a receiver or receiver/manager or if the institution threatens the interests of depositors or other creditors.[265] The Corporation may also be appointed as manager of an institution if the institution becomes significantly undercapitalised,[266] or fails to submit a capital restoration plan or to recapitalise or implement a plan of correction[267] or to resolve other deficiencies.[268] Since the powers of the manager under the Banking Act were repealed,[269] the appointment of the Corporation as manager under the Banking Act, does not serve any purpose because the Corporation can only exercise the resolution powers prescribed under the KDI Act. Consequently, I submit that the Banking Act's provisions relating to the appointment of a manager for a distressed bank should be repealed and enacted within the KDI Act as the *lex specialis* on resolution matters.[270]

(b) Appointment of the Corporation as receiver under KDI Act

The CBK may also appoint the Corporation as receiver under s 43(2) of the KDI Act of an institution that, *inter alia*, has less assets than liabilities,[271] engages in unsafe activities that threaten the interests of the institution, depositors or other creditors,[272] wilfully violates a regulatory order[273] or fails to meet a financial obligation or depositors' demand.[274] The Corporation may further be appointed as receiver if the institution incurs losses that deplete its capital with no prospect of recapitalisation without

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[262] S 34(2)(b) of the Banking Act.
[263] S 34(1)(a) of the Banking Act.
[264] S 34(1)(b) of the Banking Act.
[265] S 34(1)(d) of the Banking Act.
[266] S 34(1)(e) of the Banking Act.
[267] S 34(1)(f)(ii) of the Banking Act.
[268] S 34(1)(f)(i) of the Banking Act.
[269] See par 4.3.1. above for the repealed provisions of the Banking Act.
[270] S 3 confers supremacy on the KDI Act as the *lex specialis* on EDIS and resolution matters in any conflict with any other Act.
[271] S 43(2)(a) of the KDI Act.
[272] S 43(2)(b) of the KDI Act.
[273] S 43(2)(c)of the KDI Act.
[274] S 43(2)(e)of the KDI Act.

assistance,[275] is undercapitalised or significantly undercapitalised and unable to meet capital requirements or has substantially insufficient capital.[276]

(c) CBK's notification to the Corporation under section 44

The CBK may notify the Corporation in writing to take over the affairs of an institution under section 44 if the institution "has ceased or is likely to cease to be viable."[277] This provision implies that the Corporation should exercise powers for institutions that have "ceased to be viable" that differ from those that it exercises for institutions that are "likely to cease to be viable". Consequently, while the Corporation may take enforcement actions against institutions that are likely to cease to be viable,[278] it should assume control, as receiver, over institutions that have indeed ceased to be viable.[279] For institutions that are likely to cease to be viable, the Corporation may direct them to, *inter alia*, take corrective action to remedy the deficiencies,[280] stop receiving or paying deposits or conducting any other business[281] or to restructure.[282] It is submitted that, if the institution takes the corrective actions or restructures as directed by the Corporation, the Corporation need not assume control of the institution as receiver. Nevertheless, the CBK's notification to the Corporation of an institution's ceasing to be viable is a useful tool for the discharge of the Corporation's mandate as risk minimiser as it facilitates early intervention in problem institutions before they exhaust their capital.

The Corporation's powers under section 44(2)(a) may thus be exercised in relation to institutions that breach prudential or other regulatory requirements and appear to be similar to prompt corrective actions that are invoked under section 42 of the KDI Act, after institutions are examined by either the CBK[283] or the Corporation.[284] Consequently, I submit that the appointment of the Corporation as manager under the

[275] S 43(2)(f)of the KDI Act.
[276] S 43(2)(h)of the KDI Act.
[277] S 44(1)of the KDI Act.
[278] S 44(2)(a)of the KDI Act.
[279] S 44(2)(b)of the KDI Act.
[280] S 44(2)(a)(i)of the KDI Act.
[281] S 44(2)(a)(ii)of the KDI Act.
[282] S 44(2)(a)(iii)of the KDI Act.
[283] S 38 of the KDI Act.
[284] S 39 of the KDI Act.

Banking Act[285] should be transferred to the KDI Act[286] as part of the Corporation's power to enforce prompt corrective actions for undercapitalised or significantly undercapitalised institutions.[287]

4.4.2 Control of institutions after notification under section 44 of the KDI Act

4.4.2.1 Corporation as receiver under section 44

Once the Corporation has been notified that an institution has ceased or is likely to cease to be viable, it assumes control of the institution as receiver of the institution's assets, liabilities and affairs,[288]or appoints another person to carry on the viable assets, liabilities and affairs of the business,[289] while it (the Corporation) continues to act as receiver for the non-viable parts of the institution for liquidation.[290]

4.4.2.2 Corporation as receiver and manager under section 44

Upon assuming control of the institution, the Corporation exercises the powers of a receiver and manager,[291] under which it may run the whole of the businesses, assets, liabilities, and affairs of the institution. Thus, the Corporation's authority to act as manager under section 44[292] is duplicated by its appointment as manager under the Banking Act.[293] If the Corporation appoints another person to act as manager, the appointed manager may continue the viable parts of the failed bank as a going concern, while it (the Corporation) acts as receiver for the non-viable parts of the institutions for liquidation under section44 (2)(b)(ii).

Thus, it is apparent that there is no value addition in retaining the CBK's powers to appoint the Corporation as manager under the Banking Act, since the same grounds

[285] S 34(1)(e) of the Banking Act.
[286] S 43(2)(g) of the KDI Act.
[287] See par 4.3.9 above. S 2 of the Banking Act refers to institutions as undercapitalised if they fail to meet the prescribed capital requirements and refers to institutions as significantly undercapitalised if they hold less than fifty per cent of the prescribed capital requirements.
[288] S 44(2)(b) of the KDI Act.
[289] S 44(2)(b)(iii) of the KDI Act.
[290] S 44(2)(b)(ii) of the KDI Act.
[291] See par 4.2.1.2 above for a discussion on receiver/managers.
[292] S 44(2)(b) of the KDI Act.
[293] S 34(1)(a) of the Banking Act. Although as defined above, at par 4.2.1.2, the powers of receiver under English doctrines of equity, differ from those of a manager, the KDI Act's prescription of the powers of receiver under s 44 incorporate the powers of a manager. Consequently, the retention of the Corporation's appointment under the Banking Act, to exercise powers that it is already authorised to exercise under the KDI Act, is duplicative.

are used for the Corporation's appointment under both Acts (that is under the Banking Act for Corporation's appointment as manager and under the KDI Act for appointment as receiver), namely, if the institution fails to meet financial obligations,[294] threatens the interests of the institution, depositors or other creditors[295] or is significantly undercapitalised.[296] The Corporation may also be appointed a receiver under both Acts if the institution fails to submit or implement a capital restoration or other correction plan,[297] wilfully disobeys a regulatory order, a winding up petition is filed or a receiver appointed,[298] or if it incurs losses that are likely to deplete its capital[299] or to render it insolvent.[300]

Accordingly, the retention of the powers to appoint a manager under the Banking Act duplicate resolution functions without adding any value to the process. It is submitted that, since the provisions of KDI Act as a *lex specialis* override those of any other statute in relation to EDIS and SRR matters to which it applies, the appointment of a manager under the Banking Act is redundant and the functions of manager are fused into that of receiver under section 44 (2) (b), which are additional to those of a receiver appointed under section 43. The Corporation has used this authority to appoint other reputable banks as managers of banks under receivership. For example in the case of *Chase Bank Limited (In Receivership)* where it appointed the KCB Bank Ltd as manager and in the case of *Imperial Bank Ltd (In Receivership)* where the Corporation appointed the KCB Bank Ltd and the Diamond Trust Bank Ltd as joint managers.[301] The CBK and the Corporation appear to use their authority to establish bridge banks to appoint other banks as managers as an alternative to the power to incorporate bridge banks to continue the provision of the services of the failed bank.[302]

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294 S 34(1)(a) of the Banking Act and s 43(2)(e) of the KDI Act.
295 S 34(1)(d) of the Banking Act and s 43(2)(b) of the KDI Act.
296 S 34(1)(e) of the Banking Act and s 43(2)(h) of the KDI Act.
297 S 34(1)(f) of the Banking Act.
298 S 43(2)(c) of the KDI Act.
299 S 34(1)(b) of the Banking Act.
300 S 43(2)(f) of the KDI Act.
301 See CBK, *Press releaseImperial Bank Limited (in receivership),* 2.12.2015 and CBK, *Press release Chase Bank Limited (in receivership),* 26.4. 2016.
302 See *Key attribute* 3.4 that empowers the RA to establish one or more bridge banks to continue the critical and viable operations of the failed firm.

4.4.2.3 The powers of the receiver appointed by the Corporation under section 44(2)(b)

As indicated above,[303] the powers of the Corporation as receiver under section 44 of the KDI Act are wider than those of a receiver in equity.[304] Consequently upon taking control of an institution, the Corporation may carry on the functions of receiver for non-viable parts of the business and manage the viable parts itself or appoint a manager under section 44(2)(b)(iii) to carry on the whole or part of the business of the institution, while it continues as a receiver for any unviable parts. The manager so appointed assumes all the powers of the institution and its directors,[305] by taking control of the assets, liabilities, businesses and affairs of the institution to carry on its business,[306] until the appointment is revoked.[307] Consequently, the institution's directors cease to transact its business, unless they are authorised by the manager[308] in which case they may be remunerated.[309]

Kenyan courts have tended to uphold appointments by the deposit insurer, unless there are compelling reasons not to. Thus, in *Chuka Properties Ltd v Euro Bank (in Liquidation) Through Deposit Protection Fund Board* (unreported), the plaintiff's application to restrain the manager from selling land that had been charged to the bank under receivership, on grounds that it had never had an account with the bank, was dismissed.[310] It was held that the plaintiff's execution of the charge and use of the loan advanced six years prior to the suit, neither supported a *prima facie* case with a probability of success, nor showed a likelihood of it suffering irreparable injury not capable of compensation by damages.[311] Similarly, in *Tenet Enterprises Ltd and Three Others v Trust Bank Ltd (in Liquidation) and Three Other* an application for an

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[303] Par 4.4.2.2 above.
[304] *Ibid.*
[305] S 45(2) of the KDI Act.
[306] S 45(1)(a) of the KDI Act.
[307] S 45(1)(b) of the KDI Act.
[308] S 45(3)(a) of the KDI Act.
[309] S 45(3)(b) of the KDI Act.
[310] *Chuka Properties Ltd v Euro Bank (in Liquidation) through Deposit Protection Fund Board,* HCCC 605 of 2004 (unreported).
[311] The leading authority in East Africa in determining applications for injunctive relief against receivers of failed institutions who seek to sell charged property to recover loans is *Giella and Partners v Cassman Brown and Company* [1973] EA 358. It held that an interlocutory injunction may be granted if the plaintiff demonstrates either that he or she has a *prima facie* case with a probability of success or is likely to suffer irreparable injury not capable of compensation by damages if the injunction is not granted. If the court is still in doubt, it should consider whether the balance of convenience weighs in favour of or against the granting of the injunction.

injunction against the manager to stop the sale of charged property was dismissed for failure to disclose a *prima facie* case with a probability of success.[312]

While the appointment of a manager authorizes him or her to take over the control of the institution from its directors and officers,[313] the directors or officers are absolved from liability for breach of any fiduciary duty to their shareholders or creditors if they acquiesce or consent to the appointment of the manager.[314] This encourages board facilitation in the appointment of a manager to protect depositors' funds and promote public confidence in the financial system, which are regarded as higher public interest objectives than the interests of shareholders and other creditors of the institution.[315] Similarly, the problem bank may be expeditiously closed by the appointment of a receiver, without due process.[316] This is to protect public deposits that are susceptible to easy appropriation by managers who may anticipate receivership.[317] In addition, the filing of a notice of the intended appointment of a receiver could aggravate the bank's problems by disclosing its financial distress to depositors and other creditors and probably trigger a run on the distressed bank that could potentially initiate a contagion run on other banks.[318]

Under section 46 (1) of the KDI Act, once the Corporation or any person appointed as manager has assumed control over an institution in terms of section 44 (2) (b), no suit may be filed to challenge the Corporation's or other appointed manager's assumption of control.[319] However, aggrieved persons may file damages suits for any losses suffered from any actions of the Corporation or appointed person,[320] which suits shall not affect the Corporation' or appointed person's exercise of control over the bank concerned.[321] Thus, in *Charterhouse Bank Ltd v Central Bank of Kenya, Minister for Finance and Rose Detho,* the court upheld the CBK's authority to appoint a manager (under the repealed provisions of the Banking Act) to protect the interests of the

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[312] *Tenet Enterprises Ltd and three others v Trust Bank Ltd (in Liquidation) and Three Others* High Court Environmental and Land Case No. 422 of 2012, per Justice Gacheru.
[313] S 52 of the KDI Act.
[314] *Ibid.*
[315] *Ibid.*
[316] S 50(2) of the KDI Act.
[317] Hupkes (2003) 3.
[318] Ch 1 par 1.2.1.
[319] S 46(1)(a) of the KDI Act.
[320] S 46(2) of the KDI Act.
[321] S 46(3) of the KDI Act.

institution, its depositors and creditors.[322] In this matter the manager had been appointed after the plaintiff bank failed to take corrective actions subsequent to breaching banking regulations. The bank sought to vacate (set aside) the CBK's appointment of the manager on the grounds that it was still solvent and had not violated all the conditions of a manager under section 34 of the Banking Act.[323] The court rejected this argument and upheld the statutory manager's appointment because a violation of any one of the conditions of section 34 of the Banking Act could trigger the appointment of a manager to protect depositors before the bank exhausted its capital.[324] An appeal by the plaintiff was dismissed on grounds that the interests of the institution, depositors and other creditors were best protected by the statutory manager, who was to "discharge her duties with diligence and in accordance with sound banking and financial principles."[325]

The KDI Act overrides any decision by a creditor to set-off any debt against the institution under receivership, except for the consolidation of accounts to facilitate normal clearance and settlement services on an exchange.[326] Similarly, no person may amend, terminate or accelerate payment under any agreement with the institution merely because it is insolvent or has defaulted in terms of the agreement or because a manager has been appointed.[327] Any restrictive covenants in prior agreements with the institution that either restrict the CBK's authority to appoint a manager or his or her powers over the institution's assets are also overridden.[328]

The control of an institution under section 44(2)(b) also affects the provision of new supplies and advances to the institution as an evaluation has to be undertaken to decide which of the supplies and advances should be continued or terminated.[329] However, the manager may continue trading by paying for goods and services,[330] but is not obliged to continue service agreements for cash management, redemption of

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[322] *Charterhouse Bank Ltd v Central Bank of Kenya, Minister for Finance and Rose Detho,* (2006) High Court Miscellaneous Civil Application No 649 of 2006 reported at eKLR, available at <https://www.kenyalaw.org> accessed on 12.6.2017.
[323] *Charterhouse Bank Ltd v CBK and others* 12.
[324] *Charterhouse Bank Ltd v CBK and others* 13.
[325] *Charterhouse Bank Ltd v Central Bank of Kenya, Minister for Finance and Rose Detho,* Court of Appeal Civil Appeal No 200 of 2006.
[326] S 46(1)(b) of the KDI Act.
[327] S 46(1)(c) of the KDI Act.
[328] S 47 of the KDI Act.
[329] S 48(a) of the KDI Act.
[330] *Ibid.*

debt instruments and issue of letters of credit.[331] This enables the manager to evaluate prior agreements and conduct a due diligence to facilitate the preservation of the institution's assets. The manager could then terminate the services that are no longer needed and discharge valid financial obligations that enhance the interests of the institution's depositors, creditors and shareholders.[332] In addition, the Corporation may liquidate or sell the institution's assets and arrange for the assumption of its liabilities by a third party.[333]

4.4.2.4 The powers of Corporation as a receiver under section 50

Upon appointment as receiver under section 43, the Corporation is obliged to take office immediately under section 50, enter the institution's premises and take possession and control over its assets.[334] Once in control, the Corporation may sell or dispose of the assets,[335] arrange for the assumption of any of the institution's liabilities,[336] and assign any security to third parties,[337] without requiring approval from the institution's shareholders or creditors.[338] Further, the Corporation may carry on the institution's business,[339] and sue, settle, compromise and defend any claims against the institution.[340] It may also declare a moratorium on the institution's payments to depositors and creditors[341] and limit the rate of interest payable on deposits and debts payable by the institution to the minimum rates prescribed by the CBK.[342] However, the Corporation's assumption of the receivership powers does not confer the institution's liabilities on the Corporation.[343]

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[331] S 48(c) of the KDI Act.
[332] S 49 of the KDI Act.
[333] S 50(6) of the KDI Act.
[334] S 50(4)(a) of the KDI Act.
[335] S 50(4)(b) of the KDI Act.
[336] S 50(4)(d) of the KDI Act.
[337] S 50(4)(c) of the KDI Act.
[338] S 50(1)(a) of the KDI Act.
[339] S 50(4)(e) of the KDI Act.
[340] S 50(4)(f) of the KDI Act.
[341] S 50(2)(a) of the KDI Act.
[342] S 50(2)(b) of the KDI Act.
[343] S 50(6) of the KDI Act.

4.5 The Corporation as Resolution Authority (RA)

4.5.1 International standards on resolution powers

4.5.1.1 Overview of resolution powers

As discussed in Chapter Two,[344] *IADI Core principle* 14 requires legal frameworks that establish EDIS to include an SRR for effective protection of depositors and enhancement of financial system stability.[345] The rationale for this principle is to give depositor preference in bank insolvencies to prevent depositor panics that could lead to bank runs.[346] The *FSB Key attributes*[347] also facilitate the effective resolution of financial institutions, by defining the mandates of resolution authorities (RA).[348] The *FSB Key attributes* further require jurisdictions with multiple RAs to designate a leading RA to coordinate their activities.[349]

4.5.1.2 IADI Core principles on resolution

As alluded to above,[350] *IADI Core principle* 14 recommends that the RA in the SRR be mandated to liquidate assets and reimburse insured depositors, transfer or sell the failed institution's assets and liabilities through a purchase and assumption, establish temporary bridge institutions and write down or convert the claims of unsecured creditors and uninsured depositors into equity.[351] The *IADI Core principles* envisage that the EDIS could exercise these functions as part of its "loss minimiser" mandate.[352]

4.5.1.3 FSB Key attributes on resolution

The *FSB Key attributes* require that the resolution of financial institutions be privately funded and that bail-outs only be extended on a temporary basis to continue critical functions to facilitate orderly resolution.[353] Jurisdictions are further required to recover

[344] See ch 2 par 2.3.1.
[345] *IADI Core principle* 14.
[346] See ch 2 par 2.4.1.
[347] *Ibid.*
[348] FSB *Key attribute* 2.
[349] FSB *Key attribute* 3.
[350] Par 4.1.1 above.
[351] *IADI Core principle* 15.
[352] See *IADI Core principle* 2. See also ch 2 par 2.3.3.3 and par 4.1.1 above.
[353] See FSB *Key attribute* 6. See also ch 2 par 2.4.1.3.

resolution costs from shareholders, unsecured creditors and uninsured depositors.[354] The *FSB Key attributes* also recommend that resolution authorities appoint administrators to take over the affairs of failed institutions from their boards and for the culpable staff to be removed.[355] The *FSB Key attributes* further authorize RAs to override shareholders' rights in resolution and, *inter alia,* sell and transfer the failed institution's assets and liabilities, establish a bridge institution to carry on the viable operations of the failed institution and facilitate a bail-in within resolution by conversion of the rights of unsecured creditors and uninsured deposits and other convertible securities into equity.[356] To internalise the costs of recovery and resolution of SIFIs, the *FSB Key attributes* require them to prepare recovery and resolution plans (RRPs) to provide for their recovery from financial distress and for their resolution if they fail to recover.[357]

4.5.2 The Corporation's resolution powers

4.5.2.1 General resolution mandates

The KDI Act prescribes the objects and functions of the Corporation as the provision of a "deposit insurance scheme" for insured depositors and to act as "receiver, liquidator and carry out winding up" of institutions for which it is appointed "as receiver and liquidator."[358] As indicated above,[359] the CBK, which is the prudential supervisor of banks under the Banking Act, retains the authority to appoint the Corporation as receiver[360] and liquidator[361] under the KDI Act.[362] Although the KDI Act does not prescribe specific resolution powers, it authorises the Corporation to resolve institutions that do not pose a systemic risk[363] using the "lesser cost rule".[364] In the

[354] *Ibid.*
[355] *Ibid.*
[356] FSB *Key attribute* 3.2 as read with *Key attribute* 3.3, 3.4 and 3.5.
[357] *Idem* 17.
[358] S 5 of the KDI Act.
[359] Par 4.3.2.3 above.
[360] S 43 of the KDI Act.
[361] S 54 of the KDI Act.
[362] S 5 of the KDI Act.
[363] S 50(7)(a) of the KDI Act. See also s 2 of the KDI Act, which defines systemic risk as the possibility that the failure of one or more institutions will cause severe disruptions in the financial system.
[364] S 2 of the KDI Act defines the "lesser cost rule" as the adoption of the lower of cost of payment of insured deposits in the liquidation of an institution and undertaking the "exclusion and transfer process." Exclusion and transfer is defined as the exclusion and transfer of part of or the total assets, deposits and liabilities from the problem institution to a solvent institution and the liquidation of the residual assets

resolution of institutions that may pose systemic risk, the Corporation is required to adopt such resolution strategies as the CBK and the government may prescribe,[365] to avert disruption to the financial system or loss to its Fund,[366] whilst minimising moral hazard and preserving banking services.[367]

The Corporation's resolution powers include the bail-out of systemic institutions by granting them open bank assistance through loans, guarantees for advances to the institution and acquisition of their assets.[368] Other resolution powers are reimbursement of insured depositors and liquidation of institutions that have ceased to be viable,[369] exclusion and transfer of the assets and liabilities of the problem institution to a solvent institution,[370] the restructuring of institutions that are likely to be cease to be viable[371] and the establishment of a bridge institution to preserve the critical functions of the failed institution, while the non-viable parts are liquidated.[372] Therefore, the Corporation's resolution powers appear to implement the *IADI Core principle* 14 resolution powers outlined above.[373]

4.5.2.2 Bail-out of systemic institutions

The Corporation is empowered to extend loans, offer guarantees to third parties for loans advanced to institutions and acquire the assets of institutions, to reduce or avert a systemic risk from the failure of systemic institutions.[374] If the failure of an institution poses systemic risk, the Corporation is required to preserve banking services and consult the CBK and the government on resolution strategies that minimise moral hazard and reduce costs.[375] The resolution powers to discharge these functions include open bank assistance to bail out the distressed bank in order to prevent the

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of the institution. Thus, exclusion and transfer refers to a transaction referred to as a "purchase and assumption" from the point of view of the new owner.

[365] *Ibid*.

[366] S 6 of the KDI Act.

[367] S 50(7)(b) of the KDI Act.

[368] S 6(b) of the KDI Act. See also Malala 10.

[369] Ss 2, 33 and 55 of the KDI Act.

[370] Ss 43, 44, 50 and 55 of the KDI Act.

[371] S 6(a) of the KDI Act.

[372] S 50(7)(b) of the KDI Act.

[373] See par 4.1.1 above.

[374] S 6(b) of the KDI Act.

[375] S 50(7) of the KDI Act. See also Malala 11 where she points out that financial assistance is the resolution option that causes the least market disruption.

systemic risk that its failure may pose to the financial system.[376] However, open bank assistance promotes moral hazard, as it uses public funds to bail out a private bank and benefits its shareholders and creditors.

As observed Chapter Two,[377] the *FSB Key attributes* recommend that public funds only be used to bail out SIFIs upon a determination, and approval within the safety net provision, that the bail-out is necessary to protect financial system stability, no privately funded resolution options are available and that losses and residual costs incurred during the resolution process are borne by equity holders, unsecured creditors and the financial industry through *ex post* assessments on solvent institutions.[378] The KDI Act appears to incorporate these conditions to limit the bail-out of financial institutions in Kenya by requiring the Treasury Secretary to approve the Corporation's loans to financial institutions under section 6(b). The question is however whether the statutory criteria for such approval provides sufficient safeguards against the moral hazard of "Too-Big-To-Fail".[379] In addition, as discussed in Chapter Two,[380] open bank assistance may be provided through the deposit insurer and or the central bank as LOLR.[381] Since section 6(b) of the KDI Act only prescribes the criteria for use of open bank assistance under the KDI Act, it is arguable that it does not limit the CBK's use of public funds to bail out "Too-Big-To-Fail" institutions through LOLR.[382]

Although the KDI Act requires the CBK to provide technical assistance to the Corporation in the management of systemic risk,[383] it does not oblige SIFIs to file recovery and resolution plans (RRPs or "living wills").[384] As discussed in Chapter Two,[385] RRPs are important tools to end :Too-Big-To-Fail", by requiring SIFIs to stipulate the strategies they will adopt to recover their financial viability in the event of a material change in economic circumstances and to resolve their operations without the use of public funds if they become insolvent.[386] RRPs thus seek to limit the moral

[376] S 2 of the KDI Act.
[377] See ch 2 par 2.4.1.3.
[378] FSB *Key attribute* 6.2.
[379] See ch 1 para 1.2.5 and 1.2.7 and ch 2 par 2.3.2.3.
[380] See ch 2 par 2.3.2.3.
[381] *Ibid.*
[382] *Ibid.*
[383] S 50(10) of the KDI Act.
[384] FSB *Key attribute* 11.5.
[385] See ch 2 par 2.4.1.4.
[386] FSB *Key attribute* 1.3.

hazard emanating from the failure of SIFIs, by directing them to plan for the cost of their capital restoration and resolution of their affairs without government bail-out.[387]

It is submitted that the failure of the KDI Act to require SIFIs to prepare recovery plans may impede the Corporation's capability to assess the ability of the institutions to address systemic stress and expeditiously implement recovery measures.[388] Similarly, the failure of the KDI Act to require SIFIs to file resolution plans to limit the disruption to the financial system, arising from their failure and subsequent resolution, denies the Corporation the mechanisms to assess the capacity of insured institutions to prevent systemic disruption and protect their vital economic functions without the use of public funds.[389] It further affects the Corporation's capacity to address bank moral hazard by compelling banks to internalise the costs of their resolution. Thus, it is arguable that the KDI Act's criteria to limit the use of open bank assistance may not adequately address the moral hazard from bail-out of banks.

4.5.2.3 Bridge banks

The resolution power to establish a bridge bank to take over the viable assets and business of a failed bank seeks to ensure that the closure of a bank does not disrupt the continued provision of its critical and vital functions.[390] This measure is adopted under the "lesser cost rule"[391] if establishing a bridge bank is cheaper than depositor reimbursement or the transfer and sale of assets and liabilities of the failed bank.[392] Thus, a bridge bank is a temporary bank that is established to take over the assets and liabilities of the failed bank as the deposit insurer arranges a final resolution of the non-viable parts of the failed bank.[393] Verley observes that a bridge bank could also be established to take over the non-performing or toxic assets of a failed bank for purposes of managing such problem assets, while the deposit insurer looks for

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[387] FSB *Key attributes* 1.
[388] *Ibid.*
[389] *Ibid.*
[390] Verley15. See also Malala 13.
[391] As indicated above, the "lesser cost rule" is defined in s 2 of the KDI Act as the adoption of the strategy with the lowest costs between depositor reimbursement in the liquidation of the institution and undertaking an exclusion and transfer process. However, the "least cost rule" evaluates the costs of *all* resolution options before adopting the one with the least cost. See Verley 15.
[392] *Ibid.*
[393] *Ibid.*

purchasers or decides whether to liquidate the assets.[394] Such a bank may also be referred to as a special purpose vehicle.[395]

As discussed above,[396] although the KDI Act authorises the Corporation to establish bridge banks to preserve the banking services of the failed bank it does not stipulate any framework for their establishment.[397] The first bridge bank that was established in Kenya is arguably the Land and Agriculture Bank established in 1930 to continue the vital function of advancing credit to farmers after private banks withdrew their credit.[398] The second bridge bank, the Consolidated Bank of Kenya Ltd, was established in 1991[399] to take over the operations of the financial institutions that failed during the banking crises of the 1980s.[400] Even though bridge banks ought to be temporary, both the Land Bank[401] and the Consolidated Bank of Kenya Ltd were later restructured and continue in operation.[402] In practice, the CBK and the Corporation appear to avoid the incorporation of (new) bridge banks and prefer to enter into agreements with existing banks to serve customers of banks in receivership.

In the receivership of Imperial Bank Ltd,[403] the Corporation entered into agreements with the KCB Bank Ltd and Diamond Trust Bank Ltd to protect the interests of the depositors, creditors and the public interest through the payment of the depositors of Imperial Bank by the two banks.[404] Similarly, after the Corporation had assumed control over Chase Bank Ltd (In Receivership), under section 44(2)(b), it appointed KCB Bank Ltd[405] to carry out the business and manage the assets and liabilities of Chase Bank Ltd.[406] The CBK justified the appointment of KCB Bank Ltd as manager for Chase Bank Ltd on the grounds that KCB Bank Ltd was a "strong bank with a solid brand, adequate human resources, and wide experience in the country" that would

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[394] *Ibid.*
[395] FSB *Key attribute* 3.
[396] See par 4.2.2 above.
[397] S 50(7)(b) of the KDI Act.
[398] Ch 3 par 3.2.2.2.
[399] The Consolidated Bank of Kenya Act 5 of 1991.
[400] Brownbridge 84.
[401] *Ibid.*
[402] For a history of the Consolidated Bank of Kenya Ltd, see its website available at <https://www.consolidated–bank.com>accessed on 20.8.2017.
[403] See CBK, *Press releaseImperial Bank Limited (in receivership),* 2.12.2015.
[404] *Ibid.*
[405] Ss 44 (2) (b) and S 44 (3) of the KDI Act. .
[406] See CBK, *Press release Chase Bank Limited (in receivership),* 26.4.2016.

safeguard “the interests of Chase Bank Ltd’s depositors and creditors, and the wider public interest.”[407]

It is arguable that the use of existing banks by the CBK and the Corporation, rather than establishing new bridge banks, was motivated by the need to avoid the costs of incorporating and running a bridge bank and thus amounts to the application of the “lesser cost” rule.[408] Kenya being a developing country, is also harnessing economies of scale in using existing infrastructure to discharge the Corporation’s resolution functions. However, the appointment of other private banks as bridge banks for failed banks under receivership may engender costly disputes, relating to the appointment of a potentially rival bank to manage the affairs of banks under receivership. This could be cured by developing a framework for the establishment of bridge banks (to continue the critical functions of failed banks) and other special purpose vehicles (to manage their toxic assets).

4.5.2.4 Restructuring of institutions that are likely to be non-viable

Among the post-GFC reforms to the resolution of failed institutions discussed in Chapter Two,[409] bail-in within resolution was identified as a key strategy to end bail-outs.[410] The adoption of bail-in within resolution involves the conversion of the debts of shareholders, unsecured creditors and uninsured depositors to equity, so that they share in the losses of the failed bank.[411] Thus, the *FSB Key attributes* require a bail-in within resolution as such a measure shifts the cost of resolution from government bail-out to the use of private funds in order to infuse more capital from existing shareholders into the failing bank, and thus to absorb the bank’s losses and mitigate the moral hazard occasioned by the use of tax payers funds.[412]

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[407] *Ibid.*
[408] *Ibid.* See also Verley 16 for a discussion of the demerits of bridge banks and new banks in bank resolutions.
[409] See ch 2 par 2.4.1.3.
[410] See MH Krimminger, ‘Bail-in, not bail-out: Developing SIFI resolution strategies around the globe’, 3 available at <https://www.clsbluesky.law.columbia.edu>accessed on 12.4.2018.
[411] *Ibid.*
[412] FSB *Key attribute* 3.5 and 9.

In the event that the existing shareholders fail to raise sufficient capital, a bail-in could be effected through the conversion of the claims of uninsured depositors and unsecured creditors into equity capital through a debt-to-equity swap transaction.[413] However, since the RA has no powers to force a debt-to-equity swap, a creditor committee for the insolvent bank may be used to structure the reorganisation.[414] As indicated above,[415] the KDI Act authorises the corporation, upon being notified that an institution has ceased or is likely to cease to be viable, to direct the institution to *inter alia*, restructure the whole or part of its business in a manner that will restore its viability.[416]

The restructuring process envisaged in section 44(2)(a) of the KDI Act thus implements the post-GFC bail-in reforms by authorising the Corporation to direct the institution to restructure. Although the Act does not provide a framework for such restructuring or bail-in, the CBK has permitted depositors of failed banks to constitute informal Depositors' Committees, for example for Bullion Bank, to infuse capital into the distressed bank and restore its financial viability.[417] When such bail-in attempts fail, the CBK and the Corporation have invited *Expressions of Interest* from the general public, whose bids, if successful, may be effected through a purchase and assumption transaction rather than through the initial bail-in by the failed institution's shareholders and creditors.[418] This was effected by the CBK in the cases of Chase Bank Ltd[419] and Imperial Bank Limited,[420] where invitations were extended to private investors and other banks through notices *of Expressions of Interest* to bid for the assets and liabilities of the two banks under receivership.

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[413] For a discussion of equity swaps in an emerging market context, see I Goodspeed, 'The derivatives market', in K Van Wyk, Z Botha & I Goodspeed (eds), *Understanding South African financial markets*, (2015) 412.
[414] See R Upadhyaya, *Analyzing the sources and impact of segmentation in the banking sector: A case of Kenya,* (Unpublished School of Oriental and African Studies University of London PhD Thesis 2011) 16 for a discussion of the Depositors' Committee of Bullion Bank.
[415] Par 4.3.2.2 above.
[416] S 44(2)(a) of the KDI Act.
[417] Bullion Bank was one of several banks that failed during the 1980s, when the then CBK Governor, M Cheserem, appointed a Depositors' Committee under the CBK appointed manager, to explore ways for its potential revival. See Upadhyaya 16.
[418] See CBK press notice, *Invitation to take an equity interest in Chase Bank (K) Limited,* March 30th 2017 and CBK press notice, *Invitation to take an equity interest in Imperial Bank Limited,* June 23rd 2017.
[419] See *Invitation to take an equity interest in Chase Bank (K) Limited*.
[420] See *Invitation to take an equity interest in Imperial Bank Limited*.

4.5.2.5 Exclusion and transfer of assets and liabilities

The Corporation's "exclusion and transfer" resolution power enables it to change the ownership of failed institutions, without recourse to or approval from shareholders.[421] As observed in Chapter One,[422] since banks play a special role in the economy, the objective to preserve their special services is met through the exclusion and transfer of failed firms' vital and critical functions to solvent institutions.[423] The exclusion and transfer power exercised by the RA may also result in a "purchase and assumption" transaction exercised by the purchasing institution.[424]
The KDI Act provides for purchase and assumptions through an "exclusion and transfer" procedure that allows the receiver to sell the assets and business by private treaty or public sale,[425] dispose of the assets with security interests to any person willing to assume the obligation it secures,[426] or arrange the assumption of any of the institution's liabilities by any person.[427] The Corporation as receiver further has the power to effect an irrevocable legal transfer of assets and liabilities through the "purchase and assumption" transactions without reference to the institution's depositors, creditors or other securities holders for consent.[428]

The "exclusion and transfer" process amounts to a purchase and assumption transaction once a solvent bank acquires some or all of the assets of the failed bank and assumes some or all of its liabilities, including its insured deposits.[429] It is a merger with and acquisition of, the failed institution by the solvent institution and is preferred for SIFIs whose liquidation may lead to a disruption of financial system stability.[430] It is designed to be flexible to entice bidders to purchase more assets and assume more liabilities of the failed institution and to pay for the going concern value of the failed institution's franchise.[431]

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[421] See *FSB Key attribute* 3.2.
[422] See ch 1 par 1.2.1.
[423] See Hupkes (2003) 3.Hupkes argues that EDIS and resolution regimes facilitate the preservation of the critical functions of financial institutions.
[424] See Verley20. See also Malala 12.
[425] S 50(4)(b) of the KDI Act.
[426] S 50(4)(c) of the KDI Act.
[427] S 50(4)(d) of the KDI Act.
[428] S 50(8) of the KDI Act.
[429] Verley 20.
[430] *Ibid.*
[431] *Ibid.*

In Kenya, the State Bank of Mauritius (SBM) Kenya Ltd successfully purchased the assets and assumed the liabilities of Fidelity Bank Ltd in May 2017 and cherry picked some assets and liabilities from Chase Bank Ltd in October 2017. In both cases, the CBK appears to have opted for the purchase and assumption mechanism to protect depositors, shareholders and other creditors from the loss that would have ensued from a liquidation.[432] It was probably also the least costly strategy to save the Corporation from the potential costs of a prolonged liquidation process.[433]

4.5.2.6 Depositor pay-off and liquidation

Depositor pay-off and liquidation are considered as a last resort to be invoked only when it is the least costly strategy to the deposit insurance fund, because its eventual costs in administration, logistics and disruptions to depositors' economic activities may be more than the actual deposits reimbursed.[434] The Corporation is authorised to payoff insured depositors, if it would cost less than any other resolution strategy, by inviting claims by insured depositors upon the Corporation's appointment as a receiver[435] or liquidator.[436] To limit the moral hazard, claims from depositors[437] who also served as the institution's directors, managers, or officers may be rejected if they contributed to the institution's failure.[438] In addition, the Corporation may set-off any loans or debts owed by the claimants to the institution against any deposits due.[439] The Corporation further limits its losses from resolution by subrogating[440] to the rights of the reimbursed depositors in the assets of the insolvent institution.[441]

Apart from the full reimbursement of insured depositors, a pay-off may also partially pay uninsured deposits, pending full payment from the proceeds of the liquidation.[442] However, in the event that the proceeds of liquidation are less than the claims, the uninsured depositors and other creditors are paid according to creditor hierarchy rights

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432 *Ibid.*
433 S 54(2)of the KDI Act.
434 Par 4.4.2.2 above. See also Malala14 where she points out that depositor pay-off is generally the most costly resolution option as it also leads to the demise of the franchise value of the institution and destroys valuable relationships.
435 S 33(1) of the KDI Act.
436 S 54 of the KDI Act.
437 S 33(5) of the KDI Act.
438 S 35(3) of the KDI Act.
439 S 34 of the KDI Act.
440 S 35(1) of the KDI Act.
441 *Ibid.*
442 *Ibid.*

with a ratable sharing of any shortfall.[443] Although Verley indicates that a depositor pay-off may also be effected through the transfer of insured deposits to an insured institution,[444] it is arguable that such a transfer constitutes a "purchase and assumption" that enables depositors to either continue with their accounts in the new banks or to withdraw their deposits.[445] Liquidation of insolvent financial institutions involves the sale of the assets to meet the institution's liabilities and the winding up of its business and affairs to facilitate its exit from the financial system.[446] As discussed in Chapter One,[447] an SRR provides a market discipline mechanism for the orderly exit of inefficient banks from the financial market and frees their resources for use by the more efficient banks.[448]

4.5.2.7 Overlapping issues between receivership and liquidation under the KDI Act

The KDI Act's resolution framework for insured institutions is triggered by the appointment of the Corporation as a receiver under section 43, who may recommend the liquidation of institutions that have ceased to be viable.[449] Upon the Corporation recommending liquidation, the CBK appoints it as a liquidator for the institution under

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[443] *Ibid.*
[444] See Verley 20.
[445] See par 4.4.2.4 above.
[446] See *FSB Key attribute* 3.2 (xii).
[447] See ch 1 par 1.2.2.
[448] See Mishkin 265, where the author argues that the collapse of inefficient banks may be advantageous to the economy, by releasing their resources to more efficient banks. See also CC Okeahalam, 'The political economy of bank failure and supervision in the Republic of South Africa', (1998) *African Journal of Political Science* 38.
[449] S 53(2). S 53(2) previously provided that

> [u]pon completion of the term of receivership, the Corporation shall either –
> (a) Confirm to the Central Bank that the institution has complied with the matters that necessitated the receivership; or
> (b) Recommend to the Central Bank that the institution be liquidated, in which event the Corporation shall be appointed as liquidator.

S 53(3) provided that:

> Where the Corporation makes a decision in terms of subsection (2)(a), the management of the institution shall revert to its shareholders.

This was changed by the KDI Amendment Act 39 of 2013, that repealed s 53(2), and amended s 53 (2) to read that:

> In the course of the receivership, the Corporation may recommend to the Central Bank that the institution be liquidated in which case the CBK shall appoint the Corporation as the liquidator.

It is my argument that this amendment and repeal diluted the previous legislative intention to stipulate the two possible options of terminating a receivership.

section 53(2).[450] In contrast, if the Corporation, as receiver, determines that the institution is viable, it may direct the institution to restructure and if the institution successfully implements the restructuring plan, the Corporation may recommend that the receivership be terminated and the institution's affairs be reverted to its shareholders.[451] Since the same grounds are used for the appointment of a receiver under section 44(2)(b) and of a liquidator under section 53(2), questions arise as to what should trigger the appointment of a liquidator after a receiver has been appointed for the same institution.

In *Richardson and David Limited v Kenya Deposit Insurance Corporation and Central Bank of Kenya,* the applicant was an uninsured large depositor of Dubai Bank Kenya Limited who sought to restrain the defendant from liquidating the bank ten days after appointing a receiver to take over its affairs.[452] The plaintiff/applicants argued that the appointment of the liquidator so soon after the appointment of a receivership denied them the opportunity to recapitalise the bank and thus prejudiced their interests as depositors.[453] The court upheld their application and suspended the liquidation for six months to facilitate a bail-in by depositors, other creditors and investors.[454] The court agreed that, although the decision to liquidate the bank under the KDI Act was discretional, its exercise ten days after the bank being placed under receivership was in bad faith, malicious and meant to injure depositors.[455]

A liquidator may also be appointed under section 54(1)(b) for institutions for which a receiver had not previously been appointed, on the same grounds as those for the appointment of a receiver. These grounds are that the institution is unable to pay its debts when they fall due, a winding up order or voluntary winding up resolution was passed against it, the institution is unable to pay its depositors and creditors, institution

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[450] S 53(2) of the KDI Act empowers the Corporation, as receiver, to recommend to the CBK that the institution be liquidated, upon which the CBK shall appoint it as the liquidator.
[451] It is arguable that although s 53(3) is repealed, its original intention is still applicable because the amended section does not provide for the scenario of a successful restructuring within a receivership. In addition, the Act envisages two broad grounds for the appointment of a liquidator within its provisions, namely on a recommendation under s 54(1)(a) and on the grounds under s 54(1)(b). It is arguable that the only ground for recommending that a liquidator be appointed under s 54(1)(a) is if the institution has ceased to be viable, while all other grounds are covered under s 54(1)(b).
[452] *Richardson and David Limited v Kenya Deposit Insurance Corporation and the Central Bank of Kenya* HCCC No 482 of 2015, reported at Eklr available at <https://www.keyalaw.org> accessed on 12.6.2017.
[453] *Idem* 2.
[454] *Idem* 3.
[455] *Ibid* 13.

has less assets than liabilities or that the institution breached the law.[456] It is however clear that liquidation may only be suitable as a last resort, when the institution has ceased to be viable, which, it is submitted, may best be decided after a receiver assesses the institution's viability.

4.6 Factors influencing Kenya's implementation of international standards

From the foregoing discussion, the adoption of the *IADI Core principles* in Kenya appears to have been influenced more by public choice factors than by special interest group factors. While the failure of the DPFB may be explained by special interest group factors arising from the "political banks" that influenced the DPFB's extension of open bank assistance, the KDI Act appears to have addressed this limitation through its criteria for bank bail-out. The CBK's retention of authority to appoint a manager under the Banking Act, when the same powers are exercisable under the KDI Act may be explained by bureaucratic preference to retain authority over enforcement actions under the Banking Act. However, there appears to be sufficient cooperation between the CBK and the Corporation in the conduct of bank resolutions under the KDI Act to enhance its effectiveness.

4.7 Chapter summary and conclusions

As observed above,[457] this chapter sought to inquire into the KDI Act's implementation of the *IADI Core principles* and the *FSB Key attributes* in the design of the EDIS and SRR in Kenya with the aim of limiting the moral hazard in banking. The *IADI Core principles* recommend the limitation of the moral hazard through the design of the EDIS by means of the following measures: levying *ex ante* risk-based premiums,[458] limiting the scope of cover,[459] assigning EDIS mandates[460] and designation of the role of EDIS within the government safety net.[461] In addition, the*FSB Key attributes* recommend limiting moral hazard from financial conglomerates through: bail-in[462]or any other least costly resolution strategy,[463] *ex ante* EDIS privately funded by

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[456] S 54(1)(b) of the KDI Act.
[457] See par 4.1.1 above.
[458] See ch 2 para 2.3.3.2 and 2.4.1.3.
[459] *Ibid.*
[460] *Ibid.*
[461] See ch 2 para 2.2.2.3 and 2.3.3.4.
[462] See ch 2 par 2.4.1.2.
[463] See ch 2 par 2.4.1.3.

premiums from member banks[464] and a requirement for recovery and resolution plans (RRPs).[465]

The EDIS designed under the KDI Act appears to have implemented most of the abovementioned *IADI Core principles* as it has established an *ex ante* privately funded scheme[466] that charges premiums from member banks,[467] and limits the scope of cover.[468] While the premiums are generally charged at a flat rate, the Corporation is empowered to charge risk-based premiums on the riskier banks to limit the moral hazard that their risky activities may pose to the financial system.[469] In addition, the Kenyan EDIS has the "risk minimiser" mandate that authorises it to participate in bank supervision,[470] and "loss minimiser" mandate that authorises it to participate in bank resolutions.[471]

The KDI Act further defines the role of the EDIS as "risk minimiser" within the safety net to offer open bank assistance[472] and participate in contingency planning and crisis risk management.[473] The provisions authorising the Corporation to conduct a special examination of banks[474] and to give notice of termination of insurance cover if the CBK does not take requested corrective action[475] are particularly helpful in limiting regulatory forbearance and strengthen the Act's capacity to limit the moral hazard. I have argued above[476] that the KDI Act requires reforms to strengthen the criteria for the transfer of funds from the Deposit Insurance Fund to the operational fund, by requiring ministerial approval or a threshold majority board membership above a simple majority.[477] It is submitted that another area that requires reforms are the provisions relating to open bank assistance by the Corporation and the CBK.[478] Although the KDI Act requires the Corporation to seek ministerial approval before

[464] *Ibid.*
[465] See ch 2 par 2.4.1.4.
[466] See par 4.3.2.3 above.
[467] *Ibid.*
[468] See par 4.3.4.1 above.
[469] See par 4.3.3.2 above.
[470] See par 4.3.2.3 above.
[471] *Ibid.*
[472] See par 4.3.8 above.
[473] See par 4.3.9 above.
[474] *Ibid.*
[475] *Ibid.*
[476] See par 4.3.3.1 above.
[477] *Ibid.*
[478] Par 4.5.2.2 above.

extending any open bank assistance to a systemic bank, there is need for formal structures to co-ordinate the Corporation's open bank assistance with the CBK's LOLR function to enhance the effectiveness of supervisory responses to banking crises.[479] In addition, the prompt corrective action provisions of the KDI Act may require harmonisation with the *CBK Prompt Corrective Action Framework,*[480] to streamline the criteria for rating banks and the respective corrective actions to be enforced.[481]

As observed above,[482] the KDI Act has adopted the resolution provisions under the *IADI Core principles* and the *FSB Key attributes* which could be strengthened to enhance their effectiveness.[483] As also discussed above,[484] the Act provides for bail-in among resolution strategies and *ex ante* privately funded EDIS. However, it does not require recovery and resolution plans (RRPs). Since the KDI Act has more effective resolution features, to address bank moral hazard, than the DPFB had under the Banking Act, it is submitted that the provisions for the appointment of the Corporation as manager under the Banking Act should be repealed and if necessary be transferred to the KDI Act. In addition, the criteria for appointing the Corporation as receiver and as liquidator may require refinement to avoid complaints when a liquidator is appointed immediately following the appointment of a receiver.[485] The KDI Act could further be strengthened by requiring the preparation of RRPs adapted to the level of complexity of Kenyan financial conglomerates. This could require less complex plans than those required in the industrialised economies.

Having examined the Kenyan EDIS and SRR features under the KDI Act in this chapter, I will further consider the EDIS and SRR framework in South Africa in Chapter Five and those in the USA in Chapter Six to identify which features may be useful in addressing gaps in the Kenyan framework.

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[479] See para 4.3.9 and 4.5.2.2 above.
[480] See ch 3 par 3.2.5.2.
[481] *Ibid.* The KDI Corporation may need to develop a prompt corrective actions framework under the KDI Act in consultation with the CBK to harmonise it with the CBK prompt corrective actions framework.
[482] See par 4.1.1 above.
[483] *Ibid.*
[484] *Ibid.*
[485] See par 4.5.2.7 above.

CHAPTER 5: TRANSITION TO EXPLICIT DEPOSIT INSURANCE AND SPECIAL BANK RESOLUTION IN SOUTH AFRICA

5.1 Introduction

As was noted in Chapter One,[1] implicit deposit protection operates by default in countries that do not have explicit deposit insurance schemes (EDIS) because governments and central banks consider it necessary for the stability of their financial systems.[2] In this respect, South Africa which does not currently have an EDIS, administers implicit deposit protection system through the South African Reserve Bank (SARB).[3] Under the Twin Peaks supervisory structure that was introduced in 2017 by the Financial Sector Regulation Act[4] the Prudential Authority which took over the mandate of bank supervision from the Registrar of Banks,[5] currently oversees the resolution[6] of banks inter alia through the bank curatorship procedure under the Banks Act.[7] Although it has no statutory obligation to reimburse depositors of failed banks, the SARB has since the 1980s reimbursed small depositors and left large depositors and shareholders to bear some of the losses of their failed banks.[8] Post GFC, the South African Government, as a member of the G-20, proposed a transition from implicit deposit protection to an EDIS and has published policy papers on both the design of an EDIS[9] and an envisaged special bank resolution regime (SRR).[10] However, as at the time of completing this thesis, these initiatives have not yet been formalised or implemented.

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[1] See ch 1 par 1.2.3.

[2] See A Demirguc-Kunt, EJ Kane & L Laeven, 'Deposit insurance around the world: A comprehensive analysis and database', (2015) *Journal of Financial Stability* 156.See also R Ayadi & LM Lastra, 'Proposals to reforming deposit insurance in Europe', (2010) *Journal of Banking Regulation* 215.

[3] See South African Reserve Bank Act 90 of 1989. See also J Rossouw, *South African Reserve Bank: History, functions and institutional structure*, (2009) for a history of the SARB, including its powers to extend financial assistance to distressed banks.

[4] Financial Sector Regulation Act 9 of 2017.

[5] See ch 3 par 3.3.1.2. The Financial Sector Regulation Act sch 4 par 15 replaced the office of the Registrar of Banks with the Prudential Authority under the Twin Peaks regulatory model.

[6] International Association of Deposit Insurers (IADI) *Core principles for effective deposit insurance systems* (*IADI Core principles*) developed in 2009 (revised in 2014)10. IADI defines resolution broadly to encompass the disposition of the assets of insolvent banks through liquidation and reimbursement of depositors, the transfer or sale of assets and liabilities, the establishment of bridge institutions and the write down of debt and or its conversion to equity.

[7] See s 69 of the Banks Act 94 of 1990.

[8] See SARB, Bank Supervision Department, *Annual report,* (1998) 12.

[9] See generally SARB, *Designing an explicit deposit insurance scheme,* (2017) available at <https://www.redbank.org.za> accessed on 18.10.2017.

[10] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) <available at https://www.treasury.go.za>accessed 7.6.2017.

This chapter discusses the current implicit deposit protection system and bank curatorship system in South Africa and the strategies they adopt to address the moral hazard from banks. It also provides a brief overview of bank liquidation. It is to be noted that although curatorship of banks was developed initially as a bank rescue process it has since acquired some features that are akin to resolution features as envisaged in the Financial Stability Board (FSB) *Key attributes for effective resolution regimes for financial institutions* (*FSB Key attributes*)which were issued in 2011 (revised in 2014). The chapter further examines the envisaged transition to the proposed EDIS and SRR and considers how their design features adopt the International Association of Deposit Insurers (IADI) *Core principles for effective deposit insurance systems* (*IADI Core principles*) developed in 2009 (revised in 2014)[11] and the *FSB Key attributes* in the mitigation of bank moral hazard in South Africa.

5.2 Implicit deposit protection in South Africa

5.2.1 Administration of implicit deposit protection in South Africa

5.2.1.1 General overview of implicit deposit protection

As indicated in Chapter Three,[12] the SARB, was established in 1921 under the Currency and Banking Act, 31 of 1920[13] as the central bank of South Africa.[14] The SARB was the bank supervisor until the introduction in 2017 of the Twin Peaks model of regulation under the Financial Sector Regulation Act.[15] More significantly, like other central banks across the world, the SARB also functions as lender of last resort (LOLR)

[11] See generally *IADI Core principles.*
[12] See ch 3 par 3.3.1.2.
[13] See SARB, *Commemorative publication 90th Anniversary*, (2011) 3–4.The Currency and Banking Act 31 of 1920 was replaced by the South African Reserve Bank Act 29 of 1944, which was replaced by the South African Reserve Bank Act 90 of 1989 that is currently in operation as amended from time to time. See also JJ De Jager, 'The South African Reserve Bank: Blowing winds of change', (2013) *SA Merc LJ* 342 and S Mollentze, 'The South African Reserve Bank', in K Van Wyk, Z Botha& I Goodspeed (eds), *Understanding South African financial markets*, (2016) 37. See also J Moorcroft, *Banking law and practice,* (2009) par 1-3.
[14] S 223 of the Constitution of the Republic of South Africa, 1996.
[15] S 10(1)(s) and (v) of the South African Reserve Bank Act read with ss 3 to 35 of the Banks Act on the administration of the Act and the power to authorise the establishment of and registration of banks.

to other banks in South Africa.[16] As discussed in Chapter One,[17] central banks conduct their open market operations to assist banks to meet their daily or overnight liquidity requirements by selling or buying securities lending through the discount window facility.[18] Additionally, central banks use the LOLR facility to provide emergency liquidity assistance (ELA) for longer repayment periods to solvent banks with liquidity shortage problems.[19] The SARB is authorised to lend to banks only on security[20] and may not purchase shares of a bank or grant loans to banks on the security of the bank's own shares without the approval of the Minister of Finance.[21] The SARB considers the discharge of its LOLR powers under section 10 of the South African Reserve Bank Act as emergency liquidity assistance and the discharge of its LOLR powers under section 13 of the Act as "lifeboat" support.[22]

5.2.1.2 Discount window facility

According to De Jager[23] the role of a central bank as LOLR is distinct from its normal open market operations that are conducted through its "discount and accommodation window"[24] where it buys, sells and discounts bills of exchange and other securities as an open market operation to provide daily or overnight liquidity to banks for their normal operational liquidity requirements.[25] The SARB's mandate to provide the

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[16] See JJ De Jager, 'Central bank, lender of last resort assistance: An elusive concept?', (2010) *De Jure* 232, who argues that central banks only function as LOLR when they support banks during a systemic shortage of liquidity to off-set unusual public demand for liquidity and operate or manage the discount window facility to banks to refinance day to day operational liquidity of banks in the normal course of business. Therefore, LOLR is invoked to restore public confidence in the banking system by ensuring that depositor demands for cash are met.

[17] See ch 1 par 1.2.3.

[18] *Ibid* and ch 2 par 2.2.2.3. See also M Dobler, S Gray, D Murphy& B Radzewicz-Bak, *The lender of last resort function after the Global Financial Crisis*, (2016) IMF working papers4 and P Tucker, *The lender of last resort and modern central banking: Principles and reconstruction*, (2014) *Bank of International Settlement working paper* 11.

[19] See R Smits, 'European supervisors in the credit crisis: Issues of competence and competition', in M Giovanoli & D Devos (eds), *International monetary and financial law,* (2010) 307, who explains that central banks act as LOLR either when they provide funding to individual banks with liquidity problems or as special emergency liquidity assistance (ELA) to a group of banks suffering a system wide liquidity shortage.

[20] S 10(1)(f) of the South African Reserve Bank Act.

[21] S 13(b) of the South African Reserve Bank Act.

[22] See SARB, Bank Supervision Department, *Annual report,* (1999) 14.

[23] See De Jager (2010) 232.

[24] Discount and accommodation window is the central bank facility to relieve operational liquidity shortages within the banking sector by buying or selling bills of exchange or promissory notes to facilitate liquidity management for banks. See G Kanatas, 'Deposit insurance and the discount window: Pricing under asymmetric information', (1986) *Journal of Finance* 438.

[25] See De Jager (2010) 233.

discount window facilities is derived from section 10(1)(g)[26] and section 10(1)(h)[27] of the South African Reserve Bank Act and is separate from its mandate to carry out the LOLR facility under section 10(1)(f) and section 13(b) of the South African Reserve Bank Act discussed above.[28] The discount window facility is administered by the SARB through the use of money market repurchase (repo) agreements that enable banks with temporary daily or overnight liquidity shortages to borrow from the SARB on the security of approved commercial paper.[29] Thus, the banks repay the loans by repurchasing the commercial paper at the rate and on the date agreed in the repurchase agreement.[30] Most banks use this facility to manage their liquidity operations and are normally not considered to have solvency problems when making use thereof.[31]

5.2.1.3 The SARB's ELA powers

Banks that have persistent liquidity shortages, which require a longer period to address than what is possible in terms of the daily or overnight borrowing that the discount window provides, may borrow through either the ELA for funding for an initial period of thirty days, or "life boat" support for funding for longer periods of time.[32] Thus, the ELA represents standby liquidity assistance provided by the SARB to banks that experience temporary liquidity shortages.[33] The objective of the ELA is to provide some breathing space to banks that face temporary liquidity shortages to enable them to implement corrective measures and to prevent their liquidity problem from evolving into insolvency that may precipitate a contagion of bank runs.[34] The ELA function is additional to the SARB's provision of liquidity through the normal daily or overnight repurchase auctions under section 10(1) (g) and (h) discussed above.[35]

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[26] S 10(1)(g) of the South African Reserve Bank authorises the SARB to "buy, sell, discount or rediscount any bills or exchange drawn or promissory notes …".
[27] S 10(1)(h) of the South African Reserve Bank Act authorises the SARB to "buy, sell, or deal in financial instruments and… hold such securities in safe custody…".
[28] See De Jager (2010) 233 and Smits 307.
[29] SARB, Bank Supervision Department*, Annual report,* (1999) 15.
[30] *Ibid.*
[31] *Ibid.*
[32] *Ibid*.
[33] Rossouw 40.
[34] *Idem* 41.
[35] De Jager (2010) 233.

The ELA is granted in the first instance for thirty days, renewable upon maturity for a further thirty days, with the possibility of further extension under strict conditions.[36] To encourage banks to use the ELA while also limiting exposure to the moral hazard, the SARB requires, *inter alia*, that the banks provide collateral with a value exceeding the amount of assistance by thirty per cent.[37] Interest is also charged at a rate that motivates bank management to resolve their difficulties, whilst enabling them to use the facility.[38] In addition, the bank must demonstrate that it has exhausted private sources of capital (including from shareholders) and developed and committed to the implementation of a viable capital restoration plan.[39]

While the SARB Act does not prescribe the solvency requirement for banks as a prerequisite to access the ELA,[40] it is adopted as best practice to discourage insolvent banks from accessing the LOLR facilities.[41] The SARB considers the ELA conditions as necessary incentives to encourage banks to adopt better capital and liquidity management measures and the conditions are easily met by banks that are solvent with sufficient assets to post as collateral.[42]

5.2.1.4 LOLR for "lifeboat" support

The SARB extends "lifeboat" support[43] to banks that experience more serious liquidity problems that may require more than the thirty days limit under the ELA support range and that fail to meet ELA criteria on collateral.[44] The "lifeboat" support may only be

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[36] *Ibid.*
[37] *Ibid.*
[38] *Ibid.* The SARB's policy to charge a rate of interest that do not discourage banks from accessing the ELA is best practice to prevent banks that qualify for the ELA from avoiding the facility because of a stigma that the higher interest rate reflects their being more risky and probably negatively affects their credit rating in the money markets. See G Gorton & A Metrick, 'The Federal Reserve and panic prevention: The roles of financial regulation and lender of last resort', (2013) *Journal of Economic Perspectives* 58.
[39] SARB, Bank Supervision Department*, Annual report,* (1999) 16.
[40] See N Brink, 'Approach to bank resolution in South Africa', paper presented at CCBS workshop for Heads of Financial Stability (February 2013) Pretoria, South Africa 4.
[41] See SARB, Bank Supervision Department*, Annual report,* (1999) 16. See also J Rochet and X Vives, 'Coordination failures and the lender of last resort: Was Bagehot right after all?', (2004) *Journal of the European Economic Association* 1116. See further W Bagehot, *Lombard Street: A description of the money market,* (1896) 66.
[42] See SARB, Bank Supervision Department*, Annual report,* (1999) 14.
[43] See ch 2 par 2.3.2.3. The "life boat" concept originates from the Bank of England committee that was established to provide extended solvency liquidity to insolvent English banks during the banking crisis of 1973–1975. See Bank of England, *Second banking crisis and the Bank of England's support operations*, available at <www.bankofengland.co.uk>historicpubs>accessed on 5.7.2017. See also Smits 307.
[44] See Brink 3 and De Jager (2010) 236.

granted in exceptional circumstances through the SARB's acquisition of shares in the bank, which acquisition may only be effected if it is considered as conducive to the attainment of the objects of the SARB Act.[45] In addition, the acquisition must be approved by the Minister of Finance.[46] The requirement for ministerial approval of "lifeboat" support limits the SARB's discretion in assisting insolvent banks and, according to Bezuidenhout, motivated the SARB to strengthen its bank supervisory structures over the years to prevent the need therefor.[47]

Overall, the SARB administers the aforementioned LOLR powers to maintain financial stability as a necessary service for the country's economic growth and long term economic development.[48] It is provided to institutions whose failure would otherwise lead to financial instability.[49] In the event that the bank defaults to repay the facility upon maturity or if the SARB declines to roll over the funding, a curator may be appointed to manage the distressed bank.[50]

5.2.1.5 Addressing moral hazard through implicit deposit protection in South Africa

Since the SARB does not deal directly with depositors, its administration of the LOLR facility does not expressly seek to protect depositors of failed banks.[51] Nevertheless, in administering its LOLR functions, the SARB seeks to limit the moral hazard from banks by requiring prescribed collateral, levying high interest charges,[52] and using constructive ambiguity[53] as to its prospective reaction to potential bank failures. While the first two measures prevent insolvent banks from accessing the LOLR facility,

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[45] Under the SARB's authority in s 10(d) of the South African Reserve Bank Act. Notably the "life boat" assistance given by the SARB to *Bankorp* from 1985 to 1991 has been criticised for exceeding the normal LOLR practice by continuing over a long period, for failing to include, "measures to protect the interests of the Reserve Bank, and thereby the taxpayers, by the SARB securing a share of the equity of *Bankorp*." In addition, the assistance is alleged to have been extended without giving "conditions for the assistance that protected depositors while penalizing the shareholders and management of *Bankorp*."See *Report of the Governor's Panel of Experts to investigate the South African Reserve Bank's role with regard to the financial assistance to Bankorp*, available at <www.gov.za> accessed on 5.7. 2017.

[46] S 13(b) of the South African Reserve Bank Act.

[47] See A Bezuidenhout, 'The South African case', in J Carmichael, A Fleming & D Llewellyn (eds),*Aligning financial supervisory structures with country needs,* (2004) 122.

[48] See SARB, Bank Supervision Department, *Annual report,* (1999) 15.

[49] *Ibid.*

[50] *Idem* 18. See par 5.2.1.1 below for a discussion on curatorship.

[51] As a central bank, the SARB acts, *inter alia,* as banker to other banks and does not operate individual depositor accounts.

[52] See par 5.2.1.4 above.

[53] Ch 2 par 2.2.2.3.

"constructive ambiguity" motivates banks to act prudently because of the uncertainty as to whether they will be able access the LOLR if they fall in distress.[54]

As the SARB administers the implicit deposit protection at its discretion, not all of the measures it has adopted *de facto* on depositor protection are captured in statute. Consequently, the measures do not specifically incorporate features that adopt best practice in depositor protection or address moral hazard in banking.[55] It is partly for these reasons that the government of South Africa has embarked on reforms to make South Africa's financial sector safer by the envisaged adoption of EDIS.[56]

5.2.2 Curatorship of distressed banks in South Africa

5.2.2.1 Bank curatorship process in South Africa

Bank curatorship constitutes a bank recovery and resolution procedure in South Africa,[57] which was adopted as a mechanism to rehabilitate distressed banks[58] and to restore their financial viability.[59] According to Moorcroft, curatorship shields banks from "bank runs" by depositors upon receipt of negative publicity about the bank.[60] Pre-Twin Peaks the curatorship process was overseen by the Registrar of Banks under section 69 of the Banks Act and has substituted the judicial management procedure that was initiated by application to court when banks ran into severe financial problems.[61] In contrast, curatorship is an administrative process that is initiated by the Minister's appointment of a curator for a bank in distress.[62] The rationale behind the curatorship process was to "remove curatorship from the judicial

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[54] See D Domaniski, R Moessner & W Nelson,*Central banks as lenders of last resort: Experiences during the 2007–10 crisis and lessons for the future*, (2014) Rethinking the LOLR BIS papers 41.
[55] See ch 2 para 2.3 and 2.4.
[56] National Treasury, *A safer financial sector to serve South Africa better,* (2011) available at<https://treasury.go.za> accessed 16.5.2016; National Treasury, *Twin Peaks in South Africa: Response and explanatory document,* (2014) available at <https://www.treasury.go.za> accessed on 7.6.2017; National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015); National Treasury, *Final Twin Peaks policy, a known and trusted Ombud system for all,* (2016) available at <https://www.treasury.go.za> accessed on 7.6.2017;SARB, *Designing an explicit deposit insurance scheme,*(2017); the Financial Sector Regulation Act and South African Reserve Bank, Prudential Authority, *Draft discussion document: Financial conglomerate supervisory framework,* (2018) available at <https://www.treassury.go.za> accessed on 20.9.2018.
[57] See par 5.1 above for the definition of resolution.
[58] See generally KN Tjiane, *Curatorship of banks as a measure to rescue failing banks*,(Unpublished University of Pretoria LLM dissertation 2015) 13.
[59] Moorcroft 14-1.
[60] *Idem* par 14-2.
[61] *Idem* par 14-1.
[62] S 69(1) of the Banks Act.

to the administrative aegis" and to create a procedure that is not unnecessarily shackled by requiring appointment of curators by court and other costly judicial intervention.[63] As a result of the transition to a Twin Peaks model under the Financial Sector Regulation Act, the Prudential Authority has replaced the Bank Supervision Department of the SARB as prudential supervisor hence the Prudential Authority now oversees curatorship of banks.[64]

Note should further be taken that although banks are public companies[65] and the Companies Act[66] introduced the business rescue procedure to restructure companies as an alternative to winding-up of companies,[67] the Banks Act excludes the application of the rescue procedure to banks.[68] In general, the business rescue procedure under the Companies Act facilitates the rehabilitation of companies in financial distress, *inter alia,* by the temporary suspension of their boards from the supervision and management of their affairs and the suspension of creditor rights against them.[69] In addition, it requires that rescue plans be developed and implemented to restructure companies to either restore their solvency or enhance their potential for a better return for their creditors in liquidation.[70] Accordingly, a bank curatorship may be likened to a modified business rescue for banks because it provides them with "a temporary shield" from a run by depositors[71] and should continue for such time as is necessary to "protect the interests of the depositors."[72]

5.2.2.2 Bank curatorship under the Banks Act

Curatorship commences when the Prudential Authority advises the Minister of Finance to place a bank under curatorship,[73] upon which the Minister appoints the curator by

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[63] *Registrar of Banks v New Republic Bank Ltd* [1999] 2 All SA 459(D) 467. See further H Schulze, 'The institution of curatorship of a bank in terms of section 69 of the Banks Act 94 of 1990 – A rare decision', (1999) *SA Merc LJ* 428 for a discussion of the *New Republic Bank*-case.
[64] See ch 3 par 3.3.1.3.
[65] S 11(1) of the Banks Act requires banks to be registered as public companies.
[66] Companies Act 71 of 2008.
[67] Moorcroft par 14-1.
[68] S 51(1)(b) of the Banks Act.
[69] S 128 of the Companies Act 71 of 2008.
[70] *Ibid.*
[71] *Registrar of Banks v. New Republic Bank Ltd* [1999] 2 All SA 459 (D) 14.
[72] Moorcroft 14-1.
[73] See 69(3) of the Banks Act. See also IMF, *South Africa financial sector assessment program: Financial safety net, bank resolution, crisis management framework,* (2015) 28.

letter of appointment and publishing a notice in the official gazette.[74] Upon such appointment, the curator must act under the directions of the Prudential Authority.[75] The letter of appointment will *inter alia* set out directions with regard to security to be furnished by the curator for the proper performance of his duties and such other directions as to the management of the bank concerned or any matter incidental thereto, including directions in regard to the raising of money by that bank, as the Minister may deem necessary.[76] Before 2013, the appointment of a curator required the consent of the chief executive officer or chairperson of the board of directors of the bank to be effective.[77] This was considered an impediment to the Prudential Authority's powers to initiate curatorship as the banks could frustrate such appointment by refusing to consent.[78]

The Banks Act was subsequently amended to do away with the requirement for consent by the chief executive officer or chairman of the board of a distressed bank to protect the Prudential Authority's initiative to invoke curatorship by eliminating the opportunity for distressed banks to interfere in the appointment of curators.[79] Accordingly, the Minister may appoint a curator for a bank that is unable to repay deposits on demand or is unlikely to meet its other obligations, if such appointment is in the public interest. Written notice of the appointment is also given to the chief executive officer or chairperson of the board of directors of the bank.[80]

The legal effect of curatorship is that upon appointment of the curator the management of the distressed bank vests in the curator, subject to the supervision of the Prudential Authority.[81] Curatorship further triggers a moratorium on legal proceedings against the distressed bank.[82]

[74] See 69(3) of the Banks Act.
[75] S 69(1)(a) of the Banks Act.
[76] S 69(2)(a) to (d) of the Banks Act.
[77] S 69(1)(a) of the Banks Act was amended by s 37(a) of the Banks Act Amendment Act 22 of 2013, by substituting the words "with the written consent of", with the words, "by notifying" the chief executive officer or chairperson of the board of directors of that bank "in writing".
[78] See SARB, Bank Supervision Department, *Annual report,* (1998) 14.
[79] See s 37(a) of the Banks Act Amendment Act 22 of 2013.
[80] *Ibid.*
[81] *Alpha Bank Bpk & Andere v Registrateur van Banke & Andere* 1996(1) SA 330 (A) at 351–352 and *Unibank Savings and Loans Ltd (formerly Community Bank) v ABSA Bank Ltd* 2000 (4) SA 191 (W) par 19.
[82] S 69(6) of the Banks Act provides that

5.2.2.3 Pre-curatorship SARB surveillance

The Prudential Authority may initiate the curatorship process on the basis of information gathered during its supervision of banks or from the SARB's use of LOLR facilities.[83] As part of its robust bank supervisory framework, the SARB declared that its policy is to assist only solvent banks that face liquidity problems and to liquidate insolvent banks on the ground that further liquidity assistance to them may only prolong their problems.[84] Consequently, the SARB normally directs any banks that face potential difficulties in meeting prudential requirements to remedy such difficulties through corrective actions.[85] The Prudential Authority may discuss the issues with the bank's senior management and, depending on their response, may prohibit the bank from further expansion, direct it to increase capital requirements or even consider the withdrawal of the bank's licence.[86]

To establish whether the bank is suffering from a liquidity or solvency problem, the SARB may carry out a due diligence solvency audit using a private auditor,[87] from a firm other than the bank's external auditors.[88] If the bank is found to be solvent but suffering from a temporary liquidity shortage, the SARB may provide LOLR facilities against good security, provided that the Prudential Authority regards it to be in the interests of the stability of the banking system.[89] If the problems are not corrected, as discussed under LOLR above, a curator may be appointed before the bank becomes insolvent in an attempt to "rescue" it.[90] If on the other hand the audit finds the bank to be insolvent, the Prudential Authority will apply for its liquidation under section 68 of the Banks Act.[91]

all actions, legal proceedings, the execution of all writs, summonses and other legal process against that bank shall be stayed and not be instituted or proceeded with without the leave of the court.

[83] See generally, SARB, Bank Supervision Department, *Annual report,* (1998) and *Annual report* (2002).
[84] *Ibid.*
[85] *Ibid.*
[86] *Ibid.*
[87] *Ibid.*
[88] S 7 of the Banks Act.
[89] SARB, Bank Supervision Department, *Annual report,* (1998) 11.
[90] See par 5.2 2 above.
[91] S 68(1)(a) of the Banks Act.

5.2.2.4 Powers and functions of a curator

Once appointed, the curator takes over the management of the bank's affairs from its board of directors[92] and must manage the bank in the interests of its depositors, creditors and the banking sector.[93] The Prudential Authority may further appoint banking experts[94] to assist curators (who have mostly been appointed from large auditing firms) in the management of the bank.[95] The curator has the duty to recover and take possession of all the assets of the bank,[96] keep accounting records and prepare prescribed financial statements for the bank.[97] The curator also has the power to bring or defend, in the name and on behalf of the bank, any action or other legal proceedings of a civil nature and any criminal proceedings.[98] In addition, from 2015 and as a result of an amendment to the Banks Act occasioned by the curatorship of African Bank, the curator is authorised to raise funding from the SARB, by offering the bank's assets as security for loans.[99] The curator may also enter into any arrangement or compromise on behalf of the bank and its creditors.[100] The curator is required to account for his or her management of the distressed bank by keeping records of the nature of the actions and the reasons for taking them.[101]

The curator may transfer any of the assets of the bank,[102] provided that any transfer of more than twenty five per cent of the assets and liabilities of the bank in distress be approved by the Minister of Finance.[103] To obtain the Minister's approval, the curator must indicate the effect that such transfer will have on the bank's creditors[104] and

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[92] S 69(2A)(a) of the Banks Act.
[93] S 69(2B)(a) of the Banks Act.
[94] S 69(1)(b) of the Banks Act.
[95] IMF, *South Africa financial sector assessment program: Financial safety net, bank resolution, crisis management framework,* (2015) 28.
[96] S 69(2A)(b) of the Banks Act.
[97] S 69(2B)(c) of the Banks Act.
[98] S 69(2B)(e) of of the Banks Act. See also *African Bank v Theron and Another* [1996] 4 All SA 156 (E) 162–163.
[99] S 69(3)(j) of the Banks Act was added by s 2(d) of the Banks Amendment Act 3 of 2015 and allows the curator, notwithstanding any contractual obligations of the bank under curatorship, but without prejudice to real security rights, to provide security over the assets of the bank in respect of such funding. See also C Van Heerden, 'The rescue of African Bank: A step forward in banking regulation in South Africa', (2017) *Journal of International Banking Law and Regulation* 350.
[100] S 69(3)(k) of the Banks Act.
[101] S 69(3A) of the Banks Act.
[102] S 69(2C)(d) of the Banks Act.
[103] S 69(2C)(d) of the Banks Act.
[104] S 69(2C)(c) of the Banks Act.

whether it will be more beneficial to such creditors than the bank's liquidation.[105] However, the major determining factor to obtain the Minister's approval is whether such disposal is likely to promote the stability of the banking sector.[106]

In addition to the abovementioned statutory powers conferred on the curator by section 69 the Minister of Finance may, in the letter of appointment or at any time subsequent thereto, empower the curator to:[107]

(a) suspend or reduce the right of creditors of the bank to claim or receive interest on any money owing to them by that bank;

(b) make payments (capital or interest) to any creditor of the bank concerned at such time, in such order and in such manner as the curator may deem fit;

(c) cancel any agreement between the bank concerned and any other party to advance moneys due after the date of the curator's appointment as such, or to cancel any agreement to extend any existing facility.[108]

(d) convene meetings of the creditors of the bank for the purpose of establishing the nature and extent of the bank's indebtedness to such creditors and for consultation with them insofar as their interests may be affected by decisions taken by the curator in the course of the curatorship;

(e) negotiate with any individual creditor of the bank with a view to the final settlement of the affairs of such creditor with the bank;

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[105] S 69(2C)(b)(i) of the Banks Act.

[106] S 69(2C)(d)(i) of the Banks Act. These changes have been effected by s 2 of the Banks Amendment Act3 of 2015 which requires the curator to report on the expected effect of a transfer of the bank's assets on the bank's creditors and whether the creditors "are treated in an equitable manner and a reasonable probability exists that a creditor will not incur greater losses, as at the date of the proposed disposal , transfer or disposal and transfer, than would have been incurred if the bank had on that date been wound up under the Banks Act". It is however provided that the Minister or the Registrar (now Prudential Authority) may consent to the disposal, transfer or disposal *and* transfer notwithstanding that it may prejudice the bank's creditors if such disposal or transfer or disposal *and* transfer is reasonably likely to promote the maintenance of a stable banking sector in the Republic or public confidence in the banking sector in the Republic.

[107] S 69(3)(a) to (i) of the Banks Act.

[108] This power can be exercised if, in the opinion of the curator, such advance or any loan under such facility would not be adequately secured or would not be repayable on terms satisfactory to the curator or if the bank lacks the necessary funds to meet its obligations under any such agreement or if it would not otherwise be in the interests of the bank.

(f) make and carry out any decision which in terms of the provisions of the Companies Act would have been required to be made by way of a special resolution as contemplated in the Companies Act;

(g) cancel any lease of movable or immovable property entered into by the bank prior to it being placed under curatorship;[109]

(h) cancel any guarantee issued by the bank concerned prior to its being placed under curatorship, excluding such guarantee which the bank is required to make good within a period of 30 days as from the date of the appointment of the curator.[110]

Note should also be taken of section 69(6B) which provides for sections 35A, 35B and 46 of the Insolvency Act to apply to curatorship to facilitate finalization of outstanding derivatives and securities transactions.[111]

5.2.2.5 Challenges of curatorship

As discussed in Chapter Two,[112] the *FSB Key attributes* recommend post-GFC resolution powers to include open bank assistance, bridge bank, bail-in, purchase and assumption and depositor pay-out and liquidation.[113] The South African bank

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[109] A claim for damages in respect of such cancellation may however be instituted against the bank under curatorship after the expiration of a period of one year from the date of such cancellation.

[110] A claim for damages in respect of any loss sustained by or damage caused to any person as a result of such cancellation of a guarantee, may be instituted against the bank after the expiration of a period of one year as from the date of cancellation of the guarantee.

[111] Webber Wentzel Attorneys (the legal team who assisted African Bank curator, Tom Winterboer), 'The rescue of African Bank: A view from the trenches', paper presented at the Annual Banking Law Update (ABLU) hosted by the University of Johannesburg (October 2016), Johannesburg South Africa. S 35A of the Insolvency Act 24 of 1936 deals with transactions on an exchange and the termination thereof upon sequestration (and pursuant to s 69(6b) curatorship) whilst s 35B provides for automatic termination, upon date of liquidation (and, pursuant to s 69(6B), curatorship) of all unperformed obligations arising out of "master agreements". Once unperformed obligations terminate, values must be calculated at "market value" as at the date of liquidation (curatorship).These values must be netted and the net amount is payable. S 46 provides for set-off where the estate of one of the parties to a transaction that resulted in set-off, wholly or in part, is sequestrated within a period of six months after the taking place of the set-off or where a person to whom a claim against a debtor has been ceded has in turn ceded such claim to a third person against whom the aforementioned debtor had a claim, thus resulting in set-off, and the estate of the said debtor is sequestrated within a year after the cession. In such instance the curator may abide by the set-off or, he may, if the set-off was not effected in the ordinary course of business, with the approval of the Master of the High Court (who is responsible for administration of insolvent estates) disregard it. In the latter instance, the curator can then call upon the person concerned to pay the estate the debt he would owe it but for the set-off. Van Heerden 352 remarks that making these provisions of the Insolvency Act applicable serves to reign in much of the chaos that would otherwise be caused on a distressed bank's derivative portfolio.

[112] See ch 2 par 2.5.1.3.

[113] See EGH Hupkes, 'The role of deposit protection and resolution policy in promoting financial stability', 2 IADI research conference (June 2011) Basel, Switzerland.

curatorship process has been criticised by the IMF in its 2015 *Financial Sector Assessment Program Report* as lacking the full suite of modern resolution strategies[114] and affording the Prudential Authority a latitude of discretion.[115] Nevertheless, as is clear from the aforementioned overview, South Africa has modernised its curatorship framework by incorporating most features of the *FSB Key attributes*[116] by means of the Banks Act Amendment, 2015 that was occasioned by the curatorship of African Bank.[117] It has actually also on an earlier occasion, with the curatorship of Saambou Bank, used a resolution strategy that resembles a strategy that was later formally proposed under the *FSB Key attributes.* As such the exclusion and transfer resolution strategy under the *FSB Key attributes* was adopted in the curatorship of Saambou Bank in 2002 when the SARB assisted another bank to purchase the assets and take over the liabilities of Saambou Bank.[118]

The SARB also adopted the *FSB Key attributes* strategies of "bail-in" and "bridge banks"[119] during the curatorship of *African Bank*, in a process that limited the moral hazard in bank curatorship.[120] During the curatorship of *African Bank,* a bridge bank, the "new African Bank Ltd", was established to take over the deposits and good assets of the failed bank, leaving the old bank's bad assets under the SARB.[121] The good bank was recapitalised with funds raised from a syndicate consisting of the government, a public corporation and ABSA Bank Ltd, FirstRand Bank Ltd, Investec Bank Ltd and Nedbank Ltd (i.e the private sector).[122] This procedure combined a

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[114] IMF, *South Africa financial sector assessment program: Financial safety net, bank resolution, crisis management framework,* (2015) 28.
[115] See CC Okeahalam, 'The political economy of bank failure and supervision in the Republic of South Africa', (1998) *African Journal of Political Science* 38.
[116] See *FSB Key attribute* 3.
[117] Par 5.2.3.4 above.
[118] For example, *Saambou Bank,* which was solvent, suffered a bank run after wholesale depositors withdrew their deposits. After a determination by the SARB that it was systemically important due to its well-established branch network, the SARB facilitated an exclusion and transfer transaction by guaranteeing another bank (First Rand Bank) to purchase the assets and assume the liabilities of *SaambouBank.* See SARB, Bank Supervision Department, *Annual report*, (2002) 8 and IMF, *South Africa financial sector assessment programme*, (2015) 29. See ch 1 par 1.2.5 as regards SIFIs.
[119] See *FSB Key attribute* 3.
[120] G Marcus, *Press conference 10 August 2014: African Bank Limited*, 7 available at <https://www.org.review> accessed on 30.7.2016. See also Webber Wentzel 4 and Van Heerden 350.
[121] Marcus above.
[122] *Ibid.* While the public funds were contributed by the National Treasury and the Public Investment Corporation (PIC), the private funds were contributed by ABSA Bank Ltd, FirstRand Bank Ltd, Investec Bank Ltd and Nedbank Ltd. The good assets and deposits of the failing bank were transferred to the new 'good' African Bank Ltd, while the toxic non-performing assets were taken over under a troubled asset acquisition by the SARB, to be held in a special purpose vehicle, separate from the good bank. Collection on the bad book assets was continued to recoup the bail-out funds.

bridge bank,[123] with a mixture of a public-cum-private bail-out that recapitalised the new bank[124] and a bail-in by the conversion of debts of creditors and wholesale depositors in the failed bank at a discount (or haircut) of ten per cent.[125]

5.2.2.6 Exit from curatorship

Notably the curatorship process in terms of section 69 is not subject to a prescribed time limit.[126] Van Heerden remarks that it can in any event be expected that the curator will be especially mindful of the fact that time is of the essence in a curatorship. If a curatorship drags on unnecessarily the Prudential Authority that oversees the curator's management of the distressed bank will inevitably intervene.[127]

If the curatorship is successful, the management of the bank's affairs is restored to its board of directors, after the Minister withdraws the curator's appointment.[128] The curatorship may also lapse if it is unsuccessful and a petition to wind up the bank is allowed.[129]

5.2.2.7 Addressing moral hazard through curatorship

As observed above,[130] despite South Africa not yet having formally adopted a special bank resolution regime, the SARB *de facto* adopted *FSB Key attributes* 3 and 6 via the amendments introduced by the Banks Amendment Act of 2015[131] to facilitate the recent resolution of African Bank. Particularly, the establishment of the new African Bank adopted *FSB Key attribute* 3.4 that requires resolution authorities to establish bridge institutions to continue the critical functions of failed institutions.[132] The establishment of a special purpose vehicle to take over the old African Bank's non-performing assets adopted *FSB Key attribute* 3.2(viii) that requires resolution

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[123] See *FSB Key attribute* 3. See also ch 3 par 2.4.
[124] The public component of the bail-out was contributed by National Treasury and PIC and the private banks contributed the private component of the bail-out. See Marcus above.
[125] Marcus above.
[126] Van Heerden 353.
[127] *Ibid.*
[128] S 69(1)(a) of the Banks Act.
[129] See ss 68 and 69(10) of the Banks Act.
[130] Par 5.2.3.4 above.
[131] Par 5.2.2.4 above.
[132] *FSB Key attributes* 8.

authorities to establish a separate asset management vehicle to manage non-performing assets and difficult to value assets.[133]

The use of public funds from the National Treasury and Public Investment Corporation (PIC), in combination with the private sector bank-syndicated underwriting of the recapitalisation, adopted *FSB Key attribute* 6.4, which requires resolution authorities to provide temporary bail-out funding where private sources of funding have been exhausted.[134] The curatorship of African Bank also adopted *FSB Key attribute* 3.5that applies bail-in within resolution in conjunction with other resolution powers.[135] The imposition of the ten per cent haircut on the original debts of senior debt holders and wholesale depositors in the old African Bank transferred to the new "African Bank Limited" adopted *FSB Key attribute* 3.5, that requires resolution authorities to write down unsecured creditors and uninsured creditor claims to absorb the losses.[136]

All these measures arguably addressed the moral hazard from African Bank's curatorship and enhanced the bank resolution strategies in South Africa by publicly spelling out the resolution objectives to be achieved and execution strategies to be adopted to achieve such objectives from inception.[137] Thus, the Governor's explicit statement of the strategy[138] to adopt in the curatorship of African Bank and the amendments effected to section 69 by the 2015 Banks Amendment Act, extended the available resolution strategies for the curator, unlike the previous incidences where the appointed curator and Registrar of Banks (who was tasked with bank curatorship pre-Twin Peaks) had discretion in determining the resolution strategies to adopt.[139] To strengthen South Africa's approach to bank resolution further, the government proposes to enact a special resolution framework in alignment with the *FSB Key attributes*, which is discussed below.[140]

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[133] *Ibid.*
[134] *FSB Key attributes* 12.
[135] See MH Krimminger, 'Bail-in, not bail-out: Developing SIFI resolution strategies around the globe', 3 available at <https://www.clsbluesky.law.columbia.edu>accessed on 12.4.2018.
[136] *FSB Key attributes* 9.
[137] Remarks by Marcus above.
[138] *Ibid.*
[139] SARB, Bank Supervision Department, *Annual report,* (1998) 11.
[140] See par 5.5 below.

5.2.3 Investigation of failed banks under section 69A of the Banks Act

The other key feature of South Africa's current bank curatorship process is the accountability mechanism provided by section 69A of the Banks Act. The Act empowers the Prudential Authority to appoint a commissioner to investigate the business, trade, dealings, assets and liabilities of a bank (and its associates), that has been placed under curatorship.[141] Once appointed, the commissioner is empowered to inspect the bank and its activities[142] and to report on whether the management of the bank has contravened any banking laws or rules[143] and if so, who was involved.[144] The commissioner is also required to report to the Prudential Authority on whether the continued curatorship of the bank serves the interests of depositors and other creditors or whether such interests may be better served by winding up the bank.[145] The statutory authority of the commissioner to evaluate the potential of the curatorship succeeding, is complementary to the curator's power to form an opinion on the potential of the curatorship to restore the bank to solvency.[146]

The section 69A commissions facilitate the Prudential Authority's oversight over the administration of bank curatorship and liquidation by investigating the affairs of failed banks.[147] It is submitted that the risk of such an investigation may encourage good corporate governance and risk management structures in banks and thereby prevent excessive bank risk taking. Thus, the appointment of commissioners mitigates the moral hazard from banks by facilitating the public disclosure of the causes of their failure, which has the likely effect of deterring other banks from repeating the same mistakes and thereby protecting public funds from being used for their bail-out.

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[141] S 69A(1)of the Banks Act.In the pre-Twin Peaks dispensation the Registrar of Banks appointed the Commissioner. See also Van Heerden 353–354.
[142] S 69A(4) of the Banks Act.
[143] S 69(11)(c) of the Banks Act.
[144] S 69(11)(d) of the Banks Act.
[145] S 69(11)(b) of the Banks Act.
[146] S 69(11)(d) of the Banks Act.
[147] The Nel Commission into protection of investors, available at <https://www.gov.za>documents>nel-commission>accessed on 20.11.2018, the Governor's Panel of Experts investigation into the lifeboat assistance to Bankorp, available at <https://www.resbank.co.za>accessed on 20.11.2018 and Murburg Investigations into the affairs of *African Bank Ltd* available at<https://www.resbank.co.za.publication>accessed on 20.11.2018, were facilitated under this section and permitted the management of the banks concerned and the curators to explain the events in issue.

5.2.4 The winding up or liquidation of insolvent banks

Liquidation of banks under section 68 of the Banks Act is currently still premised on the corporate liquidation procedures under the Companies Act.[148] It may be initiated under voluntary winding up, usually of solvent banks,[149] or for insolvent banks after a due diligence solvency audit.[150] It may further be undertaken to liquidate the residue of toxic assets of a failed bank that remain after its good assets have been transferred to a bridge bank or acquired by another bank.[151] Winding up of insolvent banks may also be carried out if the curator advises the Prudential Authority that the continued curatorship of the bank will not restore its ability to pay its debts or meet its obligations.[152]

The current framework for winding up banks in SA treats bank insolvency similar to other corporate insolvency proceedings, by incorporating relevant provisions from the Companies Act and the Insolvency Act into the Banks Act.[153] The Banks Act adapts section 346 of the Companies Act on the winding up of companies to banks by requiring the service of the application and all supporting affidavits for the winding up of a banking company on the Prudential Authority and the Master of the High Court before they are filed.[154]

The Banks Act, like with the curatorship process[155], more specifically adapts the Insolvency Act to bank liquidation by incorporating sections 35A,[156] 35B[157] and 46[158] of the Insolvency Act. These provisions protect the insolvent bank's financial transactions that were already in a securities clearing or payments system exchange

[148] S 68 of the Banks Act.
[149] S 349 of the Companies Act 71 of 2008.
[150] S 7 of the Banks Act.
[151] See Marcus above.
[152] S 69(2D) of the Banks Act.
[153] S 68 of the Banks Act.
[154] S 68(2) of the Banks Act.
[155] Par 5.2.2.4 above.
[156] S 35A of the Insolvency Act requires any transactions of market participants whose estates have been sequestrated that had entered into an exchange prior to the sequestration to be completed under the rules of an exchange. See also par 5.2.3.2 above.
[157] S 35B of the Insolvency Act requires any agreements and obligations between the insolvent market participant and its counter parties to be aggregated to show only the final net balances. See also par 5.2.3.2 above.
[158] S 46 of the Insolvency Act permits any debts owing between the insolvent market participant and its counterparties to be set off. See also par 5.2.3.2 above.

immediately before liquidation.[159] Accordingly, the provisions enable financial obligations between the insolvent bank and its counterparties that are before the clearing houses to be completed by being netted and set off without forming part of insolvency proceedings.[160]

Although the South African bank curatorship and liquidation procedure does not explicitly afford depositors preference in bank insolvency,[161] the SARB has developed a *de facto* policy to reimburse depositors.[162] However, post-GFC, the South African government regards the implicit deposit protection policy as expensive and creating uncertainties for depositors in the event of bank failure.[163] Following a long engagement with financial sector standard setting bodies, the South African government consequently proposed the establishment of an EDIS and a SRR.[164]

5.3 Proposed EDIS and SRR

5.3.1 Introduction

South Africa has proposed to establish an EDIS and a SRR to increase the SARB's options in a resolution strategy, without resorting to the use of public funds.[165] As observed in Chapter One,[166] South Africa is a member of the Group of Twenty (G-20) all of which members had established EDIS by 2014, except China, Saudi Arabia and South Africa.[167] When China implemented an EDIS in May 2015 and Saudi Arabia implemented one in 2016, it left South Africa as the only G-20 member country without an EDIS.[168] Therefore, the introduction of the EDIS will enable South Africa to join its peers in the adoption of post-GFC international financial standards.[169] In addition, South Africa seeks to utilise the post-GFC experience in the design of the EDIS within

[159] S 35A of the Insolvency Act.
[160] See s 69(6B) of the Banks Act that incorporates ss 35A, 35B and 46 of the Insolvency Act to apply *mutatis mutandis* to the curator of any bank under curatorship.
[161] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 33.
[162] *Ibid.*
[163] *Ibid.*
[164] *Ibid.*
[165] *Ibid.*
[166] *Idem* 32. See also ch 1 par 1.2.8.
[167] National Treasury, *Strengthening South Africa's resolution regime*, (2015) 8.172.
[168] *Ibid.*
[169] *Ibid.*

its stabilisation and resolution frameworks,[170] in a manner that protects depositors and resolves both large and small institutions.[171] Thus, subsequent to the publication by the 2015 National Treasury policy paper on *Strengthening South Africa's resolution* for financial institutions,[172] that adopts the *FSB Key attributes*, the SARB has developed a framework for EDIS in South Africa, which has been published as the *Discussion paper on designing an explicit deposit insurance scheme*[173] in May 2017that adopts the *IADI Core principles*[174] and complements the aforementioned National Treasury policy paper.

5.3.2 The proposed EDIS

5.3.2.1 General objective of the proposed EDIS

The SARB proposes to design the South African EDIS as an integral part of a financial safety net comprising of financial regulatory, supervisory and resolution frameworks, with the objectives of strengthening "financial stability" and balancing the "costs, risks and benefits" of deposit insurance.[175] The safety net framework will promote "effective risk management" by penalising "excessive risk taking by banks" through, amongst other measures, higher capital and liquidity requirements and rewarding the more prudent banks through lower capital requirements.[176] As observed in Chapter Two,[177] these measures enhance the safety net's limitation of the moral hazard from bank risk-taking.[178]

5.3.2.2 Objectives, mandate and powers of the EDIS

The *IADI Core principles* require the public policy objectives for EDIS to be formally specified in a statute to effectively provide consumer protection to insured depositors of failed banks and promote financial system stability.[179] The public policy objectives ought to be supported by the mandates of the EDIS,[180] which may include the "pay-

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170 *Idem* 4.
171 *Ibid.*
172 National Treasury, *Strengthening South Africa's resolution regime,* (2015) 8.172.
173 SARB, *Designing an explicit deposit insurance scheme,* (2017) discussion paper 2.
174 *IADI Core principles*18.
175 SARB, *Designing an explicit deposit insurance scheme,* (2017)16.
176 *Ibid.*
177 See ch 2 par 2.3.3.1.
178 *IADI Core principles* 9.
179 *IADI Core principle* 1.
180 *Ibid.*

box", "pay-box plus", "risk minimiser", and "loss minimiser" mandates.[181] The objectives of the proposed South African EDIS are to strengthen institutional safety, enhance financial stability and reimburse depositors of failed banks to prevent bank runs and the risk of contagion to other banks.[182]

The *Discussion Paper* proposes to assign the South African EDIS the "pay-box plus"[183] mandate, which will enable it to finance reimbursements, set operational budgets and procedures and expeditiously access information to meet obligations to depositors.[184] The EDIS will be empowered to develop contingency planning and crisis management policies to respond to bank failures and other systemic events.[185] The EDIS will also be empowered to assist the designated resolution authority (RA) in other resolution strategies, for instance open bank assistance, bridge banks, exclusion and transfer of assets and depositor reimbursement.[186] The objectives and mandate under the proposed EDIS will implement *IADI Core principle* 1 on public policy objectives and *IADI Core principle* 2 on mandates.

5.3.2.3 Governance structure of EDIS

The *IADI Core principles* require the deposit insurer to be operationally independent, accountable and insulated from external interference.[187] This seeks to prevent government, central bank, supervisory or industry interference with the deposit insurer.[188] The *Discussion Paper* proposes the EDIS to be established as a subsidiary of the SARB, under a legal framework that will safeguard the autonomy of its governance.[189]The *Discussion Paper* argues that hosting the EDIS at the SARB has the advantage of reducing its initial administrative costs,[190] with legislative safeguards to prevent conflicts between the EDIS and its hosting entity.[191]

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[181] *IADI Core principle* 19. See ch 2 par 2.4.3.3 for public policy objectives and the functions of each of the mandates. See also Al-Jafari, 'General guidance for effective deposit insurance mandate', paper presented at the *IADI Executive Council Meeting* (November 2006) Rio De Janeiro, Brazil 11.
[182] SARB, *Designing a deposit insurance scheme for South Africa,* (2017) 18.
[183] Par 5.3.2.2 above. See also *IADI Core principle* 2.
[184] SARB, *Designing an explicit deposit insurance scheme,* (2017)20.
[185] *Ibid.*
[186] *Idem* par 8.2 bullets 5 and 6. See also ch 2 par 2.3.3.3.
[187] *IADI Core principle* 3.
[188] *Ibid.*
[189] SARB, *Designing an explicit deposit insurance scheme,* (2017) 24.
[190] *Ibid.*
[191] See Demirguc-Kunt *et al* 155.

This model has the advantage of reducing the start-up and operating costs of the EDIS and leveraging on the administrative infrastructure of the SARB.[192] It will also promote economies of scale for the SARB in its coordination of the EDIS and the proposed resolution functions of the SARB as the RA.[193] However, it is recognised by Demirguc-Kunt *et al*, that the housing of the EDIS in the SARB could potentially create conflicts between the EDIS, the RA, the Prudential Authority and the Financial Services Conduct Authority,[194] which call for a clear demarcation of their objectives and mandates.[195]

The *Discussion Paper* addresses these potential conflicts by proposing that the EDIS be granted independence from its hosting entity and be afforded adequate resources to discharge its functions.[196] Further, the EDIS will have its own chief executive officer and a board of directors to govern it.[197] In addition, the independence of the board will be secured by constituting it from representatives of the National Treasury, the SARB, the Prudential Authority, the Financial Services Conduct Authority and the head of the EDIS to prevent it from being directed solely by the hosting agency.[198] It is further proposed to exclude representatives of the banking industry from membership of the board of the EDIS, probably to avoid private sector special interests.[199]

South Africa has chosen to establish the EDIS within the existing safety net framework because of the SARB's established infrastructure, which has been developed from its long experience in dealing with banks in distress and handling depositor reimbursements. The public discussion pursuant to the SARB's aforementioned policy will weigh the merits and demerits of establishing the EDIS either as an independent agency or as a subsidiary of the SARB, which may enhance its effectiveness.[200]

[192] SARB, *Designing an explicit deposit insurance scheme,* (2017) 24.
[193] Under the new framework, the SARB will be designated as the RA. See par 5.3.2.5 below.
[194] The Prudential Authority and the Financial Services Conduct Authority represent the Twin Peaks of the South African financial regulatory structure under the Financial Sector Regulation Act. See ch 3 par 3.3.1.3.
[195] SARB, *Designing an explicit deposit insurance scheme,* (2017) 24.
[196] *Ibid.*
[197] *Ibid.*
[198] *Ibid.*
[199] *Idem* 25.
[200] See for example the *IADI Core principle* 3.1 that requires the deposit insurer to operate independently of any interference from government, central bank, supervisory or industry. IADI *Core Principles* 21.

However, whichever structure is adopted, it will be compliant with *IADI Core principle* 3 on the governance structure of EDIS.

5.3.2.4 Membership and scope of coverage

The *IADI Core principles*[201] require membership in the EDIS to be compulsory for all banks.[202] This is meant to prevent the stronger and well-capitalised banks from opting out of membership, thereby leaving only the smaller and weakly capitalised banks as members. The proposed EDIS will have automatic and compulsory membership and coverage for all depository institutions, including mutual banks, cooperative banks, local banks and local branches of foreign banks (subject to agreement with their home authority's deposit insurers).[203] Mandatory membership will ensure that both smaller and larger banks belong to the scheme to increase its capital base and prevent the problem of adverse selection,[204] where only the weak banks choose to be members.[205]

The qualifying deposits will be limited to retail and small to medium enterprises (SME) deposits.[206] Consequently, deposits from banks, non-bank financial institutions for instance unit trusts, insurers, pension funds, fund managers and private financial corporate sector institutions are excluded.[207] Based on surveys conducted by the SARB in 2013 and 2015 to determine the size and distribution of all deposits in South African banks,[208] and based on the SARB's past experience in reimbursing depositors of failed banks, the scope of covered insured deposits is proposed to be limited to R100 000 per qualifying depositor per bank, which is considered sufficient to protect the majority of retail and SME depositors.[209]

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201 *IADI Core principle* 7.
202 *Ibid.*
203 SARB, *Designing an explicit deposit insurance scheme,* (2017) 26.
204 FS Mishkin, *The economics of money, banking and financial markets,* (2016) 41.
205 See DC Wheelock & SC Kumbhakar, 'Which banks choose deposit insurance: Evidence of adverse selection and moral hazard in voluntary insurance systems', (1995) *Journal of Money Credit and Banking* 186.
206 SARB, *Designing an explicit deposit insurance scheme,* (2017) 29. The discussion paper defines insured deposits as "qualifying deposits" which belong to retail or individual depositors and SME depositors. The other deposits are described as "excluded deposits" and are defined as those from institutions that are financially sophisticated to make informed investment decisions.
207 Other excluded deposits are deposits by local, provincial and national government, public financial sector entities, the PIC and other public non-financial corporations and monetary authorities and bearer deposit instruments including negotiable certificates of deposit and promissory notes. SARB, *Designing an explicit deposit insurance scheme,* (2017) 29.
208 *Idem* 28.
209 *Ibid.*

Although the initial idea was to exclude wholesale deposits, it was decided on account of the small number of potentially qualifying wholesale depositors, that their deposits be included in the qualifying deposit subject to the limit of the amount of coverage of R100 000.[210] Thus, while the insured deposits cover depositors perceived to be in need of protection (whom an EDIS seeks to prevent from initiating runs on banks that are perceived to be in distress),[211] the exclusion of large deposits require the depositors of these large amounts to use market discipline as a tool to make informed investment decisions on the protection of their deposits.[212] As observed in Chapter Two,[213] the limitation of scope of coverage will implement *IADI Core principle* 8 and is designed to address depositor moral hazard by forcing them to take responsibility for amounts exceeding the sum insured.

5.3.2.5 Funding arrangements

The *IADI Core principles* require the EDIS to be funded through *ex ante* premium levies on member banks.[214] In addition, the *FSB Key attributes* require bank resolution to be financed from an *ex ante* privately funded EDIS.[215] The proposed EDIS for South Africa will be established as an *ex ante* privately funded mechanism, which adopts one of the key design features of limiting the moral hazard from banks in compliance with both the *IADI Core principles* and the *FSB Key attributes* above.[216] The *ex ante* fund will eradicate the moral hazard in banking by making banks pay for their risk-taking through premiums that will be levied by the EDIS.[217] The payment of premiums by banks shifts the costs of depositor reimbursement from public funds to the member banks and increases public confidence in the government's protection of their deposits, thereby preventing panics and bank runs when a bank is in distress.[218] In

[210] *Idem* 30.
[211] *Ibid.*
[212] *Ibid.*
[213] Ch 2 par 2.3.
[214] *IADI Core principle* 9.
[215] *FSB Key attribute* 6.5.
[216] B Bretschneider & R Benna, 'Risk-based premium modes for deposit insurance systems', in JP Notte, I Sfandyar & Z Khan (eds), *Deposit insurance systems: Addressing emerging challenges in funding, investment, risk-based contributions and stress testing*, (2017) 141.
[217] *FSB Key attributes* 38.
[218] *Ibid.*

addition, the *ex ante* funded EDIS will facilitate an expeditious pay-out to depositors of failed banks with no further legislative appropriation or government approval.[219]

The *Discussion Paper* identifies the difficulties of scientifically determining chargeable premiums[220] and leaves the exact funding arrangement to be discussed with the public, including the member banks as stakeholders.[221] The decision on whether to charge risk-based premiums as a further measure to limit the moral hazard also awaits public discussion. While there are concerns that the stakeholder banks may lobby for lower premiums, the SARB proposes to use its safety net regulatory and supervisory powers to penalise bank risk-taking through higher capital and liquidity requirements and reward prudent banks with lower requirements.[222] The *ex ante* funding of the EDIS will implement *IADI Core principle* 9 as discussed in Chapter Two[223] on funding through contribution by member banks.

5.3.2.6 The role of the EDIS in bank resolution

It is proposed that the SARB be designated as the RA and either lead in the resolution of failed banks itself or delegate such function to the Prudential Authority.[224] This has the benefit of enhancing the expeditious execution of resolution strategies, since the SARB as the RA will combine the resolution powers with its other safety net functions. However, the SARB has stated that it is aware of the potential for disputes in the exercise of its resolution powers, particularly bail-in within resolution, and the attendant legal redress of grievances.[225] In addition, such direct involvement of the SARB in resolution may expose it to unnecessary criticism of its decisions as RA. The *Discussion Paper* indicates that this could probably be avoided by designating a separate entity under the SARB as RA, which would absorb any criticism that may arise from its execution of resolution powers. The SARB could then oversee the

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219 *Ibid.*
220 SARB, *Designing an explicit deposit insurance scheme,* (2017) 34.
221 *Ibid.*
222 *Idem* 16.
223 Ch 2 par 2.3.
224 SARB, *Designing an explicit deposit insurance scheme,* (2017) 34.
225 National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 44. For global trends on the role of deposit insurers in resolution see T Beck & L Laeven, *Resolution of failed banks by deposit insurers: Cross country evidence*, (2006) World Bank research working paper11.

resolution process for accountability, particularly in view of its powers under section 69A of the Banks Act.[226]

5.3.2.7 Resolution powers

The *Discussion Paper* outlines the possible resolution strategies for the RA as: open bank assistance, bridge banks, purchase and assumption and depositor reimbursement and liquidation.[227] The RA is required to select the least costly resolution strategies with a reasonable probability of success.[228] The trigger for the depositor reimbursement is at the point when the RA invokes the EDIS.[229] The EDIS will explicitly state in advance when depositor payout may be effected[230] and thereby declare a depositor preference in the resolution of failed banks.[231] Upon reimbursement of depositors, the EDIS will subrogate[232] to the rights of reimbursed depositors in the failed banks.[233] This enables the EDIS to recover any amount it pays out from the sale of the assets of the failed institution and thereby mitigate its losses from the resolution of banks.[234]

The EDIS will further be required to coordinate its functions with other safety net participants within and outside South Africa through memoranda of understanding,[235] and bilateral agreements.[236] In line with international practice, all employees of the SARB, the EDIS and RA are to be protected from liability for anything done or omitted in the *bona fide* discharge of their duties.[237] The SARB's proposed EDIS and SRR[238] will need to be harmonized with the National Treasury's envisaged Special Resolution legislation as discussed below.[239] The role of the proposed EDIS in the context of

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[226] SARB, *Designing an explicit deposit insurance scheme,* (2017) 34.
[227] *Ibid.*
[228] *Idem* 22.
[229] *Ibid.*
[230] *Idem* 46.
[231] *Ibid.*
[232] Subrogation was defined in Chapter Two as the substitution of the deposit insurer for the insured depositors' lawful claims and remedies in the failed bank, under section 2.2.1 summary of *IADI Core principles*, in terms of *Core principle* 16. See *IADI Core principles* definition of "Key terms" at 10.
[233] *Idem* 47.
[234] *Ibid.*
[235] *Idem* 42.
[236] *Ibid.*
[237] *Ibid.*
[238] SARB, *Designing an explicit deposit insurance scheme,* (2017) 16.
[239] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 33.

resolution will implement *IADI Core principle* 14 that requires the legal framework for the EDIS to include a special resolution regime,[240] or for the EDIS and the SRR to be included in the same legal framework.

5.4 The proposed bank resolution regime

5.4.1 The National Treasury's resolution policy proposals

In 2015 the National Treasury published a comprehensive policy paper on the design of an effective bank resolution regime (in which it also incorporated ideas on the EDIS subsequently conceptualized by the complementary *SARB Discussion Paper* discussed above).[241] In this 2015 policy it proposed that a Special Resolution Act (SRA) be drafted to reform the processes for bank curatorship[242] and liquidation.[243]

5.4.2 Key reforms on bank curatorship and liquidation

The National Treasury's envisioned resolution framework policy seeks to enact a SRA to consolidate the provisions that currently forms part of the Banks Act on bank curatorship and liquidation of financial institutions. The scope of the envisaged SRA will include the resolution of SIFIs, the holding companies of non-regulated entities and financial market infra-structures designated as SIFIs.[244]

The National Treasury proposes to designate the SARB as the RA, which will establish a structure to discharge the resolution functions similar to the current SARB structures for monetary policy, financial stability, prudential supervision and reserves management.[245] The RA will be responsible for maintaining financial stability and ensure the continuation of "systemic financial services, and financial market payment,

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[240] *IADI Core principle* 14, which provides that

> [a]n effective resolution regime should enable the deposit insurer to provide for the protection of depositors and contribute to financial stability. The legal framework should include a special resolution regime.

It is arguable that the legal framework being referred to is the legal framework for the EDIS that enables the deposit insurer to protect depositors and contribute to financial stability.

[241] *Ibid.*

[242] *Idem* 30.

[243] *Idem* 31.

[244] *Idem* 9.

[245] *Ibid.*

clearing and settlement infrastructures."[246] The RA will further be responsible for the promotion of financial consumer protection in banking, insurance and other financial sectors through compensation or reimbursement schemes and mitigate resolution costs in host and cross-border economies.[247]

The Treasury's resolution policy proposes that the RA sets its priorities as maintaining the stability of the financial system, protecting insured depositors, minimising the use of public funds to bail-out banks and mitigating any adverse impact on the economy.[248] The RA will be empowered to obtain information from insured banks to enable it to supervise the preparation of recovery and resolution plans (RRPs).[249] Recovery plans will enhance the RA's ability to understand the business structure and operations of the concerned banks to facilitate a more orderly resolution, should the recovery efforts fail to return them to viability.[250] Thus, the recovery plans will be compiled by institutions themselves, and will set out the strategies they propose to execute for their recovery from financial stress without reliance on public funds.[251] However, the policy is unclear as to who between the regulated institutions and the RA should prepare resolution plans, because the policy first assigns the responsibility to the RA and later requires financial institutions and their regulators to "have resolution plans in place."[252] Nevertheless, the policy requires that each institution's resolution plans should set out the various resolution strategies to be adopted should the institution become insolvent.[253] The policy envisages that the resolution plans should be furnished to the SARB, to enable it to participate in assessments of the institutions' resolvability and direct corrective actions to be undertaken to enhance the institutions' resolvability.[254] Thus, the policy proposes to empower the RA to access information and investigate

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[246] *Ibid.* The SARB has subsequently been assigned an explicit and expanded financial stability mandate in terms of s 11 of the Financial Sector Regulation Act, which introduced the South African Twin Peaks framework. See ch 3 par 3.1.3.3.
[247] *Ibid.*
[248] *Idem*8.
[249] *Idem* 12.
[250] Seealso C Goodhart & M Segoviano, *Optimal bank recovery,* (2015) IMF working paper 4.
[251] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 12.
[252] *Idem*13.
[253] *Ibid.*
[254] *Ibid.*

institutions[255] and to evaluate and advise on recovery and resolution plans to enhance the resolvability of institutions.[256]

Th e policy proposes that resolution will be triggered when the institution has either ceased or is likely to cease to be viable, with no reasonable prospect of recovering.[257] The point of non-viability arises when the institution comes under severe financial stress. Notably, the *FSB Key attributes* recommend resolution to be invoked at a point before the institution becomes insolvent in order to limit the costs of resolution.[258] The SARB as RA will retain the powers to appoint an administrator[259] execute the resolution strategies,[260] give directives to institutions that engage in unsafe and unsound activities and remove directors and managers.[261] Although the triggers for invoking resolution and the powers of the administrator are stipulated,[262] the policy does not set out the triggers for invoking recovery plans, which should be enforced before resolution. The statutory stipulation of triggers for recovery plans is important because bankers are likely to delay voluntary entry into recovery due to the reputational damage it may cause them.[263]

5.4.3 Resolution powers under the envisaged SRA

The National Treasury policy document proposes that the RA be empowered to exercise three of the resolution powers referred to above[264], namely to establish a bridge institution, transfer assets and liabilities to a solvent institution and to restore the institution through a bail-in by requiring shareholders to recapitalise the bank and unsecured creditors and uninsured depositors to convert their debts into equity in the bank.[265] As pointed out, the requirement for bail-in within resolution was actually pre-

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[255] *Ibid.*
[256] *Idem* 15.
[257] *Idem* 18.
[258] *Ibid.*
[259] An administrator in the context of the SRB is assigned the functions currently executed by the bank curator under the Banks Act. See also *FSB Key attributes* 3.2 (ii), which authorises RAs to appoint an administrator to take over and manage distressed firms with the objective of restoring them or parts of their business.
[260] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 26.
[261] *Idem* 24.
[262] *Ibid.*
[263] See Goodhart & Segoviano 4.
[264] See par 5.4.2 above.
[265] Ch 2 par 2.4.1.2. See National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 19.

emptively implemented in the resolution of *African Bank* discussed above.[266] This strategy seeks to ensure that the shareholders, unsecured creditors and uninsured depositors are given an opportunity to restructure the bank through a bail-in and thereby save their investment.

As indicated in Chapter Two,[267] the *FSB Key attributes* require authorities to avoid the use of public funds to bail-out banks, except for temporary funding which should be recovered from shareholders, creditors, and the financial system.[268] In addition, any bail-out should be subjected to conditions that mitigate the moral hazard, including a determination that it will promote financial stability.[269] The SRR proposed in the Treasury policy document restricts the RA from using public funds in the resolution of financial institutions without the prior approval of the Minister of Finance.[270] However, the policy document does not prescribe any criteria to guide the Minister in the consideration of the RA's application for use of public funds.[271]

The *FSB Key attributes* further require the RA to ensure that depositors of failed institutions are either expeditiously reimbursed or that their deposits are transferred to a solvent institution.[272] The Treasury policy document proposes depositor preference in insolvency for qualified depositors in respect of both their covered deposits and for the balance of credit above the covered deposits.[273] This excludes them from participation in bail-in resolution strategies and leaves the unqualified depositors and unsecured creditors to shoulder any losses from bank failure whether in bail-in or liquidation.

The Treasury policy document also proposes that liquidation only be implemented where the other resolution strategies would leave creditors worse off.[274] In light of the introduction of the bail-in provisions,[275] the policy document proposes that creditor

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[266] Par 5.2.2.5 above.
[267] Ch 2 par 2.4.
[268] *FSB Key attribute* 6.2.
[269] *FSB Key attribute* 6.4.
[270] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 23.
[271] *Idem* 20.
[272] *FSB Key attribute* 3.2 (xii).
[273] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 21.
[274] *FSB Key attribute* 6.4.
[275] See VSG Babis, *Bank recovery and resolution: What about shareholder rights?*, (2012) Legal studies research paper series, University of Cambridge, Faculty of Law 6.

hierarchy rights in bail-in and liquidation be streamlined[276] so that no creditor is "worse off" under the SRR than in ordinary insolvency procedures.[277] To this end, the policy document ranks the rights of secured creditors[278] in insolvency, higher than those of preferred creditors,[279] followed by the rights of qualified depositors,[280] who rank higher than unsecured creditors and all other uninsured depositors, the latter two categories being considered as concurrent creditors.[281]

On the whole, it is submitted that the envisaged SRA, will provide a clear framework for bank resolution and strengthen South Africa's financial regulation for a safer financial sector.[282] However, since the SRA has not yet been drafted the exact scope and contents of SRA is still subject to public discussion, hence the policy positions it will express could be refined and clarified before the statute to implement them is drafted and enacted.[283]

5.5 Addressing moral hard under the proposed EDIS and envisaged SRR

5.5.1 Evaluation of South Africa's proposed EDIS and resolution regime

This chapter sought to examine how the proposed transition from an implicit deposit protection system to an EDIS and SRR in South Africa will address moral hazard in banking. As the implementation of the *IADI Core principles* and the *FSB Key attributes* seek to fill the gaps identified in deposit insurance and bank resolution, the chapter sought to consider how the design of South Africa's proposed EDIS may implement these international financial standards.

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[276] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 21.

[277] *FSB Key Attribute* 5.

[278] Secured creditors are defined in s 2 of the Insolvency Act as those who hold security for their claims as a special mortgage, landlord's legal hypothec, or right of retention and are generally entitled to be paid out of the proceeds of the property of their security. See R Sharrock, K Van der Linde& A Smith, *Hockly's insolvency law,* (2012) 182.

[279] Preferred creditors are creditors whose claims are entitled to payment before other creditors. See Sharrock *et al* 183.

[280] Qualified depositors are depositors with insured deposits and comprise of retail and small and medium enterprise depositors under the SRB. See National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015) 21.

[281] Concurrent creditors have their claims ranked equally and are paid out of the residue of the estate of the insolvent firm. See Sharrock *et al* 183.

[282] National Treasury, *Strengthening South Africa's resolution framework for financial institutions*, (2015)23.

[283] *Ibid.*

5.5.2 Implementation of the IADI Core principles

The *IADI Core principles* recommend the limitation of the moral hazard through the design of the EDIS by levying *ex ante* risk based premiums,[284] limiting the scope of cover,[285] assigning mandates[286] and defining the role of EDIS in safety net provision.[287] The proposed EDIS in South Africa appears to incorporate the suggested design features and thus to implement most of the *IADI Core principles* by establishing an *ex ante* privately funded scheme,[288] that charges premiums from member banks[289] and limiting the scope of cover.[290] While the decision on whether to charge flat rate or risk-based premiums is yet to be taken,[291] the proposed EDIS includes mechanisms for *ex ante* premium charges.[292] The proposal to assign the envisaged EDIS a "pay-box plus mandate" may be informed by SARB's robust financial regulatory and supervisory framework.[293] Thus, the proposed EDIS will participate in the safety net through contingency planning and crisis risk management.[294] However, the proposed "pay-box plus" mandate for the South African EDIS will not permit it to participate in the closure of risky banks by the termination of the insurance cover provided by the EDIS.

5.5.3 Implementation of the FSB Key attributes

The *FSB Key attributes* recommend limiting moral hazard from financial conglomerates through bail-in[295] or any other least costly resolution strategy,[296] an *ex ante* privately funded EDIS by member banks[297] and requirements for RRPs.[298] The proposed SRR appears to implement the provisions of the *FSB Key attributes* on *ex ante* funding for

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[284] Ch 2 par 2.3.3.2.
[285] Ch 2 par 2.3.3.3.
[286] *Ibid.*
[287] Ch 2 par 2.3.3.4.
[288] Par 5.3.2.5 above.
[289] *Ibid.*
[290] Par 5.3.2.4 above.
[291] *Ibid.*
[292] Par 5.3.2.5 above.
[293] Ch 3 par 3.3.2.
[294] Par 5.3.2.3 above.
[295] Ch 2 par 2.4.1.2.
[296] *Ibid.*
[297] *Ibid.*
[298] Ch 2 par 2.4.1.4.

EDIS,[299] the adoption of the least costly resolution strategies[300] and the requirements for RRPs.[301] Since South Africa has already implemented the requirement for RRPs,[302] the SRR once captured in legislation, will formalise this requirement. Once enacted, the resolution framework in South Africa will more effectively address the moral hazard from banking than the current framework.

5.5.4 Factors influencing South Africa's implementation of IADI Core principles

The implementation of the *IADI Core principles* and the *FSB Key attributes* in South Africa will be influenced more by public choice factors than special interest group factors. As noted above,[303] the SARB which is playing a key role in the financial reform process has demonstrated a practice of acting in the public interest.[304] The National Treasury has also demonstrated a clear objective of strengthening South Africa's financial regulatory structure through a deliberate process of preparing policy papers, publishing them for public discussion, incorporating the public comments and thereafter capturing the refined public driven framework in legislation.[305] Therefore, the chances of the proposed policy frameworks of the EDIS being enacted once the public discussion procedures are completed, are significantly high. The specific adaptation of the international financial standards to the South African context is also more likely to be influenced by public choice factors than special interest factors.

5.6 Chapter summary and conclusions

The SARB currently administers implicit deposit protection through the LOLR facility under its discretionary central bank prerogatives.[306] While it has devised measures to limit moral hazard from banks, it does not currently have statutory depositor preference in bank resolution or an *ex ante* fund paid for by banks premiums. The limitations occasioned by the lack of EDIS have motivated South Africa to propose the adoption of an EDIS and SRR after a long engagement with international standard setting

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[299] Par 5.3.2.5 above.
[300] Par 5.4.3 above.
[301] Par 5.5.1 above.
[302] N Brink, 'Approach to bank resolution in South Africa', 7 Paper presented at CCBS workshop for Heads of Financial Stability, (February 2013). See also IMF, *South Africa financial sector assessment program: Financial safety net, bank resolution, crisis management framework,* (2015) 19.
[303] Par 5.3.2 above.
[304] *Ibid.*
[305] Par 5.4.2 above.
[306] Par 5.2.1above.

bodies.[307] The proposed EDIS will be a privately *ex ante* funded scheme from bank premiums that will enhance the limitation of bank moral hazard[308] and depositor moral hazard through limitation of the scope of cover.[309]

The National Treasury policy paper on the design of an effective bank resolution and explicit deposit guarantee scheme,[310] is complemented by the subsequent SARB *Discussion Paper* on EDIS. The Treasury policy paper proposes a requirement for banks to prepare RRPs to enhance resolvability,[311] and the introduction of formal resolution powers to create a bridge institution, transfer assets and liabilities and require a bail-in by shareholders and certain creditors.[312] All these measures, once enacted in the envisaged special resolution legislation, will formalise some of the current resolution powers exercised by the curator and enhance the limitation of bank moral hazard by ending government bail-out of failed financial institutions.[313]

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[307] Par 5.3.1 above.
[308] Par 5.3.2 above.
[309] Par 5.3.2.4 above.
[310] Par 5.3.1 above.
[311] Par 5.5.3 above.
[312] Par 5.4.3 above.
[313] *Ibid.*

CHAPTER 6: EXPLICIT DEPOSIT INSURANCE AND BANK RESOLUTION IN THE UNITED STATES OF AMERICA

6.1 Introduction

The United States of America (USA) established the first national explicit deposit insurance scheme (EDIS) in 1933[1] after attempts by individual states had failed to sustain EDIS without government support.[2] This makes the US EDIS the oldest in the world,[3] and its experiences and practices can inform other countries in the design or reform of their EDIS.[4] As discussed in Chapter Two,[5] most of the post-GFC international financial reforms on EDIS[6] and special bank resolution regimes (SRR)[7] drew from the US experience.[8] This chapter examines the development and implementation of EDIS and SRR in the USA as administered by the Federal Deposit Insurance Corporation (FDIC), with the aim of identifying the strategies that the FDIC has adopted from its inception in 1933 to the pre- and post-GFC periods, to enhance its effectiveness in addressing the moral hazard from banks.

The chapter accordingly provides an overview of the bank regulatory framework within which the FDIC operates, and examines the governance, funding, mandates and scope of coverage of its EDIS from inception until current times. Also discussed are the challenges the FDIC has experienced in the administration of the EDIS and SRR and the reforms adopted to address those challenges. The chapter will further enquire into the role that the FDIC played during the GFC and how the USA, despite its well-established EDIS, was still responsible for causing the GFC. The objective of this

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[1] CW Calomiris & E White, 'The origins of federal deposit insurance', in C Golgin & GD Libecap (eds),*The regulated economy: A historical approach to political economy,* (1993) 145. See also FDIC, *FDIC resolution handbook,* (2014) 1. See further FDIC, *The first fifty years: A history of the FDIC 1933–1983*, available at <http://www.fdic.gov/bank/analytical/firstfisty/index.html> accessed on 14.12.2018.
[2] EN White, 'State sponsored insurance of bank deposits in the United States 1907 to 1929', (1981) *Journal of Economic History* 539.
[3] Ch 1 par 1.2.3.
[4] GL Verley, 'Global overview of resolution: A focus on purchase and assumption', Financial Safety-Net Conference (May 2015) Stockholm, Sweden, who observes that the USA experience inspired the EDIS mandates under *IADI Core principle* 2 and resolution powers under *Core principle* 14 of the International Association of Deposit Insurers (IADI),*Core principles for effective deposit insurance systems,*(2014) (*IADI Core principles*) available at <https://www.iadi.org.pdf>accessed on 14.8.2016. The USA also inspired the resolution powers under the Financial Stability Board's *Key attribute* 3. See Financial Stability Board*, Key attributes of effective resolution regimes for financial institutions*, (2014) (*FSB Key attributes*) available at <https://financialstabilityboard.org/2014/10r_141015>accessed on 25.10.2017.
[5] Ch 2 par 2.3.2.2.
[6] See *IADI Core principles.*
[7] *See FSB Key attributes.*
[8] Verley 17 and 27.

chapter is to consider lessons to be drawn from the US experience that may inform appropriate reforms to enhance the effectiveness of the Kenyan EDIS in addressing the moral hazard in banking.

6.2 Overview of US bank regulation and introduction of EDIS

After the collapse of the US capital markets in 1929, followed by the Great Depression, between 1930 and 1933, the USA experienced a banking crisis that led to the failure of 5199 banks.[9] The major cause of these bank failures was attributed to bank runs by depositors who feared for the safety of their funds.[10] A government attempt to stem the bank runs by establishing the Reconstruction Finance Corporation in 1932 for purposes of advancing credit to banks that faced liquidity problems, was however not fully successful.[11] Consequently, in 1933, the government enacted the Banking Act, 1933 to establish a federal EDIS to be administered by the FDIC.

The main objective of the EDIS was to prevent bank runs and resolve the affairs of the large number of failed banks.[12] The Banking Act, 1933 further limited bank risk-taking by separating commercial banking from investment banking (through the Glass-Steagall provisions).[13] The overriding motivation for the separation of commercial banking from investment banking[14] was to prevent a recurrence of the alleged use of depositors' funds by investment bankers to finance their speculation in the capital market that led to the stock market collapse of 1929.[15] Accordingly, the Banking Act,

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[9] RS Carnell, JR Macey & GP Miller, *The law of banking and financial institutions,* (2009) 17.
[10] *Ibid.*
[11] *Ibid.*
[12] *Ibid.*
[13] The Banking Act 1933 is also known as the Glass-Steagall Act, in reference to the provisions to separate commercial and investment banking. However, the Act also created the FDIC and reformed other aspects of banking regulation in respect of which it is referred to as the Banking Act, 1933. See ch 3 par 3.4.1.
[14] Some scholars argue that special interest groups that wanted to protect themselves from competition may also have motivated the separation. See MJ Roe, 'Political roots of American corporate finance', (1997) *Journal of Applied Corporate Finance*8-22 and SK Halpert, 'The separation of banking and commerce reconsidered', (1988)*The Journal of Corporation Law* 495.
[15] See DU Fletcher, Chairman of the Senate Committee on Banking and Currency, *US Senate report of the Committee on Banking and Currency on stock exchange practices*, (1934) 20, popularly referred to as the Pecora report after its assisting counsel Ferdinand Pecora that led witnesses during the hearings. See also WF Shughart II, 'Public choice perspectives of the Banking Act, 1933', in C England & TF Huertas (eds), *The financial services revolution: Policy directions for the future*, (1988) 96 and LD Brandeis, *Other people's money and how the bankers use it,* (1914) 17–19 where the author argues that the combination of commercial banks, insurance companies and trust companies under investment bankers enabled them to use other people's money in deposits to control the nation.

1933 included the Glass-Steagall provisions that prohibited national banks from underwriting or purchasing any issues of securities or stock for their own account.[16] National banks were also prohibited from engaging in the business of issuing, underwriting, selling or distributing securities.[17] Consequently, national banks were restricted to the narrow commercial banking business of accepting deposits, lending to their customers and other related services.[18] This protected insured banks from the risky investment banking business and restricted deposit insurance cover to depositors of commercial banks.[19]

6.3 The Federal Deposit Insurance Corporation

6.3.1 Governance, funding and mandate of the FDIC

The institutional framework for the EDIS provisions of the Banking Act, 1933 was established under the FDIC, whose mandate was to administer the deposit insurance scheme[20] and act as RA for failed insured institutions.[21] The FDIC was established as an independent agency of the US government under a board of directors,[22] comprising of five members, two of whom, the Comptroller of the Currency and Office of Thrift Supervision (the regulator for savings and loan associations), were *ex officio* members, and the other three were appointed by the President, subject to senate confirmation.[23] The FDIC's deposit insurance fund was established as an *ex ante* fund with initial funding from the sale of its stock[24] and from the premiums levied as flat rate subscription fees on member banks.[25] The FDIC mandate was to provide federal deposit insurance to national banks and state member banks and to "purchase, hold

[16] S 16 of the Glass-Steagall Act, 1933.
[17] S 21 of the Glass-Steagall Act, 1933.
[18] See CW Lichtenstein, 'Lessons for 21st Century central bankers: Differences between investment and depository banking', in M Giovanoli &D Devos (eds), *International monetary and financial law,* (2010) 222.
[19] See K Scott, 'Deposit insurance and bank regulation: The policy choices', (1989) *Business Law Review* 272.
[20] See Carnell *et al* 314.
[21] *Idem* 662.
[22] *Idem* 63.
[23] *Ibid.*
[24] S 12B of the Banking Act, 1933. The stock was to be sold to the US Treasury Secretary (under s 12B(c)), the twelve Federal Reserve Banks (under s 12B(d)) and commercial banks (under s 12B(e)).
[25] SI Greenbaum & AV Thakor, *Contemporary financial intermediation,* (2007) 490.

and liquidate assets" of member banks that were closed by regulators or their directors.[26]

As discussed in Chapter Three,[27] the dual banking structure in the USA restricted the FDIC's supervisory functions to state chartered insured banks that were not members of the Federal Reserve System.[28] Consequently, the FDIC exercised the "risk minimiser" mandate in respect of the state chartered insured banks that it supervised.[29] In addition, being the designated RA for the failed member banks, the FDIC exercised the "loss minimiser" mandate in respect of insured banks (i.e national and state chartered member banks).[30] Since the FDIC had no supervisory functions over national banks,[31] bank holding companies[32] and state chartered banks that were members of the Federal Reserve System,[33] itcould not close them even if their risky activities threatened losses to its insurance fund.[34] However, the FDIC retained the authority to terminate the deposit insurance of insured banks that it did not supervise, as a last resort to address bank moral hazard.[35] Since deposit insurance was required by all federal and state regulators as a condition for the charter of a bank, the FDIC was reluctant to terminate insurance cover because it effectively led to the withdrawal of the bank charters and ended their operations.[36]

6.3.2 Scope of cover of insured deposit

The scope of cover of the insured deposits was initially limited to $ 2 500 per depositor per category of account in 1934.[37] The FDIC classified insured deposits according to the category of legal ownership, namely single accounts, qualifying retirement

[26] S 12B(a) of the Banking Act 1933.
[27] Ch 3 par 3.4.2.1.
[28] DR Fischel, AM Rosenfield & RS Stillman, 'The regulation of banks and bank holding companies', (1987) *Virginia Law Review* 335 and GP Miller, 'The future of the dual banking system', (1987) *Brooklyn Law Review* 782.
[29] Carnell *et al* 64.
[30] *Idem* 662.
[31] Supervised by the Comptroller of the Currency under the National Banks Act, 1864.
[32] S 1842(a) of the Bank Holding Company Act, 1956 and s 9 of the Federal Reserve Act, 1913 that empowers the Federal Reserve Board to supervise member banks.
[32] See s 1842 (a) of the Bank Holding Company Act, 1956.
[33] Supervised by the Federal Reserve Board under s 9 of the Federal Reserve Act, 1913.
[34] Carnell *et al* 64.
[35] S 691 of Financial Institutions Reform and Recovery Enforcement Act, 1989 (FIRREA).
[36] 12 USC s 1818(o). Title 12 of the US Code (12 USC) is the part in the US Statutes that deals with banks and banking.
[37] See FDIC 12 Code of Federal Regulations (C.F.R) Part 330.

accounts, joint accounts, revocable trust accounts, irrevocable trust accounts, employee benefit plan accounts, and government accounts.[38] Thus, a depositor with more than one account could recover in each category in which he or she qualified as an insured depositor.[39] Accordingly, a depositor with a single account, individual retirement accounts and a revocable trust account was entitled to recover the full insured deposit in each of the categories.[40] Over the years, the scope of cover for individual retirement accounts was higher than that of single accounts, for example, when the scope of cover for an individual retirement account was increased to $250 000 in 1980,[41] the scope of a single account was increased to $100 000[42] and single account cover was only increased much later, namely to $250 000 in 2010.[43]

The initial objective of the Banking Act 1933, was to provide full cover only to deposits not exceeding $10 000 and to limit the cover of deposits between $10,000 and $50,000 to seventy five per cent and deposits between $50,000 and $75,000 to fifty per cent of deposits.[44] This design of coverage imposed a co-insurance of twenty five per cent on depositors with deposits between $10,000 and $50,000, and a co-insurance of fifty per cent on depositors with deposits between $50,000 and $70,000.[45] The objective for co-insurance was to limit depositor moral hazard by holding the larger depositors partially responsible for the safety and soundness of the banks they deposited their funds in.[46] However, even before the Banking Act's provisions on co-insurance were implemented, Congress abandoned them as they had no political support.[47]

6.3.3 Challenges to FDIC's mandate

It was observed in Chapter Three[48] that the US dual banking structure engendered multiple regulators that led to overlapping and often inconsistent supervision of insured

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38 *Ibid.*
39 *Ibid.*
40 *Ibid.*
41 *Ibid.*
42 See 12 USC s 1821(a). The scope of coverage was increased in 1934, 1950, 1966, 1969, 1974 and 1980 to $50 000, $10 0000, $15 000, $20 000, $40 000 and $100 000 respectively. See Carnell *et al* 316.
43 S 335 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010.
44 S 12B(l) of the Banking Act, 1933.
45 Carnell *et al* 331.
46 *Ibid.*
47 *Ibid.*
48 Ch 3 par 3.4.1.

banks which in turn exposed the deposit insurance fund to risk.[49] The major challenges to the effectiveness of the FDIC in addressing moral hazard were the multiple regulatory structures that led to inconsistent regulatory and supervisory standards (leading to regulatory forbearance)[50] and the charging of flat rate premiums.[51] Since the FDIC only regulated state chartered banks that had volunteered to take federal deposit insurance, it could only take enforcement actions against such state chartered banks.[52]

Enforcement action by the FDIC against risky banks for which it was not the primary regulator could only be taken after it consulted with either the Comptroller of the Currency or the Federal Reserve Board as their primary regulators.[53] This created the problem of regulatory forbearance,[54] where the primary regulators would delay the closure of the banks for fear that such closure would expose their regulatory failures or in the hope that more time would enable those banks to recover financially.[55] The effects of regulatory forbearance were felt most severely during the savings and loan crisis of the 1980s,[56] when regulators delayed action until the insured institutions had exhausted all their net worth.[57] In addition, multiple regulators created the problem of inconsistent regulatory standards as each regulator applied its own standards to the banks it regulated.[58] The levying of flat rate premiums as subscription fees to its member banks was also problematic for the FDIC.[59] Some authors were of the opinion that flat rate premiums subsidised the riskier banks and penalised the more prudent ones[60] through higher premiums and through subsidising their higher risks that made

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[49] Carnell *et al* 632.
[50] See Ch 1 par 1.2.5.4 where regulatory forbearance was described to arise when a regulator delays or fails to take action against a regulated entity. See also par 6.2 above.
[51] Par 6.3.2 above.
[52] Ch 3 par 3.4.1.
[53] BA Bennett, 'Bank regulation and deposit insurance: Controlling FDIC's losses', (1984) *Economic Review of the Federal Reserve Bank of San Francisco* 17.
[54] Par 6.3.3 above.
[55] Greenbaum & Thakor 491. The authors argue that regulators are motivated to delay action because a large firm's losses threatens their reputation. Therefore, they may delay action hoping that the bank will recover or that they will pass the problem to their successors.
[56] See ch 3 par 3.4.1.
[57] See JM Edwards, 'FDICIA and Dodd-Frank: Unlearned lessons about regulatory forbearance', (2011) *Harvard Business Law Review* 281.
[58] Carnell *et al* 632.
[59] Par 6.3.1 above.
[60] See Bennett 17.

them more likely to benefit from the EDIS.[61] Flat rate premiums thus increased bank moral hazard, which had to be addressed through reforms.

6.3.4 Reforms to the FDIC's premium assessment and regulatory enforcement actions

To address the problem of flat rate premiums, the FDIC strengthened mechanisms to limit bank moral hazard by developing a framework for the assessment of risk-based premiums on the basis of the probable loss that their failure would cause to the deposit insurance fund, the likely amount of the potential loss and the revenue needs of FDIC's deposit insurance funds.[62] Consequently, the FDIC developed a risk adjusted premium framework based on the bank's rating on capital adequacy and other prudential criteria.[63] For this purpose, the FDIC categorised banks into well capitalised, adequately capitalised and undercapitalised, where the undercapitalised banks are considered riskier and charged higher premiums.[64]

The problem of inconsistent regulatory standards outlined above,[65] were addressed by US bank regulators through the introduction of the CAMELS rating system in 1978[66] to provide a uniform system for examining and rating of the safety and soundness of financial institutions.[67] Other enforcement powers were introduced in reaction to the savings and loan crisis of the 1980s,[68] to grant the FDIC co-supervisory and enforcement powers over all insured banks with other bank regulators through cease and desist orders, civil monetary penalties, and civil litigation.[69] Further legislative reforms by means of the Federal Deposit Insurance Corporation Improvement Act (FDICIA)[70] enhanced the FDIC's authority to co-supervise and co-enforce prompt

[61] See JD Hawke Jr, 'Deposit insurance reform and the cost of bank supervision', (2000) OCC, Remarks to the Exchequer Club, 2 available at<https://www.occ.gov>exchequersspeech>accessed on 22.11.2018.
[62] S 1817(b)1(A) and (C) of the FDICIA.
[63] See FDIC 12 C.F.R. ss 327.9 and 327.10.
[64] *Ibid.*
[65] Par 6.3.3 above.
[66] See ch 3 par 3.4.2.3.
[67] See the Federal Financial Institutions Examination Council Act, 1978 that established a uniform financial institutions rating system. In addition, the FDIC later developed its *Manual of examination policies, basic examination concepts and guidelines*, (1990).
[68] See the Financial Institutions Reform and Recovery Enforcement Act, 1989 (FIRREA).
[69] Ch 3 par 3.4.2.3. See also Carnell *et al* 642.
[70] See the Federal Deposit Insurance Corporation Improvement Act, 1991(FDICIA).

corrective actions against all insured banks,[71] which enabled the FDIC to exercise the "risk minimiser" mandate over all the banks it insured.[72]

As discussed in Chapter Three[73] prompt corrective actions were introduced to obligate regulators to direct banks to restore declining capital and other sound management principles before the banks exhausted their capital reserves.[74] The prompt corrective actions obligated regulators to direct shareholders to restore the bank's capital adequacy by raising more capital to enable the banks to meet their capital requirements.[75] If the banks failed to recapitalise, regulators were obligated to enforce progressively severe prompt corrective actions as the bank's capital reduced from the highest capitalized category to the lowest capitalized category.[76] Accordingly, the reforms enhanced the FDIC's authority to enforce prompt corrective actions by intervening in distressed banks and timeously closing them[77] before they exhausted their capital and exposed the deposit insurance fund to loss.[78]

6.3.5 Addressing moral hazard through design of deposit insurance in the USA

The aforementioned reforms to the US EDIS enhanced its capacity to address bank moral hazard through the *ex ante* federal deposit insurance fund, derived from risk-based bank premiums.[79] The limitation of its scope of insurance cover to $250 000, also addressed depositor moral hazard.[80] In addition, the granting of co-supervisory and enforcement authority to the FDIC through the prompt corrective actions framework also extended its "risk minimiser" mandate over all insured banks.[81] Thus, the FDIC has adopted all the tools subsequently prescribed by the *IADI Core Principles* to limit bank moral hazard.[82] Although, Thomas[83] suggests co-insurance as a means of reducing depositor moral hazard more effectively, it has been pointed out

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[71] S 131 of the FDICIA.
[72] S 38 of the FDICIA.
[73] Ch 3 par 3.4.2.4.
[74] S 131(a) of the FDICIA.
[75] PS Rose and SC Hudgins, *Bank management and financial services,* (2010) 501.
[76] Prompt corrective actions categorised banks into "well capitalised, adequately capitalised, undercapitalised, significantly capitalised and critically undercapitalised". See Ch 1 par 1.2.5.3.
[77] S 111 of the FDICIA.
[78] S 133 of the FDICIA.
[79] Par 6.3.4 above.
[80] Par 6.3.2 above.
[81] Par 6.3.4 above.
[82] See Ch 2 par 2.3.3 for IADI measures to limit moral hazard.
[83] See LB Thomas, *Money, banking and financial markets,* (2006) 281. See also Ch 2 par 2.3.

above that it is politically impracticable to implement and was abandoned in the USA even before it had been implemented.[84]

6.4 The US bank resolution regime

6.4.1 FDIC as RA

6.4.1.1 Overview of FDIC's resolution mandate

As discussed above,[85] one of the initial mandates of the FDIC was to resolve the affairs of the banks that had failed during the Great Depression[86] and to purchase and liquidate assets of failed banks.[87] This mandate designated the FDIC as a "loss minimiser." Although it is the legally designated conservator[88] or receiver[89] only for failed national banks and federal savings and loans associations,[90] it practically serves as receiver for all state banks and savings and loans associations.[91] Since the authority to appoint a receiver for a failing bank is vested in the agency that chartered it,[92] the FDIC could only be appointed as receiver by the particular primary regulator of the failing bank.[93] As was further observed above,[94] the FDICIA enhanced the FDIC's supervisory authority by empowering it to close any insured depository institution, irrespective of its primary chartering and supervisory agency, if the grounds for the appointment of a conservator or receiver exist and such closure is necessary to mitigate losses to its insurance fund.[95] The FDIC still retained its overriding authority

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[84] Par 6.2.2.2 above. Post-GFC it has been abandoned in the UK where it had been blamed for the bank run on Northern Rock leading to its subsequent collapse. See Ch 2 par 2.4.3.2.
[85] Par 6.3.1 above.
[86] *Ibid*.
[87] S 12B(a) of the Banking Act, 1933.
[88] A conservator is an official under US bank insolvency law who is normally appointed to take over an institution in financial distress from its board of directors and operate it as a going concern, to preserve its value or facilitate its financial recovery. A conservator may also be appointed for a failed institution where there are no prospects of selling it quickly to continue to run its business in preparation of its sale. S 802 of the FIRREA and s 133 of the FDICIA. See Carnell *et al* 706.
[89] A receiver is an official (usually the FDIC) under US bank insolvency law who is appointed to take over the property and other affairs of a bank for preservation as the bank is being restructured or if not viable, for eventual distribution to creditors. See 12 USC s 1818(a). Thus, a receiver is normally appointed when the intention is to close the operations of the institution, collect and receive its debts and liquidate its assets for distribution to creditors to limit further operating expenses on its business. See Carnell *et al* 706.
[90] 12 USC s 1821 (c) (2) – (A)(ii).
[91] Carnell *et al* 700.
[92] Par 6.3.3 above.
[93] 12 USC s 1464(d)(2)(A).
[94] Par 6.3.4 above.
[95] 12 USC s 1821(d)(10).

as deposit insurer to compel any primary regulator of a failing bank to close that bank by suspending or terminating its deposit insurance, since such suspension or termination of insurance cover by the FDIC would automatically lead to the withdrawal of the bank's charter.[96]

6.4.1.2 Procedure for appointment of a conservator or receiver

As was noted in Chapter One,[97] banking business is considered special because, unlike its liabilities that are in the form of liquid deposits, its assets are loans that take long to mature and are difficult to value at short notice.[98] To protect depositor funds from the risk of misappropriation by bank managers if they had prior knowledge of regulatory plans to close the bank,[99] bank conservators and receivers are appointed without prior notice to the failing institutions.[100] For the same reasons, no judicial proceedings are required before a bank is closed because such proceedings would potentially aggravate the institution's problems by notifying depositors and other creditors of the bank's problems.[101] If the bank's problems are disclosed to the public before closure, it would probably also trigger a run on the bank by depositors seeking to avoid their funds being tied up in insolvency proceedings.[102]

6.4.1.3 Triggering events for the appointment of a receiver or conservator

A conservator or receiver may be appointed for a bank if it, *inter alia*, becomes unable to pay its depositors or other debts when they fall due; or incurs losses that substantially deplete its capital, with no prospect to restore it. Other grounds for the appointment of a conservator or receiver is if the bank becomes significantly undercapitalised and fails to recapitalise upon being ordered to do so or fails to submit a capital restoration plan or to implement a plan already submitted or becomes critically undercapitalised.[103] In addition, a conservator or receiver may be appointed

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[96] Par 6.3.1 above. 12 USC s 1821(c)(5)(J).
[97] Ch 1 par 1.2.1.
[98] E Hupkes, 'Insolvency – Why a special regime for banks?', (2003) *IMF Current developments in monetary and financial Law*, 3.
[99] See *Fahey v Mallonee* 32 US 245, 254.
[100] 12 USC ss 191 and 203(a).
[101] Carnell *et al* 701.
[102] *Ibid.*
[103] 12 USC 1831o(f)(2)(A). For circumstances under which a conservator or receiver would be appointed for a significantly undercapitalised or critically undercapitalised bank under the prompt corrective actions framework, see par 6.2.4 above.

if, the bank violates any law or acts in manner that prejudices depositor interests; or willfully violates or continues to violate a final regulatory order.[104]

6.4.1.4 Judicial review of appointment of conservator or receiver

To protect the interests of banks that have been placed under conservatorships or receiverships, the banks have the right to challenge such appointment within twenty days.[105] Courts may set aside the appointment of a conservator or receiver if they find it to have been "arbitrary, capricious, an abuse of discretion, or otherwise not according to law."[106] However, the courts generally support the ex *parte* appointment of conservators or receivers because, as was held in *Fahey v. Mallonee,* although it was a drastic procedure to have a hearing *after* rather than *before* the conservator or receiver takes possession of the insolvent bank the "delicate nature" of banking services and impossibility to preserve credit during an investigation, make it necessary to exercise the regulatory authority to appoint a conservator or receiver in a summary manner.[107]

In *United States National Bank of La Grande v Pole,* even after the court characterised the power to declare a bank insolvent as being "too sweeping and imperialistic," it still upheld the declaration of insolvency as a specific legislative authority granted to the regulator to protect the public welfare.[108] The court further observed that the regulator was better qualified than the courts to determine when to expeditiously intervene in problem banks to protect the interests of depositors, creditors and the general public than courts.[109] Regulators were also better equipped than courts to determine the valuation and appraisal of assets and liabilities in bank insolvencies.[110] In *Smith v Witherow*, shareholders of a bank that had been placed under conservatorship sued the Comptroller for losses incurred after their request to reopen the bank had been declined and the conservator appointed to reorganise the bank failed to restore it to viability.[111] It was held that where a regulator takes a remedial measure under a valid

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[104] *Ibid.*
[105] S 802(b)(1) of the FIRREA. However, the conservator may seek a stay of any judicial action for a period not exceeding forty five days under s 802(b)(2).
[106] 12 USC s 203(b)(1).
[107] *Fahey v. Mallonee,* 332 US 245 253 (1947).
[108] *United States National Bank of La Grande v Pole*, F. 2d Supp. 153, 157 (1932).
[109] *Idem* 157.
[110] *Ibid.*
[111] 102 F2d 638 (3rd Cir 1939).

law in respect of a bank that has legally been placed under conservatorship, no liability is incurred merely because the measure adopted failed to accomplish its objective.[112]

Further court support for regulatory intervention in distressed banks was given in *Franklin Savings Association v Director of Office of Thrift Supervision,* where the appellant had shifted its business from providing savings and loan services, to investment in derivatives of mortgage backed securities.[113] The Court upheld the appointment of the conservator because the appellant's shift in business focus exposed it to high risk assets, and to an unstable source of funding, that risked depleting its capital and breached statutory requirements.[114] Thus, even where a regulator acts in an "outrageous, outlandish, egregious, and deceptive" manner towards the regulated institution, the appointment of a conservator or receiver would be upheld if the institution was in fact insolvent and the statutory grounds for conservatorship or receivership had been established at the time of such appointment.[115]

6.4.1.5 Duties of a conservator

As observed above,[116] a conservator is appointed to continue the operations of the institution as a going concern. Consequently, once appointed as conservator, the FDIC assumes all the powers of shareholders, directors and officers of the bank to continue operating the bank's affairs in its name.[117] However, the FDIC is subject to the same duties, limitations and restrictions as the directors, officers, and employees of the bank and must comply with all the regulations and requirements that the bank was subject to prior to entering conservatorship.[118] Compared to receiverships, conservatorships have rarely been invoked in the USA until the savings and loan crisis of the 1980s.[119] Part of the reason why conservatorships are avoided is because, by

[112] *Smith v Witherow* 102 F2d 638 (3rd Cir 1939).
[113] *Franklin Savings Association v Director of Office of Thrift Supervision,* 934 F2d 1127 (10th Cir. 1991).
[114] *Ibid.*
[115] *Biscayne Federal Savings and Loan v Federal Home Bank Board.* 720 F 2d 1499 (11th Cir.1983).
[116] Par 6.4.1.1 above.
[117] S 805(a) of the FIRREA.
[118] S 805 (b) of the FIRREA.
[119] Carnell *et al* 705. The authors note for example that conservators have been appointed for only two FDIC insured institutions from 1934 to 2005. The appointment of conservators during the savings and loan crisis is attributed to the agency that was providing their deposit insurance, namely, the Federal Savings and Loan Insurance Corporation that was made bankrupt by the crisis and its functions transferred to the FDIC.

facilitating the continued operation of the failed institution it enables uninsured depositors to continue to withdraw their funds, which increases losses to the deposit insurer.[120] For this reason, regulators prefer receiverships above conservatorships as receiverships enable them to close the institutions and reimburse only the insured depositors.[121]

6.4.1.6 Duties of a receiver

Once it is appointed as receiver, the FDIC assumes trustee duties in respect of the closed bank to marshal its assets, pay-off its debts and distribute any residue of the assets among its creditors in accordance with the order of priority.[122] Thus, the FDIC is authorised as receiver to succeed to the rights, assets and liabilities of the institution, collect its debts and settle its obligations.[123] It may also merge the institution with, or transfer the institution, or its assets and liabilities, to another institution and pay its creditors according to their order of priority.[124] To facilitate the discharge of the aforesaid duties, the FDIC may stay proceedings against the institution and impose a moratorium on any claims against the closed bank, repudiate any leases and other executory contracts and file suits against any of the former directors, officers or employees of other affiliated parties that it may consider culpable for, or complicit in, the failure of the closed bank.[125] The FDIC, its officers and employees are further protected from legal liability in the discharge of its duties as receiver in good faith.[126]

6.4.2 The resolution powers

6.4.2.1 Overview of resolution powers

As observed above,[127] the FDICIA introduced the enforcement remedy of prompt corrective actions to authorise federal regulators to expeditiously close banks before they deplete their capital.[128] This limits bank moral hazard and reduces the potential

[120] Carnell *et al* 705.
[121] *Ibid.*
[122] 12 USC s 1821(d).
[123] *Ibid*
[124] *Ibid.*
[125] *Ibid.*
[126] S 806(a) of the FIRREA.
[127] Par 6.3.4 above.
[128] S 143(a) of the FDICIA.

losses to the FDIC insurance fund.[129] As receiver, the FDIC is authorised to exercise a variety of resolution powers, namely, open bank assistance, new banks and bridge banks, purchase and assumption and depositor pay-off and liquidation.[130] Although the FDIC is required to choose the least costly resolution power to protect the failed institution's assets for payment to depositors, shareholders and unsecured creditors, it may combine aspects of different resolution powers in the strategy it chooses to adopt.[131] Notably, these resolution powers were enacted pre-GFC and before the international financial reforms relating to bank resolution that followed post–GFC, and it could therefore be said that the US experience was instrumental in the international financial standards subsequently developed under the *IADI Core Principles*[132] and *FSB Key Attributes.*[133]

6.4.2.2 Open bank assistance

As was observed in Chapter Two,[134] open bank assistance is offered to banks that face temporary liquidity problems through a central bank's LOLR facility and the deposit insurer's loans or guarantees to distressed insured banks.[135] In the USA, open bank assistance is provided through the Federal Reserve Board's LOLR facility[136] and the FDIC's provision of a direct loan, or assisted merger or facilitated purchase of an insolvent bank's assets.[137] The objective of extending open bank assistance is to bailout the distressed bank from failure and enable it to continue operations.[138] The FDIC offers open bank assistance if the stability of the bank and a significant number of other banks is so threatened that their failure would pose a risk to the insurance fund.[139] In addition, the cost of extending such assistance should be less than that of liquidating the bank concerned.[140] However, the assistance must not benefit the bank's shareholders, unless resolving the bank under the "least cost"-rule would disrupt the

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[129] *Ibid.*
[130] JR Macey, GP Miller & RS Carnell, *Banking law and regulation,* (2001) 738–747.
[131] S 141 of the FDICIA.
[132] Ch 2 par 2.3.
[133] Ch 2 par 2.4.
[134] Ch 2 par 2.3.
[135] *Ibid.*
[136] S 142 of the FDICIA.
[137] 12 USC s 1823(a)(3), (5), (8).
[138] Carnell *et al* 731.
[139] 12 USC s1823(e).
[140] 12 USC s 1821(A)(4)(B).

economy or the stability of the financial system.[141] Due to the severe limitations these conditions place on the FDIC's use of open bank assistance, Carnell *et al,* remark that open bank assistance merely exists as a theoretical power.[142] Nevertheless, the FDIC may advance a direct loan to, or place deposits in, the failing bank on such good securities and upon such other restrictive covenants as may be necessary to enable it to exercise substantial control over the assisted bank's risk-taking.[143]

The FDIC may also purchase some of the failing bank's assets[144] and assume some of its liabilities to remove the problem assets and liabilities from the bank's balance sheet.[145] Verley remarks that open bank assistance has the merit of enabling the distressed bank to continue its services in the community which probably promotes public confidence in the financial system.[146] However, since public funds are used to sustain the operations of the failed bank, open bank assistance promotes bank moral hazard that benefits its shareholders, managers and creditors.[147] Open bank assistance has also been criticized for exposing more public funds to loss by delaying the closure of the bank, which enables its managers to use FDIC loans to gamble for resurrection, without enhancing its prospects of recovery.[148]

To limit moral hazard from open bank assistance provided through LOLR, Congress restricts the Federal Reserve Board from providing LOLR assistance to banks that become "critically undercapitalised."[149] If the Federal Reserve Board nevertheless extends LOLR to critically undercapitalised banks, itis required to reimburse the FDIC for any losses incurred from the banks' failure.[150] Congress further limits the use of public funds to bailout institutions that are considered "Too-Big-To-Fail",[151] by requiring

[141] 12 USC s 1823(c)(4).
[142] Carnell *et al* 731.
[143] 12 USC s 1823(a)(3). See also Bennett 27.
[144] 12 USC s1823(c)(5).
[145] 12 USC s 1823(c)(8).
[146] Verley 14.
[147] *Ibid.*
[148] See ch 1 par 1.2.5.1 and ch 2 par 2.2.2.3. See ch 1 par 1.2.5.1. See RA Cole, JA McKenzie & LJ White, 'Deregulation gone awry: Moral hazard in the savings and loan industry', in A Cottrell, M Lawlor and J Wood (eds), *The causes and consequences of depository institution failures,* (1995) 29.See also FM Baldursson & R Portes, 'Gambling for resurrection in Iceland: The rise and fall of the banks', presentation at Central Bank of Iceland(July 2014) 38 and D Kirti, *When gambling for resurrection is too risky*, (2017) IMF working paper 1.
[149] S 142(3)(B) of the FDICIA.
[150] *Ibid.*
[151]See Ch 1 par 1.2.5 for a discussion of "Too-Big-To-Fail".

that open bank assistance be provided only if it is the least costly resolution strategy.[152] The assistance should also be recommended in writing by a two thirds majority of the votes of the boards of directors of both the FDIC and the Federal Reserve Board confirming that, failure to assist the institution would adversely affect the economy or financial stability,[153] which systemic risk could only be averted by open bank assistance.[154] The recommendation for bail-out should further be supported by the Treasury Secretary with the concurrence of the President, as discussed in more detail below.[155]

6.4.2.3 New banks and bridge banks

The FDIC may also organise new banks[156] and bridge banks[157] to temporarily take over the assets and liabilities of a failed bank to preserve the going concern value, while it seeks a final solution.[158] A new bank may be established to take over the insured deposits of a closed national bank in order to facilitate the continuity of financial services in the community and to perform any other functions the FDIC may determine.[159] The FDIC is also required to appoint an executive officer to the new bank,[160] and to automatically insure it.[161] In addition, the FDIC is required to transfer the failed bank's insured deposits to the new bank and provide it with operational funding,[162] to enable it to expeditiously reimburse the failed bank's insured depositors.[163]

The capital of the new bank should be funded through an offer of its stock for public subscription, with priority being given to the failed bank's stockholders.[164] Should the stock offering fail to attract subscription or be undersubscribed, the FDIC is required to transfer the new bank's assets and liabilities to other institutions.[165] If such transfer

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[152] S 141(G) of the FDICIA.
[153] S 141(G)(i) of the FDICIA.
[154] S 141(G)(ii) of the FDICIA.
[155] S 141(G) of the FDICIA. See par 6.3.4.5 below.
[156] 12 USC s1821(m).
[157] 12 USC s 1821(n).
[158] *Ibid.*
[159] S 213(1) of the FIRREA.
[160] S 213(4) of the FIRREA.
[161] S 213(6) of the FIRREA.
[162] *Ibid.*
[163] S 213(14) of the FIRREA.
[164] S 213(15) of the FIRREA.
[165] S 213(17) of the FIRREA.

fails, the new bank is required to be wound up within two years.[166] This procedure limits moral hazard by preventing the continued use of public funds on the operations of the new bank that fails to attract subscriptions for its stock.

The FDIC may also charter bridge banks as national banks,[167] to take over one or more insured failed banks.[168] However, a bridge bank or multiple banks may only be chartered if the board of directors of the FDIC determines that it is in the best interests of the failed banks' depositors.[169] In addition, the costs of operating the bridge bank should be less than those of depositor pay-off and liquidation of the failed bank or banks.[170] Bridge banks have the advantage of preserving the failed bank's franchise and going concern value.[171] Bridge banks also facilitate the continued provision of banking services to the community,[172] and enable the FDIC to temporarily hold the assets of a failing large bank as it seeks potential buyers for its assets and liabilities.[173]

A bridge bank may assume the deposits[174] and other liabilities of the failed bank,[175] and purchase any assets of the failed bank or banks.[176] The FDIC may terminate the charter of a bridge bank if it is merged with or acquired by a depository institution that is not a bridge bank[177] or the majority of its stock is sold by the Comptroller of the Currency.[178] The bridge bank's charter may also be terminated if eighty per cent or more of its stock is acquired by another institution[179] or its assets and liabilities are purchased and assumed by another institution.[180] Any bridge bank not terminated may be dissolved at the discretion of the FDIC.[181]

[166] S 213(18) of the FIRREA.
[167] S 214(1)(E) of the FIRREA. Bridge banks differ from new banks in that, while new banks that fail to get subscriptions for their stock must be wound up within two years after their formation, the FDIC that charters bridge banks has the discretion to decide when to terminate their charters or wind them up. See s 214(12) of the FIRREA.
[168] S 214(1)(A) of the FIRREA.
[169] S 214(2)(ii) of the FIRREA.
[170] S 214(2)(i) of the FIRREA.
[171] Verley 15.
[172] *Ibid.*
[173] *Ibid.*
[174] S 214(1)(B)(i) of the FIRREA.
[175] S 214(1)(B)(ii) of the FIRREA.
[176] S 214(1)(B)(iii) of the FIRREA.
[177] S 214(9)A) of the FIRREA.
[178] S 214(9)(B) of the FIRREA.
[179] S 214(9)(C) of the FIRREA.
[180] S 214(9)(D) of the FIRREA.
[181] S 214(12) of the FIRREA.

Despite these merits of bridge banks, concerns have been raised that they may be more costly than a depositor pay-off and liquidation when they require the FDIC to commit more financial and human resources to run them until a purchaser is found.[182] Bennett argues that, since the prospects of the sale of the assets and liabilities of the failed banks cannot be accurately predicted in advance, the costs of running bridge banks may escalate with time and exceed the amount initially envisaged.[183] This arises from the difficulty in forecasting the length of time that the bridge bank may continue in operation, while awaiting an acquiring bank to purchase the assets and assume the liabilities of the failed bank.[184] While new banks ought to be liquidated within two years if they are not purchased, there is no time limit for the dissolution of a bridge bank.[185] This increases bank moral hazard to the insurance fund as more costs are incurred by the bridge bank, while it continues the failed bank's business.[186]

According to Bennett, the introduction of new banks and bridge banks as a restructuring or reorganisation tool in the US may have incorporated the bail-in resolution power that became popular post-GFC.[187] Thus, regulatory agencies are required to make use of substantial private investment in the chosen transactions[188] and to require new investors to share in the risk of investing in the new institution with the FDIC.[189] In addition, regulators are required to demand substantial concessions from pre-existing owners and debtors of the troubled institution[190] and to exclude directors and senior managers responsible for the failure of the institution and hire only qualified directors and managers for the resulting new bank or bridge bank.[191] While the FDIC should facilitate the successful operation of the resulting institution,[192] the transaction ought to be structured in a manner that precludes the FDIC from acquiring a significant portion of the troubled institution's assets.[193] Consequently, the FDIC

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182 Bennett 27.
183 *Ibid*.
184 *Ibid*.
185 Par 6.3.2.3 above.
186 Bennett 27.
187 *Ibid.*
188 S 143(b)(3) of the FDICIA.
189 S 143(b)(7)(B) of the FDICIA.
190 S 143(b)(4) of the FDICIA.
191 S 143(b)(5) of the FDICIA.
192 S 143(b)(6) of the FDICIA.
193 S 143(b)(7)(A)(i) of the FDICIA.

should only acquire such interests in the new institution as are proportional to its assistance.[194]

6.4.2.4 Purchase and assumption

Purchase and assumption transactions are one of the oldest bank resolution powers in the USA, having been authorised by the National Banks Act, 1864 and executed by receivers of insolvent national banks.[195] Essentially, a purchase and assumption transaction enables a solvent bank to acquire the assets and assume the liabilities of the failed bank, including insured deposits.[196] This facilitates the merger of the failed bank with the acquiring solvent bank and is mostly adopted for systemically important financial institutions (SIFIs),[197] to prevent the systemic risk their failure may pose to the financial system.[198] Purchase and assumption transactions are most effective when the new institution purchases the majority of the assets and assumes the majority of the liabilities of the failed institution.[199] This maximises the going concern value and retains the franchise of the failed institution by continuing to offer the failed bank's services in their previous localities,[200] and prevents market disruptions.[201]

By combining the transfer of assets and assumption of liabilities in the same transaction, purchase and assumption transactions save resolution costs[202] and mitigate the effects of bank failure on customers and the community.[203] This was judicially noted in *First Empire Bank-New York v FDIC*, where, in considering the approval of a purchase and assumption agreement relating to the United States National Bank of San Diego (USND), Justice Merrill observed that, purchase and assumption transactions stabilised the financial system by avoiding the consequences of liquidation that would have led to the closure of all offices of the failed bank and

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[194] S 143(b)(7)(A)(ii) of the FDICIA.
[195] Ss 192 and 194 of the National Banks Act, 1864. See *Gockstetter v Williams*, 9 F2d. 356 (9th Cir.1925). See also *Ex Parte* Moore, 6 F. 2d 907 (E.D.S.C. 1925); and *Hulse v Argentsinger,* 18 F.2d 944 (2d Cir. 1927).
[196] Verley 20.
[197] See Ch 1 par 1.2.5 for the definition of SIFIs.
[198] Verley 20.
[199] *Ibid.*
[200] *Ibid.*
[201] Macey *et al* 644.
[202] *Ibid.*
[203] *Ibid.*

would have resulted in the community losing the value of its continued services.[204] The judge further noted that, without the purchase and assumption transaction, all cheques drawn on the failed bank would have been dishonoured, and all the account holders and recipients of the cheques would have suffered harm.[205]

A purchase and assumption transaction may be the least costly resolution strategy for large banks if all deposit and credit liabilities are acquired in the transaction, as it relieves the deposit insurer from reimbursing depositors and pursuing the failed bank's borrowers.[206] It may additionally limit the effect of systemic risk that may potentially arise from the failure of a SIFI.[207] However, despite their advantages, purchase and assumption transactions tend to promote "Too-Big-To-Fail" by facilitating the acquiring bank in assuming all deposit and credit liabilities of the failed bank, which protects the owners, unsecured creditors and uninsured depositors.[208] This promotes bank and depositor moral hazard and arouses public resentment to bail-outs.[209] In addition, purchase and assumption transactions may be difficult to execute during crisis situations in economic downturns because the potential acquiring banks may be unwilling to assume more risks from the insolvent bank.[210] Accordingly, they may agree to purchase only the high quality assets and liabilities and require the FDIC to guarantee or pay the acquiring bank for any potential loss they may incur.[211] This may

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[204] See *First Empire Bank New York v FDIC*, 572 F.2d (9th Cir, 1978)1361, in relation to a purchase and assumption agreement relating to the United States National Bank of San Diego (USND). Justice Merrill observed that liquidating USND would lead to the suspension of the accounts of over 300 000 depositors to enable the FDIC to complete records to offset liabilities by paying depositors, rank creditors and adjudicate claims. In addition, the community would lose the banking services that USND offered them, which would make them to lose trust in the financial system.
[205] *First Empire Bank-New York v FDIC* 1361.
[206] *Ibid.*
[207] *Ibid.*
[208] See FS Mishkin, *The economics of money, banking and financial markets*, (2016) 265 who argues that purchase and assumption transactions enable the government to guarantee the repayment of uninsured depositors and other creditors of SIFIs whose deposits are not covered by the FDIC EDIS. Thus, purchase and assumptions tend to give "large infusions of capital into failing banks by finding a willing merger partner to take over the bank and its deposits."
[209] For example, in the purchase and assumption of USNB, par 6.3.2.4 above, Grocker National Bank, the acquiring bank, successfully bid $89.5 million for the going concern value of USNB, but received $128.78 million from FDIC as the difference between the USNB's liabilities it assumed and assets it purchased, less the going concern premium it had paid. Therefore, the FDIC appeared to be paying for uninsured depositors, unsecured creditors and USNB's shareholders, see *First Empire Bank-New York v FDIC* par 6.3.2.4 above.
[210] Verley 14.
[211] *Ibid.*

lead to the costs of the transaction being higher than the costs of liquidating the failed bank and paying its depositors.[212]

The merits and demerits of purchase and assumption transactions thus depend on whether all the assets and liabilities of the failed bank were transferred or whether the acquiring bank was permitted to choose only the high quality assets and liabilities to transfer, and leave the FDIC with the riskier ones. In this regard, Verley classifies purchase and assumption transactions into three categories, namely, basic purchase and assumption, a whole bank purchase and assumption and purchase and assumption with shared loss, according to the level of assets purchased and liabilities assumed.[213] The basic purchase and assumption transaction transfers only the high quality assets like cash, government securities, well-secured low risk loans and other marketable securities,[214] and leaves the FDIC to retain the riskier assets like recoveries on non-performing loans.[215] This increase losses to the insurance fund as the FDIC liquidates the residue toxic non-performing assets at less than market rates.[216]

The whole bank purchase and assumption is the most suitable option because it facilitates the acquiring bank in purchasing all the assets and liabilities of the failed bank and in retaining the failed bank's branch locations and customer service.[217] This causes the least disruption to the continued provision of banking services and may be cheaper than depositor pay-off option and may also enjoy cost advantages,[218] by obliging the acquiring bank to collect any non-performing loans.[219] It is for these reasons that the FDIC prefers the whole bank purchase and assumption option and only considers other options if it receives insufficient bids for the purchase of the failed bank.[220] Federal courts have also "recognized and endorsed" the FDIC's preference by deferring to and protecting the FDIC's choice, whenever purchase and assumption

[212] *Ibid.*
[213] *Ibid.*
[214] *Ibid.*
[215] Macey *et al* 644.
[216] *Ibid.*
[217] *Ibid.*
[218] See Bennett 25.
[219] *Ibid.*
[220] *Idem* 646.

transactions have been challenged in the courts.[221] However, since purchase and assumption transactions are negotiated during suppressed market conditions, they may lead to the failed bank's assets being undervalued or some of them, for example commercial real estate secured loan assets, being rejected without guarantees from the deposit insurer.[222]

Under the purchase and assumption with shared loss, the deposit insurer shares losses on some of the assets of the failed bank with the purchasing bank.[223] The assets in respect of which losses are shared may include real estate secured loans because they are susceptible to market booms and busts.[224] The shared loss purchase and assumption transactions are often used in the resolution of institutions that are designated as SIFIs to limit the high cost of reimbursing their large number of depositors.[225] However, because purchase and assumption with shared loss transactions take time to negotiate, they increase the deposit insurer's costs as the deposit insurer continues to hold any assets left by the acquiring bank before the deposit insurer disposes of them.[226]

6.4.2.5 Depositor pay-off and bank liquidation

At inception, the role of the FDIC was to prevent bank runs that would trigger further panics and subsequent bank runs by assuring depositors of payment of their deposits even if their bank failed.[227] Consequently, the priority objective of receivers of failed banks upon appointment is the expeditious payment of insured depositors.[228] Once the receiver reimburses the failed bank's insured depositors, the receiver liquidates its assets to pay its creditors, including its uninsured depositors, according to their creditor hierarchy rights.[229] The FDIC is enjoined to make a depositor pay-off whenever an insured bank is closed due to inability to meet depositor demands.[230] As

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[221] See *FDIC v Bank of Boulder* 911 F 2d 1466, at 1475. (10th Cir. 1990), upheld by the US Supreme Court at 111 S. Ct. 1103 (1991). See also *Gunter v Hutcheson* 674 F. 2d 862, at 865 (11 Cir.), upheld by the US Supreme Court at 459 US 826 (1982).
[222] Verley 26.
[223] *Ibid.*
[224] *Ibid.*
[225] *Ibid.*
[226] *Ibid.*
[227] S 12B(i) of the Banking Act, 1933.
[228] *Ibid.*
[229] *Ibid.*
[230] 12 USC s 1821(f).

already indicated above,[231] the insured deposit, is a deposit or deposits in the failed institution's account(s) of up to $250 000 held by the person or persons in each category of approved legal ownership.[232]

After paying insured depositors, the FDIC subrogates to their rights and ranks in priority over uninsured deposits and other unsecured creditors of the institution.[233] However, if the failed bank's residual assets are less than the claims of uninsured depositors and other uninsured creditors, then all the creditors including the FDIC, share the shortfall incurred on a *pro rata* basis.[234] This probably mitigates the moral hazard from the failed bank as it requires no financing from the government, except the losses that the FDIC may incur whenever it subrogates to the rights of reimbursed depositors and shares in the shortfall incurred on a *pro rata* basis.[235] Since depositor pay-off allows the FDIC not to assume the liabilities of the failed institution, it is often the least costly resolution option for non-systemic banks.[236]

Depositor pay-off may be suitable when the value of the franchise of the failed bank is low, or when a winding up order has been made.[237] However, a depositor pay-off may disrupt the provision of banking services to customers, and delay depositor accessibility to their funds during the time that the deposit insurer processes depositor claims before effecting the pay-off.[238] In addition, a depositor pay-off may trigger a run on other banks whose depositors may fear the safety of their deposits.[239] It has been argued, for example, that the depositor pay-off of Penn Square Bank of Oklahoma was responsible for triggering a wave of bank panics by depositors of other banks fearing the loss of their deposits that eventually led to a massive run on Continental Illinois National Bank in 1984.[240] As was observed in Chapter One,[241] it was during the Congressional hearing on the bail-out of the Continental Illinois Bank that the first

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231 See par 6.2.2.2 above.
232 See FDIC 12 C.F.R. par 6.2.2.2 above, part 330.
233 Macey *et al* 629.
234 *Ibid.*
235 *Ibid.*
236 *Ibid.*
237 Verley 13.
238 *Ibid.*
239 Macey *et al* 629.
240 *Ibid.*
241 Ch 1 par 1.2.2.

public statement of US government's officials in support of bailing out SIFIs because they were "Too-Big-To-Fail", was made.[242]

6.4.3 Bank liquidation

6.4.3.1 Overview of bank liquidations

Bank liquidation may be undertaken either voluntarily or through the regulator's appointment of a liquidator.[243] A bank may be liquidated, even when it is solvent, if its charter provides for voluntary dissolution.[244] In addition, a bank may be dissolved voluntarily if its shareholders approve a vote by its directors that it be merged or amalgamated with another bank.[245] The merger facilitates the transfer of the first bank's assets and liabilities to the other bank upon approval by the appropriate banking regulator and the Department of Justice.[246] Once completed, the old bank is effectively dissolved and its services are continued through the acquiring bank.[247]

6.4.3.2 Regulatory liquidation of insolvent banks

Regulatory liquidation of banks flows from the authority to appoint a conservator or receiver once the bank is declared insolvent.[248] Upon the FDIC taking over the affairs of the bank in respect of which it is appointed as conservator/receiver, it determines whether the bank is viable or should be liquidated.[249] If the bank is not viable, the FDIC considers liquidation along with the other resolution powers discussed above,[250] and will choose liquidation only if it is the least costly resolution option.[251] However, since

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[242] Macey 629.
[243] *Ibid.*
[244] *Ibid.*
[245] *Ibid.*
[246] The Department of Justice is mandated to review bank merger applications on behalf of federal antitrust agencies. See s 1828(c) of the Bank Merger Act that requires prior approval of mergers involving FDIC insured depository institutions; s 1817(j) of the Change in Bank Control Act requires prior notice for any acquisition of an FDIC insured institution by persons other than a company; s 1842 (c) of the Bank Holding Company Act that requires prior approval of the acquisition of a bank by a company and s 1467a(e)(1) of the Savings and Loan Holding Company Act, that requires prior approval of the acquisition of a thrift (as savings and loan institutions are referred to) by a company that is not a bank holding company. All these statutes have incorporated the anti-trust provisions of the Sherman Antitrust Act of 1890 that seeks to promote competition and prohibits monopolisation. See Carnell *et al* 63 and 204–205.
[247] Macey *et al* 629.
[248] S 212(a) of the FIRREA.
[249] *Ibid.*
[250] Par 6.3.2 above.
[251] S 141(a) of the FDICIA.

the FDIC may combine aspects of the resolution powers at different stages of the bank's resolution,[252] even where another option is first chosen, some of the assets of the failed bank may still be liquidated if they were not transferred in any of the other resolution strategies.[253] Thus, any assets that are not transferred to the acquiring bank remain with the FDIC as part of the residue assets that it has to liquidate during winding up of the affairs of the failed bank.[254]

6.4.3.3 Powers of the FDIC as liquidator

The fiduciary powers of a bank liquidator are to be exercised in accordance with insolvency laws, to respect the rights of creditors under creditor hierarchy laws that prevent any creditor from being worse off than in ordinary liquidation.[255] Therefore, the role of the FDIC as liquidator is to continue to marshal the assets of the insolvent bank, rank creditor claims and pay the creditors in accordance with the hierarchy of their claims.[256] Since the FDIC will have subrogated to the rights of reimbursed depositors in the assets of the insolvent bank, it recovers its expenses from the proceeds of such liquidation under liquidation rules.[257] The subrogation to rights of reimbursed depositors enables the FDIC to mitigate its losses and enhances the role of liquidation of failed banks as a market discipline tool to address bank moral hazard.[258]

6.4.4 Nexus between the US resolution powers and the FSB Key attributes

6.4.4.1 Prominence of US resolution strategies in FSB Key attributes

As discussed in Chapter Two,[259] the *FSB Key Attributes* require jurisdictions to end"Too-Big-To-Fail" through bail-in of the debts of unsecured creditors, uninsured deposits and other convertible securities into the capital of the failing bank.[260] The *FSB Key Attributes* also recommend that any bail-out only be extended on a temporary basis by the central bank or the EDIS if it is less costly than depositor pay-out and

[252] Par 6.3.2.1 above.
[253] S 142(3)(B) of the FDICIA.
[254] S 213(18) of the FIRREA.
[255] See *FSB Key attribute* 5.1.
[256] 12 USC s 1821(d).
[257] *Ibid.*
[258] *Ibid.*
[259] Ch 2 par 2.4.1.
[260] Ch 2 par 2.4.1.2.

liquidation.[261] The bail-out should be subject to approval by prescribed authorities upon a determination that it is necessary to protect financial system stability.[262] In addition, any losses and residual costs incurred during the resolution process should be borne by equity holders, unsecured creditors and the financial industry through *ex post* assessments of solvent institutions.[263] The *FSB Key Attributes* recommend other resolution options that include the transfer of assets and liabilities by the disposal of the viable functions of the failed firm to a solvent third party and either the liquidation of unviable assets of the business or their transfer to a special purpose vehicle.[264] The culpable directors, managers and officers of the failed institution are also to be pursued for compensation and the *FSB Key Attributes* further require SIFIs to prepare recovery and resolution plans (RRPs) that provide for the costs of resolving them should they fail.[265]

As discussed in Chapter Three,[266] the USA had introduced RRPs under the Dodd-Frank Act in 2010 (before the *FSB Key Attributes)* as part of the measures to enhance the Federal Reserve Board's enhanced supervision of financial conglomerates.[267] Accordingly, the Federal Reserve Board as regulator and supervisor for financial conglomerates uses RRPs alongside the annual stress testing that evaluates the adequacy of bank holding company capital to absorb losses that could arise from unexpected adverse economic conditions.[268] Due to the multiple regulatory structures in the USA, the FDIC does not have a direct responsibility for stress testing and RRPs.[269]

6.4.4.2 Addressing moral hazard under FDIC resolution powers

As the resolution regime of the USA discussed above[270] illustrates, the principles that were later assimilated into the *FSB Key Attributes* were already implemented in the USA well before the GFC. Thus, open bank assistance had been restricted to the bail-

[261] Ch 2 par 2.4.1.3.
[262] *Ibid.*
[263] *Ibid.*
[264] *Ibid.*
[265] Ch 2 par 2.4.1.4.
[266] See ch 3 par 3.4.4.3.
[267] S 165(d)(1) of the Dodd-Frank Act.
[268] S 165(i)(1)(A) of the Dodd-Frank Act.
[269] See ch 1 par 1.2.5.4 for special US multiple supervisory structure.
[270] Par 6.4.2 above.

out of systemic institutions,[271] new banks and bridge banks were established that could facilitate bail-in by existing shareholders and solicitation of new subscriptions,[272] and transfer of assets and liabilities or purchase and assumption transactions had been operational during most of the US bank insolvency history.[273] All these resolution powers appear to have adopted similar measures to address the bank moral hazard as the ones subsequently recommended post-GFC by the *FSB Key Attributes* through limiting any bail-out of SIFIs to instances where it was necessary for the prevention of systemic risk to the stability of the financial system.[274] This then begs the question, how did the GFC still originate in the USA while all these measures were in place well before the GFC?

6.4.4.3 The causes of GFC and place of FDIC in the crisis

Despite the regulatory reforms and deposit insurance measures to contain bank moral hazard discussed above,[275] US financial institutions unabatedly engaged in toxic transactions that led to the GFC.[276] As observed in Chapter One,[277] the US Senate identified the causes of the GFC as being, *inter alia*, deregulation, inappropriate incentives structures and shadow banking activities.[278] Thus, as discussed in Chapter Three,[279] the lax regulation of the rules against bank involvement in non-bank activities in the 1980s and the deregulation of the US financial markets by the Gramm-Leach-Bliley Act in 1999 permitted bank holding companies and financial holding companies to use their non-bank subsidiaries to engage in unregulated trading on the derivatives markets.[280]

The activities of shadow banking firms on the money markets, including hedge funds, investment banks, mutual funds, pension funds, and insurance firms, were neither

[271] Par 6.4.2.2 above.
[272] Par 6.4.2.3 above.
[273] *Ibid*.
[274] Par 2 par 2.4.1.
[275] Ch 1 par 1.5.
[276] C Viney & P Phillips, *Financial institutions, instruments and markets,* (2012) 38.
[277] See ch 1 par 1.2.6.
[278] See P Angelides, *Report of the National Commission on the causes of the financial economic crisis in the United States* (hereafter Angelides *Report*), (2011) US Government Printing Office xxv.
[279] Ch 3 par 3.4.3.2.
[280] See Mishkin 324. See also S McGee, *Chasing Goldman Sachs: How the masters of the universe melted Wall Street down … and why they'll take us to the brink again*, (2010) for a further analysis of the profitability of proprietary trading.

regulated nor supervised.[281] Accordingly, when the shadow banking firms entered the derivatives market to originate and distribute mortgage backed securities, they adopted inappropriate incentive structures.[282] In mortgage origination,[283] since the mortgage brokers were paid according to the number of mortgages sold, without regard to the quality of the mortgages based on the ability of the borrowers to repay, the brokers were motivated to lower the mortgage standards to facilitate more sales and earn correspondingly higher commissions.[284] The mortgage issuers also lowered standards for the brokers and resold those mortgages to securities underwriters who created special purpose vehicles to pool the mortgages and issue mortgage backed securities (MBS)[285] based on the future mortgage repayments and sold them as collateralised debt obligations (CDOs).[286] As the CDOs earned high profits in commissions for the investment banks that originated and marketed them, the investment banks had no incentive to require higher standards for the underlying mortgages and permitted sub-prime mortgages to be issued.[287]

The shadow banking firms created further markets for their derivatives by creating second and third tranche securities that were no longer backed by the original mortgage assets, but whose purchasers expected payments in the second (CDO squared) and third (CDO cupped) tranches after the purchasers of first MBS were paid.[288] The rise in the use of commercial paper to finance corporate operations through repurchase agreements (repos) led to a shift from bank reliance on deposits to reliance on the money markets.[289] The derivatives did not directly involve public deposits because the objective of mortgage origination had shifted from actually

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[281] Ch 2 par 1.2.5.5.
[282] Viney & Phillips 38.
[283] *Ibid.*
[284] *Ibid.*
[285] Ch 1 par 1.2.6.
[286] Angelides *Report* 70.
[287] *Ibid.*
[288] *Ibid.* Since the special purpose entity carried the rights to the borrower's monthly mortgage payments, it pooled the rights and divided them into tranches of mortgage-backed securities. Each tranche gave investors a different priority claim on the flow of payments from the borrowers, as well as a "different interest rate and repayment schedule". Investment banks marketed the securities using credit ratings from credit rating agencies with some getting the highest rating for the safest investments of AAA (or triple-A). See Angelides *Report* 70.
[289] Mishkin 324.

assisting people to purchase or improve the quality of their homes, to the creation of a portfolio for securitisation purposes.[290]

The major factors that protected the FDIC from liability during the GFC were that most of the victims of the crisis were borrowers who lost their homes, rather than depositors.[291] In addition, liability for default on the sub-prime mortgages had been transferred through credit default swaps (CDSs) on the derivatives market which absolved the FDIC from reimbursing depositors.[292] Indeed, the majority of the institutions that failed in the USA were savings and loan institutions that were engaged in mortgage origination[293] and investment banking firms engaged in mortgage securitisation[294] and sub-prime mortgage derivatives.[295] Some foreign banks from China, India and even the UK's Northern Rock bank that bought into the derivative securities to earn the higher profits it offered, also failed.[296]

6.4.4.4 The Government response to the GFC

The US Government responded to the GFC by assisting the Bears Sterns investment bank to be purchased by JP Morgan,[297] and placed two government enterprises that provided a secondary market for mortgage backed securities, the Fannie Mae and

[290] Angelides *Report* 70. The reason the derivatives may not have affected insured depository institutions as much as they affected investment bankers was given by the Senate GFC Commission as being that, "the mortgage company originated and sold the subprime mortgages on cash to investment banks". The investment bankers further sold the mortgages to a separate legal entity (or special purpose vehicle) that they sponsored to own the mortgages and issue the mortgage backed securities that were to be repayable with the mortgage repayments. The special purpose entity would raise its cash by selling the mortgage backed securities. The investment banks would prefer the special purpose entity to be created as a separate legal structure so that the assets would be off their balance sheets. See also P Augar, *The greed merchants: How investment banks played the free market game,* (2005) 19 for an account of the operations of investment banks in originating securities for which ten of the largest firms agreed to a global legal settlement fine of $ 1.4 billion without an admission of liability.
[291] See Angelides *Report* 70.
[292] Angelides *Report* 70.
[293] Origination is the process of making a loan, including underwriting, closing and providing the funds. See Angelides *Report* Appendix A Glossary.
[294] Securitisation is the process of pooling debt assets such as mortgages, car loans and credit card debt into a separate legal entity that issues a new financial instrument or security for sale to investors. Angelides *Report* Appendix A Glossary.
[295] See FDIC, *FDIC Report to congressional committees on financial institutions: Causes and consequences of recent bank failures,*(2013) 6.
[296] Ch 1 par 1.2.6.
[297] See RB Thompson, 'Market makers and vampire squid: Regulating securities markets after the financial meltdown', (2011) *Washington University Law Review* 324, where the author argues that all investment banks in the USA were either acquired by commercial banks or converted into financial holding companies to access insured deposits as a stable source of their funding.

Freddie Mac, into conservatorship to rehabilitate them.[298] To avoid being seen as promoting "Too-Big-To-Fail", the Government however left Lehman Brothers investment bank to file for bankruptcy protection, leading to the global losses suffered by firms that had advanced it credit.[299] Shortly thereafter, the US government assisted Merrill Lynch to be bought by Bank of America and paid $258 billion to AIG insurance company, to enable it to pay potential loses on MBS credit default swaps valued at over $400 billion, it owed to counterparties,[300] leading to even more uncertainty in the market.[301] This led governments across the globe to effectively socialise the losses of their banks by bailing them out contrary to all the free market theories that had driven the economy into the GFC in the first place.[302]

In the end, the US Government spent $700 billion under the Emergency Economic Stabilization Act, 2008 to fund the Troubled Asset Relief Programme (TARP)[303] and latter enacted the Dodd-Frank Wall Street Financial Services Reform Act, 2010 (Dodd-Frank) to promote financial stability in the US.[304] The TARP enabled the US government to extend LOLR assistance to banks, auto industry manufacturers and even airlines.[305] These bail-out were unique in the sense that it was effected directly by the government through the US Treasury and Federal Reserve Board, and not through the FDIC.[306] Yet it was mainly the investment banks that had engaged in the subprime market speculations that failed, which neither took deposits nor were normally entitled to LOLR assistance.[307] In addition, since the TARP was spent to bail-out banks that caused consumers who had been victims of those banks' predatory

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[298] Mishkin 326. Fannie Mae refers to the Federal National Mortgage Association and Freddie Mac refers to the Federal Home Loan Mortgage Corporation.
[299] *Idem* 327.
[300] *Ibid.*
[301] *Ibid.*
[302] Viney & Phillips 38–39.
[303] *Ibid.* S 101 of the Emergency Economic Stabilization Act 2008 authorised the Secretary of the Treasury to establish a Troubled Asset Relief Programme (or "TARP") to purchase troubled assets from distressed financial institutions.
[304] See the objectives of the Dodd-Frank Act.
[305] See HM Paulson Jr., *On the brink: Inside the race to stop the collapse of the financial system*, (2010) for the US Treasury Secretary's account of the initial government response to the crisis. See also TF Geithner, *Stress test: Reflections on financial crises*, (2014) for the US Treasury Secretary's account of the post-GFC reforms.
[306] *Ibid.*
[307] *Ibid.*

lending practices to lose their homes, it has been criticised for promoting the moral hazard.[308]

6.4.4.5 Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010 and FDIC

As already discussed in Chapter Three,[309] the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted to address the causes of the GFC by improving accountability and transparency in the financial system, ending "Too-Big-To-Fail", protecting American taxpayers by ending bail-outs and protecting consumers from abusive financial business services.[310] As most of the relevant provisions have already been discussed,[311] the discussion in this paragraph will focus on the provisions relating to ending "Too-Big-To-Fail" and protection of tax payers' funds from being used to bailout banks.

Dodd-Frank particularly sought to end the "Too-Big-To-Fail" problem, by requiring that government bail-out only be extended to systemic institutions, upon a majority vote of two thirds of the board of directors of both the FDIC and the Federal Reserve Board supported by a written recommendation for such bail-out by the Treasury Secretary.[312] The recommendation should contain an evaluation of the defaulting financial company[313] and the effect of the default on the financial stability of the economy[314] and on the financial stability of the low income, minority or underserved community.[315] In addition, the recommendation should also detail the nature and extent of actions to be undertaken to revive the defaulting financial institution[316] and the potential for a private sector bail-in to prevent the default.[317] Further, it should set out the effect of the default on the creditors, counterparties and shareholders of the financial company and other market participants.[318]

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[308] See N Barofsky, *Bailout: An inside account of how Washington abandoned Main Street while rescuing Wall Street*, (2012) 216 for an account of how the government forced banks to take bail-out money to facilitate their advancement of loans to consumers. See also generally S Johnson & J Kwak, *13 Bankers: The Wall Street takeover and the next financial meltdown*, (2010).
[309] Ch 3 par 3.4.4.
[310] See the objectives of the Dodd-Frank Act.
[311] Ch 3 par 3.4.4.2.
[312] S 203(a)(1) of the Dodd-Frank Act.
[313] S 203(a)(2)(A) of the Dodd-Frank Act.
[314] S 203(a)(2)(B) of the Dodd-Frank Act.
[315] S 203(a)(2)(C) of the Dodd-Frank Act.
[316] S 203(a)(2)(D) of the Dodd-Frank Act.
[317] S 203(a)(2)(E) of the Dodd-Frank Act.
[318] S 203(a)(2)(F) of the Dodd-Frank Act.

Upon receipt of the recommendation, the Treasury Secretary may only appoint the FDIC as receiver for the SIFI and invoke government bail-out after consulting the President and must inform Congress within 24 hours of the appointment of the FDIC.[319] The FDIC is required to report to Congress within 60 days of its appointment as receiver of the SIFI.[320] Although these provisions seek to subject any proposed government bail-out to congressional scrutiny and to hold the President politically accountable for the decision, they still envisage situations where "Too-Big-To-Fail" may be declared and hence do not out rightly mitigate its moral hazard.

Insured financial institutions that pose a significant risk to the financial system are also required to be liquidated in a manner that mitigates such risk and minimises the moral hazard to the financial system through their orderly liquidation.[321] Orderly liquidation is to be achieved by ensuring that shareholders and creditors bear the losses of the failed financial institution,[322] management members responsible for the failure are not retained[323] and all culpable parties among management, directors and third parties are made to bear the costs of the failure proportional to their responsibility for such failure.[324] The FDIC is required to recover the costs from culpable officers through actions for damages, restitution, and recoupment of compensation and other gains incompatible with their responsibilities.[325]

The FDIC should ensure that orderly liquidations promote the stability of the US financial system[326] and should pay shareholders of the failed institution only after all other creditors and the FDIC's insurance funds are fully paid.[327] It should also hold unsecured creditors liable for rateable losses according to their rights in priority[328] and ensure that culpable managers[329] and board members are removed.[330] However, the FDIC is prohibited from taking any equity interest or becoming a shareholder of the

[319] S 203(c)(2) of the Dodd-Frank Act.
[320] S 203(b) of the Dodd-Frank Act.
[321] S 204(a) of the Dodd-Frank Act.
[322] S 204(a)(1) of the Dodd-Frank Act.
[323] S 204(a)(2) of the Dodd-Frank Act.
[324] S 204(a)(3) of the Dodd-Frank Act.
[325] *Ibid.*
[326] S 206(a)(1) of the Dodd-Frank Act.
[327] S 206(a)(2) of the Dodd-Frank Act.
[328] S 206(a)(3) of the Dodd-Frank Act.
[329] S 206(a)(4) of the Dodd-Frank Act.
[330] S 206(a)(5) of the Dodd-Frank Act.

failed institution.[331] The government is further prohibited from bailing-out any institution engaged in credit or interest or other swap activities.[332]

6.5 Implementation of international financial standards for EDIS and SRR in USA

As argued in Chapter Two,[333] financial reforms may be influenced internally by public choice factors[334] or interest group factors.[335] In relation to the introduction and reform of the FDIC, the USA has been influenced mainly by public choice factors, since it is the public as voters who bear the burden of bank failure. Thus, after the Great Depression, the US Congress enacted the Banking Act, 1933 to *inter alia* separate commercial banking and securities business and introduced federal deposit insurance.[336] After the savings and loan crisis of the 1980s, Congress enacted FIRREA to enhance the FDIC's enforcement powers and FDICIA to introduce prompt corrective actions as mandatory directives to supervisors to take progressively severe action that culminated in the closure of a distressed bank before it depleted its capital.[337] Also, after the GFC, Congress further authorised the FDIC to, *inter alia*, rank bank shareholders of failed institutions among the last to be paid from the residue of the institution's liquidated assets and to hold unsecured creditors liable for rateable losses according to their rights in priority.[338] Since the USA had already enacted frameworks before the GFC that incorporated features similar to those under the *IADI Core Principles* and *FSB Key Attributes*, it is likely that the USA will only further reform its EDIS and SRR after another crisis.

6.6 Chapter summary and conclusions

In this chapter, I have discussed the introduction of explicit deposit insurance in the USA in 1933 and the establishment of the FDIC as the administrator of the EDIS and as the resolution authority (RA).[339] I have argued that the original intention of the US Congress was to restrict the EDIS to narrow banks that were not engaged in risky non-

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[331] S 206(a)(6) of the Dodd-Frank Act.
[332] S 716 of the Dodd-Frank Act.
[333] Ch 2 par 2.6.1.3.
[334] Par 6.1 above.
[335] *Ibid.*
[336] Par 6.2 above.
[337] Par 6.3.4 above.
[338] Par 6.4.4.4 above.
[339] Par 6.3.2 above.

banking services by including the Glass-Steagall provisions on the separation of commercial banking and investment banking in the same Banking Act, 1933 that introduced explicit deposit insurance.[340] I have also demonstrated that by reforming the initial EDIS through, *inter alia*, the introduction of risk-based premiums and prompt corrective actions, the FDIC enhanced its effectiveness in addressing moral hazard in a manner that adopted features similar to those that were later incorporated under the *IADI Core Principles*.[341]

In addition, I have also discussed the FDIC's resolution powers of open bank assistance, establishment of new and bridge banks, facilitation of purchase and assumption transactions and depositor pay-off and liquidation.[342] I have argued that although these powers were introduced in the USA well before the GFC, they are similar to the powers that were subsequently issued under the *FSB Key Attributes* and ought to have played some role in preventing the GFC from beginning in the USA, since the US already had the tools to address bank moral hazard.[343] The fact that the FDIC's EDIS and resolution powers had all the features subsequently cast into international standards under the *IADI Core Principles* and the *FSB Key Attributes* at the time the GFC began in the USA, motivated me to inquire into what role the FDIC could have played to prevent the crisis. As discussed above,[344] the FDIC as presently designed (which is in line with the *IADI Core Principles* and *FSB Key Attributes*) could not have prevented the GFC, because the Crisis was fuelled by and led to the failure of non-depository shadow banking institutions in the USA and a few commercial banks that were involved in the derivatives market.[345] Therefore, the regulatory failure appears to be attributable to the policy makers, who deregulated financial markets under the Gramm-Leach-Bliley Act and the financial regulators and supervisors who could not regulate the issuance and trading in complex financial products.[346]

The Dodd-Frank Act has restored some regulatory oversight and could probably limit the scale of any future crisis if it were effectively enforced.[347] However, if it is lightly

[340] Par 6.3.1 above.
[341] Par 6.3.4 above.
[342] Par 6.4.4.4 above.
[343] Par 6.4.2 above.
[344] Par 6.4.4.2 above.
[345] *Ibid.*
[346] Par 6.4.4.4 above.
[347] Par 6.4.4.2 above.

enforced or repealed through deregulation, the next crisis could be far worse because it could probably involve depository institutions that affect a far larger section of the population. Thus, effective enforcement of financial regulation would reduce the likelihood of widespread depositor reimbursement by limiting the number of bank failures.[348]

[348] Par 6.2.1 above.

CHAPTER 7: CONCLUSIONS AND RECOMMENDATIONS

7.1 Objectives of the thesis

The main objective of this thesis was to appraise the Kenya Deposit Insurance Act, 2012 (KDI Act) and evaluate the features it has designed to address moral hazard in banking.[1] This objective was premised on the need to address any gaps in bank regulation and supervision, explicit deposit insurance schemes (EDIS) and special resolution regimes (SRR) for banks that may have contributed to causing the GFC.[2] Since banks play a special role in the economy, governments regulate their operations to limit risk-taking that could threaten their safety and soundness.[3] I attributed risk-taking in banking, to the rise in financial conglomerates and the complexity of the corporate structures they adopted and the financial products they marketed.[4] In addition, I also observed that the focus by supervisors on the safety and soundness of individual financial institutions rather than also on the systemic risk that financial conglomerates posed, prevented early detection of such risks.[5]

7.2 Conclusions of the study

7.2.1 Conclusions on research questions

7.2.1.1 Summary of research conclusions

In this study, I have examined the gaps within the pre-GFCregulatory structures and the post-GFC international financial standards to address those gaps,[6] and appraised the bank regulatory structures[7] and EDIS in Kenya.[8] I have also discussed the current bank regulatory structures, implicit deposit protection and bank curatorship systems in South Africa,[9] and the key reforms that the proposed EDIS[10] and envisaged Special Resolution Act will introduce.[11] In addition, I have considered the bank regulatory

[1] Ch 1 par 1.4.
[2] Ch 1 par 1.2.6.
[3] Ch 1 par 1.2.1.
[4] Ch 1 par 1.2.5.
[5] Ch 1 par 1.2.5.4.
[6] Ch 2 par 2.2, par 2.3 and par 2.4.
[7] Ch 3 par 3.2.
[8] Ch 4 par 4.3.
[9] Ch 3 par 3.3 and ch 5 par 5.3.
[10] Ch 5 par 5.4.2.
[11] Ch 5 para 5.4.

structures, the EDIS and the SRR regime in the USA,[12] to draw lessons that may be adopted in the reform of the KDI Act. Consequently, I have made the following conclusions in answer to the research questions.[13]

7.2.1.2 The gaps in the pre-GFC regulatory structures

I examined the pre-GFC regulatory and supervisory frameworks and concluded that pre-GFC financial supervision was concerned more with the safety and soundness of individual financial institutions than with the systemic risk that the conduct of business of financial conglomerates posed to the financial system.[14] In particular, upon considering the rise in universal banking and the increased moral hazard[15] it created through complex financial conglomerate corporate structures and financial products and services,[16] it was concluded that the *Basel II Accord* and its foundational three pillars of minimum capital requirements, supervisory review and market discipline did not provide sufficient structures for the supervision of financial conglomerates.[17] Thus, the minimum capital requirements pillar which strengthened the minimum capital requirements for solo institutions did not effectively address the capital requirements for financial conglomerates at group level and individual affiliate level.[18] This permitted financial conglomerates to use debt and their bank capital to cross finance non-bank businesses, which increased leverage and reduced their capacity to absorb losses when the Financial Crisis intensified.[19]

The study further concluded that the *Basel II Accord* supervisory review pillar did not facilitate an effective mechanism for the monitoring of the overall risk from financial conglomerates through a consolidated supervision of group and individual affiliated entity levels.[20] This permitted financial conglomerates to exploit regulatory arbitrage by use of least regulated or unregulated entities to invest in risky financial products and services on the derivatives market.[21] The reliance on the *Basel II Accord's* market

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[12] Ch 3 par 3.4 and ch 6 par 6.2.
[13] Ch 1 par 1.4.1.
[14] Ch 1 par 1.2.5.4.
[15] Ch 1 par 1.2.5.1.
[16] Ch 1 par 1.2.5.2.
[17] Ch 1 par 1.2.5.4.
[18] *Ibid.*
[19] *Ibid.*
[20] *Ibid.*
[21] *Ibid.*

discipline pillar also limited the capacity of financial supervisors to identify and address the risk that financial conglomerates posed to the financial system through their complex corporate structures and complex innovative financial products.[22] Consequently, the pre-GFC regulatory framework failed to adequately address bank leverage and the systemic risk that the financial conglomerates posed to the financial system. It permitted conglomerates to become too complex and interconnected hence "Too-Big-To-Fail", which compelled governments to use public funds to bail them out whenever they fell into financial distress.[23]

In addition, the pre-GFC regulatory frameworks did not widely accept EDIS as an effective financial regulatory tool, and where EDIS was established, it was treated more asa mechanism to prevent bank runs and contagion than also as a component of orderly bank resolution.[24] This was problematic because it left governments with only two options in the resolution of financial conglomerates that were deemed to be SIFIs, that is, either to permit the SIFIs to be liquidated and thereby disrupt the whole financial system or to use public funds to bail them out without any mechanisms to mitigate the moral hazard the financial conglomeration created.[25]

7.2.1.3 The post-GFC reforms to international financial standards

I examined the post-GFC reforms in Chapter Two[26] and concluded that the new international financial standards, namely the *Revised Basel Core Principles*, the *Revised Joint Forum Principles*, the *IADI Core Principles* and the *FSB Key Attributes*, establish stronger bank regulatory and supervisory frameworks than those established under the *Basel II Accord* through, *inter alia*, risk-based capital adequacy requirements and consolidated supervision of financial conglomerates.[27] I further found that the post-GFC financial standards establish more effective features in the design of EDIS and SRR through, *inter alia,* privately funded *ex ante* deposit insurance schemes[28] and resolution regimes that limit the use of public funds to bail-out financial

[22] Ch 1 par 1.2.5.4.
[23] Ch 1 par 1.2.5.5
[24] Ch 1 par 1.2.7
[25] Ch 1 par 1.2.7 and ch 2 par 2.3.2.
[26] Ch 2 para 2.2, 2.3 and 2.4.
[27] Ch 2 par 2.2.
[28] Ch 2 par 2.3.

institutions.[29] However, the effectiveness of the new financial standards depends on whether their implementation is influenced by public choice or special interest group factors.[30] I have concluded that legal frameworks that implement financial regulatory reforms that are driven by public choice factors appear to address moral hazard in banking more effectively than the legal frameworks that are influenced by special interest group factors.[31]

7.2.1.4 Financial conglomerate regulation in Kenya, South Africa and the USA

Upon considering the bank regulatory and supervisory frameworks in Kenya,[32] South Africa[33] and the USA,[34] I found that the effectiveness of EDIS and SRR in addressing moral hazard in banking depends on the robustness of bank regulation and supervisory enforcement.[35] In comparing the regulatory and supervisory enforcement in the three countries, I concluded that South Africa's adoption of the Twin Peaks regulatory model integrates microprudential regulation and supervision for the safety and soundness of individual financial institutions with system wide macroprudential regulation and supervision for the systemic risk emanating from the conduct of business of financial conglomerates.[36] In addition, South Africa has a robust bank regulatory framework that is driven by public choice factors to promote the public interest.[37] I also concluded that the USA has, in response to financial crises, consistently introduced stronger financial regulation that are driven by public choice factors, which, once a financial crisis has abated, are relaxed in response to special interest group lobbying that often again leads to financial crises.[38]

In contrast, I concluded that Kenya's financial regulation focuses more narrowly on the safety and soundness of individual financial institutions than on the systemic risk that the conduct of business of the financial institutions may pose to the financial system.[39] Thus, although Kenya administers different aspects of financial conglomerate

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[29] Ch 2 par 2.4.
[30] Ch 2 par 2.5.
[31] *Ibid.*
[32] Ch 3 par 3.2.
[33] Ch 3 par 3.3.
[34] Ch 3 par 3.4.
[35] Ch 3 par 3.5.
[36] Ch 3 par 3.3.
[37] *Ibid.*
[38] Ch 3 par 3.4.
[39] Ch 3 par 3.2.3.1.

regulation and supervision using various guidelines issued by the Central Bank of Kenya (CBK), the country has no consolidated regulatory framework for financial conglomerates.[40] In this regard, Kenya could draw lessons from South Africa's financial regulatory and supervisory frameworks that has majorly been influenced by public choice factors, which has been entrenched in its Banks Act, Financial Sector Regulation Act and the proposed *Financial Conglomerate Supervisory Framework* for the identification, designation,[41] licensing and supervision of financial conglomerates.[42] This has led to a robust bank regulatory and supervisory framework in South Africa that was able to protect South African banks from the serious effects of the GFC.[43] This would also enhance Kenya's statutory supervisory framework for consolidated supervision for the safety and soundness of individual financial institutions within financial conglomerates as well as the risks posed by their conduct of business on a solo basis and on a group basis.[44]

Kenya could also draw lessons from the USA's public choice influenced financial regulatory frameworks under Banking Act in 1933 and the Bank Holding Company Act 1956 enacted after the Great Depression, FIRREA in 1989 and FDICIA 1991 after the savings and loan crisis, and Dodd-Frank in 2010 after the GFC.[45] In particular Kenya could benefit from the lessons of the US financial regulatory frameworks relating to the supervision of bank holding companies under the Bank Holding Company Act 1956 as amended, prompt corrective actions under the FDICIA 1991 and financial conglomerates under Dodd-Frank Act that were strengthened after the GFC.[46]

7.2.1.5 Appraisal of Kenya Deposit Insurance Act, 2012

An appraisal of the KDI Act found that it has implemented the post-GFC standards in EDIS and SRR to address the moral hazard in banking and limit the use of public funds to bail-out banks.[47] I also found that despite the suggestion by economists that co-insurance be adopted to limit depositor moral hazard further, the KDI Act, does not

[40] *Ibid.*
[41] Ch 3 par 3.3.3.1.
[42] Ch 3 par 3.3.3.3.
[43] Ch 3 par 3.3.4.
[44] Ch 3 par 3.2.3.
[45] Ch 3 par 3.4.5.
[46] Ch 3 par 3.4.
[47] Ch 4 para 4.3 and 4.5.2.2.

adopt it.[48] I further concluded that while the KDI Act permits the charging of risk-based premium rates, it provides no framework for assessing these risk-based premiums.[49] Other findings that affect the effectiveness of the Kenyan EDIS in addressing bank moral hazard, are that the KDI Act does not prescribe conditions for the transfer of funds from the deposit insurance fund to the operational fund, which exposes the deposit insurance fund to the risk of misuse after being transferred to the operational fund.[50] I also concluded that although the KDI Act permits the insured institutions to be represented on the board of the Kenya Deposit Insurance Corporation (the Corporation), which has the potential to create conflicts of interest, the Act has established mechanisms to limit the opportunity for such conflicts of interest. [51]

In addition, I concluded that the KDI Act protects the use of public funds in bank resolution by requiring the Corporation to adopt the least costly resolution strategy and spelling out the criteria for bailing-out systemic banks.[52] However, I also found that the failure to require financial conglomerates to prepare recovery and resolution plans (RRPs) that internalise the costs of their recovery and resolution, limits the capacity of the KDI Act to more effectively address bank moral hazard.[53] While the provisions for invoking prompt corrective actions will enhance supervisory enforcement, I concluded that the KDI Act has no dedicated prompt corrective action framework and adopts the *CBK Guidelines on prompt corrective actions*[54] which neither sufficiently differentiates the triggering events for invoking prompt corrective actions nor the separate categories of prompt corrective actions to be enforced.[55]

7.2.1.6 Transition to EDIS and SRR in South Africa

Upon a consideration of the South African legal framework for deposit protection, I found that although it currently still operates an apparent implicit deposit protection and bank curatorship system that does not contain the full suite of resolution options under the FSB Key Attributes, it has incorporated measures to address moral hazard

[48] Ch 4 par 4.3.4.2.
[49] Ch 4 par 4.3.3.2.
[50] Ch 4 par 4.3.3.1.
[51] Ch 4 par 4.3.2.2.
[52] Ch 4 par 4.5.2.2.
[53] *Ibid.*
[54] Ch 3 par 3.2.5.3.
[55] *Ibid.*

in banking.[56] These measures include the establishment of bridge banks to continue the critical functions of a failed institution as well as the requirement for bail-in within resolution from shareholders, unsecured creditors and other private sector institutions to recapitalise the failed institution.[57] I also found that South Africa has proposed to introduce an EDIS[58] and envisages to enact a Special Resolution Act regime that will expressly adopt international financial standards on EDIS and SRR to limit moral hazard in banking.[59] Among the lessons Kenya could learn from South Africa on EDIS would also be the proposal to exclude representatives of banks from the board of the EDIS.[60]

7.2.1.7 EDIS and SRR in USA

After examining the EDIS and SRR in the USA as administered by the Federal Deposit Insurance Corporation (FDIC), I found that the USA, being the jurisdiction that pioneered EDIS, has consistently strengthened its features to address the moral hazard in banking after every banking crises since 1933.[61] The measures adopted pre-GFC by the FDIC to address moral hazard in banking include the limitation of the scope of coverage of insured deposits; charging of risk-based insurance premiums and a well-designed prompt corrective actions framework with differentiated triggering events and corresponding actions to be enforced.[62] Post-GFC, the USA enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act to *inter alia* limit the use of public funds to bail-out failed financial institutions.[63] I also concluded that in comparison to Kenya, the FDIC has more effective EDIS features and more clearly defined resolution strategies than the Corporation under the KDI Act.[64]

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[56] Ch 5 par 5.2.2.7.
[57] Ch 5 par 5.2.2.5.
[58] Ch 5 par 5.3.2.
[59] Ch 5 par 5.3.3.
[60] Ch 5 par 5.4.
[61] Ch 6 para 6.2 and 6.3.4.
[62] Ch 6 par 6.3.4.
[63] Ch 6 par 6.4.4.5.
[64] Ch 6 para 6.4.2.5 and 6.4.4.2.

7.3 Recommendations to reform the Kenyan EDIS and SRR

7.3.1 Overview of recommendations

On the basis of the findings and conclusions of the study above, the Kenyan EDIS under the KDI Act clearly needs to be reformed to enhance its capacity to address moral hazard in banking. On a foundational level the reforms would entail that the EDIS is not viewed in isolation but that it should appropriately and comprehensively embrace the post-GFC stance of financial regulation which integrates EDIS and SRR within a macroprudential regulatory framework to address systemic risk from financial institutions and facilitates the orderly exit of failed institutions from the financial system whilst preserving their vital economic functions without the use of public funds.[65] As argued above,[66] effective financial regulation and supervisory enforcement is critical for the success of any EDIS and SRR.[67] Consequently, I propose the following general recommendations for the reform of Kenya's banking and financial conglomerate regulatory and supervisory framework, and also make specific recommendations to enhance the effectiveness of the EDIS and SRR under the KDI Act.

7.3.2 General recommendations

7.3.2.1 Overview of general recommendations

As indicated above,[68] Kenya's regulatory framework for financial conglomerates is spread over various CBK guidelines. To strengthen the regulation and supervision of financial institutions, I make the following recommendations:

7.3.2.2 Regulation of financial conglomerates

Although the Banking Act 1989, was amended in 2012 to introduce the regulation and supervision of banking groups by limiting the ownership of a bank's capital by a single person to a maximum of twenty five per cent and to require regulatory approval for any acquisition of more than twenty five per cent of a bank's share capital by a non-

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[65] Ch 1 par 1.2.7 and Ch 2 par 2.2.2
[66] Par 7.2.1.
[67] *Ibid.*
[68] Par 7.2.31.4.

operating holding company,[69] Kenya has not developed a consolidated framework for the supervision of financial conglomerates.[70] Accordingly, the Banking Act has neither consolidated its provisions for the designation and licensing of financial conglomerates nor prescribed group-wide capital adequacy and corporate governance and risk management requirements for financial conglomerates.

Instead Kenya uses the CBK's *Risk based supervisory framework 2013* as guidelines for the supervision of financial groups or financial conglomerates and the *CBK Guidelines on non-operating holding companies*, that impose capital conservation buffers and countercyclical buffers for non-operating holding companies.[71] However, banking groups that engage in incidental non-banking business under the *CBK Guidelines on incidental business* are not required to raise any capital conservation or countercyclical buffers.[72] Consequently, I recommend that a suitable regulatory framework be enacted to consolidate all provisions on financial conglomerates to specifically address the risks that they pose to the financial system. I also recommend thatsince both non-operating holding companies and banking groups engaged in incidental non-banking business, they should be subject to the same capital conservation buffers and countercyclical capital buffers that are currently imposed only on non-operating holding companies.

7.3.2.3 Macroprudential regulatory structures and the financial safety net

Although Kenya's first EDIS under the DPFB was subsequently strengthened by enhancing its safety net when the Corporation took over in 2012,[73] Kenya lacks an explicit macroprudential regulatory framework for the risk emanating from the conduct of business of financial institutions. The proposal to address this gap through the publication of a *Draft Financial Services Authority Bill,* 2016and a *Draft Financial Conduct of Business Authority Bill,* 2017has not come to any fruition as no progress has been made to introduce these bills to parliament for enactment.[74] Consequently, I recommend that the two bills be consolidated to incorporate macroprudential

[69] Ch 3 par 3.2.4.1.
[70] Ch 3 par 3.2.4.3.
[71] Ch 3 par 3.2.5.2.
[72] *Ibid.*
[73] Ch 4 par 4.2.1.1
[74] Ch 3 par 3.2.5.4.

regulation that addressthe risk emanating from financial market conduct and enhance consolidated supervision of financial conglomerates. Although the CBK has publicly opposed the enactment of the *Draft Financial Conduct of Business Authority Bill*because the draft bill takes away some its functions, further consultations could convince the CBK that the proposed reforms are in the public interest.[75] This is because the draft bills provide criteria forthe *ex ante* identification, designation and licensing of financial conglomerates similar to South Africa's Twin Peaks framework for designating, licensing and supervising financial conglomerates.[76]

7.3.2.4 Regulatory enforcement

As discussed in Chapter Three,[77] although the KDI Act authorises the Corporation to enforce prompt corrective actions for early supervisory intervention in problem banks before they exhaust their capital, there is no formal statutory prompt corrective actions framework.[78] Therefore, the Corporation is required to use the CBK's prompt corrective action policy framework issued for the guidance of its staff.[79] An examination of the CBK framework however concluded that it does not sufficiently differentiate between the four categories of banks that are targeted for prompt corrective action enforcement.[80] In addition, the framework neither sufficiently differentiates the triggers for each prompt corrective action to be enforced, nor specifies the sanctions and corrective actions to be enforced for more severe contraventions of the regulations.[81]

To streamline the prompt corrective actions framework to enhance effective enforcement that addresses moral hazard in banking, I recommend that the KDI Act be amended to prescribe a prompt corrective action framework with more clearly defined criteria for classifying banks, more clear triggers for enforcement and increasingly severe corrective actions that correspond to the erosion in the bank's capital. I further recommend that incentives for the best capitalised banks be provided. In this respect, the framework should subject them to less supervisory surveillance and remove the current obligations it imposes on them in relation to the execution of

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[75] *Ibid.*
[76] Ch 3 par 3.3.1.2.
[77] Ch 3 par 3.2.5.3.
[78] *Ibid.*
[79] *Ibid.*
[80] *Ibid.*
[81] *Ibid.*

a Certificate of Awareness and Commitment Letter to implement all required actions expeditiously.[82]

As pointed out in Chapter Three,[83] the appointment of a Resolution Specialist, Management Advisor and a Manager under Kenya's prompt corrective action framework duplicates the functions of a receiver under the KDI Act.[84] To eliminate this duplication, I recommend that Kenya considers the US prompt corrective actions framework and adapts the more suitable features to its context, without distorting the main objectives prompt corrective actions are to serve.[85]

7.3.3 Specific recommendations to Kenya EDIS and SRR

7.3.3.1 Overview of reforms to enhance KDI Act

In addition to the general recommendation above,[86] that also enhance the effectiveness of the KDI Act, I further recommend that the Act be strengthened through amendments of the provisions on governance and administration of the operations fund,[87] framework for the levying of risk-based premiums,[88] and to retain limitation of the scope of insured deposits without introducing co-insurance.[89] In addition, other reforms are needed to strengthen the SRR by repealing the provisions of the Banking Act for the appointment of a manager for insolvent institutions.[90] The provisions of the KDI Act relating to the appointment of the Corporation as receiver and the CBK's notification of the Corporation that an institution has become non-viable also need to be harmonised. In addition, new provisions should be enacted to require financial conglomerates to prepare recovery and resolution plans.[91]

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[82] *Ibid.*
[83] *Ibid.*
[84] Ch 4 par 4.4.2.
[85] Ch 1 par 1.2.5.3, ch 3 par 3.4.2.4 and ch 6 par 6.3.4.
[86] Par 7.3.2.
[87] Ch 4 par 4.3.2.2.
[88] Ch 4 par 4.3.3.2.
[89] Ch 4 par 4.3.4.1.
[90] Ch 4 par 4.4.1.3.
[91] Ch 4 par 4.5.1.3.

7.3.3.2 Governance and administration of fund

As pointed out in Chapter Four,[92] the KDI Act separates the Corporation's operations fund, that caters for its administrative expenses,[93] from the deposit insurance fund that caters for the reimbursement of depositors of failed institutions among other resolution strategies.[94] However, the Act permits the board of the Corporation to transfer monies from the deposit insurance fund to the operations fund, on such terms as the board may deem necessary.[95] Although the Corporation's board should be trusted to act in good faith and promote the public interest in its deliberations, the essence of an EDIS is to remove discretion in the reimbursement of insured depositors by explicitly establishing an *ex ante* fund. To protect the deposit insurance fund from being depleted by transfers to meet the operational expenses of the Corporation, I recommend that the Act be amended to require Ministerial approval for any transfer of funds from the deposit insurance fund to the operations fund. I further recommend that the Corporation be obligated to include the reasons for any such transfers in its annual report to Parliament.

It was also observed that the Act includes three representatives of banks on the board of the Corporation and seeks to prevent conflicts of interest by disqualifying officers of institutions under receivership or liquidation from membership of its board.[96] I observed that the Corporation has effective provisions to prevent conflicts of interest including requirements for members of the board that have any interest in matters before the board to disclose the interest before the relevant board meeting and abstain from any discussion, or voting on the matter. However, I recommend that to avoid any perception of conflicts of interest, financial institutions should not be represented on the Corporation's board. This is because, such inclusion creates a conflict between the interests of depositors and those of financial institutions. In this regard, Kenya could learn from the proposed EDIS in South Africa that specifically excludes representatives of insured banks from membership of the board of the EDIS.[97]

[92] Ch 4 par 4.3.2.2.
[93] Ch 4 par 4.3.3.1.
[94] Ch 4 par 4.3.3.2.
[95] Ch 4 par 4.3.3.1.
[96] Ch 4 par 4.3.2.2.
[97] Ch 5 par 5.3.2.3.

7.3.3.3 Mandate and powers of the EDIS

In the discussion on the mandate and powers of the Corporation,[98] it was observed that the Corporation may levypremiums from member banks as a flat rate annual contribution for safe and sound institutions, and risk-based premiums on financial institutions that engage in risks that threaten their safety or the interests of depositors.[99] However, the KDI Act does not prescribe the criteria to guide the Corporation in the assessment of risk-based premiums.[100] I accordingly recommend that guidelines be developed that can be issued as regulations to stipulate the procedures and criteria to be adopted in the assessment of the risk-based premiums.

7.3.3.4 Scope of coverage

In Chapter Two,[101] the two features proposed to limit depositor moral hazard were identified as the limitation of the scope of coverage by determining the maximum amount of insured deposits and the requirement that depositors take co-insurance for their deposits.[102] The KDI Act addresses depositor moral hazard by limiting the scope of the insured deposit, without requiring any co-insurance.[103] I endorse this policy and recommend that Kenya should not introduce co-insurance because it fuels bank runs as was witnessed in the United Kingdom during the GFC in the case of Northern Rock.[104]

7.3.3.5 KDI Act special bank resolution framework

It was observed in Chapter Four[105] that the KDI Act consolidates all provisions on deposit insurance and the resolution of insured financial institutions.[106] Thus, the objective of the Act is to consolidate the provisions relating to deposit insurance and resolution of financial institutions by repealing the provisions in the Banking Act that deal with these aspects.[107] However, the Banking Act still retains a provision for the

[98] Ch 4 par 4.3.2.3.
[99] Ch 4 par 4.3.3.2.
[100] *Ibid.*
[101] Ch 2 par 2.3.
[102] *Ibid.*
[103] Ch 4 par 4.3.4.1.
[104] Ch 2 par 2.3.3.2.
[105] Ch 4 par 4.2.
[106] *Ibid.*
[107] *Ibid.*

appointment of a manager for financial institutions that are likely to become non-viable.[108] To harmonise the appointment of receivers and managers or administrators for financial institutions that have ceased or are likely to cease to be viable, I recommend that the provision for the CBK to appoint the Corporation as manager under the Banking Act be repealed, because the KDI Act already provides the Corporation with powers to address the same issues.

In addition, it was observed that the Corporation may be appointed as a receiver under section 43 to exercise receivership powers under section 50, and may further be notified by the CBK that an institution has ceased or is likely to cease to be viable under section 44, which then has the effect of authorizing the Corporation to take over the institution from its board of directors immediately.[109] Since the Corporation exercises resolution powers in terms of both sections, I recommend that the KDI Act be amended to consolidate the Corporation's resolution authority over institutions that have ceased or are likely to cease to be viable. This will harmonise the triggers for resolution and subject similar institutions to the same resolution processes. It was also observed that the Corporation's receivership powers overlap with its liquidation powers[110] and that the KDI Act does not prescribe a framework for bail-in within resolution, and for the exit of successfully restructured institutions from receivership.[111] Consequently, I recommend that the KDI Act be amended to explicitly provide a framework for bail-in within resolution and for the exit of successfully restructured institutions from receivership.

It was further observed that the KDI Act does not impose any obligations on financial conglomerates to prepare recovery and resolution plans (RRPs) stipulating their strategies to recover from financial distress or for their orderly resolution if they fail to recover their viability.[112] I recommend that the Act be amended to require RRPs that will obligate financial conglomerates to internalise the costs of their financial recovery and resolution *ex ante* and thereby protect public funds from being used to bail them out when they fall into financial distress.[113] Overall, since the KDI Act was enacted in

[108] Ch 4 par 4.4.2.
[109] *Ibid.*
[110] Ch 4 par 4.5.2.7.
[111] *Ibid.*
[112] *Ibid.*
[113] Ch 4 par 4.5.1.3.

2012 prior to the revision of the *FSB Key attributes* in 2014, I recommend that the KDI Act be reviewed to align it with the updated *FSB Key attributes*.

7.4 Suggestions for further research

In the course of the study, I encountered some issues that were related to the study but outside its scope, which may require further research. These include, the regulation of bank auditing and credit rating agencies and the protection of regulators from liability.[114] The use of market discipline to prevent excessive risk-taking by banks was based on the assumption that external auditors would provide objective financial reports of the status of institutions and that credit rating agencies would provide objective assessments of the status of the credit risks of financial institutions and financial securities.[115] Thus, auditors have the statutory duty to prepare financial statements that bridge the information gap between bank managers, shareholders, creditors and depositors.[116] The main issue that the auditing of banks raises relates to whether auditors owe depositors any duty of care? The answers to this question may enhance understanding of the effectiveness of the requirements under the Banking Act in Kenya for banks to have their financial statements audited and displayed in bank premises and publicised in newspapers. In addition, the role of credit rating agencies in the assessment and rating of the credit worthiness of financial institutions and complex financial securities was identified.[117] In view of the conflicts of interest attributed to auditors and credit rating agencies,[118] further research could be needed to evaluate the post-GFC reforms Kenya has undertaken to address the integrity of bank auditors and credit rating agencies.

The other issue that may require further research relates to the requirement by most international standards that employees and officers of regulatory agencies be protected from liability.[119] The main issues for further research is what impact such protection may have on the rights of depositors and shareholders that suffer loss through the negligence of the regulators; and what the appropriate remedies for such

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[114] Ch 1 para 1.2.5.4 and 1.2.6.
[115] *Ibid.*
[116] *Ibid.*
[117] *Ibid.*
[118] Ch1 par 1.2.6.
[119] Ch 2 para 2.2, 2.3 and 2.4 and ch 4 par 4.3.6.

loss would be. Consequently, more research needs to be conducted into the extent to which regulatory enforcement could be enhanced by holding regulators accountable to the public.

Annexure A

Outline of the *Basel Core principles*

Core principle 1 requires the legislative framework to prescribe the regulatory powers of bank supervisors over banks and banking groups.
Core principle 2 requires banking supervisors to be independent, accountable, adequately funded and for *bona fide* acts done in the course of their duties to be protected from legal liability.
Core principle 3 provides for cooperation and collaboration between cross-border supervisors,
Core principle 4 provides for the licensing of the permissible activities of licensed institutions.
Core principle 5 provides for the setting of licensing criteria on bank ownership structure and for the suitability for bank management and board members.
Core principle 6 requires supervisory approval for transfer of significant ownership.
Core principle 7 requires regulatory approval for any major acquisitions, investments by banks, including their corporate affiliations and structures.
Core principle 8 requires the legal framework to provide for early intervention in problem banks and for the orderly resolution of nonviable banks to limit systemic risk.
Core principle 9 requires supervisors to employ resources in proportion to the risk profile and systemic importance of banks through risk based supervision.
Core principle 10 provides for monitoring of prudential compliance through on-site and off-site examination
Core principle 11 authorises supervisors to address threats to the safety and soundness of banks through expeditious enforcement of corrective actions.
Core principle 12 requires supervisors to apply prudential standards to a banking group's business on a consolidated basis.
Core principle 13 facilitates cross-border collaboration between home and host country supervisors for banking groups that subjects their entities to host country standards as applied to domestic banks or group entities.
Core principle 14 requires banks and banking groups to have robust corporate governance policies and procedures for strategic direction, group and organisational structure.
Core principle 15 requires banks to establish comprehensive risk management processes under the oversight of the board and senior management through contingency and recovery planning appropriate for the bank's risk profile and systemic importance.
Core principle 16 requires risk based capital adequacy requirements that are proportionate to the bank's risk profiles and their ability to absorb losses.
Core principle 17, bank management should identify, evaluate, control and mitigate credit risk.
Core principle 18 requires banks to develop and maintain policies for early identification and management of problem assets through adequate capital provisions and reserves.
Core principle 19 requires banks to develop policies and processes to *inter alia* identify, evaluate and control or mitigate concentrations of risk so as to restrict risk exposure.
Core principle 20 limits conflicts of interests by restricting transactions between related parties by requiring them to be treated arm's length.
Core principle 21 banks to provide for country and transfer risks in international lending and investments.
Core principle 22 addresses market risk from significant deterioration in macroeconomic conditions of countries.
Core principle 23 requires supervisors to address interest rate risk
Core principle 24 requires banks to provide for appropriate liquidity to match their risk appetite and reserve sufficient liquidity for any material deterioration in their economic environment.
Core principle 25 requires banks to develop policies and processes to address operational risk.
Core principle 26 provides for effective internal control and audit policies and processes.
Core principle 27 requires publication of financial reports and external auditing of banks and banking groups.

Core principle 28 requires banks and banking groups to publish operational information on consolidated basis.
Core principle 29 requires banks to prevent market abuse and fair conduct in the financial sector.

Source: Basel Committee on Banking Supervision, *Core principles for effective banking supervision*, (2012)

Annexure B

Outline of *Joint Forum Principles for the supervision of financial conglomerates*

Principle
Principle 1 requires the power and authority of functional and Group-level Supervisors to enforce group-wide supervision of financial conglomerates to be prescribed in the legal framework.
Principle 2 empowers supervisors to establish a framework for efficient and effective cooperation, coordination and information sharing to facilitate group-wide supervision.
Principle 3 provides for the prescription of independence and accountability of supervisors in the legal framework.
Principle 4 provides for the adequacy of funding for supervisors of financial conglomerates.
Principle 5 requires statutory assignment of supervisory responsibilities between functional supervisors and the Group-Level Supervisor and for a framework for the coordination of their functions.
Principle 6 authorises supervisors to establish a framework for information sharing, cooperation and coordination for the efficient and effective supervision of financial conglomerates.
Principle 7 imposes comprehensive risk based prudential standards on financial conglomerates.
Principle 8 requires supervisors to understand the operations of financial conglomerates.
Principle 9 authorises supervisors to direct financial conglomerates to take timely corrective actions to comply with prudential standards.
Principle 10 requires financial conglomerates to establish a framework for effective governance at group wide level and at individual level for regulated and unregulated entities.
Principle 11 requires financial conglomerates to adopt a transparent organisational and managerial structure that is understood by its controlling company's board and senior management.
Principle 12 provides for the vetting of the financial conglomerate's board members, senior management and key persons in positions of control for integrity, competence, experience and professional suitability.
Principle 13 requires the board of the financial conglomerate to define the appropriate strategy and risk appetite and ensure its implementation on a group wide basis by its regulated and unregulated entities.
Principle 14 requires the financial conglomerate to develop and implement a remuneration policy.
Principle 15 requires financial conglomerates to maintain adequate capital on a group wide basis, with capital management policies and capital planning processes that takes its group wide risk profile into account.
Principle 16 requires financial conglomerates to undertake capital adequacy assessments on a group wide basis, including risks from its unregulated entities, third party participations, and from minority interests.
Principle 17 requires capital adequacy assessments and measurements to limit double or multiple gearing.
Principle 18 requires financial conglomerates to prevent excessive leverage and the use of debt proceeds from its parent company as equity in its subsidiary companies.
Principle 19 requires financial conglomerates to prevent intra-group transfers of capital and to exclude any capital transferred from affiliated entities from group wide capital adequacy assessments.
Principle 20 requires the head of the financial conglomerate to manage liquidity risks on a group wide basis and provide adequate funds to equip it to enable it meet liquidity needs during times of stress.
Principle 21 requires financial conglomerates to develop effective risk management frameworks, robust internal controls and effective internal audit compliance systems.
Principle 22 financial conglomerates need to develop a group wide risk management structure and culture.
Principle 23 financial conglomerates should develop appropriate risk appetite and risk tolerance policies.
Principle 24 requires financial conglomerates to carry out a robust risk assessment survey before being approved to enter new business or product areas.
Principle 25 requires approval of outsourcing of any functions by financial conglomerates, which should first assess the risks and appropriateness of outsourcing those functions.
Principle 26 requires financial conglomerates to periodically conduct group wide stress tests and scenario analyses of the major risks they are exposed to.
Principle 27 requires financial conglomerates to prudently aggregate the group wide risk exposures.

Principle 28 requires financial conglomerates to develop and implement measures to manage and report group wide risk concentration and intra-group transactions and risk exposures.
Principle 29 requires financial conglomerate supervisors to include off-balance sheet activities, including special purpose vehicles within the scope of group wide supervision.

Source: Joint Forum, *Principles for the supervision of financial conglomerates*, (2012)

Annexure C

Outline of the *IADI Core principles*

Core principle 1 requires formal declaration of principal objectives of an EDIS through legislation or other policy documents.
Core principle 2 requires legislative prescription of the mandate and powers of the EDIS.
Core principle 3 requires the governance of the EDIS to be operationally independent, transparent and accountable.
Core principle 4 promotes the deposit insurer's relationship with other safety net providers, including: prudepntial regulation, supervision, resolution, lender of last resort, and the Ministry of Finance or Treasury.
Core principle 5 deals with cross-border collaboration between deposit insurers,
Core principle 6 requires participation of deposit insurer in contingency planning and crisis management to for effective response to bank failure pre-crisis and post crisis management.
Core principle 7 requires mandatory membership of all licenced banks to the EDIS.
Core principle 8 requires limitation of the scope of coverage to retail depositors, leaving corporate depositors to market discipline so as to limit depositor moral hazard.
Core principle 9 requires the EDIS to be privately funded through *ex ante* premium contributions by banks to limit the use of government funds to bail-out banks by reimbursing their depositors when they fail.
Core principle 10 requires public awareness of the benefits and limitations of the deposit insurance system so that the deposit insurer informs the public of all material events in relation to their deposits.
Core principle 11 requires legal protection for deposit insurer officers and employees from liability for acts or omissions done in good faith in the ordinary course of their duties.
Core principle 12 requires parties at fault in bank failure to be investigated and pursued for professional disciplinary measures; criminal prosecutions; and civil damages.
Core principle 13 requires the deposit insurer authority for timely intervention in problem banks before they become non-viable so as to provide a more effective protection of the depositors.
Core principle 14 provides for an effective failure resolution regime to enable the deposit insurer to protect depositors and contribute to financial system stability
Core principle 15 requires clear criteria for and prompt reimbursement of depositors of failed institutions.
Core principle 16 requires recovery of costs incurred in resolution including reimbursed deposits by subrogation to the rights of reimbursed depositors in the failed institutions assets.

Source: The IADI, *Core principles for effective deposit insurance systems,* (2014)

Annexure D

Outline of FSB *Key attributes of effective resolution of financial institutions*

Key attributes
Key attribute 1 extends the scope of the Attributes to include financial conglomerates, their holding companies and their nonregulated subsidiaries.
Key attribute 2 requires each jurisdiction to designate a resolution authority to exercise resolution powers over firms within the scope of the regime.
Key attribute 3 prescribes resolution powers that shifts resolution objectives from bailout to bail-in.
Key attribute 4 requires jurisdictions to enact enforceable set-off rights, and contracting netting.
Key attribute 5 requires creditor hierarchy rights to be protected in bail-in and liquidation.
Key attribute 6 recommends private funding for the resolution of banks through explicit deposit insurance.
Key attributes 7 requires a legal framework for cross-border cooperation.
Key attribute 8 requires cross-border cooperation through home and host country crisis-management groups.
Key attribute 9 recommends countries to enter cross-border cooperation agreements for each Global-SIFIs.
Key attribute 10 provides for stress tests for resolvability.
Key attribute 11 requires SIFIs to prepare recovery and resolution plans for potential financial distress.
Key attribute 12 provides for cross border and domestic collaboration between resolution authorities.

Source: Financial Stability Board, *Key attributes of effective resolution regimes for financial institutions,* (2014)

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