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Legal aspects of distressed bank rescue: Lessons for Uganda from the South African and English experience

Dissertation submitted in fulfillment of the requirements for the degree of Master of Laws (LL.M) in Banking at the University of Pretoria, South Africa.

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December, 2016

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DECLARATION STATEMENT

With the signature appended hereunder, I Silver Kayondo, hereby declare that the work presented in this thesis is based on my own research, and that I have not submitted this thesis to any other University or institution of higher learning to obtain any academic qualification.

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Silver Kayondo

Date: 20th December, 2016

DEDICATION

“It is not in the stars to hold our destiny but in ourselves.” — William Shakespeare (April 1564 - May 3, 1616)

“Destiny is not a matter of chance; it is a matter of choice. It is not a thing to be waited for, it is a thing to be achieved.” — William Jennings Bryan (March 19, 1860 - July 26, 1925)

This research is dedicated to the many young men and women across the African continent who have devoted their time, knowledge, skills and passion to positively contribute to the Africa we deserve. Our destiny is our choice!

ACKNOWLEDGEMENTS

I extend my sincere gratitude to my Supervisor, Professor Corlia Van Heerden, the Barclays Africa Chair in Banking Law at the Faculty of Law, University of Pretoria for according me the privilege and opportunity to undertake this research. It is through this generous bursary that this piece of my humble contribution in the academic world will be able to add to the existing streams of knowledge on a subject I am so passionate about.

It would be a mark of high ingratitude if I do not express my sincere appreciation to the Dean of the Faculty of Law at the University of Pretoria, Professor Andre Boraine. As a doyen of insolvency law on the African continent, he saw to it that I had the latest material on the subject and gave me the platform to explore much more than an enriching study time in South Africa. In equal measure, I must appreciate the cordial intellectual rigor of Professor Nick Huls, the Emeritus Professor of Sociology of Law at Leiden University, Netherlands. This old sage combined his knowledge and experience acquired over many decades with practical understanding of the East African legal, economic and political terrain, having served as the Vice Rector Academic Affairs at the Institute of Legal Practice and Development (ILPD), Nyanza, Rwanda, an institute of higher learning for legal professionals (judges, prosecutors and advocates).

I am also grateful to Dr. Johann De Jager, Mr. Michael Blackbeard and Mr. Jonathan Maphosa from the South African Reserve Bank legal department for the insightful discussions we had about this research. Dr. Charles Abuka, Mr. Ivan Amagaragariho from the Bank of Uganda Financial Stability Department and Ms. Christine Alupo from the Communications Department were also instrumental in helping me obtain the relevant information I needed from Bank of Uganda.

I immensely appreciate the administrative support rendered by Miss Moipone Williams at the Mercantile Law Department. I acknowledge my family, friends and all the kind people who opened their homes and ushered me in with love and hospitality. Your warm embrace kept me going strong in these foreign lands.

Lastly, much as I received insights and thoughts from various people and sources during the course of this research; all errors, misstatements and mistakes that may be contained herein are entirely mine.

"Running a bank, you might think, is largely about the numbers: ratios of capital to liabilities; of non-performing loans to performing ones; of short-to long-term funding; of provisions to book size. Yet the studies of banking collapses ultimately find explanatory power not in the numbers, but in the people." Stuart Theobald, *Management lessons from African Bank's collapse*, (Rand Daily Mail, 16th May 2016).

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CHAPTER ONE

INTRODUCTION

1.1 RESEARCH BACKGROUND

This Chapter gives an overview of the research, the problem, literature review, motivation for the study, and objectives and accordingly provides background to contextualize the study.

The current trend of globalization has turned the world into a global village. This is even more apt in the banking and finance industry. Healthy national, regional and global economic systems are underpinned by sound and well-regulated financial and banking systems. Disruptions in the banking system can have negative ripple effects on other sectors of the economy. Not only do banks act as custodians of public funds, they are also important vehicles to influence the distribution and flow of financial resources to other sectors of the economy. Due to the important role played by banks in the financial system, many countries have established independent Central Banks to regulate and supervise the banking sector and protect depositors.[1]

The purpose of this research is to examine the legal aspects of rescue powers available to Central Banks in South Africa, the UK and Uganda to intervene and restore distressed banks back to health. This subject is particularly relevant to Central Bank law and policy in the aftermath of the Global Financial Crisis (GFC). The 2008 GFC was caused by systemic failure in the financial system consequently plunging the global economy into a disastrous recession. Much as there is no universally agreed definition of "systemic risk", the common denominator is that such risk is an event or series of events such as economic shock or institutional failure that triggers negative economic consequences like significant losses to financial institutions, market failures for financial products or financial market and economic volatility. Such risk can affect financial institutions, markets or both.[2] In the context of prevention of systemic risk or addressing the consequences of systemic failure, Central Banks play a pivotal role through their regulatory and supervisory functions.

[1] As far as the selected case studies are concerned, the Bank of England (BoE) plays the role of the Central Bank in the UK, the South Africa Reserve Bank (SARB) in South Africa, and Bank of Uganda (BoU) is Uganda's Central Bank. The statutory provisions creating these regulatory authorities and their respective mandates will be discussed further during the course of this research.

[2] Steven L. Schwarcz; "Systemic Risk", Georgetown Law Journal [Vol 97: 193] Pg. 198.http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2549&context=faculty_scholarship (last accessed 21/7/2015).

Furthermore, banks also fulfil a *sui generis* role that sets them apart from other financial institutions that are role players in the financial system because of aspects like collection of deposits from the public, public interest in the integrity of the banking system, and susceptibility of banks to liquidity risk (the risk that a bank will not have sufficient cash to meet short term obligations). The rationale for rescuing distressed banks is rooted in the desire to minimize market and banking sector disruption by ensuring that banks continue to provide financial services and products as this contributes to financial stability in a specific financial system. The past few decades have seen the rise of universal banking,[3] shadow banking,[4] and the emergence of the so-called "too big to fail" (TBTF) financial institutions.[5] Banks have increased in size, complexity and interconnectedness because many of them have become so intertwined in the global economy as part of large financial conglomerates. Thus, rescuing a bank in distress and nursing it back to health can be a complex and costly exercise.

I will examine the point at which the respective Central Banks of the selected case study jurisdictions can invoke the rescue powers, the purpose, nature and extent of those powers, the major role-players in the distressed bank rescue process, checks and balances available to prevent abuse or misuse of such mandate, and I will also analyze scenarios where such powers have been invoked.

It is imperative to note that the choice of the comparative case study countries is influenced by a number of factors. For instance, South Africa has a well-developed banking sector regulatory framework and curatorship has been tested over time in a number of distressed bank interventions. It is also taking the lead on the African continent in implementing the Twin Peaks model of financial regulation. The UK is also in the process of implementing major banking

[3] Generally, universal banking is a concept that describes activities where an entity (universal bank) does commercial banking and investment banking business as well as provide other financial services such as insurance (bancassurance). For a more detailed explanation of this concept, see Macey, Jonathan R., "The Inevitability of Universal Banking" (1993). Yale Law School Faculty Scholarship Series. Paper 1654. http://digitalcommons.law.yale.edu/fss_papers/1654 (last visited on 21/11/2016).
[4] Shadow banks act as financial intermediaries that offer a wide range of securities and structured finance by financing opaque, risky, long-term assets into money-like, short term liabilities while not being subject to the prudential regulation of the traditional banks. See Zoltan Pozsar et al., Fed Reserve Bank of New York., Staff Report No. 458, *Abstract* to SHADOW BANKING (2010).
[5] The "too big to fail" doctrine is premised on the theory that some corporations, particularly financial institutions such as banks are so large and interconnected that their failure would trigger greater systemic failure, and therefore, such entities must receive government support and protective policies when they face potential failure. See Stern, Gary H.; Feldman, Ron J. (2004). Too big to fail: the hazards of bank bailouts. Brookings Institution Press. ISBN 0-8157-8152-0.

sector regulatory reforms post GFC, and London has always taken a leading role as a major banking and financial center in the world. On the other hand, Uganda, where I hail from, has a banking sector that is still relatively small, but developing both in size and complexity. As a former British colony, Uganda borrows a lot from the UK in terms of banking law legislation, and the Ugandan Central Bank is modelled on the Bank of England structure. Therefore, both South Africa and the UK are important case studies for Uganda to learn from. Lastly, the South African Reserve Bank is the only African Central Bank that has a seat on the Group of 20 (G20) Finance Ministers and Central Bank Governors meeting. Consequently, the policies and regulatory changes made by SARB have ramifications not only for South Africa alone, but also impact other African countries, Uganda inclusive.

1.2 PROBLEM STATEMENT

In the most recent 2008 GFC, bank regulators were caught off-guard and forced to respond to the effects of the crisis in a panicky and reactionary manner, in some cases without recourse to the legal and institutional frameworks designed to deal with bank distress through large-scale government support (bail out) of banking institutions deemed too big or too important to fail. This was not only costly to the tax payer, but also potentially increases moral hazard, whereby banks that benefit from such protective and rescue plans will seek to profit by deliberately taking high-risk asset allocation strategies to leverage the incentives they receive in bail outs. To protect such negative exposures to the banking industry, various regulatory reform initiatives have been undertaken at both national and international levels, including the expanding of distressed bank rescue powers and tools within defined legal frameworks.

Prior to the GFC, the regulatory situation in the non-financial sector was in sharp contrast to the regulatory paradigm in the financial services industry in the sense that the non-financial services industry already had detailed and elaborate business rescue procedures that governed the rescue and re-organization of financially distressed entities with a view of restoring them as going concern businesses. Such procedures can be found in the South African Companies Act of 2008,[6] the UK Insolvency Act of 1986[7], and the Uganda Insolvency Act of 2011[8]. In the case of banks,

[6] South Africa has detailed provisions on business rescue in terms of chapter 6 of the Companies Act No. 71 of 2008.
[7] Administration and company voluntary arrangements are procedures used to effect business rescue.
[8] The Ugandan insolvency regime also recognizes administration and company voluntary schemes of arrangement.

it is still generally up to the regulators (Central Banks) to decide how to deal with a distressed bank, and generally it appears that the regulators have a wide discretion and too little guidance on how to rescue or restructure a distressed bank to commercial viability as a going concern. When faced with a scenario of bank distress, regulators are often forced to improvise or haphazardly regurgitate solutions that were hastily applied in some past incident of bank distress – usually arranging mergers, acquisitions or a takeover by another bank, or liquidation of the distressed bank.

The GFC as a watershed event saw the demise of many financial institutions, including banks.[9] It has led to a rethink of the regulatory approach most suited to maintain and support financial stability. It has emphasized the causes of the crisis and the lessons to be learnt from it. In particular, it has emphasized the need to support and maintain financial stability as the broader rationale for bank rescue. As part of this focus, the Central Banks' power and ability to rescue distressed banks have also come under the spotlight. It is submitted that the quick haste to commence bank resolution procedures (i.e winding-up) at the expense of bank rescue ignores some of the benefits that can accrue from a rescue-focused regulatory intervention. For example, a proper recue mechanism usually has a moratorium structure under which a distressed bank will be given some breathing space in respect of creditors' and depositors' claims in order to work out a rescue plan without pressure from the creditors and depositors. Much as this can be contentious because the creditors and depositors are being locked out of their money temporarily, there is a need to weigh and assess the costs and benefits that can accrue from minimizing bank runs and bank collapses on the financial system as a whole.

Furthermore, there is also a chance that if the bank rescue is a success, the creditors and depositors will get a better dividend than in a liquidation scenario. Bank rescue also preserves jobs and skills through retention of some of the distressed bank staff to work out a business turn around with the appointed curators and rescue practitioners. The tax base is also preserved when businesses are rescued instead of being liquidated. However, to balance this rescue mechanism with the depositor protection mandate,[10] there is need for a careful analysis as to whether any

[9] See discussion of the GFC in Chapter Two of this research.
[10] There are a number of reasons why Central Banks protect depositors. Firstly, deposits are a primary form of saving for many individuals, loss of which can have disastrous financial and economic effects for individuals and

delay will not worsen the situation and inflict more losses on the depositors and the financial system as a whole. Therefore, there is need for a proper case-by-case basis approach in determining whether a given distressed bank deserves rescue in the first instance. Also, once it is determined that bank rescue is the preferred option in a given instance, it is imperative that the rescue process is tailor-made to address the *sui generis* challenges posed by the fact that the entity sought to be rescued is a bank.

Most of the research in this field has concentrated more on bank failure and its associated causes. There is scant literature on the aspect of distressed bank rescue procedures. In the South African scenario, research by Sipho Makubhela (2006) examined the causes of bank failure in post-apartheid South Africa. The more recent study by Joseph Rydell Tettey (2014) focused on an analysis of the aspects of managing bank resolution in South Africa. Both of these texts approached the respective topics from a purely banking and finance perspective. It is also noteworthy that the rescue process of African Bank opened the eyes of the SARB to the need for the 2015 amendment to the Banks Act to create flexible powers for the curator to transfer assets and liabilities of distressed banks in the process of rescue. There is very little research done on this aspect because it is a recent development. The implications of this amendment, and its effect on bank regulation will be explored in detail during the course of the discussion in the South African chapter. The study is even more imperative because section 51(1) (b) of the Banks Act expressly states that the provisions of sections 128 to 154 of the Companies Act, 2008 relating to business rescue shall not apply to a bank. Therefore, there is need to examine the legal principles relating to distressed bank rescue contained in the various pieces of legislation.

In the UK context, it is noteworthy that bank administration and bail-in are new concepts under the banking law dispensation, and this explains the lack of in-depth studies on their applicability. In the Ugandan case study, Martin Brownbridge (2002) discussed policy lessons in terms of resolving bank failures in Uganda. The aim of this research is to approach bank rescue from the prism of legal lenses by analyzing and contextualizing the efficacy of the existing statutory provisions and suggesting practical recommendations aimed at improving Uganda's banking regulation regime from a liquidation culture to a rescue culture. It is also worth noting that there

households. Secondly, depositors are in a weaker position because most lack adequate information and capacity to protect themselves against the risks and losses associated with bank failure.

has never been a successful bank rescue in Uganda's banking sector. Therefore, there is need for increased advocacy and regulatory culture and attitudinal change by highlighting the benefits that can accrue to Uganda's banking sector in the case of a policy and regulatory shift from the normalized management take-over of the distressed banks by the Central Bank, and executing transfer of assets and assumption of liabilities agreements with healthier banks. A culture of bank closures can stifle market competition, lessen public confidence in the banking system and dent the image of the regulator in instances where there is perception or reality of failure in regulation and supervision as the cause of bank distress and eventual failure.

Because of the specific nature of the banking industry and its importance to the public and the economy as a fulcrum of business, commerce and allocation of financial resources, the existing business rescue procedures under Insolvency law would be inadequate for bank rescue given that banks are special types of businesses with a myriad of public interest considerations.[11] Therefore, there is need for specific attention to an elaborate system of distressed bank rescue frameworks that are both pro-active and forward-looking so as to avoid panicky and knee-jerk reactionary interventions in case of bank distress as was witnessed during the Global Financial Crisis. In terms of relevance and scholarly intervention, this research intends to advocate for a more rescue-based intervention approach by the Uganda Central Bank (Bank of Uganda-BoU) in respect of distressed banks. I will further advocate that even the non-systemically important banks should be considered for curatorship because just like in South Africa, the smaller banks in Uganda are more exposed to the marginal lending rate, than their big counterparts which may keep funds acquired at the repo rate for their own financing needs in times of limited liquidity, thus exposing the smaller banks to credit and liquidity squeeze. Based on the above justifications, whereas most of the research and policy formulation in this area has focused on

[11] Because of banks' high liquidity risk (the risk that banks may not meet their short-term financial obligations), they require a different approach to their rescue than other types of businesses. Non-bank corporate entities normally approach insolvency procedures over an extended period and the deterioration of their financials become apparent over time. However, even relatively well-managed and profitable banks can experience liquidity problems, sometimes as a result of external negative factors prevailing within the economy. When the public or financial markets lose confidence in a bank or the banking sector, deposits are withdrawn and sources of short-term funding dries up as a result of such mass withdrawals. Even a solvent bank can fail if it cannot access funding with which to service its expenses, repay deposits and other liabilities as they become due and payable, or finance its longer-term loans and other assets. Rescuing a bank in these circumstances requires immediate intervention, which is not provided for in the normal insolvency processes hence the need for a *sui generis* approach in respect of distressed bank rescue. See, *Strengthening South Africa's Resolution Framework for Financial Institutions'* pg. 1.

bank resolution, I believe there is room for further scholarly intervention in the area of bank rescue because of the vital role played by banks in the economy.

1.3 RESEARCH AIMS AND OBJECTIVES

The aims and objectives of the research are as follows:

1.3.1 To give an overview of the role of the South African Reserve Bank as Central Bank.

1.3.2 To compare the role of the South African Reserve Bank with that of Bank of Uganda, which is Uganda's Central Bank.

1.3.3 To analyze how the role of the South African Reserve Bank is set out in the Reserve Bank Act and examine the Reserve Bank's new financial stability mandate in terms of the Twin Peaks model.

1.3.4 To appraise the distressed bank rescue powers of the SA Reserve Bank, for example the power to place a bank under curatorship and to determine how these powers will be expanded upon or changed by the proposed legislation under the envisaged Twin Peaks model under the Financial Services Regulation Bill and the Banks (Amendment) Act.

1.3.5 To provide some background on developments in bank regulation in the UK, the evolved role of its Central Bank, and examine its distressed bank rescue powers framework with a view of making comparative findings that can inform the design and essential features of a progressive blueprint of a sound bank rescue regime.

1.3.6 To make some recommendations for possible reforms that can be undertaken to strengthen the distressed bank rescue mechanisms of Bank of Uganda.

1.4 METHODOLOGY

I will largely employ the doctrinal method, which will involve a literature review and analysis of the relevant legislation, case law, publications by the relevant organs like the South African Reserve Bank, National Treasury of South Africa, the Ministry of Finance of South Africa, Bank of Uganda, the World Bank, International Monetary Fund and other jurisdictions that have adopted the Twin Peaks model of Financial sector regulation with emphasis on the United Kingdom. I will also appraise commentaries from reputable financial sector players like Klynveld, Peat, Marwick, Goerdeler (KPMG), PricewaterhouseCoopers (PwC), Deloitte, Ernst & Young, journals and academic treatises from scholars and authors.

In order to fully appreciate the changing role of the SARB under the Twin Peaks model, historical research will also play an important role in the study. Materials such as Budget speeches, Ministerial instruments, cabinet white papers, draft legislation, explanatory memoranda, commission reports, submissions by the public, press releases, news articles, previous legislation and older case law will be referred to in order to outline the deeper nuances of contextual and historical perspective of the subject matter at hand, and the changes proposed in the current legislation. Comparative jurisdictional analysis will be undertaken to investigate relevant aspects that can inform domestic and international best regulatory practices in distressed bank rescue procedures as far as relevant and applicable to our context.

1.5 DELIMITATION

For purposes of delimitation, the research will only concentrate on the banking sector, since the financial sector is very wide. The discussion will also be tailored on aspects of bank rescue with a view of saving distressed banks and transforming them into going concern entities again. It is also imperative to observe that the research will largely focus on bank recovery plans as opposed to bank resolution plans (living wills) because the latter deal with bank liquidation. Therefore, aspects of bank resolution, depositor protection schemes, receivership, resolution funds, winding up, revocation of banking licenses and dissolution are outside the scope of this study, although some brief mention of them may be made for explanatory purposes in the course of the discussion.

As an *ex ante* approach to buffer banks against financial distress, certain measures such as capital reserves, liquid assets and conservation buffers have either been put in place or augmented. Under this approach, if a given bank fails to comply with the required capital reserve and liquid-assets requirements, legislation provides Central Banks with powers to issue recapitalization directives. However, in some instances, banks encounter more severe problems that cannot be sorted out by emergency liquidity assistance.[12] This research will examine the tools available to the selected Central Banks empowering them to make swift assessment of the nature of the distress and undertake rescue or recovery interventions if there is a significant/material likelihood of restoring the affected bank back to economic viability, and if such an intervention would yield positive economic benefits like saving jobs, preserving skills within the institution and banking industry, enhancing public confidence and trust in the banking system, and preserving the tax base.

1.6 OVERVIEW OF CHAPTERS

Chapter One deals mainly with the motivation, relevance and general overview of the research. Whereas it is critical that there is need to liberate resources from ineffectual enterprises, it is acknowledged that some entities such as banks play very crucial roles in the economy, and their failure can destabilize the entire financial system, hence the need for rules and regulations to rescue such entities when they face financial distress. This is one of the major contentious public interest considerations of modern Central Banks, with one school of thought arguing that such entities should be left to fail so that their place in the market can be taken up by more efficient firms.[13] Another school of thought contends that for purposes of financial stability, and other associated benefits such as preserving employment, skills and public revenue sources, there should be a properly designed rescue framework to resuscitate such entities when they face temporary liquidity challenges.[14]

Chapter Two will address the historical background of the problems and challenges encountered in bank regulation, and highlight the regulatory reforms arising from the Global Financial Crisis (GFC). The GFC is one of the major watershed events in the discourse of bank rescue and most of the banking regulatory reforms in the area of rescue are informed by the lessons learnt from

[12] Provision of emergency liquidity assistance by Central Banks occurs where a particular bank or banks are facing liquidity problems. Central Banks can step in and provide liquidity to a particular bank or banks. For instance, the BoE supported HBOS and RBS with emergency liquidity in October 2008 to mitigate the negative effects of the 2008 GFC. In extreme cases, emergency liquidity can also be provided to the market/system.
[13] Walter, J. (2004). Closing Troubled Banks: How the Process Works. Federal Reserve Bank of Richmond Economic Quarterly Vol 90/1, pg. 50.
[14] Ratnovski, L. (2009). Bank liquidity regulation and the lender of last resort. Journal of Financial Intermediation Vol 18, pp. 541- 558. The terms on which emergency liquidity assistance (ELA) is extended is primarily guided by two factors. Firstly, the need to minimize moral hazard by means of the fee charged on the affected institution receiving the assistance. The second motivation is the need to control the risks to the Central Banks' balance sheets by the terms set for receipt and valuation of acceptable collateral.

the crisis. Key concepts like systemic risk, changes introduced by Basel III, and an analysis of the Twin Peaks model of financial sector regulation adopted by South Africa, and its implications on the bank rescue/curatorship procedure will be highlighted in the wider context of how they impact the latest discourse on bank rescue.

Chapter Three analyzes the South African legal framework on curatorship as the main bank rescue vehicle, which the SARB has used overtime to rescue failing banks. The powers, duties and legal implications of appointment of a curator in terms of section 69 of the Banks Act will be dealt with. Furthermore, the research will examine the commission of inquiry into a bank under curatorship and the role and impact thereof as evidenced in prosecution of the Director of Regal Bank, Jeffery Levenstein for fraud on the basis of an investigation report when Regal Bank was placed under curatorship by the SARB. An analysis of how the curatorship powers were used in the Saambou and most recently, African Bank case studies will also be conducted. Particularly, the research will reflect on the 2015 amendments to the Banks Act arising from the African Bank curatorship, and examine how the curatorship procedure will be impacted by the move to the Twin Peaks model of financial regulation under the Financial Sector Regulation Bill (FSRB). The choice of SAAMBOU and African Bank as case studies is motivated by the fact that the curatorship of SAAMBOU happened in 2002 before the GFC. On the other hand, the curatorship of African Bank is a watershed event that happened post-GFC in August 2014. SAAMBOU Bank represents curatorship before being influenced by the changes in global bank rescue paradigm, while African Bank represents the changing attitude in bank rescue resulting from the winds of change arising from lessons learnt by bank regulatory authorities from the 2008 GFC.

Chapter Four will examine the UK legal framework pertaining to distressed bank rescue and how it has evolved overtime. The regulatory reform effect arising out of the lessons learnt from the 2008 GFC will be examined in the wider context of the shift from bail-out to bail-in provisions enshrined in the recent legislation. In terms of bank rescue, administration will be the major point of focus and how the banking law interacts with the Insolvency Act of 1986 to aid the process of distressed bank rescue. Due to the historical role of London as one of the major banking and financial centers in the world, the prominent role played by the Bank of England will also be examined in light of the new regulatory architectural framework introduced by the shift to the Twin Peaks model of financial sector regulation.

Chapter Five will deal with the Ugandan scenario and advocate for the use of bank rescue as a public interest tool for fostering financial stability in respect of banks facing temporary liquidity problems. The Chapter will begin with a brief discussion of the role of the Ugandan Central Bank (Bank of Uganda), and its historical evolution, both in terms of its work and its governing legal framework. The power of statutory management and duties of a statutory manager will be examined during the discussion. Some examples of bank failure where statutory management has been invoked by the Central Bank will also be analyzed. Within this context, it will be highlighted that Bank of Uganda has used the powers of statutory management for bank resolution as opposed to rescue. A more rescue-oriented approach will be suggested.

Chapter Six will summarize the discussion points of the research by suggesting recommendations for Bank of Uganda based on best practice and experience from South Africa and the UK. A more rescue-focused intervention will be recommended because of the need to maintain financial stability, encourage competition in the market, and enhance the development of local banks in the Ugandan banking industry.

By and large, there are concerted global efforts to streamline and improve the efficiency of financial sector regulators and the resilience of the global financial system in order to right the wrongs and implement the bitter lessons that were learnt from the global financial crisis. This global movement is being driven by a number of factors and processes which need adequate support both in terms of economic resources and human expertise in order to deal with the massive challenges associated with rectification of inadequate systems and frameworks that were susceptible to manipulation, poor corporate governance and bad market practices that plunged the global economy into an economic disaster of unmitigated proportions. Due to the fast-changing landscape of the global economy and the failure of the multi-lateral institutions like the International Monetary Fund and the World Bank to provide strategic leadership and inspire collective action and response to the global financial crisis, there is need to re-think the existing global financial system model and adopt reforms beyond the peripheral mandate of the existing economic and financial regulatory frameworks. There is need for more global political will to craft and implement more sustainable and inclusive economic models that look at the collective interests of the human race as a whole instead of serving interests of a few developed economies. The global financial crisis is a call and a reminder for policy makers to go back to the drawing board and think broadly about the long term global economic agenda, the global financial regulatory architecture framework and the future of the citizens.

CHAPTER TWO

GENERAL CONTEXT AND EMERGING TRENDS IN BANK REGULATION

2.1 Introduction and historical background

The vital role of banks in the financial system is aptly reiterated in South Africa's Resolution Policy document, '*Strengthening South Africa's Resolution Framework for Financial Institutions'* wherein it is stated that banks play an essential intermediation function within the economy by allocating financial resources from savings to investments and consumption, provide vehicles for wealth accumulation, perform maturity transformation functions that enable and facilitate financing for long-term projects, provide liquidity, and facilitate a payment, clearing and settlement function in the economy, including cross-border payments.[15] To facilitate these functions, banks have become more complex, interconnected and integrated into the real economy. Consequently, a failure in a single bank could cause deadlock in critical financial markets and services, which could spread to other financial systems and negatively affect the financial system as a whole.

The mechanisms of handling a distressed bank differ in many respects from those under ordinary company and insolvency laws. The rationale for this different approach in respect of distressed bank interventions arises from very critical considerations pertaining to the nature and function of banks within an economy.[16] The nature of public interest involved in ensuring stability of the financial and banking system has caused the realization that banks need and deserve special protection during times of financial distress. Therefore, the major underpinning of Central Banks to have a rescue mandate as a part of their temporary liquidity assistance program is appropriate to help these regulator authorities "mop up" the dirt when a bank's financial trouble becomes significant enough to warrant structured intervention.

[15] Pg. 1 of the policy document.

[16] The intermediation function, where banks act as financial intermediaries is necessary to maintain cash flow within the economy, and banks also help maintain public confidence in the economy. Therefore, liquidity or solvency problems of a bank can threaten public confidence not only in that particular bank, but also in the financial system as a whole.

The 2008 GFC demonstrated to the global economy that many countries did not have adequate and responsive distressed bank rescue frameworks not only to detect, but also to mitigate the calamitous consequences of bank failures.[17] Many countries are now enhancing their financial regulatory systems and equipping Central Banks with emergency powers to enable them to have a wide range of crisis detection, mitigation and distressed bank rescue powers in order to safeguard internal systems from the risk or effects of excessive systemic events that may trigger bank failures.[18]

Supervisory and regulatory response prompted by the crisis at both national and international level has introduced new dynamics in global banking and finance. Some of these responses can be discerned from the G20 Seoul Summit Declaration, 2010 which recognizes the need and commitment to take action at the national and international level to raise prudential standards, and ensure that national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism and regulatory arbitrage. In particular, the summit resolved to implement fully the new bank capital and liquidity buffers introduced by Basel III in order to address regulatory challenges created by "too-big-to-fail" (TBTF) and "too-important-to-fail" banks.[19]

There appears to be general consensus on the major contributing causes of the global financial crisis, although analysis as to how and why the causes arose and the relative importance to be attributed to them as contributors is varied.[20] A summary of the contributing factors include high leverage which was only sustainable under conditions of increasing asset prices and investor

[17] See Johan de Jager 'The South African Reserve Bank: Blowing Winds of Change part 2' (2013) 25 *SA Mercantile Law Journal* 492 at 493-495. According to the author, the financial crisis was a sharp reminder of how much a well-functioning economic system is dependent on a stable financial infrastructure framework. Although in the years before the crisis struck central banks seemed to have excelled at monetary policy implementation through inflation targeting tools, the global financial crisis indicated that achievement of price stability alone does not necessarily guarantee financial stability. The central concern is that by concentrating on a narrow price stability objective, central banks failed to develop other macro-prudential tools that can be implemented together with monetary policy to address the buildup of systemic risks and exposures in the banking system.

[18] Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets*, 38 TEX. INT'L L.J. 317, 327-29 (2003).

[19] See the G20 Seoul Summit Declaration, 2010 accessed via http://www.g20.org/Documents2010/11/seoulsummitdeclaration.pdf (last accessed 9/12/2015).

[20] The Basel Committee (2010a) para 4 lists excessive leverage, inadequate level and quality of capital, inadequate liquidity buffers, and interconnectedness of the banking sector as major contributing factors leading to the severity of the global financial crisis. The proposed regulatory solutions emanate from these problems. Also see Brunnermeier, Markus K, et al. The fundamental principles of financial regulation. Geneva London: International Center for Monetary and Banking Studies Centre for Economic Policy Research, 2009.

confidence in the financial system;[21] inadequate corporate governance, accountability and remuneration frameworks and policies within financial institutions; uncontrolled liquidity creation due to global imbalances that triggered willingness of surplus countries to invest in financial assets created in deficit countries; rapid growth of the largely unregulated shadow banking sector and the development of complex financial instruments and techniques like mortgage securitization that increased risk spread and interconnectedness of the financial sector; and lack of public information and high information asymmetry level on the distribution and allocation of risk in the financial system.[22]

Some analysts have argued that the above factors are a reflection of systemic failures in the governance and accountability of financial regulation.[23] The regulatory failure school of thought has implications for the present structuring and reform of financial sector regulatory bodies. For instance, pronouncements like the Seoul Declaration are to the effect that regulatory standards need to be tightened further. It is submitted that inclusion of contingency plans to address bank rescue of the too big or too important to fail in times of financial distress is one such global movement intended to strengthen the banking system and enhance fluidity and stability in the financial system.

The GFC puts into full perspective the crucial role of Central Banks in times of bank distress. Specifically, the dual responsibility of central banks to implement monetary policy as well as exercise the mandate to enhance financial stability has become much more paramount and challenging. Global reforms have been augmented and complemented by other domestic

[21] Leverage (gearing) enables banks to increase gains and losses on a position or investment beyond what would be possible through direct employment of its own capital. It is a form of speculation on assets by buying an asset with borrowed funds at a prevailing market price with the anticipation that the income or appreciation value on the asset will be more than the borrowing cost. During the crisis, banks encountered economic leverage when they were exposed to a change in price position by more than the borrowing costs incurred on the toxic assets. (See Katia D'Hulster, The Leverage Ratio: A New Binding Limit on Banks, Crisis Response Public Policy for the Private Sector, World Bank (December 2009) pg. 1 accessed via http://www.worldbank.org/financialcrisis/pdf/levrage-ratio-web.pdf (last visited on 9/2/2016).

[22] The majority report of the US Financial Crisis Inquiry Commission FCIC (2011) states failures of regulation; leverage of risky borrowings and lack of transparency; inadequate government crisis response; failure of accountability and ethics; lowered lending standards; lack of regulation of Over the Counter derivatives and ratings agency failures. The minority report lists ten overlapping causes with emphasis placed on global capital imbalances and an international credit bubble.

[23] For example, Ross Levine in 'The Governance of Financial Regulation: Reform Lessons from the recent Crisis' BIS (2010) highlights four instances where regulators were aware of the emerging problems and had power to act on them, but did not do so. These instances are: encouragement and heavy reliance on activities and ratings of Credit Rating Agencies; risks posed by Credit Default Swap growth; lack of transparency in OTC derivative markets and inadequate supervision and regulation of investment banks.

reforms. For example, each G20 member country is undertaking national efforts toward implementing strengthened global regulatory standards. Some countries are also undertaking institutional arrangement reforms and restructurings.[24]

2.2 The Global Financial Crisis and the rough tides for the banking industry

The crash of the real estate sub-prime mortgage bubble, the resulting 2008 GFC, and the associated capital and asset market failures unleashed disastrous consequences to the world economy unprecedented since the Great Depression of the 1930s[25]. The GFC has traced origins from the burst of the United States of America's housing market as a result of the real estate bubble.[26] House prices in America reached a peak in 2006 and then dipped by more than 30% triggering a spiral effect of the greatest declines since the 1930s economic recession[27]. During the last phase of the boom, sub-prime mortgage lending to low income borrowers had reached excessive heights and the default rate increased.[28] The market experienced major shocks as properties lost value and the interbank rates at which banks used to lend each other sky-rocketed.[29] This led to liquidity shortages in the market prompting government interventions. In

[24] Detailed progress reports of all the G20 member countries including South Africa can be accessed via http://www.financialstabilityboard.org/publications/r 120619nr.html (last accessed 11/12/2015).

[25] Martin Hellwig, *Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis*, Max Planck Institute for Research on Collective Goods (November 2008). Because of the financial crisis, many financial institutions had to recapitalize, many collapsed and others were taken over. As of April 2008, the International Monetary Fund predicted aggregate losses of US$ 945 billion overall in the US alone, with US$ 565 billion attributed to real-estate lending and US$ 495 billion from the impact of the crisis on other securities. By October 2008, the loss prediction had spiraled to US$ 1.4 trillion (International Monetary Fund, 2008).

[26] The crisis began as fairly contained distortions in the US sub-prime marked and evolved into a wide spread contagious effect in financial markets causing broad negative escalations to the broader global macro-economic system. As of April 2008, the International Monetary Fund (IMF) estimated that declining US house prices and rising defaults on mortgage payments and non-performing loans could lead to aggregate losses related to the residential mortgage market and related securities of about USD565 billion, including the expected deterioration of prime loans. Adding other categories of loans originated and securities issued in the US related to commercial real estate, consumer credit market and corporations, total losses were estimated at almost USD1 trillion: T T Mboweni: Central banks in times of turmoil note 8 at pg. 3.

[27] International Organizations of Supreme Audit Institutions (INTOSAI), The Causes of the Global Financial Crisis and Their Implications for Supreme Audit Institutions', Pg.8. http://www.intosai.org/uploads/gaohq4709242v1finalsubgroup1paper.pdf (last accessed 6/8/2015)

[28] See Ben Cohen and Eli Remolona *The Unfolding Turmoil of 2007–2008: Lessons and Responses* (2008) at pg 9. A publication of the Australian Reserve Bank out of the Proceedings of a Conference held at the H.C. Coombs Centre for Financial Studies, Kirribilli on 14–15 July 2008, available at http://www.rba.gov.au/publications/confs/2008/pdf/conf-vol-2008.pdf (last visited on 19th Sept 2015).

[29] For a general overview of the causes that triggered the global financial crisis, look at the Bank of International Settlements (BIS) (2008), 78th Annual Report, BIS, Basel and Borio C (2008), 'The Financial Turmoil of 2007–?: A Preliminary Assessment and Some Policy Considerations', BIS Working Papers No 251.

2008, Northern Rock was nationalized by the United Kingdom authorities.[30] By the end of March 2008, the market capitalization of banks globally had shrunk by US$720 billion.[31]

As the liquidity problems worsened and more bad banking practices got exposed, the list of failed or almost failing financial institutions got longer.[32] The line-up even featured those non-bank financial institutions conventionally thought as "too big to fail": Lehman brothers, American Insurance Group (AIG), Washington Mutual, Freddie Mac, Fannie Mae, *et cetera*.[33] The world was plunged into a depression, jobs were lost and global trade and investment slumped.[34]

From the Americas and Europe to the emerging markets in Asia and Africa, no one was spared of the wrath of this economic catastrophe. From the perspective of the African continent, there was a decline in Foreign Direct Investment (FDI) which is a major accelerator in areas like the mining sector in South Africa.[35] There was also an increase in foreign exchange volatility.[36]

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[30] By July, major credit rating agencies had either downgraded or placed on review a large number of collateralized debt obligations (CDOs) that relied on mortgages as collateral. In August, the troubles spread to asset-backed commercial paper (ABCP) issued by entities that had invested in CDOs of mortgage-backed securities, and interbank markets around the world began to experience shortages of liquidity. On 9 August, the markets were jolted by the news that BNP Paribas, France's largest bank, halted withdrawals from three of its investment funds because it could not 'fairly' value their holdings. All these events culminated in September with a run on Northern Rock, a UK mortgage lender, when its liquidity problems became known. During this phase, the LIBOR-OIS spread rose to close to 100 basis points in the US interbank market and even higher in the UK market. (See Ben Cohen and Eli Remolona *The Unfolding Turmoil of 2007–2008: Lessons and Responses*, pg 9)

[31] TT Mboweni 'Central Banks in Times of Turmoil', address given in his official capacity as the Governor of the South African Reserve Bank, at the Gordon Institute of Business Science on 28 May 2008, available at https://www.resbank.co.za/Publications/Speeches/Detail-Item-View/Pages/Default.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=a01d874c-c3f6-4b93-a9dc-c984cf8652cf&sarbitem=102 (accessed on 20th Sept 2015).

[32] Although US sub-prime mortgage default rates, and the spreads on associated securities, had been rising since late 2006, the first significant event in the broader financial market turmoil seems to have been the emergence of rumors and market speculation the third week of June 2007 about heavy losses in two hedge funds managed by Bear Stearns. (See Chapter VI of BIS 2008).

[33] Marc Labonte *Systemically Important or "Too Big to Fail" Financial Institutions* (2015) Congressional Research Service at 1.

[34] David McNally *From Financial Crisis to World-Slump: Accumulation, Financialisation, and the Global Slowdown* York University, Toronto at 37. In the US alone, it was estimated that 250,000 jobs were lost in the financial services industry.

[35] South Africa was not immune to the global crisis, the domestic economy contracted for three consecutive quarters. The monetary policy tightening cycle which commenced in June 2006 came to an end in June 2008. The contraction in economic activity and the change in the monetary policy stance impacted the domestic bond market in two ways. Firstly, while monetary policy easing exerted some downward pressure on bond yields, this was counteracted by increased supply of government bonds. Given the rapidly slowing economy, revenue intake was substantially lower than projected, causing an increase in the budget deficit. Increased risk aversion also resulted in nonresidents reducing their exposure to the domestic bond market. The Medium Term Budget Policy Statement indicated that for 2009/10, revenue collections were projected to be R82 billion lower than projected in the February Budget resulting

However, at the time, it was argued that African economies were resilient to the crisis because most of them are not yet fully integrated into the global financial system.[37] It is submitted that this is a short-term argument because most of the African economies such as Rwanda, Ethiopia, Tanzania, Mozambique and Uganda are expanding and getting integrated into the global market arena. Therefore, proper financial regulation, banking crisis mitigation and management frameworks are increasingly becoming a necessity on the African continent. It is submitted that availability of proper distressed bank rescue policy and legislative frameworks is a major intervention towards achieving a more coherent and responsive mechanism to save distressed banks in times of economic and financial hardship.

Governments and Central Banks are clothed with the mandate to ensure financial sector stability, minimization and mitigation of systemic risk through timely supervision, effective regulation and efficient corrective action in scenarios of distressed banks. Therefore, the starting point of any interventions to alleviate such banking sector threats needs to be multi-faceted, dynamic and responsive to the market needs, both inward-looking and outward-looking since the banking industry continues to develop in size, complexity and sophistication. The rescue framework must keep in pace with the evolution of the banking sector in all spheres.[38]

2.3 The evolution of the concept of systemic risk

There is no universally accepted definition of the term "systemic risk", but a working definition can be gathered from the Group of Ten (G10) Report on Financial Sector Consolidation[39] as a risk that an event will trigger a loss of confidence in a substantial portion or segment of the

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in the budget deficit for 2009/10 increasing from 3.4 per cent of GDP to 7.6 per cent. See 'South Africa Amidst the Crisis' Address by AD Mminele, Deputy Governor of the South African Reserve Bank, at the "Spire Awards" Ceremony, held at the Johannesburg Stock Exchange, 3 November 2009. This can be accessed via https://www.resbank.co.za/Lists/Speeches/Attachments/97/South+Africa+Amidst+the+Crisis.pdf (last accessed on 19th Sept 2015).

[36] Africa Development Bank; Impact of the Global Financial and Economic Crisis on Africa, March 2009. http://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/BAD%2096%20Anglais%20%20INTERNET%20PDF.pdf (last accessed 6/8/2015).

[37] See presentation by Bank of Uganda Governor Emmanuel Tumusiime Mutebile on 'The Global Financial Crisis and access to Finance' presented at the African Development Bank Ministerial Round Table Discussions, Dakar, Senegal on May 12, 2009 at pg. 3)

[38] National Treasury of the Republic of South Africa *A Safer Financial Institution to Serve South Africa Better* (2011) 9.

[39] This Report was compiled in 2001 by the Group of Ten (G-10) Member States. These comprise of eleven industrialized States (the Netherlands, France, Germany, Italy, the United States, Japan, Belgium, Sweden, Canada, Switzerland and the United Kingdom) which use this membership to consult, co-operate and influence economic, monetary and financial policy. See chapter III of the Report: *Effects of consolidation on financial risk*. Pg. 126.

financial system thereby creating adverse consequences for the real economy. This doctrine envisages a shock or series of negative shocks that build up in the financial system causing negative economic consequences in the system as a whole.[40]

A firm or combination of firms, government or individual market participants can cause this negative trend if failures arising from their financial systems cause failures to other market players (domino effect) or news about their failure triggers signals that other entities in the same market or trading in similar assets or products will also be assaulted by economic distress (contagion effect).[41] This approach considers potential sources of disruptions in the financial system as a whole as opposed to the failure of a single individual entity.[42]

Such risk can be spontaneous in nature within a short time, or can accumulate over time and have snowball effects across the entire domestic economy, or even the global economy. It can include bank runs, financial market collapses and infrastructure collapses.[43] Bank runs occur when depositors lose interest in the banks and demand repayments at once, causing banks to liquidate investment assets to satisfy their exiting customers' claims.[44] Financial market collapses are triggered by bubble bursts in some classes of asset markets, for example real estate. This causes firms to sell such assets to cover margins and reduce financial exposure in a volatile market hence causing loss of value and deterioration of the system as a whole. Shocks may propagate from one bank to another through interconnectedness.[45] Infrastructure collapse results from

[40] Constantin Zopounidis, Emilios Galariotis *Quantitative Financial Risk Management: Theory and Practice* Wiley Publishers at pg. 4.

[41] Edward V. Murphy; *What Is Systemic Risk? Does It Apply to Recent JP Morgan Losses?* Congressional Research Services, Pg. 1. Contagion effect is also known as domino effect.

[42] Marc Labonte *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Systemic Risk and the Federal Reserve* CRS Report R41384

[43] For a detailed analysis of systemic spillover, see 'The Fundamental Principles of Financial Regulation' Geneva Reports on the World Economy 11 (2009), International Center for Monetary and Banking Studies (ICMB) at pg. 31.

[44] George Kauffman 'Bank Runs: Causes, Benefits, and Costs' *Cato Institute Journal,* Vol. 7, No. 3 (Winter 1988) at 559.

[45] Interconnectedness may be direct or indirect. Direct interdependencies arise from interbank on-balance and off-balance sheet exposures. The direct contractual interconnections may be due to payment and settlement relationships, for example credit lines that facilitate the transfer of money or from one bank to another through the large-value payment systems or interbank lending and credit facilities. See Michiel Bijlsma et al 'Systemic risk in the financial sector: A review and synthesis' CPB Netherlands Bureau for Economic Policy Analysis No 210 at pg. 24.

pervasive compromise of the mechanisms put in place to regulate and control transactions leading to market inefficiency and failure.[46]

In practical scenarios, the disastrous economic consequences associated with systemic risk can encompass a cocktail of all these events.[47] Systemic shocks can also arise from the real economy and hurt the financial system. For instance, a currency crisis can lead to a financial crisis[48]. The concept of systemic risk is very broad in effect. Much as it builds up within the financial sector systems, its effects can be felt across the other spheres of the economy like agriculture, housing and wages.[49] This is because of the interconnectedness and close interlinks that the financial sector bears on other sectors of the economy.[50] It is submitted that banks, mainly those that fit the category of being systemically important, and sometimes, those banks which fulfill a specific niche role such as providing cheap credit access to low income individuals and households are of critical importance to the financial system and are inextricably interlinked to other sectors, thus making them deserving candidates for rescue interventions in times of financial distress.[51]

Consequently, as a result of the above risks, there are regulatory tools that have been deployed to reduce systemic risk. These include: implementation of a leverage ratio to cap credit growth at banks,[52] loan-to-value or debt-to-income limits on particular lending transactions, adjustment of risk-weights on specific classes of assets or loan types to discourage asset bubbles in selected

[46] Hans Falkena et al *Financial Regulation in South Africa* at pg. 15. The publication can be accessed via http://www.finmark.org.za/wp-content/uploads/pubs/Rep_FinancialReginSA_2005.pdf (last accessed 20th Sept 2015).
[47] Darryll Hendricks, The Pew Financial Reform Project Briefing Paper, 2009. http://fic.wharton.upenn.edu/fic/Policy%20page/PTF-Note-1-Defining-Systemic-Risk-TF-Correction.pdf (last accessed 9/8/2015)
[48] Kaminsky et al (1998), *Leading Indicators of Currency Crises*; IMF Staff Papers; Vol 45, pp.1-48.
[49] Sebastian Dullen et al *The Financial and Economic Crisis of 2008-2009 and Developing Countries* United Nations Conference on Trade and Development (UNCTAD) Publication at pg. 44.
[50] "A liquid, highly innovative financial system is necessary for the growth of modern economies. It is not only the lubricant that smooth the friction of exchange from the neighbourhood shop to global money markets, it is also when mixed with entrepreneurship, skills and innovation, the fuel in the engine of economic growth (...) But finance is highly volatile material, liable to explode and destroy the very engine is oils and fuels. It must be managed with care." J. Eatwell & L. Taylor, *Global Finance at Risk, a Case for Global Financial Regulation*, The New Press 2000, pg. 208.
[51] For example, in the South African scenario, African Bank is not a systemically important bank, but it had to be rescued because it played an important specific niche role of providing cheap credit access to low income earners, thus entrenching financial inclusion and cheap financial products to a market segment that other banks would not effectively serve due to high customer default risk and low profitability yield.
[52] Leverage ratio is a financial measurement that looks at the capital mobilized by an entity in the form of debt in order to assess the entity's ability to meet its short, medium and long term financial obligations as and when they become due.

market sectors,[53] and adjustment of collateral or margin requirements to reduce leverage growth in the financial sector.[54] However, it is submitted that such preventative measures are not meant to be impediments to block rescue interventions in the event of distress, but merely act as safeguard measures to ensure that fewer banks encounter distress.

2.4 The changing winds of global financial regulation: Basel III

The Basel Accord is a series of agreements set by the Basel Committee on Bank Supervision (BCBS) to provide guidelines and recommendations on banking regulation in order to minimize risks inherent within the financial sector.[55] The revised framework on supervision and risk management of the banking industry is now contained in a document popularly known as Basel III. Since 1988, banks had been regulated under the Basel I Accord but this Accord was deemed to be deficient because it provided for a one-size-fits-all approach in regard to banking regulation.[56] The Basel Accord was upgraded in content to the Basel II accord, but it was still more focused on bank capital requirements with less emphasis on issues like moral hazard[57], systemic risk and crisis control. It could not stand the test of time when the financial crisis pushed the banking sector.[58]

To cater for the above deficiencies, Basel III takes into account the lessons learnt from the recent global financial crisis and is more robust in terms of the objective of improving the banking sector's ability to absorb shocks occasioned by financial and economic stress thereby insulating

[53] Risk-weighted Assets (RWAs) refer to a bank's assets or off-balance sheet exposures weighted against the risk exposures of the bank so as to determine the amount of minimum capital to be held by a particular bank in order to reduce the risk of distress or actual insolvency.

[54] For a detailed analysis of how economic and financial sector policies interact, see Dale Gray and Samuel Malone, *Macro financial Risk Analysis*, Wiley Finance.

[55] Rachanaa Datey & Kavita Tiwari 'Basel III Norms and Indian Banks- A New Definition of Risk Management' *International Journal of Advanced Research* (2014), Volume 2, Issue 7, at pg. 894.

[56] Jacobus Wilem Mostert, *A critical evaluation of the Basel III changed proposal on the Liquidity coverage ratio*, Limpompo Department of Economic Development, Environment and Tourism.

[57] Moral hazard refers to a situation where a party takes risk with the belief that they will not bear the consequences of their actions. In the scenario of the banking and finance industry, the regulator's aim is to alleviate this moral hazard problem by requiring banks to raise capital. By setting capital requirements, the regulator attempts to increase banks' shareholders' losses in case of default and induce banks to reduce the probability of failure by improving their risk management systems. See Jukka Vauhkonen 'Bank safety under Basel II capital requirements' *Bank of Finland Research Discussion Papers* 29 (2009) at pg. 8, accessed via http://suomenpankki.fi/en/julkaisut/tutkimukset/keskustelualoitteet/Documents/0929netti.pdf (last visited 21st Sept 2015).

[58] Kevin Davis *Regulatory Reform Post the Global Financial Crisis: An Overview,* Australian Centre For Financial Studies pp. 19-20, accessed via http://www.apec.org.au/docs/11_CON_GFC/Regulatory%20Reform%20Post%20GFC-%20Overview%20Paper.pdf (last visited 20th Sept 2015).

spillover effects from the financial sector into the real economy. This includes disclosure obligations on financial institutions in areas of on- and off-balance sheet transactions to enhance more transparency and lessen exposures in the shadow banking system.[59]

Furthermore, the Basel III approach also deals with issues of systemic risk and interconnectedness. It is acknowledged that interconnectedness among systemically important banks can send shocks across the entire financial sector and real economy. The proposed solution is to enhance regulatory frameworks to ensure that systemically important financial institutions have loss absorbing capacity beyond the stipulated minimum. This is through a series of qualitative and quantitative mechanisms to assess the systemic importance of such institutions.

In light of the above newly introduced dimensions, various countries have adopted some of the proposals to fine tune their regulatory models. For instance, the South African *Financial Sector*

[59] *Basel III: A global regulatory framework for more resilient banks and banking systems*, Bank for International Settlements (BIS), December 2010 (revised June 2011). A shadow bank is defined as a non-bank entity that provides lending services similar to a traditional bank but does so outside the traditional regulatory environment in which a commercial bank must operate. The main differentiator between shadow banks and traditional banks is that shadow banks are prohibited from taking deposits as they do not hold a banking license. Shadow banking entities include, but are not limited to, hedge funds, money market funds, structured investment vehicles, exchange-traded funds, private equity funds, securitizations and other asset-backed financing vehicles. Shadow banks can provide credit to clients more cost efficiently than traditional banks as they do not have to comply with the rigorous regulations enforced on those banks. Corporate clients seek to limit costs in financing their operations, the result of which is financing through special vehicles such as asset-backed securitizations. For instance, a company would sell off its debtors to a securitization vehicle which would then repackage those debtors as bonds, which would then be sold to investors. The company obtains financing while the investors will obtain regular payments as the special purpose vehicle receives interest and capital payments from debtors. These special purpose vehicles were a major factor in the 2007-2008 financial crisis. The assets that backed the debt fell in value; to the point where the debts could no longer be serviced based on the underlying assets. In the aftermath of the crisis, governments called for far tighter regulation over these special purpose vehicles specifically used for debt financing purposes. The upside to this form of lending is that it boosts economic growth, as even low income earners have access to credit and continue to spend on goods. The downside is that the consumers that would make use of these lending facilities are normally financially illiterate and not aware of the actual cost implications of the money borrowed. They only realize later that they cannot afford the credit provided, which leads to further credit and finally they land up in a constant debt cycle. It has been noted in the past that the levels of unsecured debt in South Africa are extremely high especially for low income earners. The National Credit Act (NCA) was implemented to, amongst other things, regulate credit provided to consumers and to also provide a way to re-organize debt due to over-indebtedness. Shadow banks are obliged to register with the National Credit Regulator (NCR) who regulates in terms of the NCA. Thus, at least in South Africa, shadow banks providing credit to consumers are regulated in some way. However, some have said that the current NCA is not rigorous in terms of the current affordability calculations applicable when a consumer requests credit finance. A NCA 2 Act has been muted, which will address this issue and further control the amount of lending to consumers. See analysis by KPMG South Africa, 'The place for Shadow Banking in the economy' (2014) accessible via http://www.kpmg.com/za/en/issuesandinsights/articlespublications/financial-services/pages/shadow-banking-in-the-economy.aspx (last accessed 20th Sept 2015). Also see Agasha Mugasha: *Shadow Banking: Achieving the Optimal Policy and Regulatory Interventions*, a paper presented on the 17th Biennial Meeting of the International Academy of Commercial and Consumer Law, 16-19 July 2014, İstanbul Bilgi University.

Regulation Bill as discussed in more detail in chapter 3, captures the spirit of the Basel III proposals on key areas such as designation of systemically important financial institutions as provided for in chapter 5 of the Bill and supervision of financial conglomerates as enunciated in chapter 11 of the Bill. On 1 January 2013, South Africa adopted the Basel III framework. The implementation of the several requirements under this framework were incorporated into the domestic banking regulations commenced on 1 January 2013 with phased implementation to go on until 1 January 2019 in order to give banks adequate time to meet the Basel III requirements while at the same time continuing to support lending operations to the real economy.[60] Additionally, South Africa undertook a Financial Services Board (FSB) peer review in 2013 and also participated in the International Monetary Fund/World Bank Financial Sector Assessment Program (FSAP) in order to assess the stability of the financial system and identify key sources of systemic risk in order to implement policies to enhance resilience to shocks and contagion.[61]

In the United Kingdom, the Basel recommendations have triggered several reforms. For instance, the Capital Requirements Directive IV of the European Union, which the United Kingdom adopted, creates a new framework for implementation of the Basel III agreement on matters of new liquidity and leverage requirements and capital buffer requirements for systemically important financial institutions.[62] An extensive discussion of the reforms being undertaken to strengthen the UK's banking system and its regulatory architectural framework in relation to distressed bank rescue will be addressed comprehensively in Chapter 4 of the research.

In Uganda, the Minister of Finance issued a Statutory Instrument in May 2013 to introduce Basel III capital adequacy measures including a capital conservation buffer of 2.5% of banks' risk

[60] Francois Groepe 'Strengthening Financial Sector Supervision and Current Regulatory Priorities' (2015) 7, a keynote address delivered in his capacity as the Deputy Governor of the South African Reserve Bank on the Tenth BCBS-FSI High-level Meeting on recent developments in the African Region held in Cape Town, South Africa, 29-30 January 2015, available at https://www.resbank.co.za/Publications/Speeches/Detail-Item-View/Pages/default.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=a01d874c-c3f6-4b93-a9dc-c984cf8652cf&sarbitem=427 (last visited on 10th Sept 2015)

[61] Overall, the assessment of South Africa's financial sector, its supervision and regulation posted a positive outlook especially through high level of compliance and strong bank supervision.

[62] See Shearman & Sterling LLP Financial Institution's Advisory & Financial Regulatory Client Publication 'Basel III Framework: US/EU Comparison' published on 17 September 2013 at pg. 3, accessed via http://www.shearman.com/~/media/Files/NewsInsights/Publications/2013/09/Basel-III-Framework-USEU-Comparison/Files/View-full-memo-Basel-III-Framework-USEU-Comparison/FileAttachment/BaselIIIFrameworkUSEUComparisonFIA091713.pdf (last visited on 20th Sept 2015).

assets in order to minimize risk and enhance the banking sector resilience.[63] There are more regulatory reforms being undertaken to improve and enhance the resilience and capital buffers of banks to mitigate bank distress. These new developments will be addressed in Chapter 5 of the study within the specific context of distressed bank rescue/recovery.

2.5 Central Banking in the post global financial crisis era: The search for a new regulatory paradigm, Lender of Last Resort function, and the shift to the Twin Peaks model of financial sector regulation

Central Banks have traditionally had three main mandates: to maintain price stability, to maintain financial stability, and to act as lenders of last resort (LOLR).[64] Of critical importance to this research is the exercise of the lender of last resort function as a tool of bank rescue in times of emergency liquidity challenges.[65] The exercise of these functional roles has experienced some changes overtime, but it is the changing balance between the monetary policy (price stability) and the financial stability mandate that generates debates.[66] The GFC brought to the fore the importance of flexibility in LOLR policies because many Central Banks extended emergency liquidity support on an unprecedented scale and scope. Much as there is some criticism that some Central Banks overstepped their mandate and bailed out insolvent banks, thus causing moral

[63] Bank of Uganda Financial Stability Report, June 2013 Issue No. 5 https://www.bou.or.ug/bou/bou-downloads/financial_stability/Rpts/All/Financial-Stability-Report-_Issue-5_-June-2013.pdf (last accessed 11/8/2015).

[64] In his book, "Lombard Street: A Description of the Money Market" (1873), Walter Bagehot propounded the LOLR theory. He argued that unlike commercial banks, the role of the Central Bank is peculiar because it is the holder of liquid reserves. Hence, when commercial banks encounter illiquidity or financial distress, the Central Bank has the capacity and duty to lend the commercial banks to satisfy liquidity demands. The main object in satisfying this LOLR is to prevent bank defaults that can trigger subsequent failures through the system. Bagehot was of the view that in exercising this mandate, Central Banks must be guided by four major pillars: (1) They must lend freely, (2) at a higher interest rate that is penal to deter moral hazard, (3) to any institution with good collateral security, and (4) the lending must be to solvent but illiquid firms. (Also see: Gayane Oganesyan, The Changed Role of the Lender of Last Resort: Crisis Responses of the Federal Reserve, European Central Bank and Bank of England, Institute for International Political Economy Berlin at pg. 2)

[65] According to Goodhart, the traditional financial stability focus has been on Central Banks' ability to lend, and thus provide liquidity either to an individual bank as a lender of last resort (LOLR), or to the market as a whole through open market operations (OMO). See C.A.E. Goodhart, The Changing Role of Central Banks, Financial Markets Group, London School of Economics, accessed via http://www.bis.org/events/conf100624/goodhartpaper.pdf (last visited on 14/11/2016).

[66] See Eichengreen, B.J., (1992), Golden Fetters: The Gold Standard and the Great Depression, 1919-1939, New York, Oxford University Press.

hazard, there is also acknowledgement that Central Banks' exercise of the LOLR function contained systemic risk.[67]

In a paper entitled, "*Dilemmas in Central Banking: An Emerging Economy Perspective*", Duvvuri Subbarao examines the cross roads of modern central banking.[68] He stresses the paradox that Central Banks have been blamed for getting the world into the crisis, but also are being praised for getting the world out of the crisis. During post-crisis recovery times, the Central Banks are being blamed at the same time for not doing enough to stimulate economic recovery, but also doing too much at the same time to stimulate economic reconstruction. There is criticism that central banks have tightened the regulation of banks and financial markets too much, but there is also a school of thought that argues that central banks have tightened the regulation of banks and financial institutions by too little.[69]

Regulatory paradigms can become outmoded and are then replaced by new paradigms.[70] Globally, the entire financial services industry in general, and the banking industry specifically, has rapidly grown and radically transformed.[71] This transformation has had both positive and negative implications on regulatory conduct and response. It is acknowledged that internal conditions for regulatory structures, opportunities and constraints define the underlying context in which regulatory agencies have to operate.[72] There are various aspects of banking industry

[67] For a more detailed analysis of the LOLR function, see "Re-thinking the lender of last resort", BIS Papers No. 79, Monetary and Economic Department, Sept 2014 accessed via http://www.bis.org/publ/bppdf/bispap79.pdf (last accessed on 14/11/2016).

[68] Dr. Duvvuri Subbarao is the 22nd Governor Emeritus of the Reserve Bank of India (2008-13). He delivered this public lecture on 22nd September 2015 at the 23rd annual Bank of Uganda Joseph Mubiru Memorial Lecture. Joseph Mubiru was the first Governor of Bank of Uganda in 1966 and spearheaded its foundational development. He served as Governor up to August 1971 when his contract expired. Tragically, in 1972, he was abducted and eventually murdered under unclear circumstances during the politically unstable times of the Idi Amin regime. See pg.2 of his paper accessed via BoU's official website https://www.bou.or.ug/bou/bou-downloads/speeches/Joseph_Mubiru_lectures/23rd-Joseph-Mubiru-Memorial-Lecture-Dilemmas-in-Central-Banking-Sept-2015.pdf (last accessed on 14/11/2016).

[69] Ibid. Pgs. 2-3 of the Paper. Subbarao further argues that the crisis shows that central banks had declared victory over single instrument inflation targeting too soon. The crisis showed the failure of central banks to acknowledge and mitigate the dangers of global imbalance. "In their single minded pursuit of inflation, neglecting the cancer of instability brewing in the underbelly of the financial system."

[70] See Thoma S. Kuhn, The Structure of Scientific Reevolutions, (1970) (for a general discussion of the concept of paradigm).

[71] See Tommaso Padoa-Schioppa (Chairman, CONSOB, Italy), Remarks *on Regulatory Responses to the Integration of Financial Services* delivered during a panel session of the XXII Annual Conference of the International Organization of Securities Commissions, Taipei, Nov. 5, 1997, for a discussion of the recent changes in global finance and their implications on regulation.

[72] Thomas K. McGraw, Prophets of Regulation 305 (1984).

revolution. Particularly, the increased participation of banks in trading activities, the increased globalization of their activities (banking beyond borders), their incorporation into diversified and complex conglomerate group structures handling a wide range of banking, securities and insurance business, as well as the shrinking distinction between debt, equity and insurance contracts necessitate a fundamental re-thinking of the traditional regulatory paradigm/model.[73] All this complexity supports a case for a specific distressed bank rescue framework so as to save the critical products and services that are rendered by such banks.

The broad regulatory approach that has attracted most interest since the 1990s is undoubtedly the Twin Peaks approach which has pushed the issue of financial stability as the apex objective of financial regulation to the forefront. The earliest discourse on the Twin Peaks model of financial can be traced to as early as 1995 in Michael Taylor's paper, "Twin Peaks: A Regulatory Structure for the New Century".[74] His central thesis was that the financial industry has become very ubiquitous and that silo regulation[75] has become untenable. He advocated for separation of the systemic protection/financial stability role to be exercised by a separate department and the supervision of banking practice and consumer protection mandate to be exercised by another department/regulator.[76] It is these interdependent and complimentary sister mechanisms he

[73] Michael Taylor, The Search for a New Regulatory Paradigm, Mercer Law Review (1998), Vol 49 at 798. Taylor has served as an advisor to the Governor, Central Bank of Bahrain, formerly Head of Banking Policy, Hong Kong Monetary Authority, Senior Economist, International Monetary Fund; Reader in Financial Regulation, ICMA Centre, University of Reading. Currently, he is the Managing Director Chief Credit Officer Asia Pacific at Moody's Investors Service, Hong Kong.
The concept of regulatory paradigm has a lot in common with the concept of a "regulatory strategy" as developed by Helen Garten. See Helen Garten, Why Bank Regulation Failed (1991).

[74] Issue 20 of Centre for Study of Financial Innovation Series, 1995. He has extensively authored and co-authored on financial sector regulation. Some of his key works include; Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Response to the Regulatory Challenges of Modern Financial Markets*, 38 TEX. INT'L L.J. (2003), Richard K. Abrams & Michael W. Taylor, *Issues in the Unification of Financial Sector Supervision* (Int'l Monetary Fund, Working Paper No. 00/2013, 2000), available at http://www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf , Michael Taylor & Alex Fleming, *Integrated Financial Supervision: Lessons from Northern European Experience* 17 (World Bank, Working Paper 2223, 1999), available at http://info.worldbank.org/etools/docs/library/50180/TaylorFleming_1999.pdf , Michael Taylor, *The Policy Background* in BLACKSTONE'S GUIDE TO THE FINANCIAL SERVICES & MARKETS ACT OF 2000 14 (Michael Blair ed., 2000), Michael Taylor, *Fin. Svcs..& Mkts. Act: The Policy Background-II*, 31 AMICUS CURIAE (2000), Heidi Mandanis Schooner & Michael W. Taylor, Global Bank Regulation: Principles and Policies, *Burlington, MA, Academic Press, 2010*.

[75] Silo regulation means a regulatory framework based on supervision and regulation of according to industries, such as separate regulators for banking, insurance, securities and pensions. This differs from Twin Peaks in the sense that the peaks model regulates according to function, such as consumer treatment and systemic risk management.

[76] In Michael Taylor's view, the first peak, the Financial Stability Commission, would ensure that there are adequate and sufficient prudential measures to ensure soundness of the financial system, capital adequacy of banks and

identified as the "Twin Peaks". He identifies some of the features of financial sector revolution as:

(a) The end of Geography

The internationalization of banking and financial systems has reached a very high level with cross-border transactions experiencing unprecedented high levels of growth. This has resulted in what is termed as "the end of geography".[77] Market intermediaries and investors do not have geographical barriers, and major markets also operate around the clock. There is also increasing e-trade and e-commerce as products of electronic transactions.[78]

(b) Functional de-specialization

Different financial institutions like banks have increased their scope of handling the same functions or types of transactions. Technological innovation has also facilitated creation of products that are not categorical to the traditional business forms such as debt, equity and insurance. For example, there has been emergence of structured transactions like credit derivatives and securitization. Contract standardization has also encouraged unbundling of risks to enable different financial institutions to have appetite for exposure to risks that were previously outside their core business domain.[79]

(c) Conglomerate group structures

Group structures and conglomerates are becoming increasingly complex, involving a diversity of firms and businesses operating in a wide range of different industries like banking, insurance, pensions, *et cetera* and in different geographical jurisdictions that are mostly subject to different regulatory frameworks. Globalization and diversification have increased institutional and geographical integration and harmonization of banking business.[80] This has caused new

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control of risk. The second peak, the Consumer Protection Commission, would enforce business conduct regulations to ensure that customers received a fair, honest and transparent service.

[77] Richard O'brien, Global Financial Regulation: The End of Geography (1992).

[78] Michael Taylor, "The Search for a New Regulatory Paradigm" Mercer Law Review (1998), Vol. 49, PP. 793-795

[79] Ibid.

[80] Multinational banks such as Standard/Stanbic bank, Bank of Baroda, Citibank and Ecobank have presence both in Uganda and South Africa.

approaches to systemically important financial institutions, interconnectedness, systemic risk and contagion spread effects.[81]

(d) Market integration

Different financial markets and their associated products are also growing more integrated. Investors are able to diversify their risk and business portfolio by operating in several different markets at once, often through cross-border transactions. Banks can also choose the regulatory environment most convenient to them. This may increase the potential for systemic risk through undetected exposures as well as increase the risk of market manipulation and insider trading.[82]

Prior to the occurrence of the global financial crisis, bank failures as a result of systemic risk had been a rare occurrence. In fact, many central banks did not even have the human resources and expertise required to deal with risks of such unimaginable scale. For example, in the United Kingdom, the Bank of England had even reduced its staff in the Financial Stability Department and the Financial Services Authority mainly focused on consumer treatment and competition regulation among the financial services providers.[83] However, the crisis necessitated urgent measures and interventions. The existing models had to be re-thought through and solutions crafted to deal with the problems and consequences arising from failing economic and financial systems. This demanded a wide profile of a mix of skills ranging from the traditional skills like policy advice and recommendations to the more nuanced and specialized skills like technical skills for bank interventions, re-capitalization, distressed rescue planning, restructuring and debt management.[84]

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[81] Taylor further argues that institutional and geographical integration are in fact two sides of the same coin. (See pg. 799).

[82] Ibid.

[83] Report of the Treasury's management response to the financial crisis, March 2012 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/220506/review_fincrisis_response_290312.pdf at pg. 5. (last accessed on 9/8/2015).

[84] Opp cit note 53 at pp. 5-6. Once the broader implications of the collapse of Northern Rock in the autumn of 2007 became clear, the Treasury reacted quickly to establish a well-resourced project team, led at Second Permanent Secretary level. The team had a few staff members with specific banking expertise and they were highly valued. The majority of staff had to learn on the job. After Northern Rock was nationalized in February 2008, part of the crisis team was kept on to work on state aid issues and the bank's business plan. The Treasury undertook contingency planning to manage the risks of a broader crisis. After the collapse of Lehman Brothers in September 2008, it was clear that a systemic crisis was now a certainty. The Treasury, which had increased its capability steadily over the summer, quickened the pace of its recruitment. Staff working on financial stability policy and interventions increased from around 20 in September 2008 to around 45 by the end of the year. This rapid mobilization of staff from across the Treasury in connection with bank recapitalization issues in the autumn of 2008 was a significant

A key component of the recent global financial crisis was the drying up of liquidity in the banks.[85] As Phillip David has argued, the traditional regulation models of bank liquidity risk, bank runs and the role of the lender of last resort employed pre-crisis were outdated. Recent financial innovations mean that funding and market liquidity risk now interact more vigorously, and that this is a key reason why interbank markets played a pivotal role during the global financial crisis. While traditional models focus on 'bank runs', the primary concern is now the possibility of 'financial market runs' which, via market-to-market accounting, can threaten the solvency and viability of financial institutions to freely operate as business entities. These developments clearly pose new challenges for Central Banks, since it is clear that they should not lend to insolvent institutions, but financial innovation has made it far more difficult to distinguish illiquidity from insolvency.[86] Therefore, this supports the view that bank rescue is a viable option to provide temporary liquidity and is a practical intervention that can save a distressed bank from contaminating the financial system as a whole in the event of failure.[87]

Regulators have to "think outside of the box" for interventions. It is through such need for desirable economic effects that systems like the Twin Peaks model of regulation were identified. It is also no longer viable to assume that regulations which make individual financial institutions safe also make the financial system safe. A holistic approach has to be adopted.[88] For example, in England, it was discovered that the inherent regulatory weaknesses were a result of the disjointed tripartite approach whereby three regulators – the Bank of England, the Financial Services Authority and the Treasury – were collectively responsible for financial stability. This realization led to the creation of a new Financial Policy Committee (FPC) within the Bank of

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achievement. Staff working on financial stability peaked in the summer of 2009 at around 120, although the total number, including officials providing support from other Treasury teams, was closer to 200. However, there was enormous pressure on workloads and staff well-being, including for people not directly working on the crisis.

85 See publication by the Reserve Bank of Australia entitled *Lessons from the Financial Turmoil of 2007 and 2008* at pg. 3, available at http://www.rba.gov.au/publications/confs/2008/pdf/conf-vol-2008.pdf (last visited 21st Sept 2015).

86 Phillip Davies *Liquidity, Financial Crises and the Lender of Last Resort –How Much of a Departure is the Sub-prime Crisis?* (2008) 111.

87 See Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, BIS Papers No. 79 at pg. 10 for a discussion of the four schools of thought on the LOLR function. For purposes of context, this research is mainly concerned with the "classic" Bagehot view which supports lending freely to solvent but illiquid banks against good collateral.

88 Markus Konrad Brunnermeier, et al; *The Fundamental Principles of Financial Regulation*, International Center for Monetary and Banking Studies, 2009.

England.[89] It is this FPC that has been clothed with the mandate and given the macro-prudential tools to deal with systemic risk.[90] In South Africa's scenario, apart from the regulatory overhaul that will be introduced once the Financial Sector Regulation Act becomes operational, a Special Resolution Bill (SRB) will be enacted to, inter alia, put in place a rescue framework for distressed banks in order to augment the curatorship procedure under the Banks Act.[91] In Uganda, the Bank of Uganda (BoU), which is Uganda's Central Bank created the Financial Stability Department in July 2009 at the height of the global financial crisis.[92] Its purpose is to identify and assess potential systemic risks through regular monitoring, surveillance and evaluation of internal as well as external economic phenomena likely to have an impact on the financial system. In March 2015, a Financial Crisis Management Framework was adopted as a guiding framework for the decision-making process in case of systemic shock to the banking sector.[93]

Generally, regulatory interventions and policies are changing in scope and landscape to meet the complexity of modern day financial systems.[94] At the heart of this response are two competing mechanisms. The first is the traditional model of a unified single agency that regulates both

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[89] Supra note 54. There was a transfer of responsibilities for prudential supervision to the Bank of England and the abolition of the Financial Services Authority (FSA). A new macro-prudential body, the Financial Policy Committee (FPC) was established in the Bank and a new prudential regulator – the Prudential Regulation Authority (PRA), a subsidiary of the Bank – was set up. The new arrangement also led to establishment of a new conduct of business and markets regulator – the Financial Conduct Authority (FCA).

[90] Great Britain Treasury, *A New Approach to Financial Regulation: Judgement, Focus and Stability*, The Stationery Office, 2010.

[91] In terms of the draft resolution policy document, the Prudential Authority will be required to ensure that banks and all other financial institutions falling under its regulation have sufficient recovery plans that set out possible strategies that the affected institution can implement to recover from severe stress scenarios. (See pg. 12 of the policy document). A distinction should be made between recovery plans (which deal with bank rescue) and resolution plans (living wills), which deal with bank resolution/liquidation.

[92] An overview of the Financial Stability Department and Financial Crisis Management at Bank of Uganda can be accessed via https://www.bou.or.ug/bou/supervision/Financial_Stabilty/Financial_Crisis_Management_at_BOU.html (last visited on 30th July 2015).

[93] This is contained in an internal document published by the Bank of Uganda Financial Stability Department entitled 'Financial Crisis Management Plan' (March 2015). A copy has kindly been provided by Dr. Charles Abuka, the head of Department for purposes of this research.

[94] Failure of regulation, by wide agreement, was one of the main causes of the 2008 global financial crisis. It is unsurprising therefore that reforming regulation has taken center stage post-crisis: See the inaugural address by the then Indian Reserve Bank Governor Duvvuri Subbarao on 'Financial regulation for growth, equity and stability in the post-crisis world' BIS Papers No 62 Financial sector regulation for growth, equity and stability Proceedings of a conference organized by the BIS and Centre for Advanced Financial Research And Learning in Mumbai, 15–16 November 2011 Monetary and Economic Department January 2012 at pg. 1, accessed via http://www.bis.org/publ/bppdf/bispap62.pdf (last visited 20th Sept 2015).

financial sector market segments of economic soundness and consumer welfare.[95] The alternative and increasingly fashionable alternative model is the Twin Peaks model, as alluded to above, which encompasses a structure of two agencies, with one handling the safety and financial soundness of the system in question (prudential regulation) and the other dealing with consumer protection and competitive practices of the sector players (market conduct regulation).[96] This approach has been adopted by Australia, Netherlands, the UK and its off-shoots can be found in Spain, Canada, France and South Africa.[97] The focus on macro-prudential policy is motivated by the fact that micro-prudential regulation is necessary but not sufficient to deal with systemic risk. Micro-prudential regulation (such as the Basel I and II capital accords) tends to view financial institutions in isolation and aims mainly to ensure that each is individually solvent.[98]

However, solvency of individual institutions is not a sufficient condition for the stability of a system as a whole, for two main reasons. First, the focus on individual institutions neglects risks that are of systemic rather than individual nature, such as correlation risk. Second, certain aspects of micro-prudential regulation, while aimed at protecting individual institutions, may at times destabilize the financial system. For example, micro-prudential capital requirements that become binding following a negative shock to banks' assets can turn individual deleveraging into a system-wide credit crunch. Given these limits, the purpose of macro-prudential regulation is to focus on the financial system as a whole, with an ultimate objective of limiting systemic risk.[99] Therefore, these objectives need to be underpinned by an effective bank rescue framework to enable saving of the systemically important financial institutions (SIFIs) so as to maintain financial and market stability. Furthermore, as earlier observed, there are also compelling socio-

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[95] The single regulatory approach faces criticism because no single regulator possesses all of the information and authority necessary to monitor systemic and synergistic risk or the potential that seemingly isolated events could lead to broad dislocation and a financial crisis so widespread that it affects the real economy. Also no single regulator can take coordinated action throughout the financial system. See: Dick K. Nanto *The Global Financial Crisis: Analysis and Policy Implications* Congressional Research Service at pg. 24.

[96] Michael W. Taylor 'The Road from Twin Peaks and the Way Back' *Connecticut Insurance Law Journal* Vol. 16:1, Pg. 63.

[97] For a general discussion on Twin Peaks model and the various regulatory systems see Richard J. Herring & Jacopo Carmassi *The Structure of Cross-Sector Financial Supervision* Wharton School, University of Pennsylvania (unpublished) at pg. 10, accessed via http://fic.wharton.upenn.edu/fic/papers/07/0734.pdf (last visited on 23rd Sept 2015).

[98] Viral V Acharya *Systemic Risk and Macro-Prudential Regulation* New York University Stern School of Business, Center for Economic Policy Research & National Bureau of Economic Research (2011) at pp.3-5.

[99] De Nicoló et al *Externalities and macro-prudential policy* (2012) IMF Staff Discussion Note at pg 4. Can be accessed via http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.432.4905&rep=rep1&type=pdf (last visited on 21st Sept 2015).

economic reasons such as deepening financial inclusion and credit access for low income consumers that may justify rescue of niche banks even when they are not SIFIs.

2.5.1 Lessons learnt from the global financial crisis

The enormous costs of the events leading to the global financial crisis have forced governments to reconsider how they approach financial sector regulation. Most regulators, particularly in advanced economies, were taken by surprise by the events of 2007-2009 and were unable to anticipate the rise in systemic risk that culminated in the crisis. Within the South African context, these lessons are contained in the policy document, *"A safer financial sector to serve South Africa better"*[100] which advocates for a holistic view of financial sector regulation. Financial regulatory reform has been focused on ensuring that authorities and regulators adopt a macro-prudential approach towards supervision as opposed to a purely micro-prudential one. The macro-prudential approach entails the analysis of macroeconomic trends and how they interact with the prudential soundness and stability of financial firms and the financial system. In contrast, micro-prudential supervision is mostly concerned with the prudential soundness of individual financial institutions or groups.[101] If one financial institution has large exposures to another, then the health of one will necessarily affect the health of the other financial institutions that are interconnected with the entity in question. Also, actions to boost the health of one entity might have unanticipated and adverse effects on the other.[102]

Furthermore, the global financial crisis also highlighted the failure of "light-touch" regulation of the financial sector at the global level. The idea that the financial sector can successfully regulate itself has lost credibility in the aftermath of the crisis. Even if individual financial institutions are able to improve risk management practices, regulators must proactively monitor changes in systemic risk. This is coupled with the importance of regulating market conduct to support

[100] This policy document is a publication of the Department of National Treasury. It was published in February 2011 with proposals to shift to a twin peaks system of financial regulation, a proposal which was formally adopted by Cabinet in July 2011.

[101] Before the crisis, some believed that micro-prudential supervision was sufficient to maintain financial stability: if all institutions were soundly regulated, then the system must be stable. The financial crisis, however, has highlighted that the build-up of macroeconomic risks (such as asset bubbles, high household debt levels or the increasing linkages between large financial institutions) may pass unnoticed by micro-prudential regulators who focus only on individual institutions. The macro-prudential approach also attempts to identify and control risks arising from linkages between financial institutions.

[102] Dale Gray and Samuel Malone, *Macro financial Risk Analysis*, Wiley Finance (2012). Specifically, chapter 19 deals with *International Shocks, Risk Transmission, and Crisis Prevention: Backdrop for Understanding the 2007–08 Global Financial Credit Turmoil* at 267–284.

prudential regulation. The crisis has proven that it is poor policy to force banks to lend to consumers who cannot afford to repay their loans. Inappropriate lending practices in the US and the resultant fall-out of the subprime mortgage crisis demonstrated the need to balance the socio-economic objectives of increased access to credit and homeownership with the imperative of financial stability. The regulation of market conduct must eliminate lending malpractices in order to both protect consumers and reduce systemic risk.[103]

There was paradigm shift in regulatory approach globally. The Financial Stability Board took on a more central role in international standard setting in post-GFC financial regulation.[104] Of critical importance to this research, the "*Key Attributes of Effective Resolution Regimes for Financial Institutions"* (KAs) were enacted with a view setting standards for saving banks which could be saved, and resolving those banks which are insolvent.[105] For purposes of contextual delimitation, the salient features of bank recovery are addressed in Recovery and Resolution Plans (RRPs).[106] Specifically in terms of recovery planning, any bank adjudged by the regulatory authorities as systemically important, must have a recovery plan to serve as a rescue guide in the event of distress.[107] During this phase, the bank will not yet have met the conditions for resolution, or entered the resolution regime (formal state of insolvency).[108] The recovery plan must entail measures that can be taken to reduce the risk profile of a distressed bank and preserve its capital, as well as other strategic interventions such as divestiture of the problematic business

[103] There is need for global cooperation in preventing macroeconomic imbalances. The macroeconomic imbalances in savings and consumption that laid the ground for the crisis have shown no signs of disappearing. The global community must act together to find a sustainable solution to this problem.
[104] The Financial Stability Board (FSB) is an international body that monitors and makes recommendations about the global financial system by coordinating national financial authorities and international standard-setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies. For more details about the FSB's mandate, framework and key standards, visit the official website http://www.fsb.org/about/ (last accessed on 16/11/2016).
[105] The KAs stipulate the major principles the FSB considers to necessary for an effective resolution regime. Their major aim is to allow authorities to resolve insolvent financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of vital economic functions by entities that are commercially viable. The KAs were adopted by the FSB at its plenary meeting in October 2011. The G20 Heads of States and Government subsequently endorsed them at the Cannes Summit in November 2011 as "a new international standards for resolution regimes. As a member of the G20, South Africa must see to it that its financial sector regulatory laws and policies are compliant with these international standards. For a detailed background and context of the KAs, visit http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/ (last accessed on 16/11/2016).
[106] For purposes of this research, I will only examine recovery planning because it is the theme that is relevant to bank rescue.
[107] See objective 1.5 of the KAs.
[108] However, there should be a reasonable prospect of recovery if appropriate recovery measures are undertaken.

lines and business restructuring.[109] The responsibility of implementing this rescue plan must lie with the bank's senior management.[110] Furthermore, firms must be required to regularly update their recovery plans, especially upon occurrence of events that materially change their business structures, operations and exposure limits.[111]

Lastly, the GFC highlighted the importance of swift regulatory action to prevent contagion. The financial crisis swelled from a prudential crisis at a few institutions to a liquidity crisis across global markets in 2008 and 2009. By 2010, the crisis had turned into a sovereign crisis in fiscally weak European economies and has recently spilled into political crises in countries which have suffered from extended unemployment. From a bank rescue perspective, this is an important lesson to take into account where delay in rescuing an interconnected or systemically important bank would cause instability in the banking sector as a whole. These lessons have instigated a paradigm shift in global financial sector regulatory reform to address the gaps and create a system that is responsive and better equipped to supervise the financial sector and pay more attention to systemic risk. It is in the context of these changes in banking regulatory paradigm that bank rescue/ curatorship in South Africa will be analyzed.

CHAPTER THREE

THE SOUTH AFRICAN BANKING SYSTEM AND SEARCH FOR A NEW REGULATORY PARADIGM

3.1.The South African Reserve Bank (SARB)

The South African Reserve Bank (SARB), in accordance with the Constitution of the Republic of South Africa (the Constitution)[112] and the South African Reserve Bank Act (SARB Act),[113] functions as the Central Bank of the Republic of South Africa. Apart from establishing the SARB as the central bank, both the Constitution and the SARB Act states the SARB's primary

[109] See pg. 43 of the KAs document.

[110] According to the FSB's requirements, Central Banks must review the recovery plans as part of the general supervisory process by assessing their credibility and practical capability to be effectively implemented.

[111] The FSB requires that Central Banks must regularly assess the relevance and applicability of the recovery plans, and if necessary, firms should adapt their recovery plans in accordance with the directives from the regulatory authorities.

[112] The Constitution of South Africa is established by Act No. 108 of 1996. Article 223 of the Constitution establishes the SARB as the central bank of the Republic and is to be regulated in terms of an Act of Parliament.

[113] The South Africa Reserve Bank Act is gazetted as Act 90 of 1989. The purpose of this Act is to consolidate the laws relating to the South African Reserve Bank and the monetary system of the Republic; and to provide for matters connected therewith.

mandate as protection of the value of the currency in the interest of balanced and sustainable economic growth in the Republic.[114]

Furthermore, both the Constitution and the SARB Act enjoin the Reserve Bank to perform its functions independently and without fear, favor or prejudice while exercising its primary mandate, but provides that there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters.[115] The powers and functions of the South African Reserve Bank as determined by the SARB Act are those customarily exercised and performed by all central banks. Such powers and functions must be exercised or performed subject to the conditions prescribed in terms of that Act.[116]

Generally, in principle, there appears to be consensus that the core mandate of Central Banks globally is to ensure stable financial conditions in order to protect the value of domestic currencies.[117] To achieve this financial stability objective, the Central Bank must be given

[114] Article 224(1) of the Constitution read together with section 3 of the SARB Act. This role is wide and encompasses the using of the monetary policy tools at the central bank's disposal to contain inflation pressures on the economy. High inflationary pressure has the tendency to erode the value of the country's currency. Monetary policy in this sense refers to all the deliberate actions and interventions by the monetary authorities to influence the monetary aggregates, the availability of credit and interest, exchange rates, and other monetary indicators with a view of affecting the demand, supply, income, output, prices and the balance of payments: *see Final Report of the Commission of Enquiry into the monetary Policy in South Africa* (1985) in para 13.7 at 139.

[115] Article 224(2) of the Constitution establishes the independence and autonomy of the Reserve Bank. The bank therefore has the mandate to use monetary policy tools to achieve its monetary policy goals and objectives. The independence is limited to policy implementation but not formulation. The Governor of the Bank holds regular discussions with the Minister of Finance and meets periodically with members of the Parliamentary Portfolio and Select Committees on Finance. In terms of section 32 of the South African Reserve Bank Act, 1989, the Bank publishes a monthly statement of its assets and liabilities and submits its Annual Report to Parliament. The Bank is therefore ultimately accountable to Parliament. See the Reserve Bank mandate https://www.resbank.co.za/AboutUs/Mandate/Pages/Mandate-Home.aspx (last accessed 1st August 2015)

[116] Article 225 of the Constitution provides a general statement of the powers and functions of the South African Reserve Bank by providing that the powers and functions of the South African Reserve Bank are those customarily exercised and performed by central banks, which powers and functions must be determined by an Act of Parliament and must be exercised or performed subject to the conditions prescribed in terms of that Act. These powers are catalogued in section 10 of the SARB Act and include, but are not limited to making and issuing bank notes and coins, destroying notes and coins, perform such functions, implement such rules and procedures and in general, take such steps as may be necessary to establish, conduct, monitor, regulate and supervise payment, clearing or settlement systems, accepting money on deposit, allowing interest on any deposit or on a portion of a deposit and collecting money for other persons among many others. Section 13 of the Act however prohibits the SARB from engaging in certain business like purchasing its own shares or grant loans or advances upon the security thereof. Buying, discounting or re-discounting bills of exchange or promissory notes drawn or issued for commercial and industrial purposes, which have a maturity exceeding 120 days is also prohibited.

[117] B Bekink & C Botha, 'The Role of a Modern Central Bank in Managing Consumer Bankruptcies and Corporate Failures: A South African Public-Law Angle of Incidence' (2009) 21 *SA Merc LJ* 74 at 84.

adequate powers and the responsibility to stimulate, foresee and supervise the development of sound and well managed banking institutions.[118]

3.2 The rescue mandate: The Reserve Bank's power to appoint a curator for a distressed bank

3.2.1 Introduction

The SARB as central bank, lender of last resort and supervisor of banks is also the authority currently tasked by the Banks Act to deal with bank distress. When a bank is in financial distress, the SARB needs to act swiftly to deal with any negative effects that such distress may have not only with regard to such bank's investors and depositors, but also on the financial system if the bank is sufficiently interconnected for its collapse to pose a systemic threat.[119] The policy followed in South Africa does not aim at zero bank failure, because bank failure is a reality of life.[120] Instead, the policy of the SARB is that banks with temporary liquidity problems may be assisted.[121] When bank distress is detected by the SARB, corrective action is taken. The exact type of action differs on a case by case basis depending on the nature and extent of the distress and difficulty experienced by the bank in complying with any aspect of the prescribed prudential requirements. The corrective actions are not prescribed in detail under South African legislation, and thus the regulator is given a wide discretion to enforce compliance.[122]

When a bank encounters financial difficulty in its operations, a special investigation is conducted by the SARB to establish conclusively whether the affected bank suffers from a liquidity or a solvency problem.[123] If it is ascertained that the distressed bank has a temporary liquidity problem, the SARB will extend to it secured emergency liquidity assistance. The main objectives

[118] See the address by Dr C Stals, former Governor of the SA Reserve Bank (entitled 'The Role of Central Banks in Today's Economies: The Experience of South Africa'), at the Conference on Current Economic Policy Issues (25 April 1997) in Durban, South (available at http://www.bis.org/review/r970514a.pdf) last accessed 9/11/2015.

[119] Material interconnectedness of a bank within the banking and financial system is an indicator of systemic importance of such a bank.

[120] Jannie Rossouw, South Africa Reserve Bank: History, functions and institutional structure, SARB Publishing section, First edition, October 2009 at pg. 35.

[121] An insolvent bank cannot be allowed to continue with market operations because its problems are most likely to become worse. This would trigger a resolution, the objective of which is to ensure that depositors of failing banks recover as much of their deposits as possible in order to maintain public confidence in the banking system.

[122] Corrective actions may range from a discussion of the area of concern noted by the regulator, to formal sanctions such as fines, restrictions and prohibitions on further expansion.

[123] If the bank's liquidity problem is short term and temporary, meaning that it will not affect its solvency, the SARB will decide in the interest of the public and with a view of maintaining the stability of the banking system, whether or not to provide temporary liquidity assistance in its cardinal role as a lender of last resort (LOLR) against acceptable security provided by the distressed bank.

of such assistance are to provide some breathing space to the distressed entity in order to implement the corrective actions; and to act as a preventative measure against temporary illiquidity precipitating insolvency that can cause contagion and bank runs.[124] The major condition precedent for the provision of emergency liquidity support is whether in the opinion of the SARB, the failure of an illiquid bank due to deprivation of emergency liquidity would cause systemic financial risk.[125] A possible next step would be a recommendation that the affected bank is placed under curatorship. It has been argued that through the mechanism of curatorship, the intention of the legislature was to create an alternative option by which the administration of a bank experiencing financial distress could be effected.[126]

The appointment of a curator[127] for a distressed bank is one of the key powers of the SARB. It should be noted that curatorship is a protection procedure akin to business rescue in insolvency law,[128] which gives the SARB the legal means to embark on a turn-around plan to ensure that a distressed bank gains a secure future prospective as a viable lending institution with a

[124] The LOLR function is different from the SARB's ordinary liquidity provision function through repo rate sales. LOLR decisions are made on a case by case basis, taking into consideration the effect of probable bank failure on the overall economic and financial stability.

[125] Other preconditions are that the entity receiving emergency liquidity should have a sufficient margin of solvency; the emergency liquidity assistance should be adequately collateralized; the distressed bank should have sought other reasonable sources of funding options available to no avail before seeking emergency liquidity; the shareholders of the illiquid institution should have made all reasonable efforts to provide liquidity to the institution as a demonstration of their commitment to the institution; there should be no evidence that the management of the illiquid institution is not fit and proper, or the distress is due to fraud; and the institution should have a developed, and demonstrates the willingness and commitment to implementation of, an appropriate corrective remedial action plan to deal with its illiquidity. (See SARB's Commemorative Publication, 2011 at pg. 67).

[126] J Moorcroft, **Banking Law and Practice**, Lexis Nexis Durban (November 2015), at pg. 14.

[127] . A curator is person appointed to take care of anything for another. In some cases referred to as a guardian. One appointed to take care of the state of a minor above a certain age, a lunatic, a spendthrift, or other person not regarded by the law as competent to administer it for himself. Law Dictionary: *http://thelawdictionary.org/curator/* (last visited on 1/8/15). The curator is in the same position as a business rescue practitioner under the Companies Act, where "business rescue practitioner" means a person appointed, or two or more persons appointed jointly, in terms of Chapter 6 of the 2008 Companies Act to oversee a company during business rescue proceedings. This business rescue practitioner has replaced the judicial manager under the old process of judicial management. A business rescue practitioner has a duty to investigate the company's affairs and then decide whether or not there are any reasonable prospects of rehabilitating the company. If the rescue practitioner decides or is of the view that there is such a prospect, he must then prepare a business rescue plan which must be placed before shareholders, creditors and all affected or interested parties or persons for approval. Once approved, the business rescue practitioner must oversee its implementation. Court sanction of the business plan is not a strict requirement.

[128] In terms of section 51(1)(a) of the Banks Act, banks cannot go for the business rescue procedure enshrined in the Companies Act, 2008. However, interestingly from a curatorship perspective, in terms of section 51(1)(b) of the Banks Act, section 155 of the Companies Act relating to an arrangement or compromise between a company and its creditors shall not apply to a bank unless it is under curatorship in terms of section 69 and the Minister has empowered the curator to propose and enter into an arrangement or compromise in terms of section 69(3)(k) of the Banks Act.

transformed and profitable business model.[129] Former South African Finance Minister, Trevor Manuel equated this process to the placement of a distressed bank in "intensive care" where it is nursed back to strong health.[130]

The option of curatorship is born out of the realization that banks perform a special social and economic function of managing depositors' savings and can only competently perform this role when there is public trust and confidence in the bank by the depositors.[131]

One of the major objectives of curatorship is to prevent a "bank run", where the depositors withdraw their funds *en masse* usually as a reaction to bad publicity about the financial position of the bank, or market speculation about suspected imminent failure of a bank.[132] Curatorship is not designed to be a "temporary shield" against such a run on the bank. It must remain in force

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[129] Business recue has been called "the new baby". The new South African Companies Act, 71 of 2008 came up with novelties or innovations that did not exist in the old Companies Act, 1973 (Act 61 of 1973) as amended ("*the Act*"). Among those innovations is the so-called business rescue. In terms of section 128(b) of the 2008 Companies Act, business rescue means proceedings to facilitate the rehabilitation of a company that is financially distressed by providing for— (i) the temporary supervision of the company, and of the management of its affairs, business and property; (ii) a temporary moratorium on the rights of claimants against the company or in respect of property in its possession; and (iii) the development and implementation, if approved, of a plan to rescue the company by restructuring its affairs, business, property, debt and other liabilities, and equity in a manner that maximizes the likelihood of the company continuing in existence on a solvent basis or, if it is not possible for the company to so continue in existence, results in a better return for the company's creditors or shareholders than would result from the immediate liquidation of the company. "Business rescue, as the definition proclaims or explains, is a regime which is largely self-administered by the company, under independent supervision within the constraints set out in Chapter 6 of the Act, and subject to court intervention at any time on application by any of its stakeholders. This is an important difference or aspect that differentiate business rescue from its counterpart in the old Companies Act, 1974, namely, judicial management. Business rescue is geared at saving significant costs, thus among others enabling financially distressed small (and big) companies to opt for it as a viable alternative to last resort liquidation." See Carl Stein & Geoff Everingham: *The New Companies Act Unlocked*, 2011 Edition, pp 409-411. "Unlike during judicial management, business rescue does not require that a company be restored to solvency, though this is of course one of the objectives of business rescue. As the definition (of business rescue) further demonstrates, business rescue is also a system that is aimed or geared at temporarily protecting a company against the claims of creditors so that its business can thereafter be disposed of (if concern could not be saved) for maximum value as a going concern in order to give creditors and shareholders a better return than they would have received had the company been liquidated. Business rescue clearly envisages a restructuring of a company's business, followed, if all else fail, by a realisation of its assets by, for example, a sale of its business to a third party followed by a voluntary winding-up of the company under section 80 of the Companies Act, in accordance with the rules regulating voluntary winding-up of solvent companies." See Judgment of Kgomo, J in *Redpath Mining South Africa (Pty) Ltd v Marsden No and Others* (18486/2013) [2013] ZAGPJHC 148 (14 June 2013) [paras 42-44].

[130] Page 3 of the Ministerial statement on SAAMBOU Bank curatorship available at *http://www.treasury.gov.za/comm_media/speeches/2002/2002021401.pdf* (visited on 2nd Aug 2015).
This procedure is considered especially vital given the role banks play in the economy and the possibility of contagion effect on other banks and the entire financial system as a whole should the bank fail.

[131] See the 'Statement by the Minister of Finance on the placement of SAAMBOU Bank Limited under Curatorship in terms of section 69 of the Banks Act to Parliament, on Thursday 14 Feb 2002, available at *http://www.treasury.gov.za/comm_media/speeches/2002/2002021401.pdf* (visited on 1/8/15)

[132] See *Ex Parte Registrar of Banks 1968 (3) 300 (C).*

for as long as it is required to safeguard the interest of depositors and protect the integrity of the financial system.[133] By and large, curatorship is a public interest driven process. Its aim is the broader promotion of financial stability.

In this curatorship process, the Registrar of Banks plays a pivotal role. In terms of the Banks Act, if in the opinion of the Registrar, any bank will be unable to repay customers' deposits or will probably be unable to meet any of its obligations when legally obliged to do so, the Minister of Finance may, if he or she deems it desirable in the public interest, appoint a curator for the affected bank.[134] Thus, although the Minister does the actual appointment of the curator, it is the Registrar of Banks who decides whether a bank "qualifies" for curatorship, as will be seen from the discussion below. It is also the Registrar of Banks who supervises the curatorship process.

Curatorship of banks is a complex process and a mammoth task, hence the Banks Act provides for the appointment of assistants to alleviate the duties of the curator. These assistants may be appointed by the Registrar of Banks and need not be appointed by the Minister. As such the Registrar may appoint a person, other than a person employed by the bank under curatorship, who in the opinion of the Registrar has wide experience of and is knowledgeable about the specific field of activities in which the bank under curatorship is predominantly engaged to assist the curator in the management of the affairs of the bank under curatorship.[135]

[133] See *Registrar of Banks v New Republic Bank Ltd [1999] 2 All SA 459 (D).*

[134] In terms of the Banks Act, the guiding litmus is the bank's inability to pay customers' depositors when obliged to do so, or the inability to meet any other of its obligations. The first test of inability to satisfy depositors' requests for their deposits is except for the time limit imposed, correlational with the first limb of the definition of the expression financially distressed company in terms of section 128(1)(f), which is to the effect that "financially distressed'', in reference to a particular company at any particular time, means that— (i) it appears to be reasonably unlikely that the company will be able to pay all of its debts as they fall due and payable within the immediately ensuing six months; or (ii) it appears to be reasonably likely that the company will become insolvent within the immediately ensuing six months. Like curatorship, a business rescue plan cannot be invoked where a company is already insolvent. This is one of the aspects differentiating business rescue from judicial management: Proceedings can be started six months in advance when the tell-tale signs are starting to appear. For instance, a company that is trading profitably and is cash positive but does not have the wherewithal to repay a large debt which will become due and payable within the next six months would qualify to be classified as being financially distressed, thus being a candidate for business rescue. It used to an initial requirement that the Minister must notifying the chief executive officer or the chairperson of the board of directors of that bank in writing, but this requirement was abolished by the 2015 amendment to the Banks Act because it caused unnecessary bureaucratic gridlock in the curatorship system yet time is always of the essence when a bank is in distress.

[135] Section 68(1) (a) & (b) of the Banks Act. The person appointed to assist the curator shall in respect of the services rendered by that person pursuant to his or her appointment be paid such remuneration out of the funds of the bank under curatorship as the Registrar of Banks may after consultation with the curator determine.

In practical terms, the Minister of Finance appoints the curator by a letter of appointment specifying the name of the bank in respect of which the curator is appointed and the address of its head office; directions in regard to the security which the curator has to furnish for the proper performance of his or her duties; directions in regard to the remuneration of the curator; 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,[136] as the Minister may deem necessary.[137]

The legal effect of curatorship in terms of section 69 of the Banks Act is that on appointment of a curator, the management of the bank concerned vests in the curator, subject to the supervision of the Registrar of Banks. Any other person vested with the management of the affairs of that bank is divested thereof and the curator is tasked to recover and take possession of all the assets of the affected bank, much like the trustee in an insolvent estate.[138] Furthermore, a section 69(6) moratorium sets in, whereby all actions, legal proceedings, the execution of all writs, summonses and other legal process against that bank are stayed and are not be instituted or proceeded with without the leave of the court.[139] This moratorium creates an opportunity for the curator to manage the bank out of its distress without the further liquidity drainage occasioned by execution against the bank's assets.

3.2.2 The obligations and powers of the curator in terms of section 69 of the Banks Act

The law imposes a series of obligations on the curator in conducting the management of the bank under curatorship. The rationale of these obligations is to ensure that management of the bank under curatorship is done in the manner the Registrar of Banks may deem best to promote the interests of the creditors of the bank concerned and of the banking sector as a whole.[140]

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[136] One of the sources of money for a distressed bank can be emergency liquidity assistance from the SARB against recognized collateral in terms of section 10 of the SARB Act.
[137] Section 69(2) of the Banks Act.
[138] In terms of s 69(2A) of the Banks Act. The powers and duties of the curator are discussed in detail in the remaining provisions of s 69, discussed below.
[139] This is intended to give the curator and the bank some breathing space to undertake the required reforms and functions required to curate the affected bank without wasting time and financial resources in legal and execution proceedings.
[140] Subject to the supervision of the Registrar, must conduct the management contemplated in subsection (2A)(a) in such a manner as the Registrar may deem to best promote the interest of the creditors of the bank concerned and of the banking sector as a whole and comply with any direction of the Registrar. The rights of employees in accordance

The curator, being supervised by the Registrar of Banks, is obliged to comply with any direction of the Registrar of Banks,[141] keep such accounting records and prepare such annual financial statements, interim reports and provisional annual financial statements as the bank or its directors would have been obliged to keep or prepare if the bank had not been placed under curatorship.[142] He or she must convene the annual general meeting and any other meeting of members of the bank provided for by the Companies Act and, in that regard, comply with all the requirements with which the directors of the bank would in terms of the Companies Act have been obliged to comply if the bank had not been placed under curatorship.[143] It is noteworthy that the curator also has the power to apply for an extension of time for convening an annual general meeting in terms of section 61(7)(b) of the Companies Act, No. 71 of 2008.

The curator is further given 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, subject to the provisions of any law relating to criminal proceedings, any criminal proceedings. This power must of course be construed against the background of the moratorium on legal proceedings contained in section 69(6) of the Banks Act.[144] In *African Bank Ltd v Theron and Another*,[145] the court considered the legal question whether an earlier version of section 69 of the Banks Act, which had the same legal import of the present section 69, bestowed onto the curator the power to litigate on the affected bank's behalf. On analyzing the power of curatorship such as vesting of the bank's

with relevant labor legislation are to be taken into consideration. These powers and obligations are creatures of statute.

[141] Sec 69(2B)(b) of the Banks Act.

[142] Sec 69 (2B)(c) of the Banks Act.

[143] Sec 69(2b)(d) of the Banks Act.

[144] See section 69(2B)(e) of the Banks Act (as amended). In relation to suits, while the bank is under curatorship, 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 court under section 69(6). This moratorium on legal proceedings is of the same practical effect like in company rescue, where section 133(1) of the 2008 Companies Act is to the effect that during business rescue proceedings, no legal proceedings, including enforcement action, against the company, or in relation to any property belonging to the company or lawfully in its possession, may be commenced or proceeded with in any forum, except *inter alia*, with the leave of the court and in accordance with any terms the court considers suitable.

[145] [1996] 4 All SA 156 (SE). Also see the decision in *ABP 4x4 Motor Dealers (Pty) Ltd v IGI Insurance Co Ltd 1999 (3) SA 924 (SCA)* where court had to resolve the question surrounding the meaning of the legal provision with a phrase 'a person under curatorship' under section 13(1)(a) of the Prescription Act 68 of 1969. Marais JA made comparison with the curator appointed in terms of the Banks Act and observed that, "By way of contrast, s 69 of the Banks Act 94 of 1990 provides for the appointment of a curator 'to' any bank in financial difficulties. The effect is profound: those who had been managing the bank are divested of control and the management of the bank is vested in the curator (subject to the supervision of the Registrar of Banks); the curator must recover and take possession of all the assets of the bank; the curator may be empowered to do a variety of far-reaching acts in the exercise of his or her discretion which the erstwhile managers of the bank would not have been empowered to do."

management into the hands and control of the curator, and stepping into the shoes of those vested with its management were divested from, the court held that:[146]

> 'These are sections of wide import. Their intention is to clothe the curator with full powers of management. He steps into the shoes of the board of directors. He has all powers of the directors, which he must exercise in a manner which he considers most economic and most promotive of the interests of its members and creditors.'

Any money of the bank that becomes available to the curator must be applied by him or her in paying the costs of the curatorship and in the conduct of the bank's business in accordance with the requirements of the curatorship and, as far as the circumstances permit, in the payment of the claims of creditors which arose before the date of the curatorship.[147] Every disposition of the bank's property, which if made by an individual could for any reason be set aside in the event of such individual's insolvency, may, if made by a bank that is unable to pay its debts, be set aside by a court at the suit of the curator in the event of that bank being placed under curatorship, and the provisions of the law relating to insolvency, shall *mutatis mutandis* apply in respect of such disposition.[148]

Another provision rooted in insolvency law relates to mortgage debts in respect of a bank under curatorship. The period during which any bank that is a mortgage debtor in respect of any mortgage bond is subject to curatorship in terms of this section shall be excluded in the calculation of any period of time for the purpose of determining whether such mortgage bond confers any preference in terms of section 88 of the Insolvency Act 1936, as applied to the winding-up of banks in terms of the Banks Act.[149]

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[146] See page 162 of the judgment for the quote.
[147] Section 69(2E) inserted by section 10(b) of Act 36 of 2000.
[148] Sec 92(2F) (a) of the Banks Act. For purposes of clarity, sec 69(2F)(b) provides that the event which shall be deemed to correspond with a sequestration order under the Insolvency Act, 1936 (Act No. 24 of 1936), in the case of an insolvent, shall be the presentation to the Court of the letter of appointment of the curator. In terms of the Insolvency Act, dispositions without value, undue preferences to creditors, voidable preferences and collusive dealings are recognized as impeachable transactions under sections 26, 29, 30 and 31 of the South African insolvency law.
[149] Section 69(2G) of the Banks Act. Section 88 of the Insolvency Act invalidates certain types of mortgages. In terms of this section, a mortgage bond, other than a kustingsbrief (the first mortgage over the property and thus outranks subsequent mortgages), whether special or general, passed for the purpose of securing the payment of a debt not previously secured, which was incurred more than two months prior to the lodging of the bond with the registrar of deeds concerned for registration or for the purpose of securing the payment of a debt incurred in novation of or substitution for any such first-mentioned debt, shall not confer any preference if the estate of the mortgage debtor is sequestrated within a period of six months after such lodging, provided that a mortgage bond shall be deemed not to have been lodged as aforesaid, if it was withdrawn from registration.

The aforementioned statutory powers of the curator may be augmented by the Minister of Finance through the addition of further powers set out explicitly in the letter of appointment of the curator, or at any time subsequent thereto. As such, the Minister may empower the curator in his or her discretion, but subject to any condition which the Minister may impose, to take certain actions listed in section 69(3)(a) to (k). These powers entail suspending or reducing, as from the date of the curator's appointment as such or any subsequent date, the right of creditors of the bank concerned to claim or receive interest on any money owing to them by that bank.[150] It is imperative to note that the Minister may also give the curator power to cancel any agreement to extend any existing facility, if, in his or her opinion, 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.[151] In *Rand Bank Ltd v Lornadawn Investments (Pty) Ltd*, which involved interpretation of the corresponding section 40(3)(c) of the repealed Banks Act 23 of 1965, it was held that this provision had to be restrictively construed and could not be available to a curator to cancel a post-curatorship commencement agreement entered into by his own staff under his or her supervision.[152]

The Minister may further empower the curator to convene from time to time, in such manner as the curator may deem fit, a meeting of creditors of the bank concerned for the purpose of establishing the nature and extent of the bank's indebtedness to such creditors and for consultation with such creditors in so far as their interests may be affected by decisions taken by the curator in the course of the management of the affairs of the bank concerned.[153] The curator may also be given the power by the Minister to negotiate with any individual creditor of the bank concerned with a view to the final settlement of the affairs of such creditor with the bank.[154]

The curator may further be empowered by the Minister of Finance to make and carry out any decision in respect of the bank which in terms of the provisions of the Banks Act, the Companies Act, the bank's memorandum of incorporation or the rules of any securities exchange, on which

[150] Section 69(3)(a) of the Banks Act.
[151] Section 69(3)(c) of the Banks Act.
[152] Reported as *1978 (4) SA 868 (T).*
[153] Section 69(3)(d) of the Banks Act.
[154] Section 69(3)(e) of the Banks Act.

any securities of the bank or its controlling company are listed, would have required an ordinary resolution or a special resolution of shareholders of the bank or its controlling company.[155]

In respect of leases, the curator may be given the power by the Minister to cancel any lease of movable or immovable property entered into by the bank concerned prior to its being placed under curatorship, provided that a claim for damages in respect of such cancellation may be instituted against the bank after the expiration of a period of one year as from the date of such cancellation.[156] The power of cancellation which may be accorded to the curator by the Minister also extends to 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, provided that a claim for damages in respect of any loss sustained by or damage caused to any person as a result of the cancellation of a guarantee may be instituted against the bank after the expiration of a period of one year as from the date of such cancellation.[157]

It is to be noted that the Minister may at any time and in any manner amend the directions contained in the curator's appointment letter, and the powers granted to the curator by the Minister in terms of 69(3).[158] This adds a good measure of flexibility to the curatorship process.

The curator's power to raise funding on behalf of the bank under curatorship from the SARB, or any entity controlled by the SARB, notwithstanding any contractual obligations of the bank, but without prejudice to real security rights to provide security over the assets of the bank in respect of such funding is codified in the Banks Act.[159] Without limiting any of the provisions under section 69 of the Banks Act, the curator is further empowered to propose and enter into an arrangement or compromise between the bank and all its creditors, or all the members of any class of creditors, in terms of section 155 of the Companies Act of 2008.[160]

[155] Section 69(3)(f) of the Banks Act.
[156] Section 69(3)(g) of the Banks Act.
[157] Section 69(3)(i) of the Banks Act.
[158] Section 69(4) of the Banks Act.
[159] Section 69(3)(j) of the Banks Act. This power can be exercised subject to the requirement that any claim for damages in respect of any loss sustained by, or damage caused to any person as a result of such security, may be instituted against the bank after the expiration of a period of one year as from the date of such provision of security.
[160] This section 69(3)(k) was added by section 2(d) of Act 3 of 2015.

To create checks and balances on the exercise of this mandate, the curator must duly record the nature of and the reasons for each act performed by him or her under any power conferred by the Banks Act, and such records shall be examined as part of the normal audit performed in respect of the affairs of the bank concerned.[161]

While a bank is under curatorship, the curator must on a monthly basis furnish the Registrar with a written report containing an exposition of the affairs of the bank concerned and in which it is stated whether or not, in the opinion of the curator, a reasonable probability exists that the bank will be able to pay its debts or to meet its obligations and to become a successful concern.[162] Hence, the prospect of the bank being restored to financial health is determinative of whether the curatorship will be allowed to continue pending the aforesaid desired outcome. It is also important to note that notwithstanding anything to the contrary contained in any law, the suspension, cancellation or termination of the registration of a bank while such bank is under curatorship does not affect any appointment made, direction issued, or any other thing done under the provisions relating to curatorship in respect of such a bank.[163]

The Banks Act also stipulates how the curator’s mandate can be terminated, and events that can trigger the lapse of curatorship. In this regard, it is provided that the Minister of Finance may at any time withdraw the appointment of a curator either on the Minister’s own volition or upon application by the Registrar of Banks.[164] Curatorship shall lapse upon the issue by the Minister of written notification to that effect to the curator or upon the winding-up of the bank.[165]

By and large, the curator’s powers under section 69 of the Banks Act are wide and flexible enough to enable the curator to deal effectively with a distressed bank scenario. However, section 69 does not stand on its own. The legal framework further creates mechanisms through

[161] Section 69(3A) of the Banks Act.
[162] Section 69(6A) of the Banks Act.
[163] The suspension, cancellation or termination of the registration of a bank under curatorship does not also affect any power to be exercised or duty to be executed in respect of that bank under curatorship by the Minister, the Registrar or the curator, by virtue of the provisions of section 69 of the Banks Act. The Minister, the Registrar and the curator, respectively, shall until such time as the curatorship is terminated continue to exercise their respective powers and to execute their respective duties under this section in respect of the public company of which the registration as a bank has been so suspended, cancelled or terminated, as if such suspension, cancellation or termination had not taken place.
[164] Section 69(9) of the Banks Act.
[165] Winding up of a bank is governed by section 68 of the Banks Act. Since the scope of this research is limited to bank rescue, the provisions relating to winding up will not be examined in too much detail.

which the causes of the distress are revisited and examined, with a view of rectifying the corporate mistakes made, and attributing personal liability to those who might be culpable or complicit in causing the bank failure. It is in this spirit that section 69A (commission of investigation) is being examined as an augmentative and supportive process to curatorship.

3.2.3 Commission of investigation in terms of section 69A of the Banks Act

While a bank is under curatorship, the Registrar of Banks has the discretion to appoint a person to be a commissioner for the purpose of investigating the business, trade, dealings, affairs or assets and liabilities of that bank or of its associate or associates.[166] The Registrar also has the discretion to appoint a person or more persons to assist the commissioner in carrying out the investigation concerning the affairs of a bank under curatorship.[167]

The commissioner and any person or persons appointed as his or her assistant(s), shall for the purpose of their functions in terms of section 69A of the Banks Act have powers and duties in all respects corresponding to the powers and duties conferred or imposed by sections 4 and 5 of the Inspection of Financial Institutions Act,[168] upon a registrar or an inspector contemplated in the Inspection of Financial Institutions Act.[169] These powers entail summoning any person who is or was a director, employee, partner, member, trustee or shareholder of the bank and whom the commissioner believes is in possession of or has under his or her control, any document relating to the affairs of the institution, to lodge such document with the commissioner; administering an oath or affirmation or otherwise examining any person who is or formerly was a director, employee, partner, member or shareholder of the bank under investigation; entering and searching any premises occupied by the bank, *et cetera*.[170]

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[166] Section 69A(1) of the Banks Act.
[167] Under section 69A(2) of the Banks Act, the Registrar may appoint a person as an assistant or two or more persons as assistants to the commissioner referred to in subsection (1) in order to assist the commissioner, subject to the control and directions of the Registrar, in an investigation contemplated in subsection (1) of section 69A. However, before the Registrar appoints a commissioner in terms of subsection (1) or a person or persons in terms of subsection (2), the Registrar is obliged to take all reasonable steps to ensure that the person or persons so appointed will be able to report objectively and impartially on the affairs of the bank concerned or the associate or associates of such bank.
[168] Act No. 80 of 1998.
[169] The Inspection of Financial Institutions Act applied from 28 October 1998, the date of commencement to 11 May 2000, the day before commencement of the Financial Services Board Amendment Act 12 of 2000
[170] Section 5 of the Inspection of Financial Institutions Act governs the powers of inspectors of financial institutions relating to other persons.

The commissioner must within a period of five months from the date of his or her appointment complete the investigation into the affairs of a bank that was placed under curatorship. Within a period of 30 days after completion of the investigation, the commissioner must also prepare a written report. This report should *inter alia* state whether or not, in the opinion of the commissioner it is in the interest of the depositors or other creditors of the bank concerned that the bank remains under curatorship or be wound up.[171] The commissioner is also tasked to report on whether it appears that any business of such bank was carried on recklessly or negligently or with the intent to defraud depositors or other creditors of the bank concerned or any other person, or for any other fraudulent purpose and the perpetrators must be named.[172] It is submitted that the purpose of this provision is to entrench accountability on the side of bank managers and senior staff by providing a mechanism for personal civil and/or criminal liability in case the bank's business was conducted negligently, or with the intent to defraud customers. The provisions of section 69(8) *mutatis mutandis* apply in respect of a bank under curatorship of which the registration as a bank is suspended, cancelled or terminated while an investigation under this section in respect thereof is in progress.[173]

3.2.4 Practical scenarios on the exercise of curatorship powers under the South African dispensation

Curatorship has been utilized in a number of scenarios, but for purposes of delimitation, I will only examine SAAMBOU and African Bank.[174] As noted above, the choice of these two case

[171] Section 69A(11) of the Banks Act. A report by a commissioner completed in accordance with the provisions of this section shall be forwarded to the Registrar of Banks, the Minister of Finance, and in the event of findings that it appears that any business of such bank was carried on recklessly or negligently or with the intent to defraud depositors or other creditors of the bank concerned or any other person, or for any other fraudulent purpose, and if it appears that that any business of such bank was carried on recklessly or negligently or with the intent to defraud depositors or other creditors of the bank concerned or any other person, or for any other fraudulent purpose, any person identified by the commissioner was a party to the carrying on of the business of that bank in such manner, a copy of the report must be submitted to the Attorney General concerned.
[172] See section 69A(11) of the Banks Act.
[173] Notwithstanding anything to the contrary contained in any law, the suspension, cancellation or termination of the registration of a bank while such bank is under a section 69A investigation does not affect any appointments made, direction issued, or any other thing done in respect of the affected bank.
[174] There are many examples of bank curatorship both in apartheid and post-apartheid South Africa. For example, Alpha Bank failed in 1990 and was in curatorship for four years, Cape Investment Bank failed in 1991 and was in curatorship for a year, Pretoria Bank failed in 1991 and was in curatorship for six months, and in post-apartheid South Africa, there have been several bank failures such as Prima Bank (1994), Sechold Bank (1994), African Bank (1995), which later failed again as I will examine below, Community Bank (1996), Islamic Bank (1997), New Republican Bank (1999), FBC Fidelity Bank (1999), Regal Treasury (2001), Saambou (2002) and BOE Bank (2002). For an elaborate discussion of the causes of bank failure in South Africa, see Sipho Makhubela, Causes of Bank Failure in Post Democratic South Africa, UKZN MBA Thesis, 2006.

studies is hinged on the fact that the curatorship of SAAMBOU Bank happened in 2002 before the GFC. This case study represents the regulatory mindset before the GFC and by tracing back in time, with the benefit of hindsight, we are able to see the changes in regulatory paradigm that have been informed by the GFC. On the other hand, the curatorship of African Bank is the major milestone event in South Africa's post GFC bank curatorship legal dispensation. It represents a mindset shift that had been influenced by a new/modern global thinking such as the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions" of October 2011. This new paradigm influenced a more innovative approach for bank regulators to deal with distressed banks, as shall be illustrated through the timeline of events set out in this part of the study.

3.2.4.1 Saambou Bank

Saambou was South Africa's seventh largest bank before its collapse in 2002 after investors withdrew more than R1 billion of their savings due to erosion of trust and confidence in the bank.[175] Consequently, on 9th February 2002 it was placed under curatorship by the Finance Minister. This decision was premised on public interest to stem abnormal outflows of funds from the bank, which created liquidity pressures on the bank, and to safeguard depositors' funds. The SARB also took the view that committing financial assistance through a bailout plan to the distressed Saambou Bank would not be prudent because there was no guarantee that an injection of public funds would restore public confidence in the bank or will not be used to fund further large capital outflows out of the bank.[176]

According to SARB Bank Supervision Department (BSD) 2002 report, the first indication of problems at Saambou was the sale of shares by two of the bank's executive directors, which triggered media speculation that the directors sold their stake because they knew the bank was underperforming.[177] Saambou's issue of a profit warning to its investors made the situation even worse. This was followed by the Johannesburg Stock Exchange (JSE) announcement that it

[175] See 'Auditor explains findings in Saambou case' http://www.iol.co.za/news/south-africa/auditor-explains-findings-in-saambou-case-387404 (last visited on 4/12/16).
[176] Supra, page 2 of the speech. The appointed curator was Mr. John Louw who was tasked with facilitating the orderly management of the bank. Furthermore, taking the decision of appointment of the curator entailed freezing all the accounts held by the bank to enable the curator acquaint himself with the bank book details.
[177] Pg. 8 of the BSD's report (2002), an annual publication of the SARB.

would institute insider-dealing investigations into the share-sale transactions of the two directors.[178]

Since Saambou was the seventh largest bank in the Republic, with a large retail deposit base and an expansive branch network, the SARB regarded it as systemically important. The BSD requested one of the big four auditing firms to conduct a solvency due-diligence audit of the bank.[179] Contagion spread after putting Saambou under curatorship. Not only did smaller banks catch the bug, but it also moved to the larger banks like BOE, which was the sixth-largest in the economy.[180] Saambou was eventually acquired by FirstRand's First National Bank (FNB).[181]

As a result of the problems experienced by the South African banking sector in 2002, the SARB adopted a framework for dealing with distressed banks.[182] It is now the practice and policy of the SARB that where a bank has a liquidity problem, the SARB must assess whether settlement failure (the bank's inability to meet its payment obligations) is imminent.[183] Once this state of affairs is detected, the SARB then considers granting the affected bank a concession to use its statutory liquid assets and minimum cash reserves (prudential assets) to allow the bank to sort out the settlement function and stabilize its operations. If the liquidity problem is short term and the concession cures the situation, and the prudential assets are restored, the SARB may then condone the shortfall in the statutory prudential assets for the period of non-compliance.[184]

If the concession does not ameliorate the liquidity problem and it proves to be long term, the affected bank's directors are summoned to the SARB and advised to explore other private sector solutions. For purposes of rescue, these may include injection of new or additional share capital,

[178] Because of all these factors, and huge losses in the bank's microfinance business, its share price fell and there were massive withdrawals that exacerbated the bank's failure.
[179] The auditors were of the opinion that the bank was solvent. However, the credit rating agency, Fitch, placed SAAMBOU Bank on a negative rating, pending the resolution of its liquidity problems.
[180] Some of the smaller banks lost up to 40 percent of their deposit base, resulting in a severe wipe out of their share prices on the JSE. BOE suffered large withdraws in its wholesale depositors business and approached the SARB for liquidity assistance. The liquidity injunction did not curb the mass withdrawals and National Treasury issued a guarantee to all depositors that their withdrawals would be met from the *fiscus*. Nedbank (a bigger bank in the market) eventually acquired BOE and the National Treasury withdrew its guarantee because it was no longer necessary.
[181] FNB acquired SAAMBOU's operations, its traditional housing book, and approximately half of its low-cost housing book.
[182] Pg. 10 of the BSD Annual report (2002), a publication of SARB.
[183] In the normal and ordinary course of its regulatory and supervisory duties, the SARB conducts solvency assessments, assesses risk-management processes and controls by the banks. Therefore, it is able to identify events and signals which can trigger distress or loss of public confidence in a particular bank.
[184] Pg. 11 of the BSD Report, (SARB, 2002).

securitization of assets, a new shareholder or reference taking up a large stake in the affected bank, or subordination of some deposits as secondary capital. In the meantime, SARB will appoint an auditing firm to do a solvency due-diligence audit of the bank in order to establish whether it is still solvent.[185]

If the solvency due-diligence audit establishes that the bank in distress is solvent, the SARB must determine whether the affected bank is systemically important. This entails an assessment of whether the entire banking sector would be jeopardized if the distressed bank was unable to settle its transactions and whether the public confidence in the banking system would be eroded if the affected bank was left to fail. Where the SARB determines that the bank is systemically important, the SARB, as lender of last resort, will step in and provide liquidity assistance, in combination with one or two of the private sector rescue options highlighted above.[186] If this combined public/private-sector intervention assistance is successful, the special liquidity assistance provided to the distressed entity will be repaid to the SARB, and the bank will continue to be supervised in the normal and ordinary process like all the other banks in the industry. However, if the discussed intervention measures are unsuccessful, a merger with another bank will be pursued.[187]

Where a distressed bank is found to be solvent, but not systemically important, the SARB would provide special short-term liquidity assistance, at a penal rate (to minimize moral hazard). This would be mixed with private-sector measures already discussed in the study. Additionally, such assistance would have a sunset clause (a measure within the policy that provides that such

[185] To minimize conflict of interest, the audit firm appointed should not be one of the external auditors of the bank.
[186] In other terms, where a bank encounters distress, a special investigation is conducted to establish beyond doubt whether such a bank suffers from a liquidity or solvency problem. If the nature of the bank's problem is a short-term liquidity shortage of a temporary nature and does not affect its solvency, the SARB will decide in the interest of maintaining stability in the banking sector, whether or not to provide emergency liquidity assistance (ELA) against acceptable collateral security tendered by the affected banks. This assistance serves two objectives. Firstly, it provides some breathing space to the distressed bank in order to implement corrective measures to cure its liquidity problem before it morphs into a crisis. Secondly, it prevents illiquidity from precipitating a run on the bank thus precipitating insolvency and spreading contagion to other banks.
[187] Such a merger will be effected with a well-managed bank, in the interest of a stable banking system in the Republic, which is of interest to all of the banks.

assistance shall cease to have effect after a specific date, unless further regulatory action is taken to extend the period).[188]

If, however, a distressed bank is found to be insolvent, but the SARB determines that it is systemically important, the SARB might arrange for a purchase-and-assumption of assets and liabilities transaction. With this action, the distressed bank is purchased by the public authorities until it can be cured from the distress (nursed back to normal health), and privatized again.[189] If the distressed bank is neither solvent nor systemically important, the SARB can approach the Minister of Finance to appoint a curator, or apply for its liquidation. Liquidation is outside the scope of this research because it is a form of resolution, and not recovery/rescue, which is the subject of discussion in this study.

By and large, the case study of SAAMBOU and the legal position pre-GFC has some salient lessons that inform the position post-GFC, as will be explored when handling the discussion on African Bank below. As the policy framework highlights, the way in which SARB will deal with a distressed bank depends on the particular circumstances surrounding the nature of the distress, the size of the institution, and its significance/importance in the market.

3.2.4.2 African Bank International Limited (ABIL)

Most recently, curatorship has been adopted to rehabilitate African Bank. Towards the end of 2012, the SARB was concerned with African Bank's credit growth. In the six months period to March 2014, the distressed bank (African Bank) incurred a headline loss of R3.1 billion. By September 2014, the losses of African Bank's holding company, African Bank International Limited (ABIL) had skyrocketed to R6.4 billion. A furniture chain, Ellerine Holdings Ltd, like African Bank, was a wholly owned subsidiary of ABIL. Ellerine Furnishers had caused significant capital drain on ABIL, requiring funding support of a minimum of R70 million per month as capital injection. African Bank was the only South African bank exposed to such a magnitude to a furniture store. Due to the untenable financial distress, Ellerine Furnishers was

[188] If the short-term special liquidity assistance to a solvent but non-systemically important bank is not successful to rescue the entity, a curator is appointed to freeze the bank's assets and deposits in order to commence asset-liquidation process in order to pay the depositors.
[189] According to the SARB, this option was successful in Sweden to salvage the banking industry in the 1960s when 18 percent of the total unconsolidated bank loans were reported lost.

placed into business rescue on 7 August 2014. The monthly bailout capital injection from ABIL and African Bank to Ellerine Furnishers had to end.[190]

Consequently, on 10 August 2014, African Bank was placed under curatorship. The bank's board did not oppose the curatorship and a framework with the necessary resolutions was put in place. The Minister appointed Tom Winterboer as the curator with immediate effect and conferred on him the full authority bestowed by the law on curators.[191] In practical terms of the business turn around, the SARB formed a consortium consisting of six banks in South Africa, the Public Investment Corporation (PIC) and the SARB itself.[192] Then, a new registered bank holding company ("New Holdco") was formed to hold the "Good Bank", and to acquire the various insurance entities within the ABIL Group, including the Standard General Insurance Company Limited (Stangen). R10 billion of equity was injected by the Consortium into New Holdco, and the African Bank loan book was split into a "Good Book" and a "Residual Book". Some of the assets, including the Good Book, and selected liabilities of African Bank were transferred to the

[190] See the 'Remarks by the Governor of the South African Reserve Bank' issued by Gill Marcus at the Press Conference of August 10th, 2014 concerning African Bank Limited, available at https://www.resbank.co.za/Lists/Speeches/Attachments/414/Governor's%20Address%20-%20ABIL.pdf (visited on 9th September 2014). The problems that befell African Bank were attributable to its unsustainable business model, which did not include a diversified set of market products and income inflow streams. It did not offer transactional banking services thus making it vulnerable to the changing tides of the banking business environment in South Africa.

[191] Ibid, page 4 of the speech. Tom Winterboer is a member of the Global financial services leadership team at PWC. A team of other experts including Mr. Peter Spratt and Mr David Gard from PWC London were also appointed to assist Tom Winterboer. Brian Riley, formerly with Wesbank was appointed as the Chief Executive Officer of the "good" bank division that was salvaged from the wider African Bank Limited. African Bank mainly offers unsecured personal loans to individuals in the medium to lower income segments in South Africa and plays an important role as a regulated loan provider for many South Africans. Since curatorship, Webber Wentzel and Linklaters have been advising the Curator on the restructuring of African Bank. The curatorship of African Bank was South Africa's only experience of a bank curatorship in recent history. At the same time as African Bank was placed under curatorship, the then Governor of the SARB, Gill Marcus communicated a restructuring proposal to the market. In the months following the curatorship, significant time was spent to further develop this restructuring proposal and a detailed restructuring plan was published for comment in 2015. Offers to various classes of creditors were then launched in early February 2016. The principal terms of the restructuring that; a new group was established and the new holding company received a ZAR10 billion capitalization from the SARB, the Government Employees Pension Fund in South Africa and a consortium of South African banks; A newco ("Good Bank") acquired part of the African Bank business (the "Good Bank business"); and African Bank made offers to its creditors, including offers to its senior and subordinated bondholders, to exchange certain bonds they currently hold in African Bank for new bonds in Good Bank (or, for subordinated bondholders, shares in its holding company), cash payments and a residual claim in African Bank. See *"Webber Wentzel and Linklaters advise on the restructuring of African Bank"*, accessed via http://www.webberwentzel.com/wwb/content/en/ww/ww-in-the-news?oid=55273&sn=Detail-2011&pid=32711 (Last visited on 20/5/16).

[192] The consortium comprises of Absa Bank Limited, Capitec Bank, First Rand Bank Limited, Investec Bank Limited, Nedbank Limited and Standard Bank. It also involves the Government Employees Pension Fund in South Africa to support and underwrite a restructuring. This consortium agreed to inject in a total of R 10 billion to acquire part of the "Good bank business" and form a new bank, the "Good Bank".

Good Bank. This was followed by the transfer of the senior funding liabilities and retail deposits from African Bank to the Good Bank (which retained the name African Bank), after trimming the face value of the senior funding liabilities by 10%. Subsequent to the commencement of curatorship, it was agreed to transfer 37.5% of the Tier II subordinated funding liabilities to the Good Bank, which was eventually listed on the Johannesburg Stock Exchange (JSE) in April 2016.[193]

In essence, the bank continued to run as usual. However, the disbursement of loans was altered and reduced in that only secure or less risky loans will be disbursed in contrast to the pre-collapse business model that had a very high appetite for unsecured loans. Payments of interest and capital have also been barred except for those awarded to retail depositors and trade creditors, since they make up only 1% of the bank's total creditors. Moreover, the conglomerate of six South African banks pooled resources and undersigned a capital raising exercise aimed at attaining R10 billion to aid the separation of the good bank from the bad bank by using that money to prevent the full collapse of African Bank and help refinance the feasible sectors and departments of the bank and re-establish the bank as a new "Good Bank", a wholly owned subsidiary of a public listed company trading on the JSE.[194] The curator also set certain suspensive conditions for restructuring of African Bank, such as the approval of the restructuring by the Minister of Finance and the approval of the Registrar of Banks for the registration of the "Good Bank". Both of these approvals were obtained and thus the suspensive conditions were fulfilled and the restructuring of African Bank has been accomplished. Furthermore, upon conclusion of the restructuring, African Bank changed its name to Residual Services Limited, but will continue trading under the name and style of "African Bank Limited".[195]

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[193] See Winterboer, T 'African Bank Limited (in curatorship) Annual Financial Statements' (2015) at pg. 5. In order to understand this process and how it is intended to resuscitate the Bank, there is need to first understand SARB's "Good Bank" and "Bad Bank" proposal. The rationale is that African Bank would be placed under curatorship and its loan book would be divided into good and bad loans. The good book represented the good business of the Bank both before and after its collapse. This was folded into a "good bank". The rest of the book representing the bad loans was marked as the "bad" or "residual" bank, which was purchased by the SARB for R7 billion. The consortium of the six banks and the PIC injected R10 billion to re-capitalize ABIL through a new vehicle/entity which will be listed on the JSE. The good loans were transferred to this new entity.

[194] See Stanlib update on the restructuring of African Bank and its engagement with stakeholders accessed via http://www.stanlib.com/newsatstanlib/Pages/AfricanBankcuratorshipupdateNovember.aspx (last visited on 1/6/16).

[195] See suspension of all ABIL and African Bank securities on the exchange operated by the JSE and renewal of cautionary dated 11/08/2014 accessed via the JSE website https://www.jse.co.za (last visited on 1/6/16).

On 17th March 2016, African Bank's CEO designate Brian Riley announced the management's intention to build African Bank into a retail bank by implementing an appropriate strategy with the correct tools, skill set and solid capital foundation. On 4th April 2016, the bank launched with an equity base of R10 billion and a cash position of some R24 billion. The surplus cash, in conjunction with restructured wholesale funding arrangements, will enable the bank to build a track record without the need to raise funds for a number of years.[196]

3.2.5 Lessons learnt from the African Bank curatorship: Setting the scene for the 2015 Amendments to the Banks Act

The rescue of African Bank has been hailed a success story but it needs to be noted how much legislative footwork had to be done by the SARB in order to augment the then existing curatorship framework to address the African Bank scenario. The 2015 Banks Amendment Act largely facilitated the African Bank rescue. The exercise of placing African Bank under curatorship was a significant learning experience for the SARB. As part of the African Bank "Good Bank" (solvent part) and the "bad bank" (non-performing loans) restructuring, the curator had to engage in the transfer of assets and liabilities.[197] However, as much as the curator had the power to dispose of assets of a bank under the existing curatorship framework in terms of the Banks Act, he had to do so within the restricted proviso that the bank would then be able to meet its financial obligations. Additionally, the Banks Act also did not allow the curator to make many decisions on behalf of corporate shareholders, who could possibly cause gridlocks by voting against any proposed restructuring plans of the distressed bank by the curator.

Therefore, the challenges faced by the curator in the disposing of assets necessitated an amendment to the Banks Act in order to enable the curator to take certain vital steps targeted at

[196] The African Bank press release of March 17th 2006 also noted that the management team focused on evaluating and creating improved structures throughout the bank and over the past months to reform the bank towards improved financial risk management systems and have implemented a prudent impairments methodology; curbing the decline of sales volumes and focused to build to sustainable profit levels; instituting a performance management process which cascades from CEO across the entire business; offering additional collection channels through Eazy Pay, Shoprite and in-branch options; stabilizing information technology systems and revised strategy in support of business transformation; creating predictability of credit outcomes through appropriate credit risk criteria; conducting cost saving initiatives which will continue to be refined, and constitution of a new board and defined sub-committees.

[197] The "good bank" and "bad bank" concepts are bank restructuring measures whereby the assets of a distressed bank are divided into two categories. The illiquid, high risk securities and other troubled assets such as non-performing loans go into the "bad bank" portfolio. The good assets which represent the going concern of the core business of the bank are put in the "good bank" portfolio. This helps to prevent contamination of the good assets by the bad and toxic ones.

dealing with the African Bank scenario. Consequently, in June 2015, Parliament, in a record time, expediently amended the Principal Act. The new amendment expressly gives the curator the power to dispose any of the bank's assets, transfer any of the bank's liabilities or dispose of any of its assets and transfer any of its liabilities in the ordinary course of the bank's business.[198] The provisions of the Banks Act regarding compromises, amalgamations, arrangements and affected transactions apply to the curator while exercising this mandate.[199]

In terms of business continuity under the 2015 amendment to the Banks Act, any company previously registered as a bank or as a controlling company continues to be a company in terms of the Companies Act, and the provisions of that Act, subject to the necessary modifications and adaptations, continue to apply to any such company to the extent to which they are not inconsistent with any provision of the Banks Act.[200] Furthermore, while seeking the ministerial consent for a disposal of assets or transfer of liabilities or such disposal and transfer, the curator is obliged to report to the Finance Minister or the Registrar of Banks on the expected effect of

[198] However, the curator must not effect a disposal of the bank's assets unless a reasonable probability exists that such disposal will enable the bank to pay its debts or meet its obligations and become a successful concern. In terms of correlational analysis with business rescue law, the requirements for the granting of a section 131 Companies Act rescue order include that the company under consideration must have a reasonable prospect of recovery. *In Oakdene Square Properties (Pty) Ltd and Others v Farm Bothasfontein (Kyalami) (Pty) Ltd and Others (609/2012) [2013] ZASCA 68; 2013 (4) SA 539 (SCA); [2013] 3 All SA 303 (SCA)* (27 May 2013), the Supreme Court of Appeal interpreted "reasonable prospect" as a lesser requirement than the 'reasonable probability' test which was the yardstick for placing a company under judicial management in terms of s 427(1) of the 1973 Companies Act (see *Southern Palace Investments 265 (Pty) Ltd v Midnight Storm Investments 386 Ltd 2012 (2) SA 423 (WCC)* para 21). But on the other hand, it requires more than a mere *prima facie* case or an arguable possibility. Of even greater significance, it must be a reasonable prospect – with the emphasis on 'reasonable' – which means that it must be a prospect based on reasonable grounds. A mere speculative suggestion is not enough.

[199] These provisions are contained in section 54 of the Banks Act. The Minister must consent in writing conveyed through the Registrar of Banks to an amalgamation, merger or arrangement which involves a bank as one of the principal parties to the relevant transaction and an arrangement for the transfer of more than 25 per cent of the assets, liabilities or assets and liabilities of a bank to another person. In terms of section 1 of the Companies Act (2008) as amended, an "amalgamation or merger" means a transaction, or series of transactions, pursuant to an agreement between two or more companies, resulting in the formation of one or more new companies, which together hold all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement, and the dissolution of each of the amalgamating or merging companies or the survival of at least one of the amalgamating or merging companies, with or without the formation of one or more new companies, and the vesting in the surviving company or companies, together with any such new company or companies, of all of the assets and liabilities that were held by any of the amalgamating or merging companies immediately before the implementation of the agreement. To contextualize the legal provisions to bank curatorship, references to the board of a company, the liquidator of a company and an authorized director in section 155 of the Companies Act is regarded as a reference to a curator.

[200] The provisions of the Companies Act governing the conversion of public companies into other forms of companies shall not apply to any such company. Furthermore, the provisions of sections 128 to 155 of the Companies Act relating to business rescue and compromise with creditors do not apply to a bank.

such transactions on the bank's creditors.[201] The curator is expected to disclose whether the creditors have been treated in an equitable manner and also to report on whether 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 been wound up under the provisions of section 68 of the Banks Act.[202]

More fundamentally, a wider view of the entire banking sector and not just the specific distressed bank is also to be put into consideration. The Minister or Registrar can consider the curator's report and consent to the disposal, transfer or disposal and transfer of a bank's assets and liabilities notwithstanding the fact that the creditors have not been treated in an equitable manner and a reasonable probability exists that a creditor will 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 been wound up under section 68 of the Banks Act if such transaction is reasonably likely to promote the maintenance of a stable banking sector as a whole or improve the public confidence in the banking sector.[203] It is submitted that this legal provision is revolutionary in the sense that it subordinates private interest of shareholders and bondholders to the wider public interest in financial stability in order to safeguard the public confidence in the banking system and promote a stable banking sector as a whole. The 2015 amendment guarantees wider powers to the regulator to contain moral hazard that may flow from the public losing trust in the banking system.

Furthermore, in terms of the amendment, the curator has been accorded the express power to raise funding from the SARB or any entity controlled by the SARB on behalf of the distressed bank under curatorship notwithstanding any contractual obligations of the bank, but without prejudice to real security rights.[204] This is what has commonly come to be known as a "bail out".[205] Essentially, a bail out happens when a government makes payments (including loans,

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[201] Section 69(2C) (c) of the Banks (Amendment) Act, 2015.
[202] This provision for a curator's report is contained in the current section 69(2C)(c) of the Banks Act.
[203] Section 69(2C)(d)
[204] Section 69(3)(j) of the Banks Act. This subsection also gives a window period to any claim for damages in respect of any loss sustained by, or damage caused to any person as a result of such security referred to in this subsection. Such a claim may only be instituted against the bank after the expiration of a period of one year as from the date of such provision of security.
[205] A bailout can be defined as transfer of money or other resources from the government to a private entity. Since the 2008 financial crisis and the market interventions to save corporations and financial institutions in the United States of America and Europe, the word "bail out" has become popular in political and economic lexicon. (Anthony

guarantees, cash, bonds, or other types of consideration) to a liquidity constrained private entity to pay off debts or recapitalize.[206] It must be noted that currently the South African legal framework does not have an express Deposit Insurance scheme, thus resulting in the unfavorable situation that tax payers' money has to be utilized to buffer the financial system against collapse in those instances where the government decides that a bailout is appropriate. However, it is submitted that irrespective of the side one takes (whether pro-bail out or anti-bail out), this provision is specifically important because it introduces a legislative framework to govern bailouts in the banking history of South Africa. This is one of the lessons learnt from the devastating effects of the global financial crisis and one of the solutions aimed at not only rescuing failing banks, but also restoring public confidence in the banking system.[207]

The 2015 amendment further gives the curator powers to propose and enter into an arrangement or compromise between the bank and all its creditors, or all the members of any class in terms of section 155 of the Companies Act.[208] One leading legal practitioner in South Africa has argued that the policy consideration behind the curatorship provisions is to give the curator, under the Registrar of Banks oversight, complete freedom and flexibility in running the distressed bank's business and restoring it to viability a going concern.[209] It is also imperative to note that to a larger extent, the 2015 amendments to the Banks Act were inspired by the global shift in attitude and practical considerations in regard to handling distressed banks as a result of the GFC and

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J. Casey & Eric A. Posner, 'A Framework for Bailout Regulation', University of Chicago Law School, 26th Jan 2015 Pg. 1). This has been a very controversial topic in recent times with proponents of tax payers' money arguing that private entities should be responsible for their own debts while supporters of bail out interventions premise arguments on social concerns to save businesses, taxes, jobs and restore stabilization in the financial system.

[206] Supra, page 2. The essential characteristic of a bail out is that it is *ex post*. This has been the major cause of controversy because everyone expects any borrower (whether a corporation or individual) to take the necessary precautions to ensure that they can satisfy their debt as and when it falls due.

[207] Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy or Bailouts*?, 35 J. Corp. L. 469 (2010); Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 Temp. L. Rev. 449 (2009); Anna Gelpern, *Financial Crisis Containment*, 41 Conn. L. Rev. 1051 (2009); Schwarz, Systemic Risk, 97 Geo L.J. 193 (2009); see also Richard W. Painter, *Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab*, 41 McGeorge L. Rev. 131 (2009) (for a discussion on implications of the financial crisis and theories of political and crony corruption associated with government interventions.)

[208] In terms of section 155(2) of the Companies Act (2008) as amended, the board of a distressed company facing winding up, or the liquidator may propose an arrangement or a compromise of its financial obligations to all of its creditors, or to all of the members of any class of its creditors. In terms of the Banks (Amendment) Act, 2015 the curator is given similar powers.

[209] Milton Seligson SC, "*When Statutes Collide: The Application of section 45 of the Companies Act to a Bank under Curatorship in terms of section 69 of the Banks Act*", Business Tax & Company Law Quarterly, Vol. 6 Issue 1, Mar. 2015 at pg. 5.

benchmark standards contained in the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions.[210]

In terms of the section 69A investigation into African Bank's situation, the SARB made the report submitted to the Registrar of Banks by Advocate JF Myburgh available to the public, following consultation with the Minister of Finance. The report includes the findings of the investigation into circumstances that led to African Bank Limited being placed under curatorship. The contents of the report further represents Advocate JF Myburgh's opinion, based on the findings of the investigation conducted.[211] The report *inter alia* indicates that there were major corporate governance failures at African Bank that led to its distress.[212] Interestingly, the report does not recommend criminal prosecution to be sanctioned against African Bank CEO Leon Kirkinis because no evidence of criminal behavior was found in African Bank's collapse. This contrasts with the collapse of Regal Bank where the Director, Jeff Levenstein, who was described by the 2002 Myburgh report as an incompetent fraudster who "confused corporate governance with thuggery" was jailed[213], or Saambou in 2002 where the bank's top leaders were

[210] The provisions pertaining to bank recovery mechanisms have been addressed earlier on in the course of this research.
[211] The report can be accessed via https://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=7288 (last visited on 21/5/16). The investigation in terms of s69A is inquisitorial, and not accusatorial or adversarial, in nature. The difference between the two is highlighted by the respective definitions. Inquisitorial: "A system of criminal procedure in which the judge has the duty to investigate the facts", accusatorial: "of a system of criminal procedure: in which the facts are ascertained by the judge or jury from evidence presented by the prosecution and the defense" (Shorter Oxford English Dictionary); Inquisitorial system: "A system of proof-taking used in civil law, whereby the judge conducts the trial, determines what questions to ask, and defines the scope and extent of the inquiry"; adversary system: "A procedural system, such as the Anglo-American legal system, involving active and unhindered parties contesting with each other to put forth a case before an independent decision-maker." (Black's Law Dictionary). The opinions expressed by the Commissioner in terms of s69A(11) are not decisions. The opinions are not binding on anyone. Eight teams of legal representatives, counsel and attorneys, represented the 26 witnesses who gave evidence.
[212] On page 416 of the Report, paras 615-616, it was found that in approving the loans from the bank to Ellerines, the directors of the African Bank board acted in breach of their fiduciary duty to the bank; did not exercise the required care and skill; did not act for the benefit of the bank; and did not act in the best interests of the bank. These findings are premised on the reasons *inter alia* that the loans grew from about R450 million in September 2012 to about R900 million in September 2013 to R1,4 billion in July 2014; the aggregate amounts of the loans increased at the very time that the bank was producing poor results in 2013 and 2014; and no reasonable banker would have lent R450 million or R900 million or R1,4 billion to a furniture business which was unprofitable or barely profitable in an industry which was struggling, without security.
[213] A copy of this report can be accessed via https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/4695/Annexure_D3.pdf (last visited on 10/6/16). Jeff Levenstein of the collapsed Regal Bank was eventually found guilty of several counts of fraud and contravening the Companies Act and sentenced to 15 years' imprisonment in 2009, but the Supreme Court of Appeal (SCA) reduced his sentence to eight years in 2013.

also prosecuted.[214] The disclosure of these reports is a positive direction for South Africa because it not only improves public transparency and access to information, but also enables the banking industry to undertake self-correction measures to improve bank corporate governance and exercise ethical management as mitigation measures to reduce bank failure.

By and large, it should also be noted that curatorship is not necessarily an economic magic wand that will perform recovery miracles all the time. The Act thus provides that if at any time the curator is of the opinion that there is no reasonable probability that the continuation of the curatorship will enable the bank to pay its debts or meet its obligations and become a successful going concern business again, the curator is required to write to the Registrar of Banks and notify him of such opinion.[215]

3.3 Blowing winds of change: The evolution of curatorship powers of the Reserve Bank under the proposed "Twin Peaks" dispensation

3.3.1. Introduction

Since its inception, the SARB has always evolved to meet the changing needs and dynamics of the banking industry.[216] This change is often driven by legislative and policy changes in light of prevailing financial and economic realities. The recent global financial crisis of 2008 is one of those realities. The evolution in financial markets deregulation coupled with rapid innovation and technological developments in the financial sector orchestrated massive financial gains and booms that plunged the world into an economic disaster of unimaginable proportions. Governments' interventions through bailout packages to stimulate recoveries created larger financial markets and thus contributed to larger financial crises when the market bubble burst.[217]

[214] See *Levenstein v S (890/12) [2013] ZASCA 147; [2013] 4 All SA 528 (SCA).*
[215] Section 69(2D) of the Banks Act as amended.
[216] Johann De Jager 'The South African Reserve Bank: Blowing Winds of Change Part 1' (2013) 25 *SA Mercantile Law Journal* at 342. The author notes that these changes require a dynamic approach and flexibility since Central Banks need to grow, change and adapt to the emerging needs and trends of the financial system like living organisms to ensure continuation of public support in their operations. Fundamentally, this growth process happens twofold at both an external and internal level. Externally, the Central Banks have to adjust to the market needs in the financial system. Internally, growth and change happens in the internal decision making and management structures of the Central Banks.
[217] Johann de Jager 'The South African Reserve Bank: Blowing Winds of Change Part 2' (2013) 25 *SA Mercantile Law Journal* at 492. An elaborate discussion of the evolutionary nature of post-crisis reform can be found in James Crotty 'Structural causes of the global financial crisis: A critical assessment of the ''new financial architecture'' (2009) 33(4*) Cambridge Journal of Economic*s 563; Stephanie Blankenburg & José Gabriel Palma 'Introduction: The global financial crisis' (2009) 33(4) *Cambridge Journal of Economics* 531.

Combatting the negative effects of the GFC necessitated robust reforms in the global and national financial sector regulatory frameworks to deal with the excesses committed in the period leading to its build up, create anchors for future growth and economic activity and ensure stronger and more efficient regulatory and financial stability linchpins.[218]

In 2008, the World Bank and the International Monetary Fund (IMF) conducted a Financial Sector Assessment Program (FSAP) on the state of South Africa's financial sector regulation and suggested reforms aimed at strengthening the prudential standing and market conduct within the sector. It was highlighted that there was a need to further augment efforts of legislation like the National Credit Act[219] to protect consumers and cushion the economy from the financial shocks of the GFC. The IMF Report pointed out that the South African financial system is dominated by a number of financial conglomerates with activities, often undertaken in separate legal entities, in several markets.[220] There is thus a need for regulators to combine strong sectoral supervision, both prudential and market conduct, with a focus on identifying and managing risks that span more than one sector. In addition to strengthening communication and coordination between regulators, the report highlighted the need to identify gaps and overlaps and establish clear-cut delineations of responsibility. It was pointed out that a mechanism for resolving policy

[218] Erland Walter Nier 'Financial stability frameworks and the role of central banks: Lessons from the crisis' (2009) *IMF Working Paper WP/09/70 7*. The ongoing overhaul of domestic and global financial sector regulatory frameworks is broad and entails a wide range of issues. Some of the key interventions include addressing the too-big-to-fail (TBTF) institutions, identification and regulation of the systemically important financial institutions (SIFIs), building more resilient systems, reducing opacity of over-the-counter (OTC) derivative markets, mitigating negative impact of shadow banking on financial stability, enhancing financial sector transparency and promoting harmonization of accounting standards and principles.

[219] Act 34 of 2005. The objective of this law is stated as to promote a fair and non—discriminatory marketplace for access to consumer credit and for that purpose to provide for the general regulation of consumer credit and improved standards of consumer information; to promote black economic empowerment and ownership within the consumer credit industry; to prohibit certain unfair credit and credit—marketing practices; to promote responsible credit granting and use and for that purpose to prohibit reckless credit granting; to provide for debt re-organisation in cases of over-indebtedness; to regulate credit information; to provide for registration of credit bureaux, credit providers and debt counselling services; to establish national norms and standards relating to consumer credit; to promote a consistent enforcement framework relating to consumer credit; to establish the National Credit Regulator and the National Consumer Tribunal; to repeal the Usury Act, 1968, and the Credit Agreements Act, 1980; and to provide for related incidental matters.

[220] It was observed that although prudential regulation had been strengthened in recent years, there is scope for further development because the extensive interlinkages among the financial markets make supervisory cooperation of particular importance.

disagreements among different regulators and departments and assessing trade-offs among differing policy objectives was lacking in the South African system.[221]

Through identification of such risks and collaborative efforts of the G20, South Africa committed itself to pursue financial system reform by moving towards a Twin Peaks model of financial regulation with a view of improving financial stability through avenues such as strengthening the regulatory framework, enhancing effective supervision, addressing systemic crisis control and undertaking regular assessments and peer reviews to ensure compliance with international best practice standards.[222]

Against this background, a number of reforms were mooted in 2010. These reforms included, *inter alia*, imposing a comprehensive financial stability mandate on SARB; establishing a Prudential Authority tasked with prudential regulation, a Financial Sector Conduct Authority (FSCA) tasked with market supervision of financial institutions, and the establishing of a Financial Stability Oversight Committee comprising of the SARB, Financial Services Board (FSB) and the National Treasury. This was proposed to be under the joint chairmanship of the Governor and the Minister of Finance. Another proposal was the creation of the Council of Financial Regulators to provide interagency coordination between the respective regulators on matters of legislation, enforcement and market conduct.[223] The original 2011 policy document on Twin Peaks highlighted key proposals relating to enhancing financial stability, consumer protection and financial inclusion.[224]

In the 2012 budget speech, the Finance Minister Pravin Gordhan announced the policy shift to the Twin Peaks model of financial regulation and laid the ground for the tabling of the legislation that later came to be known as the Financial Sector Regulation Bill (FSRB).[225] The first draft of

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[221] IMF South Africa Country Report No. 08/349, Financial System Stability Assessment, Pg.23-24 https://www.imf.org/external/pubs/ft/scr/2008/cr08349.pdf (last accessed 9/8/2015)

[222] National Treasury Policy Document, *A Safer financial sector to serve South Africa better*, 2011. http://www.treasury.gov.za/twinpeaks/20131211%20-%20Item%202%20A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf (last accessed 10/8/2015).

[223] Supra

[224] See the policy document titles, *A Safer Financial Sector to Serve South Africa Better* (commonly known as the Red Book), released by the National Treasury in February 2011.

[225] The first draft of the Financial Sector Regulation Bill was published in December 2013. Close to 300 pages of comments were received on the draft Bill and numerous interactions were held with the stakeholders. The second draft of the Bill was released in December 2014. The comments on the first draft of the Bill were made by the

the FSR Bill was published for comment in December 2013. In December 2014, the National Treasury released the second draft of the Bill for public comment. This draft included key changes that were incorporated from comments received on the first draft. The amendments were made in the second draft.[226]

On 27th October 2015, the Minister of Finance tabled the FSRB in Parliament after taking into consideration the comments received on the second draft of the Bill published in December 2014. Further amendments and clarifications were made in the second draft. The tabling of the Bill is the first step in the process to implement the Twin Peaks system, with Parliament now in charge of the process to finalize and enact the Bill. The object of the Bill is to achieve a stable financial system that works in the interests of financial customers and that supports balanced and sustainable economic growth in the Republic, by establishing, in conjunction with the specific financial sector laws, a regulatory and supervisory framework that promotes financial stability; the safety and soundness of financial institutions; the fair treatment and protection of financial customers; the efficiency and integrity of the financial system; the prevention of financial crime; financial inclusion; and confidence in the financial system.[227]

The Minister of Finance will be in charge of the administration of the Act when it becomes operational.[228] The Act will have a paramount role to play in the sense that in the event of any inconsistency between a provision of the Financial Sector Regulation Act other than a regulation or a regulatory instrument made under this Act and a provision of another Act that is a financial sector law, the provision of the Financial Sector Regulation Act will prevail.[229]

Actuarial Society of South Africa (ASISA), Bakgatla Group, Banking Association of South Africa (BASA), Cape Chamber of Commerce and Industry, Competition Commission of South Africa, Deloitte, Financial Intelligence Centre (FIC), Financial Intermediaries Association of Southern Africa (FIA), Free Market Foundation (FMF), Johannesburg Stock Exchange (JSE), Melbourne Law School, Micro Finance South Africa, MMI Holdings Limited, National Housing Finance Corporation, Parliamentary Monitoring Group Subscriber, Promontory, Resolution Policy Working Group, South Africa Institute of Chartered Accountants (SAICA), South African Insurance Association (SAIA), Standard Bank South Africa, STRATE, Voluntary Ombudsman Schemes and the World Bank.

[226] Department of National Treasury, Stakeholder consultation workshop: Second draft of the Financial Sector Regulation Bill, Jan-Feb 2015, pg. 5.

[227] Clause 7 of the FSRB, 2015.

[228] Clause 8 read in conjunction with clause 1(1) which is to the effect that the word Minister as used in the Bill means the Minister of Finance.

[229] Clause 9 of the Bill. Furthermore, In the event of any inconsistency between a provision of a Regulation or a regulatory instrument made in terms of this Act and a provision of a Regulation or a regulatory instrument made in terms of a specific financial sector law, the provision of the Regulation or regulatory instrument made in terms of this Act will prevail.

Chapter 2 of the Bill imposes on the SARB responsibility for financial stability. In terms of clause 4 of the Bill, financial stability means a situation where financial institutions generally provide financial products and financial services without interruption; financial institutions are capable of continuing to provide financial products and financial services without interruption despite changes in economic circumstances; and there is general confidence in the ability of financial institutions to continue to provide financial products and financial services without interruption despite changes in economic circumstances.[230]

The SARB will be responsible for protecting and enhancing financial stability and, if a systemic event has occurred or is imminent, for restoring or maintaining financial stability.[231] When fulfilling this responsibility, the SARB may, *inter alia*, utilize any power vested in it as the Republic's Central Bank or conferred on it in terms of the Financial Sector Regulation Act once it becomes operational, or any other legislation.[232] In terms of this provision, it is submitted that the curatorship powers to rescue banks in financial distress will still fall under this new dispensation because the Financial Sector Regulation Act will allow the application of the Banks Act.

Chapter 3 of the Bill proposes the constitution, composition and structure of the Prudential Authority. It will be a juristic person operating within the administration of the Reserve Bank.[233] The major objectives of the Prudential Authority will be to promote and enhance the safety and soundness of financial institutions that provide financial products, market infrastructures or payment systems in order to protect financial customers, including depositors and policyholders, against the risk that those financial institutions may fail to meet their obligations and assist in maintaining financial stability.[234] In exercising this mandate, the Prudential Authority must

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[230] A reference to maintaining financial stability includes, where financial stability has been adversely affected, a reference to restoring financial stability.

[231] Clause 11(1) of the FSRB.

[232] Clause 11(2)(b) of the FSRB.

[233] See clause 32 of the FSRB. However, the Prudential Authority will not be a public entity within the meaning of the Public Finance Management Act.

[234] Clause 33 of the FSRB sets out the objective of the Prudential Authority. In terms of Clause 34, the functions of this Authority will be: regulating and supervising all financial institutions that provide financial products or are market infrastructures and payment systems operators, assisting the Reserve Bank in exercising its functions relating to financial institutions providing a payment system or settlement system, co-operating with and assisting the Reserve Bank, the Financial Sector Conduct Authority and the National Credit Regulator, co-operating with the Council for Medical Schemes in the handling of matters of mutual interest, co-operating with and assisting the Financial Intelligence Centre in preventing and combating financial crime, supporting sustainable competition in the

manage its affairs in an efficient and effective way, and establish and implement appropriate and effective governance systems and processes, having regard to, among other things, internationally accepted standards and practices.[235]

Chapter 4 of the Bill entails the composition, structure and operational framework of the proposed Financial Sector Conduct Authority (FSCA).[236] The objective of this Authority will be to protect financial customers by ensuring that financial institutions treat financial customers fairly, enhancing the efficiency and integrity of the financial system and providing financial customers and potential financial customers with financial education programs, and otherwise promoting financial literacy and financial capability.[237] When exercising this mandate, the FSCA will have a primarily pre-emptive, outcomes-focused and risk-based approach, in terms of which it focuses its resources in areas that pose significant risks to the achievement of its objectives.[238]

The SARB, as a result of the wake-up call afforded by the GFC and international developments in banking regulation, finds itself on a new regulatory path, facilitated by the envisaged implementation of the Twin Peaks model of financial regulation by means of, *inter alia*, the introduction of a comprehensive Financial Sector Regulation Bill (FSRB). In terms of its regulatory reform framework, the FSRB covers the core areas of emerging issues in post-financial crisis Central Banking such as mitigation measures for entities considered "too-big-to-fail" and systemically important financial institutions (SIFIs) to prevent contagion spread in the event of failure, and powers of the SARB to intervene in the event of distress of such entities. The center of focus is on the legal implications, nature and scope of the emergency tools and

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provision of financial products through co-operating and collaborating with the Competition Commission, supporting financial inclusion, regularly reviewing the perimeter and scope of financial sector regulation and taking steps to regulate risks identified, conducting and publishing research concerning developments in or affecting the prudential regulation or supervision of financial institutions providing financial products, market infrastructures and payment systems.

[235] Clause 35 of the FSRB, 2015.

[236] See clause 56 of the FSRB. The FSCA will also be a juristic person. However, unlike the Prudential Authority, the Financial Sector Conduct Authority will be a national public entity for the purposes of the Public Finance Management Act and the Commissioner will be the accounting officer.

[237] See clause 58 of the FSRB. The functions of the FSCA will be *inter alia* to: regulate and supervise the conduct of financial institutions, co-operate with and support the Reserve Bank and the Financial Stability Oversight Committee in performing their functions with respect to financial stability, co-operate with and support the Prudential Authority and the National Credit Regulator, support financial inclusion with focus on unserved and underserved persons, administer the collection of levies and the distribution of amounts received in respect of levies.

[238] Clause 58(5) of the FSRB. Furthermore, the FSCA is tasked to perform its functions without fear, favor or prejudice.

powers accorded to the SARB to rescue distressed banks within this legislative framework, and its interaction with the other regulators and legislation like the Banks Act and the SARB Act.

3.3.2 The operational framework of the financial stability mandate and powers of the SARB under the Financial Sector Regulation Bill

(a) Monitoring of systemic risk

As earlier noted, under this dispensation, the SARB will be responsible for protecting and enhancing financial stability and if a systemic event has occurred, or is imminent, for restoring or maintaining financial stability.[239] When fulfilling this comprehensive financial stability mandate, the Reserve Bank must act within a framework agreed between the Minister of Finance and the Governor. To operationalize the applicability of the Banks Act under this new legal framework, the SARB will be authorized to utilize any power vested in it as the Republic's Central Bank. However, the SARB will be expected to have regard to, amongst other matters, the roles and functions of other organs of state exercising powers that affect aspects of the economy.[240]

The SARB will also be tasked with periodical monitoring and reviewing of the strengths and weaknesses of the financial system; and any risks to financial stability, and the nature and extent of those risks, including risks that systemic events will occur and any other risks contemplated in matters raised by members of the Financial Stability Oversight Committee (FSOC) or reported to the SARB by a financial sector regulator.[241] This role will encompass taking steps to mitigate risks to financial stability, including advising the financial sector regulators and any other organ of state on steps to take to mitigate those risks. The SARB will also regularly assess the observance of principles developed by international standard setting bodies for market

[239] A systemic event is defined as an event or circumstance, including one that occurs or arises outside the Republic, that may reasonably be expected to have a substantial adverse effect on the financial system or on economic activity in the Republic, including an event or circumstance that leads to a loss of confidence that operators of, or participants in, payment systems, settlement systems or financial markets, or financial institutions, are able to continue to provide financial products or financial services. It is imperative to note that this definition encompasses external shocks that may build up outside the South African banking system. Such a wide definition is also motivated by the lessons learnt from the global financial system on how toxic assets abroad can have negative effects on interconnected financial institutions. South Africa is also exposed to the global financial system driven by the forces of globalization.
[240] See clause 11 of the FSRB.
[241] Clause 12(a) of the FSRB.

infrastructures and report its findings to the financial sector regulators and the Minister, taking into consideration the circumstances and the context within South Africa.[242]

(b) Financial stability review

Another role of the SARB within this framework will be to conduct a financial stability review at least every six months. This review must involve the SARB's assessment of financial stability in the period under review, identification and assessment of the risks to financial stability in at least the next twelve months, an overview of steps taken by the SARB and the financial sector regulators to identify and manage risks, weaknesses or disruptions in the financial system during the period under review and that are envisaged to be taken during at least the next 12 months. The SARB and the Financial Sector Oversight Committee (FSOC) must also make an overview of recommendations during the period under review and progress made in implementing those recommendations. However, a financial stability review must not include information the publication of which may materially increase the possibility of a systemic event.[243]

(c) Determination of systemic events

A particularly important emergency power relates to the determination of systemic events. The Governor may, after having consulted the Minister, determine in writing that a specified event or circumstance, or a specified combination of events or circumstances, is a systemic event.[244] Before making this determination, the Governor of the SARB may consult the FSOC. The aforementioned determination can be made whether or not the event or circumstance, or combination of events or circumstances, has already occurred or arisen.[245] It is submitted that the power to determine an event as systemic before it occurs is meant to give a pre-emptive effect to this legal provision. It is an improvement from the old regulatory model which is reactionary after the crisis has already occurred.

Once the determination has been made, the Governor of the SARB must notify the Minister and keep the determination under review. The Governor has the discretion at any time, after having consulted the Minister, to amend or revoke a determination in writing. However, such an

[242] Clause 12(b) & (c) of the FSRB.
[243] Clause 13(1), (2) & (3) of the FSRB.
[244] Clause 14(1) of the FSRB.
[245] Clause 14(2) & (3) of the FSRB.

amendment or revocation must be notified to the Minister of Finance.[246] Furthermore, the SARB must publish and notify the financial sector regulators if such a determination is made, and in case of any amendment or revocation of such a determination.[247]

(d) Functions of the Reserve Bank in relation to systemic events

Under the Twin Peaks model, the SARB must take all reasonable steps to prevent systemic events form occurring; and if a systemic event occurs or is imminent, the SARB must mitigate the adverse effects of the financial instability without delay and manage the systemic event and its effects.[248] Thus, when a systemic event occurs, swift regulatory action is called for and the SARB must invoke its emergency powers to deal with the challenges posed by the occurrence of the systemic event. While acting on these terms, the SARB must have regard to the need to minimize adverse effects on financial stability and economic activity. Financial customers should appropriately be protected and the cost of the systemic event to the Republic must be contained.[249]

Where the Governor of the SARB makes a determination that a systemic event has occurred or is imminent, the Governor must ensure that the Minister of Finance is kept informed of the event and of any steps being undertaken or proposed to manage the systemic event and the implications involved. In order to avoid creating jeopardy over public funds, the SARB will not take any step that will bind the National Revenue Fund to any expenditure, have a material impact on the cost of borrowing for the National Revenue Fund or create a future financial commitment or a contingent liability for the National Revenue Fund without the Minister's approval.[250]

Co-ordinated exercise of powers and functions relating to financial stability is a central theme in the FSRB. The Bill also provides for responsibilities of other financial sector regulators to the

[246] Clause 14(5) of the FSRB.
[247] Clause 14(6) & (7) of the FSRB. This is required so that the other financial regulators are put on notice of such amendments and changes to the Governor's determination in relation to systemic events. This will enable co-ordination in approach and proper information flow between the SARB and other regulators.
[248] Clause 15(1) of the FSRB.
[249] Clause 15(2) of the FSRB.
[250] Clause 16 of the FSRB.

SARB in times of financial crisis.[251] Once the Governor has made a determination that a systemic event has occurred or is imminent, each financial sector regulator must provide the SARB with any information in their possession, which may be relevant to help SARB to manage the systemic event or the effects of the systemic event. The financial sector regulators must also consult the SARB before exercising any of their powers in a way that may compromise steps taken or proposed by the Governor to manage the systemic event or the effects of the systemic event.[252]

The SARB is further empowered to issue directives to other financial sector regulators in times of systemic events. The Governor may write to any financial sector regulator requesting to be provided with information that is in the possession of the financial sector regulator or obtainable by it as specified in the directive to enable the Governor or the SARB exercise powers to determine a systemic event.[253]

If the Governor of the SARB has determined that a systemic event has occurred or is imminent, the Governor may issue a written directive to a financial sector regulator requiring that regulator to assist the SARB with prevention, mitigation or management of a systemic event by acting in accordance with the directive while exercising its powers. Such a directive may include directions aimed at supporting the restructuring, resolution or winding up of any financial institution; preventing or reducing the spread of risk, weakness or disruption through the financial system or increasing the resilience of financial institutions to risk, weakness or disruption.[254]

A framework of exercise of powers by other organs of state in times of systemic events is created under the Bill. If the Governor has made a determination that a systemic event has occurred or is imminent, an organ of state exercising powers in relation to the financial system may not without

[251] In terms of Clause 1.1 of the FSRB, financial sector regulator means the Prudential Authority, the Financial Sector Conduct Authority, the National Credit Regulator or the Financial Intelligence Centre, each with their respective mandates under various parts of the Bill.
[252] Clause 17 of the FSRB. This provision is also intended to ensure harmonized and consistent decision making to ensure economic recovery. It puts the Governor and the Reserve Bank at the helm of the process to avoid any inconsistencies or duplicity with any other organ of the State. Uncoordinated interventions can cause confusion and make a bad situation worse.
[253] Clause 18(1) of the FSRB. This provision also widens the SARB's and the Governor's powers and mandate to oversee effective resolution of systemic events.
[254] Clause 18(2) of the FSRB.

the Minister of Finance acting in consultation with a Cabinet Minister responsible for that organ of state, exercise its powers in a way which is inconsistent with a decision or steps taken by the Governor or the SARB in order to manage that systemic event or the effects of that systemic event.[255] To foster collegiality between the respective Ministers, any unresolved issues must be referred to Cabinet.[256] To avoid excessive bureaucracy, legal gridlocks and institutional paralysis, this provision will not be applicable to the financial sector regulators. In the event of an actual or imminent systemic event, the other financial regulators other than the SARB must exercise their powers in accordance with the provisions applicable to them.[257]

(e) Establishment of the Financial Stability Oversight Committee (FSOC)

Part 3 of the proposed framework deals with the establishing of the Financial Stability Oversight Committee, whose primary objectives will be to serve as a forum for representatives of the SARB and of each of the financial sector regulators to be informed, and to exchange views, about the activities of the SARB and the financial sector regulators regarding financial stability. This forum will also be responsible for making recommendations to the Governor on the designation of systemically important financial institutions.[258]

The FSOC will further be mandated to advise the Minister and the SARB on steps to be taken to promote, protect or maintain, or to manage or prevent risks to financial stability. A very crucial aspect under this framework is the powers given to the FSOC to advise the Minister of Finance and the SARB on matters relating to crisis management and prevention.[259] The FSOC will also make recommendations to other organs of state regarding steps that are appropriate for them to take to assist in promoting, protecting, maintaining, managing or preventing risks to financial stability.[260]

[255] Clause 19(1) of the FSRB.
[256] Clause 19(2) of the FSRB.
[257] Clause 19(3) of the FSRB.
[258] Clause 21 of the FSRB. In terms of Clause 22, the FSOC will be comprised of the Governor of the SARB, the Deputy Governor responsible for financial stability matters, the Chief Executive Officer, the Commissioner, the Chief Executive Officer of the National Credit Regulator, the Director-General, the Director of the Financial Intelligence Centre and any other persons appointed by the Governor.
[259] Clause 21(c)(ii) of the FSRB.
[260] Clause 21(d) of the FSRB. The SARB must provide administrative support and other resources, including financial resources, including financial resources for the effective functioning of the FSOC. The SARB must also ensure that minutes of each meeting of the Committee are kept in a manner determined by the Governor. It is submitted that increased operational costs on the SARB will be one of the major critiques of the Twin Peaks model.

It is submitted that close interaction, collaboration and information sharing among the respective regulators is very vital for the success of the Twin Peaks model. As the major agency, the Reserve Bank will require the support of other sister regulatory bodies in the financial sector. The establishment of this committee seeks to put in place mechanisms to address that challenge.

(f) Establishment of the Financial Sector Contingency Forum (FSCF)

Another important structure to augment the functioning of the Financial Stability Oversight Committee will be the Financial Sector Contingency Forum. The Governor will be tasked to establish this forum to assist the Financial Stability Oversight Committee in performing the Committee's crisis management and preparedness functions. Its specific mandate will be assistance with identification of potential threats of a systemic nature that may adversely impact the stability of the South African financial sector and coordination of appropriate plans, mechanisms and structures to mitigate the threats identified.[261]

(g) Co-operation among SARB and financial sector regulators in relation to financial stability

Co-operation between the various role players in the financial regulation sphere will be key to the effective functioning of the envisaged Twin Peaks model. Under the new framework, the financial sector regulators must co-operate and collaborate with the SARB, and with each other in order to maintain, protect and enhance financial stability. The regulators must also provide such assistance and information to the SARB and the FSOC to maintain or restore financial stability upon request, promptly report to the SARB any matter of which the financial sector regulator becomes aware of that poses or may pose a risk to financial stability, and gather information from, or about, financial institutions that concerns financial stability.[262]

Beyond the operational budget of the SARB, financial resources for the FSOC will also have to be availed to enable it to function.

[261] The Financial Sector Contingency Forum is established under part 4 of the Financial Sector Regulation Bill. In terms of clause 25(3), it will be chaired by a Deputy Governor of the Reserve Bank as appointed by the Governor. It will consist of representatives from relevant industry bodies, the financial sector regulators and any relevant organ of state, entity or body as determined by the Forum's chairperson.

[262] Clause 26(1) of the FSRB.

To create institutional interlinkage and interdependence, the Bill obliges the SARB to take into consideration the views expressed and any information reported by the financial sector regulators. It must also consider any recommendations of the FSOC.[263]

(h) Specification of roles of other organs of state in relation to financial stability

The proposed legal framework also specifies the nature and extent of the roles that other organs of state can play in maintaining financial stability. It further defines the nature and extent of the relationship between the SARB and these organs. Organs of state other than financial sector regulators, in performing functions with implications for financial stability, must have due regard to the implications of its activities on financial stability and provide assistance and information to the SARB and FSOC to maintain and restore financial stability upon request.[264] It is submitted that this is a progressive provision, since it aims at controlling errant state financial indiscipline that can have negative effects on financial stability. This clause also entrenches the independence of the SARB from any other state organ in performance of its financial stability mandate.

(i) SARB's power to designate systemically important financial institutions (SIFIs)

The SARB's power is further widened by giving the Governor authority to designate a financial institution or a financial conglomerate as a systemically important financial institution.[265] In taking the decision to designate a financial institution as systemically important, the Governor will take into account the size of the institution, the complexity of the institution and its business affairs, the interconnectedness of the institution with other financial institutions within and outside of South Africa, whether there are readily available substitutes for the financial products

[263] Clause 26(2) of the FSRB. To further augment this regulatory interlinkage and interdependence, the financial sector regulators and the SARB must, not later than six months after this Chapter becomes operational, enter into one or more memoranda of understanding with respect to how they must co-operate and collaborate with, and provide assistance to each other and otherwise perform their roles and comply with their duties relating to financial stability. In terms of Clause 27(2), the memoranda of understanding must be reviewed and updated as appropriate at least once every three years.

[264] Clause 28 of the FSRB. In terms of clause 1 of the Bill, "organ of state" is accorded the meaning defined in article 239 of the Constitution. This means any department of state or administration in the national, provincial or local sphere of government or any other functionary or institution exercising a power or performing a function in terms of the Constitution or a provincial constitution or exercising a public power or performing a public function in terms of any legislation, but does not include a court or a judicial officer.

[265] This is contained in clause 29 of the FSRB. In terms of clause 1 of the Bill, a financial conglomerate means a group of companies that comprises one or more financial institutions eligible to be licensed as banks, the holding companies including any controlling companies of an eligible financial institution, their related or inter-related persons including persons located or incorporated outside of South Africa and their associates as identified in the International Financial Reporting Standards issued by the International Accounting Standards Board or a successor body. However, financial conglomerates do not include any holding company or similar entity incorporated outside South Africa.

and financial services that the institution provides, recommendations of the FSOC, submissions made by or for the financial institution and any other matters as will be provided by Regulation.[266]

The proposed framework also creates checks and balances within which this power must be exercised by the Governor. Prior to the designation of an entity as systemically important, the Governor must give the FSOC notice of the proposed designation and a statement of the basis on which the designation is proposed to be made, and invite the FSOC to provide advice on the proposal within a specified reasonable period. If after considering the FSOC's advice, the Governor proposes to designate the financial institution as a SIFI, he or she must invite the affected financial institution to make submissions on the matter, and give it a reasonable period to do so.[267]

It is important to note that designation of an institution as a systemically important financial institution does not imply or give rise to any right for the institution to a guarantee or other credit support from the Government.[268] It is submitted that this provision is intended to lessen moral hazard occasioned by SIFIs and their officers abusing this designation by putting financial institutions in destress in anticipation of bail out packages at the expense of public funds.

A very important emergency power in relation to SIFIs is the power granted to the Governor to designate a systemically important institution without complying with the notification requirements if a systemic event has occurred or is imminent.[269] In the event that the Governor makes the designation without complying with the notification requirements fully or at all, the affected financial institution may make submissions to the Governor concerning the designation within 30 days after notification of the designation.[270] The Governor must then proceed to consider the submissions made by the affected financial institution and by notice to that institution, either confirm or revoke the designation.[271] The Governor also has the discretion to

[266] The list of considerations to be taken into account by the Governor in terms of clause 29(3) is provided as a bare minimum. The Governor will be free to have other considerations basing on the circumstances surrounding a particular systemic scenario as and when it arises.
[267] Clause 29(2) of the FSRB
[268] Clause 29(5) of the FSRB.
[269] Clause 29(4) of the FSRB.
[270] Clause 29(4)(b) of the FSRB.
[271] Clause 29(4)(c) of the FSRB.

revoke a designation of an institution as systemically important, in writing and subject to due process.[272] Any designation or revocation must be published.[273]

It is submitted that the exception provision in relation to designation of SIFIs is intended not to curtail the Governor from swift action in times of systemic events requiring immediate emergency interventions. It appears that an aggrieved institution will have an option of seeking judicial review of the Governor's decision taken while exercising this mandate. The legal framework establishes the Financial Services Tribunal to judicially review the decisions taken by financial sector regulators upon application by an aggrieved person.[274] More fundamentally, the Promotion of Administrative Justice Act (PAJA) will be applicable to any administrative action taken by a financial sector regulator in terms of this new legal framework or a specific financial sector law.[275]

Being designated as a systemically important financial institution carries some very crucial legal consequences. For instance, to mitigate risks that systemic events may occur, the SARB may, after having consulted the Prudential Authority in relation to a SIFI or a class of financial institutions that is systemically important, impose thorough directives or prudential requirements relating to; capital requirements, which may include requirements in relation to counter-cyclical capital buffers, leverage ratios, liquidity, organizational structures, risk management arrangements including guarantee arrangements, sectoral and geographical exposures, required statistical returns, recovery and resolution planning, and any other matter prescribed by Regulations made on the recommendation of the Governor.[276] The SARB and the FSOC must be notified by the Prudential Authority of any steps taken to enforce a directive issued or any additional prudential standard imposed by the SARB, and the effect of those steps.[277]

Another legal implication arising from being designated as a SIFI is the exclusion of certain actions from being taken in relation to such designated institution without the approval of the SARB, namely: suspension, variation, amendment or cancellation of a SIFI's license; adoption

[272] Clause 29(6) of the FSRB.
[273] Clause 29(7) of the FSRB.
[274] See Clauses 214 and 215 of the FSRB for establishment and functions of the Financial Services Tribunal.
[275] Clause 91 of the FSRB.
[276] This provision is contained under clause 30(1) of the FSRB. The financial sector regulators are required to exercise their powers to ensure that the standards set by the Reserve Bank are met. These standards may be in addition to the any other requirements in terms of a finance sector law governing that specific sector.
[277] Clause 30(3) of the FSRB.

of a special resolution in terms of section 80 of the Companies Act to wind up a SIFI voluntarily; application to court in terms of section 81 of the Companies Act for an order to wind up a SIFI; appointment of an administrator, trustee or curator for the institution; appointing an administrator or curator to the institution, placement of a SIFI under business rescue or adopting a business rescue plan for the institution in terms Chapter 6 of the Companies Act; entering into an agreement for amalgamation or merger with another company in terms of section 113 of the Companies Act and entering into a compromise arrangement with creditors of the institution in terms of section 155 of the Companies Act.[278] To ensure compliance and enforceability of the above provisions, the Bill nullifies and voids any action taken in relation to a SIFI without the approval of the SARB.[279]

It must be emphasized that in terms of clause 29(5), the designation of a financial institution as a systemically important financial institution does not imply, or entitle the financial institution to, a guarantee or any form of credit or other support from any organ of state. It is for this reason that

[278] This extensive list of prohibited actions without the approval by the Reserve Bank is contained in clause 31(1) of the FSRB. Any action taken in terms of this provision without the Reserve Bank's approval is of no legal force. In terms of section 80(1) of the Companies Act 2008, a solvent company may be wound up voluntarily if the company has adopted a special resolution to do so, which may provide for the winding-up to be by the company, or by its creditors. This is prohibited in the case of a designated systemically important financial institution without the approval of the Reserve Bank. Apart from voluntary winding up, in terms of section 81(1)(a) of the Companies Act, winding up of solvent companies can be triggered by a court order. A court may order a solvent company to be wound up if the company has resolved by special resolution that it be wound up by the court or applied to the court to have its voluntary winding-up continued by the court. This can also be in circumstances where the practitioner of a company appointed during business rescue proceedings has applied for liquidation on the grounds that there is no reasonable prospect of the company being rescued or one or more of the company's creditors have applied to the court for an order to wind up the company on the grounds that it is otherwise just and equitable for the company to be wound up or the company, one or more directors or one or more shareholders have applied to the court for an order to wind up the company on the grounds that the directors are deadlocked in the management of the company, and the shareholders are unable to break the deadlock, and irreparable injury to the company is resulting or may result from the deadlock and the company's business cannot be conducted to the advantage of shareholders generally as a result of the deadlock. The Reserve Bank's approval is also required if such winding up process is being contemplated by any of the affected parties in respect of a systemically important financial institution. Section 113 of the Companies Act is in relation to mergers or amalgamations. Two or more profit companies, including holding and subsidiary companies, may amalgamate or merge if, upon implementation of the amalgamation or merger, each amalgamated or merged company will satisfy the solvency and liquidity test. Before this can be exercised in respect of a transaction involving a merger or amalgamation with a systemically important financial institution, the Reserve Bank's approval must be sought.

[279] Clause 31(2) of the FSRB is to the effect that any action specified in clause 31(1) taken without the SARB's concurrence is void.

a specified rescue regime is considered as an option to deal with the failure of an entity that may be a SIFI.[280]

(j) Significant owners and approval to be a significant owner of a financial institution

Principle 6 of the Basel Committee on Banking Supervision Core Principles speaks to the regulator's power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.[281] The Bill addresses this by clearly defining significant owners within the South African context.[282] A financial sector regulator may, with the concurrence of another financial sector regulator and on application declare a person not to be a significant owner of a specified financial institution.[283] A financial sector regulator may not declare a person not to be a significant owner of a specific financial institution, and may not give its concurrence to such a declaration, unless the financial sector regulator is satisfied that the declaration will not prejudice the achievement of its objective and that it is not necessary to apply the requirements of this provision to the person in question.[284] Financial sector regulators will have powers to set standards relating to required personal character qualities of honesty and integrity; competence, including experience, qualifications and knowledge; and financial standing of significant owners.[285]

[280] Under normal insolvency proceedings, the only options available when a SIFI fails are either an injection of public (taxpayer) funds to rescue the institution by way of a bail out or a disorderly insolvency with high economic cost. Because of the size of large SIFIs relative to the economy, a rescue with public funds can be unaffordable or (at the very least) have long-term fiscal effects. Regardless of the affordability aspect, bail-out with public funds carries major moral hazard risks and reduces market discipline, both of which give rise to higher-risk financial systems over the longer term. Normal insolvency processes are therefore insufficient for the orderly rescue of a SIFI.

[281] Bank for International Settlements (September 2012), pg. 10. This principle is further enunciated on pg. 27 of the Basel 3 document on core principles. One of the most important criteria is creation of requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest. The supervisor is also given power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.

[282] In terms of clause 157 of the FSRB, a person is a significant owner of a financial institution if that person *inter alia*, directly or indirectly, alone or together with a related or inter-related person has the power to appoint a person to be a director of the governing body of the financial institution; or in the case of a financial institution that is a company, holds a qualifying stake in the financial institution.

[283] Clause 157(4)(a) of the FSRB.

[284] Clause 157(4)(b) of the FSRB.

[285] See clause 160 of the FSRB.

It is submitted that this provision is intended to curb the potential abuse of a controlling interest by unscrupulous individuals who may use financial institutions as shams to perpetrate fraud or conduct business in utter disregard to the interests of depositors/customers. It is noteworthy that since poor management and abuse of ethical principles of corporate governance of financial institutions by people and entities with controlling interests was one of the causes of the global financial crisis, there are attempts to create safeguards and safety nets to prevent abuse of control and influence under this new regulatory dispensation.

It is further submitted that the designation of significant owners is important to the rescue mandate because it acts as a vetting procedure to identify entities that are deserving of rescue. For instance, if significant owners have engaged in fraudulent dealings, or have violated the standards set by SARB, then they can be held personally liable. Secondly, public funds may not be used to clean up the mess caused by extravagant lifestyles of significant owners of private banks.

(k) Framework for supervision of financial conglomerates

The emergence of financial conglomerates, many of which are engaged in so-called "universal banking"[286] changed the nature of systemic risk because of their size and ownership interests and relationships within them. These institutions have a cross-border footprint and increasingly dominate the financial services market. Because of their dominant position, a sizeable number of market assets have become concentrated in the hands of a few conglomerate groups with various layers of holding and subsidiary entities.

By the mid-1990s, financial conglomerates were being run on an integrated basis with centralized risk control, irrespective of the entity and the sub-sector in which the risk arose.[287] Large firms operating in diverse markets in a range of locations create a high likelihood and possibility that systemic shocks can be transmitted throughout the group. Problems in one business unit of a conglomerate can lead to loss of market access in the other and destroy public confidence in the group as a whole. The financial crisis provided some live case studies. For

[286] Universal banking is a system where banks provide a wide variety of financial services, including personal, commercial and investment banking. Proponents of this system argue that it helps banks diversify their risk portfolio.

[287] See Michael W. Taylor, 'Twin Peaks' Revisited: A Second Chance for Regulatory Reform, (London, Centre for the Study of Financial Innovation, September 2009) pgs. 8-10.

example, the problems in AIG's financial products division undermined confidence in an otherwise triple-A rated insurance group as a whole.[288]

In terms of the FSRB, the Prudential Authority may designate members of a group of companies as a financial conglomerate. The designated entities must include both an eligible financial institution and a holding company of the eligible financial institution, but need not include all the members of the group of companies. This designation must be done for the purpose of facilitating the prudential supervision of the eligible financial institution.[289] It is submitted that conglomerate groups pose peculiar regulatory challenges in times of systemic events, since risk may emanate and build up in one of the group holdings. The SARB will have to identify the proper regulatory tools in coordination with the Prudential Authority to ensure effective systemic regulation and an efficient and cost effective resolution framework in the event of bank failure emanating from conglomerate group effect and contagion spread.

In a sharp contrast to the Banks Act, the new legal dispensation will give the SARB a wider mandate and more intrusive powers. In terms of curatorship, the designation of SIFIs and the enhanced prudential and consolidated supervision requirements are far-reaching and envisage a more active and pre-emptive role by the SARB in times of financial distress. The new dispensation will also give the Governor a more involved role in the affairs of distressed banks, as opposed to the legal regime under the Banks Act, where the Registrar of Banks was the major focal person taking the lead in curatorship matters and supervising the curator.

By and large, it must be emphasized that the Twin Peaks system will be implemented in two phases. In the first phase, supporting legislation will be drafted and tabled before Parliament for enactment. In the second phase to be implemented over the next several years, there will be broader harmonization of specific financial sector laws and regulations.[290] In terms of the real impact of the new dispensation on the curatorship procedure, reference can be made to clause

[288] See Taylor (supra). He further argues that the development of conglomerate groups led to functional de-specialization in which firms with different legal forms (banks, insurers, and securities firms) began to resemble each other in the forms of risks they assumed. The emergence of securitization exposed banks to market and liquidity pipeline risks not encountered or anticipated before, while other financial intermediaries which purchased asset-backed securities and over-the-counter (OTC) derivatives were exposed to credit risk that was previously borne by the banks.
[289] See clause 158 of the FSRB.
[290] See Roadmap document to Implementation of the Twin Peaks model of financial regulation in South Africa, pg. 13.

31(1)(d) which prohibits the appointment of a curator for a systemically important financial institution without the concurrence of the SARB.

3.3.3 Strengthening South Africa's Resolution Framework for Financial Institutions, 2015

On 13th August 2015, the National Treasury, the SARB and the FSB issued a policy document entitled, *"Strengthening South Africa's Resolution Framework For Financial Institutions"* which acknowledges that banks require a different approach to their rescue because of the high liquidity risk that is inherent in their business.[291] This policy proposal is motivated by the international trends set by the FSB's "Key Attributes of Effective Resolution Regimes" (KAs), as earlier discussed. However, it is imperative to note that according to the policy document,

> '…the KAs does not replace existing resolution tools available to authorities, but enhances them by introducing, among other things, an additional set of powers that should make it possible for losses to be borne by shareholders and informed creditors rather than by the government. The KAs also aim to resolve a SIFI while maintaining critical functions and without incurring large costs on the rest of the financial sector and the real economy.'[292]

It is imperative to note that because of the change in regulatory paradigm as result of international standards-setting and post-GFC regulatory shift, in February 2012, the SARB issued a Guidance Notice requiring all banks to develop Recovery and Resolution Plans (RRPs) in line with the KAs.[293] In the further Guidance Notice G4/2012, the SARB observed that the FSB, in terms of the KAs, required all member countries to have in place RRPs for all SIFIs. Consequently, the Bank Supervision Department had identified RRPs as one of its three "flavor-of-the-year" topics for 2012.[294] According to Rene van Wyk, the then Registrar of Banks, RRPs comprise of two separate components, namely the recovery plan and the resolution plan.[295] Recovery plans serve as a guide to the bank's senior management and board of directors on how

[291] See pg. 1 of the policy document accessed via http://www.treasury.gov.za/publications/other/RFFI/2015%20Resolution%20Framework%20Policy.pdf (last visited on 4/12/16).
[292] Pg.4 of the policy document.
[293] Guidance Notice 3/2012 dated 16 February 2012 was supplemented by Guidance Notice 4/2012 issued in terms of section 6(5) of the Banks Act providing further guidance on the development of RRPs by South African banks. A copy can be accessed via https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5034/G4%20of%202012.pdf (last visited on 4/12/16).
[294] Introduction to the Guidance Notice.
[295] The Guidance Notice observes that both the recovery and the resolution plans play an integral part of the banks' risk management processes.

the bank's risk profile would be reduced in the case of distress to ensure its survival without being placed under resolution.[296]

In relation to curatorship, the policy document affirms that the Banks Act allows a curator to transfer specific assets and liabilities of a distressed bank subject to certain statutory conditions and approvals. It is noted that although the conditions and approvals attempt to prevent unilaterally assigning losses to creditors within the same class, a situation resembling a 'good bank, bad bank' split may occur, with economic results similar to an explicit bail-in. Because of the intrusiveness of bail-in as a recapitalization tool, it is proposed in the policy document that a framework should be enacted to provide more clarity and transparency on issues such as the point at which a bail-in may be effected, the liabilities that will be subject to a bail-in, the sequence or manner in which liabilities may be bailed in, and the liabilities that are or may be exempt from bail-in.[297]

Like many other jurisdictions, South Africa is undertaking financial sector regulatory reforms in a phased approach. The first phase deals with ending the "too-big-to-fail" problem, in order to reduce the risk of recourse to public funds to deal with failures of large banks, through increasing capital resilience and soundness of individual banks.[298] The policy document highlighted above is a precursor to the second phase, which enhances the SARB's powers to reduce the economic and social costs of failure of financial institutions. This framework is important in the context of this research because bank rescue may entail the re-capitalization of a failed bank. However, this must be done in a manner that balances both the private interests of shareholders and/or creditors and the public interest in safeguarding trust and confidence in the banking system. The process should also have regard to cost-effectiveness and maintenance of critical functions played by banks in the economy.

It is envisaged that a Special Resolution Bill (SRB) will be enacted to, *inter alia*, designate the SARB as the resolution authority, provide for resolution objectives and enhance current

[296] Banks are not required to follow recovery plans to the letter in case of distress. These plans are meant to enable banks to think and plan ahead by way of structuring corrective strategies to rescue themselves from distress. However, if the rescue/recovery fails, the Central Bank must place the distressed entity under resolution. The purpose of the resolution plan is not only to minimize the costs of bank failure, but also minimize the use of public funds in resolution of banks.

[297] Pg. 50 of the policy document.

[298] Basel III for banks was implemented through the 2013 Bank Regulations and the Banks Amendment Act (Act 22 of 2013), while other measures will be introduced by the FSRB once it becomes operational.

applicable powers of the SARB as a resolution authority. It is anticipated that the SRB will streamline a proper approach that is not only cognizant of the resolution tools, but also of recovery/rescue procedures as a tool to enhance the stability of the banking sector and the promotion of public confidence in the banking system as a whole.

3.4. Final remarks

The Financial Sector Assessment Program noted that the present distressed bank framework in South Africa is comprised of powers given to a curator who has broad powers to take control of an ailing bank and its assets. However, the framework lacks critical tools necessary to deal with a systemic case and to minimize the risks to public funds. For instance, the existing legal regime does not require mandatory recovery plans to be prepared by the banks, but the SARB Supervision Department only recently announced the introduction of recovery and resolution planning in a phased-in approach through Guidance Notes.[299]

It was further observed that formal systemic protection is limited in South Africa. The SARB has intervened in bank failure cases on an ad hoc basis. There is no depositor protection scheme or a systemic liquidity provision framework, but in the past, capital and liquidity support were made by SARB to curb deposit contagion and preserve financial stability. The authorities have mooted the creation of a deposit insurance scheme for some time. The SARB has set up a Committed Liquidity Facility (CLF) to support banks to comply with the Basel III Liquidity Coverage Ratio (LCR) requirements from 2015, but this does not bar the SARB from providing emergency liquidity support under a different arrangement from the CLF.[300] However, as recommended by the IMF, there is a need to introduce a solvency test within the framework, preferably in the SARB Act, so that any emergency liquidity assistance to banks that may be insolvent should only take place with an indemnity from the government.[301]

Presently, the Financial Sector Contingency Forum (FSCF), chaired by a Deputy Governor of the SARB and with membership including representatives from the National Treasury, SARB and

[299] IMF Country Report No. 15/55, pg. 14. The Detailed Assessment of Compliance on the Basel Core Principles for Effective Banking Supervision on South Africa was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in February 2015.
[300] Ibid. Paragraph 30 under Part B concerning Frameworks for Financial Stability Oversight, Crisis Management, and Systemic Protection.
[301] See pg. 5 of IMF Country Report No. 15/53 (March 2015) accessed via https://www.imf.org/external/pubs/ft/scr/2015/cr1553.pdf (last visited on 4/12/16).

FSB, coordinates the efforts on contingency planning for financial crises. The enactment of the Financial Sector Regulation Bill will introduce several changes in the legislative framework governing regulation and supervision of distressed banks in South Africa. The Reserve Bank will be accorded wider and more intrusive emergency powers whose nature and extent has been discussed above. This indeed has serious ramifications for the various role players involved on both sides - regulatory bodies and regulated entities alike.

Proper demystification of the complex framework will be required through massive public sensitization seminars, short courses and close interaction between the implementing bodies, the private sector, state organs and the general public. If well implemented and periodically reviewed as suggested, the Twin Peaks model is a revolutionary mechanism with the adequate tools to aid the SARB to deal with emergency scenarios presented by systemic risk and financial crises. This new framework will work in tandem with the Banks Act and the Governor will take on a leading role in the determination of systemic events and the exercise of powers that previously resided in the Registrar of Banks, while the FSOC will play a supporting role.

The system-wide powers include powers to address system-wide shortages of Rand liquidity in the domestic money market; foreign-exchange liquidity shortages at authorized dealer banks; extreme financial market illiquidity, volatility or mispricing; and destabilizing capital inflows and outflows. The SARB Act further provides the SARB with powers to provide emergency liquidity assistance and to acquire shares in a limited company, but not in a bank without the Minister's approval. This is a potential way to inject capital into a distressed bank.[302] By and large, it is anticipated that the phased approach in the FSRB and the planned enactment of the Resolution Bill will lay a robust legislative framework for the proper functioning of bank curatorship by putting in place mechanisms and safeguards regarding the designation of SIFIs, the creation of a depositor protection scheme to protect depositors and minimize moral hazard, and a well-articulated policy governing special and emergency liquidity assistance to distressed banks undergoing curatorship.

[302] The SARB can facilitate a private-sector solution through participation in negotiations. However, an assisted merger or acquisition would require coordination with National Treasury if guarantees or funding arrangements are involved. These powers are assigned to the SARB as central bank and not in its capacity as the RA and should therefore not be replicated or moved within the ambit of the SRB. However, there may be a need for relatively minor amendments to align the SARB Act and the SRB, for example by referencing the SARB's responsibilities as RA and associated financial stability criteria in the SARB Act.

Lastly, it is imperative to note the enhanced powers of the SARB under the Twin Peaks model. Under the Banks Act, apart from curatorship, other emergency powers that can be exercised by the SARB in the event of bank distress include fining the bank for non-compliance with prudential and solvency standards, and suspension of the bank's license and its trading activities. This can be regarded as a "fire-fighting" intervention approach. However, under the new legal dispensation under the FSRB, the position of the SARB will be augmented to a "prevention is better than cure" approach. By strengthening the financial stability mandate and crystalizing it into statutory provisions, the SARB will be required to oversee micro-prudential supervision, aided by the Prudential Authority that will monitor the safety and soundness of financial institutions. This will put the SARB in better position to intercept and manage systemic risk in a more pro-active approach. The "fire-fighting" powers will remain tools of last resort in extreme cases where the public interest will not be served by the continuation of business by an affected bank. One major criticism I have of the FSRB is that it places a major emphasis on SIFIs and says nothing expressly about curatorship of niche banks, such as African Bank, in the event of distress. It must be emphasized that a rescue procedure can support socio-economic functions such as financial inclusion, credit access and black empowerment if targeted to deserving banks that are playing these roles in the market.

CHAPTER FOUR

THE BANK OF ENGLAND AND THE UNITED KINGDOM'S BANK REGULATORY FRAMEWORK

4.1. INTRODUCTION AND HISTORICAL CONTEXT OF THE BANK OF ENGLAND.

With a rich history dating back to 1694 when it was founded, the Bank of England (BoE) is the central bank of the United Kingdom (UK). It is also known as the 'Old Lady' of Threadneedle Street. Its mission is to promote the good of the people of the United Kingdom by maintaining monetary and financial stability.[303]

The constitutions of the BoE and its subsidiary, the Prudential Regulation Authority (the 'PRA') are largely contained in the following documents: the Bank of England Act 1694 (the '1694 Act'); the Charter of the Bank of England 1694 (the '1694 Charter'); the Bank Charter Act 1844

[303] Retrieved from the Bank of England website http://www.bankofengland.co.uk/about/Pages/default.aspx (last visited in 14/2/16).

(the '1844 Act'); the Bank of England Act 1946 (the '1946 Act'); the Charter of the Bank of England 1998 (the '1998 Charter'); the Bank of England Act 1998 (the '1998 Act'); the Financial Services and Markets Act 2000 (the '2000 Act'); the Banking Act 2009 (the '2009 Act'); the Financial Services Act 2012 (the '2012 Act'); the Articles of Association of the PRA; and related Orders.[304] The Memorandum of Understanding on financial crisis management between the Treasury on the one hand and the BoE and the PRA on the other, entered into pursuant to the 2012 Act, is also relevant.

The Bank is a body corporate incorporated by Royal Charter pursuant to the 1694 Act. The 1694 Charter incorporated the Bank, constituted its capital stock and authorized it to have a common seal, to hold land and other property, and to sue and be sued. As a chartered corporation, incorporated pursuant to statute, the powers of the Bank have to be determined with reference to the 1694 Charter and statute and subsequent Charter and legislative amendments. Since 1694 there have been a number of enactments directly affecting the Bank and its organization. Various statutory provisions remain in force. They are concerned with the Bank's organization, governance, powers and functions.[305]

The 1844 Act obliged the Bank to separate its issue and banking functions and to keep them in distinct departments. Under the 1946 Act the Bank was nationalized and its capital stock transferred to the Treasury. At that time a revised Charter was granted, and the 1946 Act and the Charter contained various provisions relating to the management of the Bank.[306]

The 1998 Act introduced several important changes in the legal framework of the BoE: Part I and Schedule 1 replaced the provisions relating to the constitution and operation of Court (the Board of Directors who oversee the management of the BoE) in the 1946 Act and the 1946

[304] See Guidance from the Legal Directorate of the Bank of England contained in 'The Bank of England Act 1998, the Charters of the Bank and related documents' (July 2015) accessed via http://www.bankofengland.co.uk/about/documents/legislation/1998act.pdf (last visited on 14/2/2016).

[305] A detailed list of the governing statutes is detailed in the link provided in footnote 2. The 1998 Act was brought into force on 1 June 1998. A list of the Orders made under the 1998 Act, together with the dates on which they came into force, is set out in the document headed 'Orders'. Various changes to the 1998 Act and related Orders have been made since 1998, in particular with the introduction of the Financial Services and Markets Act 2000, the 2009 Act and more recently the 2012 Act. These too are shown in the relevant documents, as are the Bank immunity and information disclosure provisions introduced by the 2009 Act (as amended by the 2012 Act) and the provisions in the 2012 Act concerning collaboration between HM Treasury and the Bank, FCA or PRA.

[306] Section 4(l) of the 1946 Act enabled the Treasury from time to time to give directions to the Bank as, after consultation with the Governor, they thought to be necessary in the public interest.

Charter. As a result, much of the 1946 Charter became redundant and was replaced by the 1998 Charter. Part I and Schedule 2 of the 1998 Charter imposed formal reporting requirements on the Bank and placed the funding on a statutory basis. Part II and Schedule 3 conferred operational responsibility for monetary policy on the Bank and established the Monetary Policy Committee (the 'MPC') as a Committee of the Bank with responsibility for the exercise of its powers in relation to the formulation of monetary policy. Part III dealt with the transfer of the Bank's supervisory functions to the Financial Services Authority (FSA) and Part IV with miscellaneous matters.[307]

The 2009 Act, in response to the Global Financial Crisis, introduced further important changes regarding the responsibilities, powers and role of the Bank. These included provisions regarding the governance of the Bank and a new statutory financial stability objective. It created a new Special Resolution Regime (SRR) for dealing with distressed banks and building societies. It also conferred a statutory oversight role on the Bank in relation to inter-bank payment systems recognized by the Treasury and created a new framework for the issuance of banknotes in Scotland and Northern Ireland to be overseen by the Bank. The Act also granted the Bank immunity in its capacity as a monetary authority (including its central bank and financial stability-related functions) and authorized the Bank to disclose financial stability-related information to certain bodies.[308] These provisions will be examined in detail in the subsequent parts of the discussion within the specific context of bank rescue.

The 2012 Act introduced significant changes by shifting to the Twin Peaks regulatory framework for financial services and abolished the Financial Services Authority.[309] The Act created a new regulatory structure consisting of the Bank's Financial Policy Committee ('FPC'), the PRA (a

[307] Section 4(l) of the 1946 Act was amended to exclude monetary policy from the matters in relation to which the Treasury can give directions.
[308] Singh, Dalvinder, The UK Banking Act 2009, Pre-Insolvency and Early Intervention: Policy and Practice (November 11, 2010). Journal of Business Law, No. 1, 2011; Warwick School of Law Research Paper No. 2010/27.
[309] In a July 2010 speech to the British Bankers' Association, Lord Adair Turner, Chairman of the Financial Services Authority (FSA) highlighted a new approach to regulation in the U.K's banking sector. Specifically, Lord Turner presented a case for a "major shift in philosophy" towards a "more pre-emptive and intrusive approach to supervision". The UK officially shifted to the "Twin Peaks" model on April 1st, 2013. Under this move, the Financial Services Authority ceased to exist and its work was split between two new regulatory authorities. Specifically, the Prudential Regulation Authority, part of the Bank of England, was tasked with the prudential regulation of deposit-taking entities such as banks and credit unions, as well as insurers and major investment firms. On the other hand, the Financial Conduct Authority regulates the conduct of all the listed financial services firms to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants.

subsidiary of the Bank) and the Financial Conduct Authority ('FCA'). It also made other important changes to the 1998 Act, the 2000 Act and the 2009 Act. In particular, as regards the Bank, it assumed responsibility for the supervision of central counterparties[310] and securities settlement systems in the UK to sit alongside its existing responsibilities for overseeing recognized payment systems.[311]

The 2012 Act also introduced revised governance arrangements regarding Court (the Board of Directors who oversee the management of the BoE) and the newly created Oversight Committee and provided for revised appointment arrangements of the Governor of the Bank, with the effect that the Governor is to be appointed for a single term of eight years rather than a maximum of two five-year terms.[312] The 2012 Act was introduced on a phased basis during 2013. The first Commencement Order was made on 23 January 2013. Other provisions relating to appointments came into force on 19th February 2013. The 2012 Act came into full operation on 1st April 2013. The relevant provisions of this law will be discussed in so far as they touch on emergency aspects of the rescue of banks in financial distress.

From January 2015, with the transposition into UK law of the European Union Bank Recovery and Resolution Directive (BRRD),[313] the Bank took on an augmented set of legal powers for

[310] Central counterparties (CCPs) are structures that help facilitate the clearing and settlement process in financial markets. They have long been utilized in the derivatives markets, but more recently, they have been adopted in cash securities markets and currently there is growing interest in further expanding their use. Their regulation had remained a grey area. The BoE is now mandated to regulate the efficiency and systemic importance of current and evolving CCP structures, including ownership and governance structures; the management of credit, liquidity, operational, legal and other risks by CCPs; mutualization of counterparty credit risk; costs and benefits of CCP structures; innovation, competition and integration initiatives among CCPs; relationships between CCPs and their clearing participants or agents; use of CCPs in over-the-counter (OTC) and exchange-traded products; cross-product clearing; and policy issues relating to the design, operation, oversight and supervision of CCPs.

[311] See Harvard Law School Forum on Corporate Governance and Financial Regulation commentary on, 'Financial Services Act 2012: A New UK Financial Regulatory Framework' (March 24, 2013) accessible via https://corpgov.law.harvard.edu/2013/03/24/financial-services-act-2012-a-new-uk-financial-regulatory-framework/ (last accessed on 28/2/2016).

[312] Mark Carney is the current Governor of the BoE and Chairperson of the Monetary Policy Committee, Financial Policy Committee and the Board of the Prudential Regulation Authority. In addition to his duties as Governor of the Bank of England, he serves as Chairman of the Financial Stability Board (FSB), First Vice-Chair of the European Systemic Risk Board, a member of the Group of Thirty (G-30) and the Foundation Board of the World Economic Forum.

[313] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text

bank resolution that complies with international standards for resolution regimes.[314] This will therefore call for an analysis of the relevant bank rescue provisions contained in the Bank Recovery and Resolution Order 2014, the Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014 and the Banking Act 2009 (Restriction of Special Bail-in Provision etc.) Order, 2014. Provisions of the Insolvency Act 1986 and the Companies Act 2006 are also applicable in relation to rescue powers available to the bank regulator in respect of distressed banks.

4.2. THE UK, THE GLOBAL FINANCIAL CRISIS AND THE GENESIS OF BANK REGULATION REFORMS.

4.2.1. The search for a cure to the UK bank regulation problems: A UK solution for a UK problem within a global context

Bank regulation in the UK is inextricably linked to its politics and the banking history of London as one of the oldest and major banking centers in the world. For several years before the election of a new Labour Government in May 1997, there had been debate about the need to reform the UK's bank regulatory framework, but the discussion did not focus much on proposing the creation of a single regulatory body with a mandate to supervise the entire banking, insurance and investment industries.[315] The idea of a single regulator only came into consideration on 20 May 1997 when the new Chancellor of the Exchequer, Gordon Brown, announced to the House of Commons that the government intended to create a single regulatory agency for the banking and securities industries.[316]

Before this announcement by the Chancellor of the Exchequer, the UK Banking regulatory system was a combination of institutional and functional regulation. Banks were regulated by the

[314] The Treasury launched a consultation on 23 July 2014 entitled 'Transposition of the Bank Recovery and Resolution Directive ('the consultation'). The consultation began on 23 July and closed on 28 September 2014. The BRRD was adopted on 15 April 2014 and published in the EU Official Journal on 12 June 2014. The transposition deadline was 31 December 2014. In order to transpose the BRRD into UK law, a number of statutory instruments subject to the affirmative resolution procedure were laid before Parliament. These were: The Bank Recovery and Resolution Order 2014; The Banks and Building Societies (Depositor Preference and Priorities) Order 2014; The Banking Act 2009 (Restriction of Special Bail-in Provision etc.) Order 2014; and The Banking Act 2009 (Mandatory Compensation Arrangements Following Bail-in) Regulations 2014. These orders were laid before Parliament on 24 November 2014, debated on 15 December 2014 and came into force on 1 January 2015.

[315] Heidi Mandanis Schooner & Michael Taylor, *United Kingdom and United States Responses to the Regulatory Challenges of Modern Financial Markets*, 38 TEX. INT'L L.J. 320 (2003).

[316] Michael Taylor, *The Road from "Twin Peaks"- and the Way Back*, 62 CONNECTICUT INS L.J. Vol 16:1 65 (2009).

Bank of England (BoE) under the Banking Act 1987.[317] The role of the BoE as regulator of banks had however come under scrutiny in the first half of the 1990s on two incidents. The first scrutiny of the BoE emanated from the failure of the Bank of Credit and Commerce International (BCCI), which became insolvent after massive fraud.[318] In an investigation conducted by Sir Thomas Bingham (later Lord Justice), it was found that the BoE had not been effective in regulating BCCI.[319]

The second event that piled a lot of scrutiny on the BoE and raised further debate on its role as a bank supervisor and regulator was the failure of Barings Merchant Bank in early 1995.[320] The failure of Barings was associated with poorly controlled activities of a futures trader based in Singapore who took on large unhedged positions on the Singapore and Osaka futures exchanges.[321] This unfolding of events was very devastating to the image of the BoE, since it emerged that Barings had enjoyed a relatively light touch regulation and a greater share of self-regulation.[322]

By the end of the 1990s, the UK like many of the other member countries of the Organization for Economic Cooperation and Development (OECD), had already embarked on major reorganization of its institutional regulatory structures in banking and finance.[323] These reform interventions were necessitated by the challenges arising from increased integrated financial

[317] Banking Act, 1987, c. 22, (repealed 2001). It should be underscored that in this discussion, "bank" means a UK institution which has permission under Part 4 of the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits (within the meaning of section 22 of that Act, taken with Schedule 2 and any order under section 22). It does not include a building society within the meaning of section 119 of the Building Societies Act 1986, a credit union within the meaning of section 31 of the Credit Unions Act 1979, or any other class of institution excluded by an order made by the Treasury. "UK institution" means an institution which is incorporated in, or formed under the law of any part of, the United Kingdom.

[318] See H.M. Stationary Office, Inquiry into the Supervision of the Bank of Credit & Commerce International (1992).

[319] 212 Parliamentary Debates of the House of Commons (6th series) (1992)

[320] According to Michael Taylor, Barings was a centuries old merchant bank that had been part of the City of London's "aristocracy" to the extent of providing several Governors of the Bank of England. It had failed once before in in 1890 as a result of speculation in rail road construction in South America, but had been bailed out by the Bank of England, then as a private company.

[321] See John Gapper & Nicholas Denton, All That Glitters: The Fall of Barings 2 (1996) at pgs. 28-29. Also see H.M. Stationary Office, Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings (1995).

[322] See Gordon Brown, Chancellor of the Exchequer (as he was then), Statement of H.C. on the Bank of England (May 20, 1997), where he announced that the current system of bank self-regulation will be replaced by a new and fully statutory system which will put public interest first and increase public confidence in the banking sector.

[323] See Schooner & Taylor, *supra* note 1, at 320 for a discussion of finance and banking reforms elsewhere in the OECD.

markets, and the emergence of highly diversified financial conglomerates necessitating a wider perspective to ensure effective group supervision.[324]

Two broad responses were mooted to tackle these new challenges to bank regulation. The first was the approach eventually adopted in the UK, which created a single unified regulatory body responsible for regulating all the main segments of the financial services industry (banking, securities and insurance) for both financial soundness and consumer protection considerations.[325] The other approach, which had originated in the UK but was not adopted there until 2013, was the "Twin Peaks" model that entails structuring regulation around two agencies, one responsible for the safety and soundness of all financial institutions and the other for regulating their market conduct.[326]

It should also be noted that the creation of a single regulatory body, the Financial Services Authority (FSA) in the UK was a radical approach that fundamentally overhauled the entire regulatory framework of the finance sector. Not only did it sanction a merger of nine pre-existing regulatory bodies, but it also involved removal of the responsibility of bank regulation from the Bank of England, the UK's central bank, and transfer that mandate to the FSA.[327] It has also been stressed that although unified financial regulatory systems had been created in the Scandinavian countries, none of those models involved removal of the bank regulation mandate from the central bank.[328] Thus this intervention in the realm of banking regulation in England was quite unprecedented. It was the Twin Peaks structure that had been debated actively in the UK before

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[324] *Id*. at 323.

[325] See Richard K. Abrams & Michael W. Taylor, Issues in the Unification of Financial Sector Supervision 22-23 (IMF, Working Paper No.00/213, 2000), available at http://www.imf.org/external/pubs/ft/wp/2000/wp00213.pdf (last visited on 1/3/2016). Also see Eilis Ferran*, Examining the United Kingdom's Experience in Adopting the Single Regulator Model*, 28 Brook. J. Int'l L. 257 (2003).

[326] See Michael Taylor discussion under his seminal discussion of Twin Peaks as a new regulatory structure for the new century as discussed in Chapter 1. It should however be noted that within these two broad categorizations of approaches to banking regulation, there is room for variations, for example as applied in Spain, France, Canada and presently, the ongoing financial sector regulation reform in South Africa.

[327] See Clive Briault, *The Rationale for a Single National Financial Services Regulato*r 6 (Fin. Servs. Auth., Occassional Paper No.2 , 1999), available at http://www.fsa.gov.uk/pubs/occpapers/OP02.pdf (last accessed on 29/2/2016). The entities that were merged to form a single regulatory body include the Securities and Investment Board (SIB), the Personal Investment Authority, the Investment Management Regulatory Organization, the Securities and Futures Authority, the Supervision and Surveillance Division of the Bank of England, the Building Societies Commission, the Insurance Directorate of the Department of Trade and Industry, the Friendly Societies Commission, and the Registrar of Friendly Societies.

[328] See Michael Taylor & Alex Fleming, *Integrated Financial Supervision: Lessons from Northern European Experience* 17 (World Bank, Working Paper 2223, 1999), available at http://info.worldbank.org/etools/docs/library/50180/TaylorFleming_1999.pdf. (Last accessed on 28/2/2016).

the 1997 reform, but it was strongly opposed by the BoE which regarded the proposal as an attempt to divest the central bank of its regulatory mandate.[329]

The official historical narrative account of the GFC in the UK is interlinked with the fall of Northern Rock.[330] This is contained in official documents like the Treasury Select Committee of the House of Commons report entitled 'The Run on the Rock'.[331] Following the bank run, Northern Rock became dependent on public funds through a combination of loans and guarantees. On 17th February 2008, it was announced that the Government would acquire shares

[329] Michael Taylor had proposed that instead of being modeled on the tripartite categories of banking, securities and insurance, the regulatory structure of UK finance should comprise of a Financial Stability Commission and a Consumer Protection Commission. The former was proposed to ensure stability of the financial system as a whole through application of prudential standards. The latter would be tasked with ensuring that financial firms deal with their customers in a fair and transparent manner. The two bodies would be able to discharge their respective mandates irrespective of the legal composition or form of the institutions that they regulated.

[330] Northern Rock was a British Bank that became best known for becoming the first bank in 150 years to suffer a bank run after having had to approach the Bank of England for a loan facility, to replace money market funding, during the credit crisis in 2007. Having failed to find a commercial buyer, it was taken into public ownership in 2008, and was then bought by Virgin Money in 2012. During 2012 the Northern Rock brand was phased out and replaced by Virgin. Northern Rock (a previous mutual building society) converted to bank status in 1997. On conversion, and stripped of the previous constraints on its business powers under the Building Societies Act, it acquired legal powers to conduct the full range of banking business. However, it opted to remain focused predominantly on the residential mortgage market. From the outset, it adopted a securitization and funding strategy which was increasingly based on secured wholesale money (by issuing mortgage-backed securities) and other capital market funding. At its peak, Northern Rock had assets of over £ 100 billion and a growth rate of around 20 percent for over a decade. Although it was only the seventh largest UK mortgage lender, in the first half of 2007 its new mortgage lending accounted for around one-quarter of the total in the UK. The pace of mortgage lending substantially exceeded the growth of retail deposits with the "funding gap" met through securitization and other wholesale market funding. Two particular problems emerged during the summer months of 2007: a generalized lack of confidence in a particular asset class (mortgage bank securities) associated in large part with developments in the sub-prime mortgage market in the United Sates, and doubts emerged about the viability of the Northern Rock business model in particular. In September 2007, Northern Rock was forced to seek substantial assistance from a reluctant Bank of England even after the regulatory authorities had given assurances that the bank was solvent. This announcement sparked a run on the bank until the government moved to offer a guarantee to all deposits and that this would not be restricted to the normal limit of the Financial Services Compensation Scheme. (See David T. Llewellyn, (2008) "The Northern Rock crisis: a multi-dimensional problem waiting to happen", Journal of Financial Regulation and Compliance, Vol. 16 Iss: 1, pp.35 – 58)

[331] This is the fifth report of 2007-2008 published on 24th Jan 2008. The Report introduction states that the news that Northern Rock needed emergency assistance from the Bank of England started bank run, with very long queues of depositors at its branches asking for their money back. The bank run was stopped when the then Chancellor of the Exchequer, Alastair Darling announced that the Government would guaranteed the bank's deposits as a way of restoring public confidence in the ailing bank. David T. Llewellyn further argues that four major and long-standing structural weaknesses in the UK regime made the Northern Rock problem inevitable at some stage: (1) The deposit protection scheme was fundamentally flawed. (2) The UK had no special insolvency arrangements for banks but applied the long drawn-out normal insolvency arrangements for other companies. (3) There were no clearly-defined ex ante Resolution procedures in the event of failing banks. (4) The institutional structure of regulation (and the split between the Treasury, FSA and Bank of England) proved to be an uncertain arrangement in time of crisis.

in Northern Rock. Consequently, the Banking (Special Provisions) Act[332] of 2008 was enacted to give legislative force to this proposal.

The Treasury Report also outlined the regulatory failures and weaknesses that led to the bank's collapse, and the tripartite regulatory system in force at the time came under criticism.[333] The global financial crisis subsequently created room for a re-examination of the UK banking regulatory framework. The British Government's White Paper on regulatory reform after the crisis concluded that the then existing bank regulatory framework placed too much weight on ensuring that systems and processes were clearly and correctly defined rather than challenging business models and strategies of financial firms. It was also discovered that the system placed more emphasis on the conduct of business regulation rather than the prudential regulation of banking institutions.[334] Thus, the reasoning that there were natural automatic synergies between prudential regulation and conduct of business regulation was discredited by the events before and during the financial crisis. It is this narrative that this research intends to examine within the context of the emergency powers of central banks to deal with banks experiencing financial distress.

It is also noteworthy that even the FSA's senior management acknowledged the regulatory lapse when the Authority neglected prudential supervision of banks before the Turner review.[335] This was apparent in the FSA's supervision of Northern Rock as the first British casualty of the global financial crisis. The collapse of Northern Rock and the Turner Review are discussed in detail below.

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[332] This Act can be accessed via http://www.legislation.gov.uk/ukpga/2008/2/pdfs/ukpga_20080002_en.pdf (last accessed on 2/3/2016). As can be discerned from its long title, the objective of the act was to make provision to enable the Treasury in certain circumstances to make an order relating to the transfer of securities issued by, or of property, rights or liabilities belonging to an authorized deposit-taker; to make further provision in relation to building societies; and for other connected purposes.

[333] This regulatory system had been set up following the election of a new Labor Government in 1997 to replace the old system of bank regulation headed by the Bank of England. The Financial Services Authority (FSA) was set up after the collapse of the Bank of Credit and Commerce International (BCCI) and Barings. As basis for passing the Bank of England Act of 1998, the move towards a single regulator (FSA) was favored.

[334] H.M. Treasury, Reforming Financial Markets, 2009, Cm. 7667, at 56.

[335] In the Turner report, it is documented that the FSA's regulatory practices resulted in a bias tilted to conduct regulation as opposed to prudential regulation. Turner repeated this admission to a House of Lords Committee. See Report of the Select Committee on Economic Affairs, Banking Supervision and Regulation, 2008-09, H.L. 101-I, at 33.

a) The lessons learned from the collapse of Northern Rock

In October 2007, the Chief Executive Officer (CEO) of the FSA asked Internal Audit to carry out a "lessons learned" review of the supervision of Northern Rock plc from 2005 to August 2007. From early August 2007, conditions at Northern Rock had deteriorated and FSA had to engage with the other tripartite authorities on the situation of Northern Rock. This period has come to be known as the "crisis period".[336] Majorly, the terms of reference for this review required an examination of the main elements of the FSA's regulatory framework; its coverage of stress tests, liquidity and the agency's governance and managerial competence; intelligence and information flows within the FSA; and its supervisory resources.

The review highlighted weaknesses of the FSA in regard to flow of information and intelligence both internally and externally. There was inconsistent and poor use of publicly available data. There were also lapses in FSA management, where oversight was insufficient to identify that some tools of the risk framework were not being used as intended. On this aspect, the report concluded that the supervision of Northern Rock revealed the most significant combination of shortcomings.[337]

The bank had received several contacts from the FSA pertaining to the "Treating customers fairly" initiative but supervision of capital and liquidity was deficient to the point that the bank held only one major prudential meeting every three years. The FSA's own report on Northern Rock noted that there was no record of discussion meetings held between the bank and the regulator.[338] In a nutshell, the failure of Northern Rock was an important event that informed the banking sector regulatory framework reform in the UK during and after the global financial crisis. The massive negative public sentiment concerning bank bailouts necessitated a shift in regulatory paradigm to explore other distressed bank rescue tools and mechanisms.

b) The Turner review: A regulatory response to the global banking crisis

In October 2008, the Chancellor of the Exchequer asked the FSA Chairman, Adair Turner, to review the causes of the financial crisis and make recommendations for the regulatory and supervisory reform to create a more robust banking sector. On 18th March 2009, Turner delivered

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[336] FSA, The Supervision of Northern Rock: A Lessons Learned Review (March 2008) at pg. 1. Accessed via http://www.frank-cs.org/cms/pdfs/FSA/FSA_NR_Report_25.4.08.pdf (last visited on 3/3/16).
[337] See pg. 8 of the Report.
[338] Pg. 36 of the Report.

the review, setting out a number of policy changes and recommendations for the banking sector regulatory reform.[339] According to Turner, the legislative interventions needed to address both the factors which drove the initial over-extension of credit, and the factors which played a crucial role in increasing the length and severity of the crisis. He identified these factors as:[340]

The massive growth and increasing complexity of the securitized credit model, underpinned by inadequate capital requirements against trading books, which facilitated unsustainable growth in credit extension to households and to some parts of the corporate sector; extensive commercial bank involvement in trading activities, which meant that falling asset prices have had a large and rapid effect on bank profitability, and in turn on perceptions of their credit worthiness, creating a collapse in bank funding liquidity; high leverage in multiple forms, which helped drive the rapid growth in credit extension and asset prices, and which increased the vulnerability of the system, since asset price falls had an amplified impact on system capital adequacy; expanded maturity transformation dependent on the marketability of assets, which made the system hugely more vulnerable to a loss of confidence and disappearance of liquidity; the complexity and opacity of the structured credit and derivatives system, built upon a misplaced reliance on sophisticated mathematics, which, once irrational exuberance disappeared, contributed to a collapse in confidence in credit ratings, huge uncertainty about appropriate prices, and a lack of trust that published accounting figures captured the reality of emerging problems.

The report further identified hard-wired pro-cyclicality,[341] which exacerbated the scale of the downturn, with credit ratings, margin calls, Credit Default Swaps spreads and general market confidence, interacting to create self-reinforcing feedback loops; and a lack of adequate capital buffers, as a result of which commercial banks losses have driven falling confidence in the banking system, impairing the ability of the banking system to extend credit, and creating a

[339] The Turner review can be accessed via http://www.fsa.gov.uk/pubs/other/turner_review.pdf (last accessed 1/3/16)

[340] These findings are contained in Chapter 1, page 28 of the Turner Review report on an analysis of 'What went wrong?'

[341] Pro-cyclicality is the term used to characterize financial and economic systems prone to credit driven phases of boom and bust. In the boom phase, rising optimism about the economy leads to an expansion of credit which drives up asset prices, encourages spending, and leads to more optimism in turn. These patterns eventually prove inconsistent with underlying fundamentals, and the bust phase follows, often triggered and exacerbated by a sharp tightening of credit standards by those left exposed to imprudent loans made earlier. It is this behavior that contributed in some way to the recent Global Financial Crisis. See *'New Financial Order Recommendations by the Issing Committee'*, Centre for Financial Studies, White Paper No. II (Feb 2009).

powerful feedback loop between banking system stress and downturn in the real economy. It was clear that the crisis revealed fault lines in the global regulation and supervision of some of the cross-border firms, which raised fundamental issues about the appropriate future approach. The essence of the problem – as the then Governor of the BoE, Mervyn King, put it – is that global banking institutions are “global in life, but national in death”. That is, when crises occur, it is national Central Banks which have to provide lender-of-last-resort (LOLR) support and national governments that provide fiscal support, and if there is a failure, bankruptcy procedures are national and it matters with which specific legal entity a creditor has their claim.[342] The Turner Report was later to trigger one of the most far-reaching banking sector regulation reforms in UK history.

c) The Banking (Special Provisions) Act 2008 and the Banking Act 2009

According to the International Bar Association (IBA) Financial Crisis Report, the Banking Act 2009 was the most important legislative response by the UK on issues pertaining to the global financial crisis.[343] It replaced and extended the Banking (Special Provisions) Act 2008, which had been enacted as a temporary, emergency measure during the wake of the Northern Rock failure. In broad terms, this new legislative creature addressed the following emergency powers of regulators to deal with distressed entities. It created a new ‘Special Resolution Regime’ which includes powers for the authorities to take action in relation to failing financial institutions before they are formally insolvent; a new bank insolvency procedure; and a new bank administration procedure. The Act also introduced changes to the Financial Services Compensation Regime (FSCR);[344] created provisions giving the BoE powers to oversee certain interbank payment systems; enacted enabling provisions for the Treasury to make new regulations concerning the insolvency of investment banks and financial collateral arrangements; and established a new BoE Financial Stability Committee and clarification and extension of the Bank’s immunity from legal action.

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[342] Pages 35-36 of the Turner Report.

[343] See IBA Taskforce on the Global Financial Crisis Report (Oct 2010) accessed via http://www.davispolk.com/files/uploads/FIG//Financial_Crisis_Report_IBA.pdf (last visited on 1/3/16).

[344] The Financial Services Compensation Scheme (FSCS) is the UK’s statutory compensation scheme out of which customers of authorized financial services firms are paid, if the firm is unable; or likely to be unable to pay claims against it. It is funded by a levy on the authorized financial firms, and it covers deposits, insurance policies, insurance brokerage, investments, mortgages and mortgage arrangements.

By and large, it must be emphasized from the onset that the Banking Act is principally concerned with procedures to be followed and options available to the regulators when banks encounter serious financial difficulties. It is not directly concerned with new regulations designed to make it less likely that a banking crisis will occur again. It is the nature and extent of the rescue mandate under the bank administration procedure contained in this Act that will form the major subject of discussion under this part of the research.

d) The Independent Commission on Banking

The Independent Commission on Banking (the Commission) was established by the UK Government in June 2010 to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition. The Commission was asked to report to the Cabinet Committee on Banking Reform by the end of September 2011.[345] The Commission's recommendations were aimed at reducing the probability and impact of systemic financial crises in the future; maintaining the efficient flow of credit to the real economy and the ability of households and businesses to manage their risks and financial needs over time; and preserving the functioning of the payments system and guaranteed capital certainty and liquidity for small savers including small and medium-sized enterprises (SMEs).[346]

The Commission's recommendations would achieve the above aims in the context of the wider regulatory reform agenda both in the UK and abroad by curbing incentives for excessive risk-taking by neutralizing subsidies and the unpriced risk of triggering financial crises, and by enabling the market to function more effectively; reducing the costs of systemic financial crises

[345] See Background to the Committee Report accessible via http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf (last accessed on 3/3/2016). Its members were Sir John Vickers (Chair), Clare Spottiswoode, Martin Taylor, Bill Winters and Martin Wolf.

[346] Page 20 of the Report captures the aims and principles of the Commission. The recommendations in the report aim to create a more stable and competitive basis for UK banking in the longer term. That means much more than greater resilience against future financial crises and removing risks from banks to the public finances. It also means a banking system that is effective and efficient at providing the basic banking services of safeguarding retail deposits, operating secure payments systems, efficiently channeling savings to productive investments, and managing financial risk. To those ends there should be vigorous competition among banks to deliver the services required by well-informed customers. It was also the thinking of the Commission that the international reform agenda – notably the Basel process and European Union (EU) initiatives – is making important headway, but needs to be supported and enhanced by effective national measures. This is especially so given the position of the UK as an open economy with very large banks extensively engaged in global wholesale and investment banking alongside UK retail banking. Part of the challenge for reform is to reconcile the UK's position as an international financial center with stable banking in the UK.

through increased resilience of institutions and the financial system as a whole, and through improved resolvability of institutions; promoting effective competition in the provision of banking services in the UK; having regard to any impact on GDP through the cycle, any fiscal implications, and the competitiveness of the UK financial and professional services sectors and the wider UK economy; and having regard to the possible impact of recommendations on non-bank parts of the financial system, and to the effects of wider regulatory reforms in the financial sector.[347]

The Commission proposed the "ring-fencing" of vital banking services.[348] The purpose of the retail ring-fence is to isolate those banking activities where the continuous provision of service is

[347] The Commission's approach was rooted in the philosophy that more stable banking requires a combination of measures. Macro-prudential regulation by the new Financial Policy Committee should help curb aggregate financial volatility in the UK. But domestic financial shocks, for example related to property markets, cannot be eliminated. Moreover, the UK remains exposed to international financial volatility, in part through the global operations of UK banks. Improved supervision by the new Prudential Regulation Authority should avoid some shortcomings of regulation exposed by the recent crisis. But information problems mean that supervisory regulation will never be perfect. In any case, it should not be the role of the state to run banks. In a market economy that is for the private sector disciplined by market forces within a robust regulatory framework.

[348] A number of UK banks combine domestic retail services with global wholesale and investment banking operations. Both sets of activities are economically valuable while both also entail risks – for example, relating to residential property values in the case of retail banking. Their unstructured combination does, however, give rise to public policy concerns, which structural reform proposals – notably forms of separation between retail banking and wholesale/investment banking – seek to address. First, structural separation should make it easier and less costly to resolve banks that get into trouble. By 'resolution' is meant an orderly process to determine which activities of a failing bank are to be continued and how. Depending on the circumstances, different solutions may be appropriate for different activities. For example, some activities might be wound down, some sold to other market participants, and others formed into a 'bridge bank' under new management, their shareholders and creditors having been wiped out in whole and/or part. Orderliness involves averting contagion, avoiding taxpayer liability, and ensuring the continuous provision of necessary retail banking services – as distinct from entire banks – for which customers have no ready alternatives. Separation would allow better-targeted policies towards banks in difficulty, and would minimize the need for support from the taxpayer. One of the key benefits of separation is that it would make it easier for the authorities to require creditors of failing retail banks, failing wholesale/investment banks, or both, if necessary, to bear losses, instead of the taxpayer. Second, structural separation should help insulate retail banking from external financial shocks, including by diminishing problems arising from global interconnectedness. This is of particular significance for the UK in view of the large and complex international exposures that UK banks now have. Much of the massive run-up in bank leverage before the crisis was in relation to wholesale/investment banking activities. Separation would guard against the risk that these activities might de-stabilize the supply of vital retail banking services. Third, structural separation would help sustain the UK's position as a pre-eminent international financial center while UK banking is made more resilient. The improved stability that structural reform would bring to the UK economy would be positive for investment both in financial services and the wider economy. The proposed form of separation also gives scope for UK retail banking to have safer capital standards than internationally agreed minima, while UK-based wholesale/investment banking operations (so long as they have credible resolution plans, including adequate loss-absorbing debt) are regulated according to international standards. Without separation there would be a dilemma between resilient UK retail banking and internationally competitive wholesale and investment banking. Moreover, separation accompanied by appropriate transparency should assist the monitoring of banking activities by both market participants and the authorities. Among other things it should allow better targeting of macro-prudential regulation. Separation has costs however. Banks' direct operational costs might increase. The economy would suffer if separation prevented retail deposits from financing household mortgages and

vital to the economy and to a bank's customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such provision can be maintained in the event of the bank's failure without government solvency support. The Commission further recommended that the ring-fencing should make it easier to sort out both ring-fenced banks and non-ring-fenced banks which get into trouble, without the provision of taxpayer-funded solvency support; insulate vital banking services on which households and SMEs depend from problems elsewhere in the financial system; and curtail government guarantees, reducing the risk to the public finances and making it less likely that banks will run excessive risks in the first place.[349] The Committee further recommended stronger capital and other loss-absorbing capacity for the banks as some of the preventative measures against bank failure.[350]

some business investment. Customers needing both retail and investment banking services might find themselves with less convenient banking arrangements. And although global wholesale and investment banking poses risks to UK retail banking, there are times when it might help cushion risks arising within UK retail banking. In addition, the cost of capital and funding for banks might increase. But insofar as this resulted from separation curtailing the implicit subsidy caused by the prospect of taxpayer support in the event of trouble, this would not be a cost to the economy. Rather, it would be a consequence of risk returning to where it should be – with bank investors, not taxpayers – and so would reflect the aim of removing government support and risk to the public finances. For these reasons, the Commission regarded structural reform as a key component of reforms aimed at enhancing the long-run stability of UK banking

[349] Page 233 of the Independent Banking Commissions Report. The Commission further recommended that only ring-fenced banks should be granted permission by the UK regulator to provide mandated services. Mandated services should be those banking services where even a temporary interruption to the provision of service resulting from the failure of a bank has significant economic costs; and customers are not well equipped to plan for such an interruption. Such services were identified as taking of deposits from, and the provision of overdrafts to, individuals and small and medium-sized organizations. It was also suggested that ring-fenced banks should be prohibited from providing certain services which make it significantly harder and/or more costly to resolve the ring-fenced bank; directly increase the exposure of the ring-fenced bank to global financial markets;) involve the ring-fenced bank taking risk and are not integral to the provision of payments services to customers, or the direct intermediation of funds between savers and borrowers within the non-financial sector; or in any other way threaten the objectives of the ring-fence.

[350] Governments in the UK and elsewhere prevented banks from failing in 2008 because the alternative of allowing them to go bankrupt was regarded as intolerable. Vital banking services, the continuous provision of which is imperative, would have been disrupted at potentially enormous economic and social cost. Even after the comprehensive government rescues and accompanying monetary expansion, credit provision to the economy has been seriously disrupted and national output remains low. There was a double failure of banks' ability to bear losses. First, they had too little equity capital in relation to the risks they were running. Leverage ratios of assets to equity capital had ballooned to beyond normal levels. This was allowed to happen in part because there was no restriction on leverage, but instead limits on the ratio of capital to 'risk-weighted' assets. But the supposed 'risk weights' turned out to be unreliable measures of risk: they were going down when risk was in fact going up. Second, when the thin layer of equity capital was eroded, banks' debt proved poor at absorbing losses. Debt holders might have borne substantial losses in insolvency, but fears of the wider consequences of insolvency – not only interruptions to ordinary banking services, but also contagion to other banks and disruption of financial markets more generally – forced governments to make taxpayers bear the contingent liabilities of bank failures. In any case ordinary retail deposits would have had no priority over bank debt in the insolvency process. So the Financial Services

The Government made a formal response to the recommendations of the Independent Banking Commission.[351] It noted what the Chancellor called the "British Dilemma" a robust banking system that provides important services – such as payment systems, deposit-taking and domestic lending – to households and businesses as vital to any economy. But the UK also benefits hugely from its position as a global financial center. As an employer and contributor of tax revenues, as an exporter of UK services to the rest of the world, and as a vital part of the economic infrastructure, a healthy financial sector is an important driver of growth in the UK. However, it was acknowledged that the very size of the UK financial sector means that the UK cannot afford to let banks be underwritten by the British taxpayer, putting the broader economy at risk. It agreed that a structural reform of financial regulation was needed to make banks more resilient, to allow banks that still fail to do so safely without cost to the taxpayer, and to improve the stability of the financial system as a whole.[352]

Compensation Scheme (FSCS) as deposit insurer would have had to take losses as well. The risks inevitably associated with banking have to sit somewhere, and it should not be with taxpayers. Nor do ordinary depositors have the incentive (given deposit insurance to guard against runs) or the practical ability to monitor or bear those risks. For the future, then, banks need much more equity capital, and their debt must be capable of absorbing losses on failure, while ordinary depositors are protected. Under Basel III, banks will be required to have equity capital of at least 7% of risk-weighted assets by 2019, while risk weights have also been tightened. As a backstop, there is a proposal to limit leverage to thirty-three times. Recent further proposals from the Financial Stability Board and the Basel Committee on Banking Supervision are to increase risk-weighted capital requirements by up to 2.5% for global systemically important banks (G-SIBs), with provision for a further 1% for banks whose systemic importance grows yet more. These increases to capital requirements will not only improve banks' ability to absorb losses, but will also make them less vulnerable to liquidity problems, which are often a symptom of concerns about solvency. Basel III also includes specific proposals requiring banks to hold more liquid assets, to make them better able to withstand any temporary problems in accessing liquidity in the market. These are important steps but, in the Commission's view, they do not go far enough. First, if capital requirements could be increased across the board internationally, then the best way forward would be to have much higher equity requirements, in order greatly to increase confidence that banks can easily absorb losses while remaining going concerns. The Commission is however conscious that unilateral imposition of a sharply divergent requirement by the UK could trigger undesirable regulatory arbitrage to the detriment of stability. Second, a leverage cap of thirty-three is too lax for systemically important banks, since it means that a loss of only 3% of such banks' assets would wipe out their capital. Third, in contrast with the Basel process, the Commission's focus is on banks with national systemic importance, as well as on ones with global importance. Fourth, the loss-absorbency of debt is unfinished business in the international debate.

[351] The response can be accessed via https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31585/govt_response_to_icb_191211.pdf (last visited on 3/3/2016).

[352] See page 14 of the Government response, which cites the IMF Spillover Report for the 2011 Article IV Consultation and Supplementary Information, July 2011. Available at: http://www.imf.org/external/pubs/ft/scr/2011/cr11225.pdf. This Report on the UK observes that; "The stability and efficiency of the UK financial sector is a global public good, requiring the highest quality supervision and regulation."

4.3. THE UK SPECIAL RESOLUTION REGIME (SRR) FOR FAILING BANKS

In terms of the Banking Act 2009, the purpose of the special resolution regime for banks is to address the situation where all or part of the business of a bank has encountered or is likely to encounter financial difficulties.[353] This regime consists of the three stabilization options, the bank insolvency procedure,[354] and the bank administration procedure.[355] The three stabilization options are: transfer of a distressed bank to a private sector purchaser;[356] transfer to a bridge bank;[357] or transfer of ownership.[358] Each of the three stabilization options is achieved through the exercise of one or more of the stabilization powers, which are: the share transfer powers[359] and the property transfer powers.[360] The framework also identifies the BoE, the Treasury and the Financial Services Authority (FSA) as having a role to play in the special resolution regime.[361] It should be noted that this research, for purposes of delimitation, is more concerned with the bank administration procedure as a vehicle of distressed bank rescue. The brief discussion on resolution options will be merely for purposes of context. The resolution regime will therefore be discussed within the context of bank rescue.

The objectives of the special resolution regime are to protect and enhance the stability of the financial systems of the UK and to ensure continuity of banking services; protect and enhance public confidence in the stability of the financial system; to create a framework to protect depositors; protection of public funds and to avoid interfering with property rights in contravention of a Convention right.[362] The Treasury is mandated to issue a code of practice about the use of the stabilization powers, the bank insolvency procedure, and the bank

353 See overview of the introductory part of Part 1. The Act can be accessed via http://www.legislation.gov.uk/ukpga/2009/1/pdfs/ukpga_20090001_en.pdf (last visited on 2/3/2016).
354 Provided by Part 2 of the Act.
355 Provided by Part 3 of the Act.
356 This transfer is regulated by section 11 of the Act.
357 Transfer of a financially distressed bank to a bridge bank is governed by section 12 of the Act.
358 Section 13 of the Act.
359 Sections 15, 16, 26 to 31 and 85 of the Act.
360 Sections 33 and 42 to 46 of the Act.
361 Section 1(5) of the Act.
362 The right to property is specifically addressed in the Human Rights Act 1998. The special resolution objectives are set out in section 4 of the Banking Act. However, the order in which the objectives are listed in this section is not significant. They are to be balanced as appropriate in each case. The Financial Services Act 2012 introduces objective 6, which applies in any case in which client assets may be affected. The regulator must protect those assets under section 8A. "Client assets" are defined as assets which an institution has undertaken to hold for a client, whether or not on trust, and whether or not the undertaking has been complied with. The Financial Services Act also extended the scope of the regime to bank holding companies, central counterparties and certain investment firms and their group companies. These amendments were operationalized on 1 August 2014.

administration procedure.[363] This code was enacted to support the legal framework of the SRR, and provides guidance as to how and in what circumstances the authorities will use the special resolution tools.[364]

The general powers for the exercise of the rescue powers under this regime are also regulated. A stabilization power must only be exercised in respect of a bank if the FSA is satisfied that specific conditions are met. Firstly, the bank that is subjected to the special regulation regime must be failing, or is likely to fail to satisfy the threshold conditions imposed on banks.[365] The second condition is that, having regard to timing and other relevant circumstances, it is not reasonably likely that, save for the stabilization powers, action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.[366] The FSA must treat these two conditions as met if satisfied that they would be met but for financial assistance provided by the Treasury or the BoE.[367] To create co-ordination of regulatory action, before determining whether or not the second condition has been met, the FSA must consult the BoE and the Treasury.[368]

Interestingly, unlike South Africa's present legal regime, which seems to emphasize fire-fighting through SARB intervention in terms of curatorship only when a bank is failing, the UK dispensation allows the authorities to intervene when they assess that a given bank is likely to fail. This is more pro-active in nature and helps the regulator to move into action and appoint an administrator to take over the administration and affairs of a distressed bank before the situation gets out of hand.

4.3.1 BANK ADMINISTRATION AS A RESCUE MECHANISM

[363] Section 5(1) of the Act.

[364] The code of practice can be accessed via https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/411563/banking_act_2009_code_of_practice_web.pdf (last accessed on 4/3/2016). In terms of section 6(3) of the Act, the Treasury may revise and re-issue the code of practice. This code is enacted in accordance with sections 5 and 6 of the Banking Act and to give these provisions an operational effect.

[365] The threshold conditions are imposed by section 41(1) and schedule 6 of the Financial Services and Markets Act (FSMA) 2000. They relate to legal status of a bank, location of offices, close links as a parent or subsidiary, adequate resources and suitability.

[366] Section 7(3) of the FSMA.

[367] Section 7(4) of the FSMA. The assistance envisaged under this section does not include ordinary market assistance offered by the BoE on its usual terms.

[368] Section 7(5) of the FSMA. It IS Important to note that under section 7(6), it is provided that the special resolution objectives are not relevant to the two conditions that trigger the operation of the special resolution regime.

The Banking Act, *inter alia*, makes provision for the bank administration procedure.[369] The main tenets of this procedure are that: it is used where a part of the business of a bank is sold to a commercial purchaser in accordance with section 11 or transferred to a bridge bank in accordance with section 12.[370] The court appoints a bank administrator on the application of the BoE.[371] The bank administrator must be able and is required to ensure that the un-sold or non-transferred part of the bank ("the residual bank") provides services or facilities required to enable the commercial purchaser ("the private sector purchaser") or the transferee ("the bridge bank") to operate effectively.[372] In other respects, the process is the same as for normal administration under the Insolvency Act 1986 subject to specified modifications and adaptations.[373] For purposes of delimitation, this research will mainly focus on normal administration because it is the procedure that best suits the rescue of a distressed bank as a going concern, without transfer to a private sector purchaser or a bridge bank.

A bank liquidator who thinks that administration would achieve a better result for the bank's creditors as a whole than would the bank's insolvency, may apply to the court for an administration order.[374] Such application can be made if a set of conditions are satisfied. Firstly, the liquidation committee must have passed a full payment resolution. Secondly, the liquidation committee must have resolved that moving to administration might enable the rescue of the bank as a going concern. And lastly, the bank liquidator must be satisfied that, as a result of arrangements made with the FSCS, any depositors still eligible for compensation under the scheme will receive their payments or have their accounts transferred during administration.[375]

In the interaction between banking and insolvency law, the law grants cross application of other traditional insolvency procedures to bank insolvency. Some provisions of the Insolvency Act, such as the dismissal of a pending winding-up petition and the moratorium on insolvency

[369] Section 136(1).
[370] Section 136(2)(a). It can also be used in certain cases of multiple transfers under Part 1of the Banking Act.
[371] Section 136(2)(b).
[372] Section 136(2)(c).
[373] Section 136(2)(d).
[374] Section 114(1) of the Banking Act read in conjunction with paragraph 38 of Schedule B1 to the Insolvency Act, 1986.
[375] Section 114(5) of the Banking Act.

proceedings, apply to a bank insolvency order as they would apply to an administration order in insolvency law.[376]

An application for an administration order in respect of a bank may not be determined unless the PRA has been notified – by the applicant for the administration order – that the application has been made.[377] Similarly, an administrator of a bank may not be appointed unless the PRA has been notified by the person proposing to appoint an administrator of the proposed appointment.[378] A copy of the notice complying with these conditions must be filed with the court and made available for public inspection by the court.[379] Another condition to be satisfied is that the period of two weeks, beginning with the day on which the notice is received, has ended, or the PRA has informed the person who gave the notice that it does not intend to apply for a bank insolvency order, and the BoE has informed the person who gave the notice that it does not intend to apply for a bank insolvency order or to exercise a stabilization power.[380] Lastly, there should not be a pending application for a bank insolvency order.[381]

A bank administrator has two objectives. Firstly, he or she must support the commercial purchaser or bridge bank, and secondly, he or she must undertake the "normal" administration of the distressed bank.[382] The first objective takes precedence over the second objective but a bank administrator is obliged to begin working towards both objectives immediately upon appointment.[383] The first objective is to ensure the supply to the private sector purchaser or

[376] See section 119 of the Banking Act. For purposes of this cross-reference, a reference to an administration order in the Insolvency Act is a reference to a bank insolvency order, a reference to a company being in administration is a reference to a bank being in bank insolvency, and a reference to an administrator is construed as a reference to a bank liquidator.
[377] Section 120(5)(a) of the Banking Act as amended by the Financial Services Act in relation to the PRA.
[378] Section 120(5)(d) of the Banking Act.
[379] Section 120(6) of the Banking Act.
[380] Section 120(7) of the Banking Act.
[381] Section 120(8) of the Banking Act. In terms of clause 10, where the PRA receives a notice, it shall inform the BoE of such notice. The PRA then must inform the person who gave the notice within the 2 weeks period whether it intends to apply for a bank insolvency order. If the BoE decides to apply for a bank insolvency order or to exercise a stabilization power, it must inform the person who gave the notice.
[382] Section 137(1).
[383] Section 137(2).

bridge bank of such services and facilities as are required to enable it, in the opinion of the BoE, to operate effectively.[384]

In the case of bank administration following a private sector purchase the bank administrator must co-operate with any request of the BoE to enter into an agreement for the residual bank to provide services or facilities to the private sector purchaser; and in pursuing the first objective to support the commercial purchaser, the bank administrator must have regard to the terms of that or any other agreement entered into between the residual bank and the private sector purchaser. In particular, the bank administrator must avoid action that is likely to prejudice performance by the residual bank of its obligations in accordance with those terms. If in doubt about the effect of those terms, the bank administrator may apply to the court for directions under paragraph 63 of Schedule B1 to the Insolvency Act 1986.[385] The private sector purchaser may refer to the court a dispute about any agreement with the residual bank by applying for directions under paragraph 63 of Schedule B1 of the Insolvency Act.[386]

In the case of bank administration following transfer to a bridge bank, the bank administrator must co-operate with any request of the BoE to enter into an agreement for the residual bank to provide services or facilities to the bridge bank. The bank administrator must avoid action that is likely to prejudice performance by the residual bank of its obligations in accordance with an agreement. Furthermore, the bank administrator must ensure that, so far as is reasonably practicable, an agreement entered into includes provision for consideration at market rate. This does not prevent the bank administrator from entering into an agreement on any terms that the bank administrator thinks necessary in pursuit of the first objective of ensuring the supply to the private sector purchaser or bridge bank of such services and facilities as are required to enable it to operate effectively.[387]

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[384] Section 138(1). For the purpose of this objective, the reference to services and facilities includes a reference to acting as transferor or transferee under a supplemental or reverse property transfer instrument, and the reference to "supply" includes a reference to supply by persons other than the residual bank.
[385] This provision of the Insolvency Act is entrenched by section 145 of the Banking Act.
[386] See section 138(3) of the Banking Act.
[387] Section 138(4). This provision does not apply after the first condition has been met or once it ceases to subsist. In terms of clause 5, where a bank administrator requires the BoE's consent or approval to any action in accordance with this Part, the Bank may withhold consent or approval only on the grounds that the action might prejudice the achievement of the first objective the administrator is tasked to achieve. In terms of section 139, Objective 1 ceases if the Bank of England notifies the bank administrator that the residual bank is no longer required in connection with the private sector purchaser or bridge bank. A bank administrator who thinks that Objective 1 is no longer required

The second objective of the bank administrator relates to "normal" administration. This entails rescuing the residual bank as a going concern and achieving a better result for the residual bank's creditors as a whole than would be likely if the residual bank were wound up without first being in bank administration.[388] In pursuing this second objective, a bank administrator must aim to rescue the residual bank as a going concern unless he or she is of the opinion that either it is not reasonably practicable to rescue the entity, or achieving a better result for the residual bank's creditors as a whole than would be likely if the residual bank were wound up without first being in bank administration would achieve a better result for the residual bank's creditors as a whole.[389]

In practical terms, an application for a bank administration order may be made to the court by the BoE. The application must nominate a person to be appointed as the bank administrator.[390] A bank administration order is an order appointing a person as the bank administrator of a bank.[391] A person is eligible for appointment as a bank administrator if he or she is qualified to act as an insolvency practitioner and the appointment can only be effectual if the appointed person consents to act.[392]

The Act also lists grounds for the application of a bank administrative order. The BoE may apply for a bank administration order if it has made or intends to make a property transfer instrument in respect of the bank in accordance with section 11(2) or 12(2), and it is satisfied that the residual bank is unable to pay its debts, or is likely to become unable to pay its debts as a result of the property transfer instrument which the BoE intends to make.[393] The court may grant a bank

may apply to the court for directions under paragraph 63 of Schedule B1 to the Insolvency Act 1986 (applied by section 145 below); and the court may direct the Bank of England to consider whether to give notice under subsection (1) above. If immediately upon the making of a bank administration order the Bank of England thinks that the residual bank is not required in connection with the private sector purchaser or bridge bank, the Bank of England may give a notice under subsection (1). A notice under subsection (1) is referred to in this Part as an "Objective 1 Achievement Notice".

[388] Section 140(1) of the Banking Act.

[389] Section 140(2) of the Banking Act.

[390] See section 142 of the Banking Act. The affected bank must be given notice of an application, in accordance with rules under section 411 of the Insolvency Act 1986 as applied by section 160 of the Banking Act.

[391] See section 141 of the Banking Act. A bank administration order takes effect in accordance with its terms; and (a) the process of a bank administration order having effect may be described as "bank administration" in relation to the bank, and (b) while the order has effect the bank may be described as being "in bank administration".

[392] Section 141(3) of the Banking Act.

[393] Section 143 of the Banking Act.

administration order if satisfied that these conditions have been met.[394] The bank administrator is an officer of the court.[395]

Upon appointment, the bank administrator must as soon as practicable make a statement setting out proposals for achieving the objectives under his or her mandate. The statement must have been agreed with the BoE.[396] Upon successful rescue, the bank administrator may give a notice bringing his or her appointment to an end on achievement of the objectives under paragraph 80 of Schedule B1 to the Insolvency Act 1986. On issuance of such a notice, the bank administrator exercising this mandate must send a copy to the PRA and the FCA.[397]

The power of a bank administrator to make a notice to the effect that there are no more assets for distribution, or to propose a voluntary arrangement and summon meetings, is also crystalized in the Act.[398] On the termination of a company's voluntary surrender, the bank administrator may apply to the court to lift the suspension of the bank administration order.[399] However, the bank administrator should not take action under this provision unless he or she is satisfied that the bank has received any funds it is likely to receive from any scheme under a resolution fund order.[400]

Before the PRA or the FCA exercises an insolvency power, for example an application for an administration order in respect of a residual bank, whichever of them is exercising the power

[394] Section 144 gives a discretionary power to the court. On an application for a bank administration order the court may (a) grant the application, (b) adjourn the application (generally or to a specified date), or (c) dismiss the application.
[395] Section 146 of the Banking Act.
[396] See section 147 of the Banking Act. But a bank administrator who is unable to agree a statement with the Bank of England may apply to the court for directions under paragraph 63 of Schedule B1 to the Insolvency Act 1986 (as applied by section 145); and the court may make any order, including dispensing with the need for the Bank of England's agreement. The statement shall be treated in the same way as a statement under paragraph 49 of Schedule B1 to the Insolvency Act 1986.
[397] In terms of the amendments to Part 3 of the Banking Act introduced by the Financial Services Act, 2012. Under section 153(4), failure to issue the notice without reasonable excuse is an offence.
[398] See section 154 of the Banking Act read with sections 1, 3 and paragraph 84 of Schedule B1 to the Insolvency Act 1986.
[399] Section 154(6) of the Banking Act. In terms of section 121(3) of the Financial Services (Banking Reform) Act 2013, the power to make rules conferred by section 411(1B) of the 1986 Insolvency Act (rules relating to bank administration) applies for the purpose of giving effect to this Part as it applies for the purposes of giving effect to Part 3 of the Banking Act, 2009.
[400] Section 154(7) of the Banking Act.

must give notice to the BoE, which may participate in any proceedings arising out of the exercise of the power.[401]

4.4 The Financial Services (Banking Reform) Act 2013

On 18th December 2013, another important piece of legislation was enacted to make further provision for banking and other financial services, including provision for the Financial Services Compensation Scheme; to make provision for the amounts owed in respect of certain deposits to be treated as a preferential debt on insolvency; to make further provision for payment systems and securities settlement systems; to make provision for the accounts of the BoE and its wholly owned subsidiaries; to make provision in relation to persons providing claims management services; and for connected purposes.[402]

4.4.1. Ring-fencing requirements

Part 1 of this Act deals with the ring-fencing provisions to implement the core recommendation of the Independent Commission on Banking (ICB) that banks in UK should ring-fence their retail and small and medium-sized enterprise (SME) and deposit-taking operations in separate and financially independent legal entities from those entities undertaking riskier, wholesale and investment banking operations. The Act further provides for amendments to Part VII of the Financial Services and Markets Act 2000 (FSMA) to allow transfer schemes intended to give effect to the ring-fence.[403]

The framework also distinguishes between the core banking activities and the excluded activities. The core banking activities are facilities for the accepting of deposits or other payments into an account which is provided in the course of carrying on the core activity of accepting deposits, facilities for withdrawing money or making payments from such an account

[401] See section 157 of the Banking Act read in conjunction with amendments to Part 3 introduced by the Financial Services Act, 2012. In terms of section 157(2)(a) of the Banking Act, a residual bank means a bank all or part of whose business has been transferred to a commercial purchaser in accordance with section 11 or to a bridge bank in accordance with section 12 of the Act.
[402] See the long title of the Financial Services (Banking Reform) Act 2013 Chapter 33.
[403] See sections 1-4 of the Act. In terms of section 142A, a "ring-fenced body" means s a UK institution which carries on one or more core activities as enunciated in section 142B in relation to which it has a Part 4A permission. It does not include a building society within the meaning of the Building Societies Act 1986, or a UK institution of a class exempted by order made by the Treasury. UK institution means a body corporate incorporated in the United Kingdom. In terms of section 142B (2), the regulated activity of accepting deposits (whether carried on in the United Kingdom or elsewhere) is a core activity unless it is carried on in circumstances specified by the Treasury by order.

and overdraft facilities in connection with such an account.[404] On the other hand, the regulated activity of dealing in investments as principal, whether carried on in the United Kingdom or elsewhere, is an excluded activity unless it is carried on in circumstances specified by the Treasury by order.[405] The Treasury may by order provide for an activity other than the regulated activity of dealing in investments as principal to be an excluded activity, either generally or when carried on in circumstances specified in the order.[406]

The Treasury is also given powers to prohibit ring-fenced bodies from entering into transactions of a specified kind or with persons falling within a specified class; establishing or maintaining a branch in a specified country or territory; or holding in specified circumstances shares or voting power in companies of a specified description.[407]

A ring-fenced body which carries on or purports to carry on an excluded activity, or contravenes any provision of an order of Treasury is to be taken to have contravened a requirement imposed on the body by the appropriate regulator.[408] However, a contravention in terms of this provision does not make a person guilty of an offence; nor does it make a transaction void or unenforceable.[409] However, in certain instances as the Treasury may specify by order, the contravention is actionable at the suit of a person who suffers loss as a result of the

[404] Section 142C (2) of the Financial Services (Banking Reform) Act 2013. The Treasury may by order provide that any other specified services provided in the course of carrying on the core activity of accepting deposits are also core services. If an order under section 142B(5) provides for an activity other than that of accepting deposits to be a core activity, the Treasury must by order provide that specified services provided in the course of carrying on that activity are core services.
[405] Section 142D (2) of the Financial Services (Banking Reform) Act 2013. An order under this subsection may be made only if the Treasury is of the opinion that allowing ring-fenced bodies to deal in investments as principal in the specified circumstances would not be likely to result in any significant adverse effect on the continuity of the provision in the United Kingdom of core services.
[406] Section 142D (4) of the Financial Services (Banking Reform) Act 2013. In terms of subsection (6), in deciding whether to make an order under this provision in relation to any activity, the Treasury must have regard to the risks to which a ring-fenced body would be exposed if it carried on the activity concerned, and consider whether the carrying on of that activity by a ring-fenced body would make it more likely that the failure of the body would have an adverse effect on the continuity of the provision in the UK of core services.
[407] This power is contained in section 142E (1) of the Financial Services (Banking Reform) Act 2013. In terms of subsection (2), when taking a decision whether to make an order imposing a prohibition, the Treasury must have regard to the risks to which a ring-fenced body would be exposed if it did the thing to which the prohibition relates, and consider whether the doing of that thing by a ring-fenced body would make it more likely that the failure of the body would have an adverse effect on the continuity of the provision in the UK of core services.
[408] Section 142G (1) of the Act.
[409] Section 142G (2) of the Act.

contravention, subject to the defenses and other incidents applying to actions for breach of a statutory duty.[410]

In terms of ring-fencing rules, the appropriate regulator is mandated to require a ring-fenced body to make arrangements to ensure the effective provision to the ring-fenced body of services and facilities that it requires in relation to the carrying on of a core activity, and make provision for the group ring-fencing purposes applying to ring-fenced bodies and to authorized persons who are members of a ring-fenced body's group.[411]

To this effect, group ring-fencing rules restrict the power of a ring-fenced body to enter into contracts with other members of its group otherwise than on arm's length terms.[412] The rules also curtail the payments that a ring-fenced body may make by way of dividend or otherwise to other members of its group; require the disclosure to the appropriate regulator of information relating to transactions between a ring-fenced body and other members of its group; require a ring-fenced body to ensure that its board of directors (or if there is no such board, the equivalent management body) includes, to a specified extent, members who are treated by the rules as being independent of other members of the ring-fenced body's group, members who are treated by the rules as being independent of the ring-fenced body itself, and non-executive members.[413]

Most importantly, the ring-fencing rules require arrangements made by the ring-fenced body for the identification, monitoring and management of risk to meet specified requirements.[414] This provision, together with other checks and balances, for example, requirements for a ring-fenced body to act in accordance with a remuneration policy and a human resources policy, are intended to ensure than banks adhere to proper and sound corporate governance systems that prevent bank

[410] Section 142G (3) of the Act. In terms of the entire provision under section 142G, the appropriate regulator means in relation to a ring-fenced body which is a PRA-authorized person, the PRA and in relation to any other ring-fenced body, the FCA.

[411] See section 142H of the Act. The group ring-fencing purposes are to ensure as far as reasonably practicable that the carrying on of core activities by a ring-fenced body is not adversely affected by the acts or omissions of other members of its group; ensuring as far as reasonably practicable that in carrying on its business a ring-fenced body is able to take decisions independently of other members of its group, and does not depend on resources which are provided by a member of its group and which would cease to be available to the ring-fenced body in the event of the insolvency of the other member; and ensuring as far as reasonably practicable that the ring-fenced body would be able to continue to carry on core activities in the event of the insolvency of one or more other members of its group.

[412] The arm's length principle ensures that firms are acting in their own self-interest, without any pressure, duress, coercion or undue influence from the other party. It

[413] See section 142H.

[414] Section 142H (5)(g).

failure.[415] In this regard, it is submitted that this legislative framework is much more pre-emptive in nature, as it seeks to address structural weaknesses that cause the failure of banks from within. Furthermore, the ring-fencing principle is an important tool in bank rescue operations because it helps the administrator identify those banking services that are very important to the general public, and whose failure would destabilize the banking system. It is such important services and products that the rescue tool is designed to protect in public interest by guaranteeing the stability of the financial system as a whole.

It is imperative to note that these reforms are being implemented in a phased approach and the process is still on-going. In October 2016, the PRA issued a consultation paper covering amendments to the ring-fencing rules.[416] This follows up from consultation papers and policy documents issued in July 2016 with a view of adopting a suitable framework to govern implementation of a systemic risk buffer, and prudential requirements and intragroup arrangements of ring-fenced institutions.[417] It is planned that the ring-fencing of UK banking groups will become operational on 1 January 2019. Ahead of that, the Financial Policy Committee (FPC) is finalizing the Systemic Risk Buffer (SRB) framework that will provide institutions with more certainty regarding the regulatory capital framework and also provide adequate time for firms to increase their capital buffers.[418]

4.4.2. Group restructuring powers

The appropriate regulator may exercise the group restructuring powers only if it is satisfied that one or more of these four conditions discussed hereunder are present in relation to a ring-fenced body that is a member of a conglomerate group.[419] The first condition is that the carrying on of core activities by the ring-fenced body is being adversely affected by the acts or omissions of other members of its group.[420] The second condition is that in the course of carrying on its

[415] The reference in subsection (5)(e) to a remuneration policy is a reference to a policy about the remuneration of officers, employees and other persons who in each case are of a specified description. In the same vein, the reference in subsection (5)(f) to a human resources policy is a reference to a policy about the appointment and management of officers, employees and other persons who in each case are also of a specified description.
[416] See chapter 5 of Consultation Paper 36/16 'Occasional Consultation Paper' accessed via http://www.bankofengland.co.uk/pra/Pages/supervision/structuralreform/default.aspx (last visited on 4/12/16).
[417] All the consultation papers can be accessed on the BoE's official website above.
[418] See 'The Financial Policy Committee's framework for the systemic risk buffer' accessed via http://www.bankofengland.co.uk/financialstability/Documents/fpc/srbf_cp260516.pdf (last visited on 4/12/16).
[419] Section 142K (1).
[420] Section 142K (2).

business, the ring-fenced body is unable to take decisions independently of other members of its group, or depends on resources which are provided by a member of its group and which would cease to be available in the event of the insolvency of the other member.[421] The third condition is that in the event of the insolvency of one or more other members of its group the ring-fenced body would be unable to continue to carry on the core activities carried on by it.[422] Lastly, the ring-fenced body or another member of its group has engaged, or is engaged in conduct which has or is likely to have an adverse effect on the advancement by the appropriate regulator.[423]

Group restructuring powers means one or more of the powers accorded to the appropriate regulator. Where the appropriate regulator is the PRA, the powers conferred by the law are, in relation to the ring-fenced body, the power to impose a requirement on the ring-fenced body requiring it to dispose of specified property or rights to an outside person; to apply to the court for an order sanctioning a ring-fencing transfer scheme relating to the transfer of the whole or part of the business of the ring-fenced body to an outside person; or to make arrangements discharging the ring-fenced body from specified liabilities.[424]

In circumstances where any member of the ring-fenced body’s group which is a PRA-authorized person or entity, the group restructuring power applicable to such person or entity relates to the power to impose a requirement on such person or entity requiring him/her or it (in case of companies) to dispose of any shares in or securities of the ring-fenced body to an outside person; or dispose of any interest in any other body corporate that is a member of the ring-fenced body’s group to an outside person; or dispose of other specified property or rights to an outside person; or to apply to court for an order sanctioning a ring-fencing transfer scheme relating to the transfer of the whole or part of the business of the authorized person or qualifying parent undertaking to an outside person.[425]

[421] Section 142K (3).
[422] Section 142K (4).
[423] In terms of the appropriate regulator in section 142K (5), in the case of the PRA, the business conduct must be adverse to the objective in section 2B(3)(c). In the case of the FCA, the business conduct must be adverse to the continuity objective for the FCA to exercise the group restructuring powers.
[424] Section 142L (2)(a) read in conjunction with section 142L (5).
[425] Section 142L (2) (b) read in consonance with section 142L (6). A parent undertaking of a ring-fenced body by reference to which the group restructuring powers are exercisable is for the purposes of this Part is a qualifying parent undertaking if it is a body corporate which is incorporated in the United Kingdom and has a place of business in the United Kingdom, and it is not itself an authorized person. In terms of subsections (5) and (6), an outside person means a person who, after the implementation of the disposal or scheme in question, will not be a member of

In terms of the procedural aspects, if the appropriate regulator proposes to exercise the group restructuring powers in relation to any authorized person or qualifying parent undertaking, the regulator must give each of the relevant persons a written preliminary notice which must state that the regulator proposes to exercise the group restructuring powers, the action which the regulator proposes to take in the exercise of those powers, and give reasons for the proposed action.[426]

If the appropriate regulator has given the requisite preliminary notice, it must if, having considered any representations made by any of the relevant persons, the regulator still proposes to exercise the group restructuring powers, the regulator must give each of the relevant persons or entities affected a warning notice. This must be done during the warning notice period, or before the end of the warning notice period, and the written notice must state that the regulator has decided not to exercise the powers and give a copy of that notice to the Treasury.[427] If a regulator is satisfied that a person who is or has been a qualifying parent undertaking has contravened a requirement of a directive given by that regulator as a result of group restructuring, the regulator may impose a penalty of such amount as it considers appropriate on the parent undertaking or any person who was knowingly concerned in the contravention. The regulator may, instead of imposing a penalty on a person, publish a statement censuring the person.[428]

In terms of pension liability for ring-fenced bodies, the Treasury is mandated to make arrangements to ensure that, except in prescribed cases, the ring-fenced body cannot become

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the group of the ring-fenced body by reference to which the powers are exercised whether or not that body is to remain a ring-fenced body after the implementation of the disposal or scheme in question.

[426] See section 142M on procedure and form of the preliminary notices. The preliminary notice must specify a reasonable period which may not be less than 14 days within which any of the relevant persons may make representations to the regulator.

[427] See section 142N on the procedure for a warning notice and decision notice. Before giving a warning notice, the appropriate regulator must give the Treasury a draft of the notice, provide the Treasury with any information that the Treasury may require in order to decide whether to give their consent, and obtain the consent of the Treasury. If the regulator decides to exercise the group restructuring powers it must give each of the relevant persons a decision notice. The decision notice must specify the date or dates by which any disposal of shares, securities or other property that is required by the notice; and any transfer of liabilities for which the notice requires arrangements to be made must be completed.

[428] See section 142S for the power to impose penalty or issue censure. The regulator may not take action against a person under this section after the end of the limitation period unless, before the end of that period, it has given a warning notice to the person. The limitation period means the period of 3 years beginning with the first day on which the regulator knew of the contravention. In terms of this section, a regulator is to be treated as knowing of a contravention if it has information from which the contravention can reasonably be inferred.

liable to meet or contribute to the meeting of pension liabilities which arise in connection with a persons' service on or after a date specified in the regulations in any employment other than service in an employment in respect of which the employer is a ring-fenced body. The Treasury must also ensure that except in prescribed cases, the default of a person other than another ring-fenced body would not result in the ring-fenced body becoming liable to meet or contribute to the meeting of pension liabilities arising in connection with persons' service in any employment before the specified date.[429] It is submitted that all these are measures to curtail financial crises and mitigate bank collapse should a banking crisis occur.

4.4.3. Loss-absorbency requirements

Another important aspect of this Act relates to the introduction of a loss-absorbency mechanism. This is intended to ensure that the losses arising from bank failure do not fall on the taxpayer, but instead are imposed on the shareholders and unsecured creditors of the bank. Under this mechanism, systemically important UK banks must hold primary loss-absorbing capacity (PLAC) in addition to required regulatory capital requirements. In exercise of this power in relation to loss-absorbency requirements, the Treasury may by order make provision for the exercise by either regulator of its functions require a ring-fenced entity, or any other body corporate in the business of deposit taking to issue any debt instrument, or ensure that any part of the relevant body's debt consists of debt owed by it in respect of debt instruments, or debt instruments of a particular kind.[430]

The order issued by Treasury may in particular require the regulator to exercise its functions so as to require relevant bodies to do either or both of the actions mentioned above in relation to debt. The order may also limit the extent to which the regulator may require a relevant body's debt to consist of debt owed in respect of debt instruments or of debt instruments of a kind specified in the order; impose on the regulator in connection with the exercise of a specified function procedural requirements which would not otherwise apply to the exercise of the

[429] See section 142W which addresses pension liabilities. In terms of this section, the regulations contain provisions enabling the trustees or managers of a relevant pension scheme in respect of which the employer or one of the employers is a ring-fenced body to transfer to another relevant pension scheme all or part of the pension liabilities arising in connection with persons' service before the specified date together with all or part of the assets of the scheme or to divide the scheme into two or more sections in relation to which prescribed conditions are met.

[430] See section 142Y in relation to the loss-absorbency framework. In terms of this section, a debt instrument means a bond, any other instrument creating or acknowledging a debt, or an instrument giving rights to acquire a debt instrument.

function, or require the regulator to consult, or obtain the consent of the Treasury before making rules of a specified description or exercising any other specified function.[431]

4.4.4. Introduction of bail-in as a stabilization option

During the financial crisis, several governments bailed out failing banks because letting these banks fail and enter insolvency would have caused excessive disruption to the critical banking services that these institutions provide and to the wider financial system.[432] This was necessary because households, businesses and governments rely on services provided by the banks. Furthermore, the central banks did not have an effective means of dealing with bank failure without the use of public funds.

However, bailing out large banks is undesirable. It is costly to the tax payer, and it is also likely to undermine the incentives for firms to be run in a prudent manner and for investors to monitor the activities of the firm to prevent excessive risk-taking from jeopardizing their investment (moral hazard). Following the financial crisis, the Financial Stability Board (FSB) developed a set of principles for managing the failure of systemically important financial institutions. These 'Key Attributes' of effective resolution regimes sought to ensure that firms could fail without disrupting the financial system, without interrupting the critical services they provide and, importantly, without requiring public sector support. One of the tools included in the Key Attributes was "bail-in".[433]

[431] See section 142Y (4) for the full list of what the order by Treasury can entail.

[432] In the UK, A bank rescue package totaling some £500 billion (approximately $850 billion) was announced by the British government on 8 October 2008, as a response to the global financial crisis. The plan aimed to restore market confidence and help stabilize the British banking system, and provided for a range of short-term loans and guarantees of interbank lending, as well as up to £50 billion of state investment in the banks themselves. The rescue plan provided for several sources of funding to be made available, to an aggregate total of £500 billion in loans and guarantees. Most simply, £200 billion was made available for short term loans through the Bank of England's Special Liquidity Scheme. Secondly, the Government supported British banks in their plan to increase their market capitalization through the newly formed Bank Recapitalization Fund, by £25 billion in the first instance with a further £25 billion to be called upon if needed. Thirdly, the Government temporarily underwrote any eligible lending between British banks, giving a loan guarantee of around £250 billion. Lloyds and RBS were the recipients of this bailout package which was open to all UK incorporated banks and all building societies including Abbey, Barclays plc, Clydesdale Bank, HBOS, HSBC / HSBC Group, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland / Royal Bank of Scotland Group and Standard Chartered Bank. (See Langley, Paul (2015). Liquidity Lost: The Governance of the Global Financial Crisis. Oxford University Press. pp. 83–86. ISBN 0199683786 and Darling, Alastair (8 October 2008). "Statement by the Chancellor on financial stability". HM treasury. Archived from the original on 11 October 2008).

[433] When the FSB adopted the Key Attributes of Effective Resolution Regimes for Financial Institutions in 2011, it was agreed to develop further guidance on their implementation, taking into account the need for implementation to accommodate different national legal systems and market environments and sector-specific considerations like

As noted by Lucy Chennells and Venetia Wingfield of the BoE's Resolution Directorate, in a typical bail-in scenario, the claims of shareholders and unsecured creditors of the failed firm are written down and/or converted into equity in order to absorb the losses and recapitalize the firm or its successor. A bail-in is not negotiated, but is rather imposed upon the distressed bank and its creditors by the Central Bank. It is designed to stabilize the firm, providing time and breathing space to enable the distressed bank to be restructured in order to address the underlying causes of its failure or illiquidity. The aim is to resuscitate the firm, or its successor, so that it is able to operate without public support through emergency liquidity assistance. The rescue of both small and large/complex banks is likely to involve bail-in. However, there are different approaches to bail-in and the mechanisms that would be used to achieve bank rescue using the bail-in tool vary across jurisdictions.[434]

The concept of bail-in evolved in the aftermath of the failure of Lehman Brothers in 2008. Some of those who were involved in the discussions on how to handle the fallout from the failure of a large, cross-border investment bank, set out a method for using the firm's own resources, rather than public funds, to restore the balance sheet of the firm (a cram down). The holders of the firm's bonds would have their investments in the firm written down and converted into shares. This would be an alternative to a public bailout or a disorderly insolvency and would provide the capital that the firm was required to hold in order to be allowed to operate by its regulator. This in turn would give the authorities, and the firm's new management, the time they needed to find

insurance and financial market infrastructures in order to promote effective and consistent implementation across jurisdictions. On 15 October 2014, the FSB adopted additional guidance that elaborates on specific Key Attributes relating to information sharing for resolution purposes and sector-specific guidance that sets out how the Key Attributes should be applied for insurers, financial market infrastructures (FMIs) and the protection of client assets in resolution. The newly adopted guidance documents have been incorporated as annexes into the 2014 version of the Key Attributes document. No changes were made to the text of the twelve Key Attributes of October 2011. The twelve Key Attributes remain the umbrella standard for resolution regimes covering financial institutions of all types that could be systemic in failure. A copy can be obtained via http://www.fsb.org/2014/10/r_141015/ (last accessed on 6/4/2016).

[434] Lucy Chennells and Venetia Wingfield, Bank failure and Bail-in: An introduction (Bank of England Quarterly Bulletin 2015 Q3 at pg. 228). Although the concept of a bail-in can be succinctly summarized, it is a two-step process to absorb losses and recapitalize a failing firm or its successor, in practice; it also requires a significant restructuring of liabilities and of the failing firm. Resolution authorities therefore need practical mechanisms, tools, skills and processes to carry out a bail-in. Although bail-in has not yet been used in the United Kingdom, and its mechanisms and procedures continue to be developed, the approach currently envisaged is set out by these authors.

a permanent solution to the problems of the failing firm, which would involve a major restructuring of its activities and the adoption of a new business plan.[435]

In a bail-in, the claims of shareholders and unsecured creditors are written down and/or converted into equity to absorb the losses of the failed firm and recapitalize the firm or its successor. This is done in a manner that respects the hierarchy of claims prescribed in insolvency law. A bail-in allows the firm to continue to operate and to meet supervisory requirements so that the critical functions the firm provides can be maintained immediately after entry into a rescue procedure, such as administration.[436]

In common with the other emergency tools, bail-in allows a failing firm to be stabilized prior to a restructuring. There are two distinct steps to the stabilization phase: The first step is loss absorption, which entails an estimate of the outstanding losses of the bank, which is achieved through an initial valuation of its asset and liabilities. This is necessary prior to any resolution, in order to establish whether the bank is failing, or likely to fail. Losses which have not already been fully recognized are absorbed by writing down the value of assets. The losses may or may not wipe out the existing equity in the firm, but they are likely to push the firm's capital level below that which is required by the firm's prudential supervisor. If the losses exceed the existing equity, each layer of unsecured creditors in the creditor hierarchy will be written down, in the order of their ranking in insolvency until the amount necessary to recognize the outstanding losses is covered.[437]

The second step entails recapitalizing the bank balance sheet. This means restoring the capital the bank needs to support its activities, to ensure that the market has confidence in the bank, and to meet the requirements of the prudential supervisor through the subsequent restructuring phase.

[435] Calello, P and Ervin, W (2010), 'Economics focus: from bail-out to bail-in', The Economist, 28 January 2010.

[436] Unlike a debt-for-equity swap, where the terms of any exchange of debt for shares are negotiated by the relevant private parties, a bail-in would be imposed upon the firm and its creditors by the resolution authority. There would be no requirement to get the consent of shareholders, creditors or the existing management of the firm. And there is no requirement for court approval of the bail-in.

[437] As noted by Lucy Chennells and Venetia Wingfield, There is more than one way to carry out a bail-in. In particular it can be done either through the use of powers to write down and convert liabilities into forms of ownership in the restored firm, or using a bridge bank. The economic effect is largely the same in each case, although the legal processes followed are likely to differ. In each case the bail-in allows the resolution authority to stabilize a firm. It provides time that will allow for an orderly re-organization of all or part of a failing firm, in order to address the underlying cause of the failure. And in each case losses are absorbed and the firm or a successor entity is recapitalized.

The bulk of the re-capitalization is likely to be achieved by converting the claims of creditors into equity.[438] In many regards, bail-in is similar to curatorship in the sense that it is explicitly a prelude to the reorganization of the business of a failing bank. Once the bank has been stabilized, the causes of the firm's failure must be addressed.

In terms of bank restructuring, a resolution instrument may require a bail-in administrator or one or more directors of the bank to draw up a business re-organization plan with respect to the bank, and submit it to the BoE within the period allowed by or under the instrument.[439] Where a person has submitted a business re-organization plan to the BoE, it must approve the plan if satisfied that the plan is appropriately designed to restore the viability of the bank. The Central Bank can also require the person to amend the plan in a specified manner.[440] Further functions may be accorded to such administrator to authorize a bail-in administrator to manage the bank's business or confer on a bail-in administrator any other power with respect to the management of the bank's business; authorize a bail-in administrator to exercise any other powers of the bank; confer on a bail-in administrator any other power the BoE may consider appropriate; and provide that the exercise of any power conferred by the instrument is to be subject to conditions specified in that instrument.[441]

4.5. Oversight of conduct of persons working in the banking sector

[438] Lucy Chennels and Venetia Wingfield on this aspect discuss open and closed bank bail-in procedures. In an 'open bank' bail-in liabilities are written down or converted into equity in the existing firm. The bank remains open for business throughout the process. In a 'closed bank' bail-in, the liabilities that are to absorb losses remain in the original legal entity that is put into an insolvency process and/or bailed in while the activity that is to be continued is transferred to a newly created entity. Since the original firm is closed this is known as a closed bank bail-in. Both options are available to UK resolution authorities under the Bank Recovery and Resolution Directive.

[439] Business re-organization plans are governed by section 48H. In terms of this section, business re-organization plan means a plan that includes an assessment of the factors that caused the bank distress, a description of the measures to be adopted with a view to restoring the viability of the bank, and a timetable for the implementation of those measures.

[440] Where the BoE has required a person to amend a business re-organization plan, the person must re-submit the amended plan within the period allowed by or under the resolution instrument. Before deciding what action to take, the BoE must for each submission or re-submission of a plan consult the PRA and the FCA. A business re-organization plan may include recommendations by the person submitting the plan as to the exercise by the BoE of any of its powers under this Part in relation to the affected bank. The viability of a bank is to be assessed by reference to whether the bank satisfies, and if so for how long it may be expected to continue to satisfy the threshold conditions as defined in section 55B of the Financial Services and Markets Act 2000.

[441] Section 48I (1) of the Act. A resolution instrument may require a bail-in administrator to make reports to the BoE on any matter specified in the instrument, and at the times or intervals specified in the instrument as provided for under section 48I (2).

In its June 2013 report entitled *"Changing banking for good"*, the Parliamentary Committee on Banking Standards (PCBS) criticized the approved persons' regime by observing that a lack of personal responsibility had been common place throughout the banking industry and senior figures had continued to shelter behind an accountability firewall.[442] In light of these criticisms the PCBS recommended that a senior persons' regime (now known as a senior managers' regime) and a new certification regime be created to improve senior management responsibility.[443]

The FSMA of 2000 is amended in several material respects by introducing a senior management conduct and certification regime.[444] Under Part IV of the Banking (Reform) Act, senior management functions are enacted. In terms of this provision, a function is a "senior management function" in relation to the carrying on of a regulated activity by an authorized person if the function will require the person performing it to be responsible for managing one or more aspects of the authorized person's affairs so far as relating to the activity, and those aspects involve or might involve a risk of serious consequences for the authorized person, or for business or other interests in the UK.[445]

Section 60 of FSMA 2000 relating to applications for approval is amended to reflect the change in requirements to the effect that if the application is for the approval of a person to perform a designated senior management function, the appropriate regulator must require the application to contain, or be accompanied by, a statement setting out the aspects of the affairs of the authorized

[442] See copies of the report and the recommendations via http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/ (last visited on 3/4/2016). The committee further observed that it is not just bankers that need to change. The actions of regulators and Governments had also contributed to the decline in banking standards.

[443] The approved persons regime dealt with approved persons to do controlled functions within the bank. Such persons were required to meet the fit and proper person requirements; comply with the Statements of Principle and Code of Practice; and were required to report anything that could negatively affect their standing to deal with the regulators and the bank. This regime has now been replaced with the Senior Managers & Certification Regime (SM&CR). The key concept remains individual accountability of senior managers of financial institutions for eventualities such as bank failures so that enforcement action can be taken against them in case of breaches in their respective roles.

[444] Section 59 of FSMA 2000 governing approval for particular arrangements is for instance amended by introducing a provision to the effect that the PRA may specify a description of function under subsection (3)(a) only if, in relation to the carrying on of a regulated activity by a PRA authorized person, it is satisfied that the function is a senior management function as defined in section 59ZA of the Banking (Reform) Act 2013.

[445] Section 59ZA (1) & (2). In subsection (2)(a) the reference to managing one or more aspects of an authorized person's affairs includes a reference to taking decisions, or participating in the taking of decisions about how one or more aspects of those affairs should be carried on.

person concerned which it is intended that the person will be responsible for managing in performing the function.[446]

A vetting procedure is also introduced under these new amendments. Before a relevant authorized person may make an application for a regulator's approval under section 59, the authorized person must be satisfied that the candidate in respect of whom the application is made is a fit and proper person to perform the function to which the application relates.[447] In deciding that question, the authorized person must have regard in particular to whether the candidate, or any person who may perform a function on the candidate's behalf has obtained a qualification; has undergone or is undergoing training; possesses a level of competence, or has the personal characteristics required by general rules made by the regulator in relation to persons performing functions of the kind to which the application relates.[448]

As part of implementing the recommendations in the final report of the Parliamentary Commission on Banking Standards (PCBS), in 2014 the PRA and Financial Conduct Authority (FCA) started developing new Senior Manager and Certification Regimes that will help to support a change in culture at all levels in relevant authorized persons. On 7th March 2016, the Senior Managers Regime (SMR) was implemented.[449] The SMR is a central element of the post-financial crisis agenda concerning bank management, supervision and regulation. Under the SMR, banks are required to produce and keep updated a Responsibilities Map which describes the bank's management and governance arrangements and shows how responsibilities have been allocated, including how they have been allocated among the bank's senior managers.[450] When looked at as a whole, the map should not leave any gaps or underlaps in accountability mandated by the regime.[451]

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[446] This statement provided under subsection (2A) is known as a statement of responsibilities. A designated senior management function means a function designated as a senior management function under section 59(6A) or (6B).
[447] Section 60A (1) is inserted after section 60 of FSMA 2000.
[448] Section 60A (2) outlines these requirements to take into account when assessing a particular senior management candidate's suitability under the fit and proper person test.
[449] Further information can be accessed via the BoE website link http://www.bankofengland.co.uk/pra/Pages/supervision/strengtheningacc/default.aspx (last visited on 3/4/2016).
[450] Under the PRA senior management regime every relevant firm other than a small credit union will be required to have one or more persons performing a Chief Executive, Chief Finance and Chairman Senior Management Functions.
[451] See guidance on the Senior Managers Regime issued by the PRA via http://www.bankofengland.co.uk/pra/Documents/authorisations/smr/prasmrinternal.pdf (last visited on 3/4/2016).

In terms of guidance from the FCA, the Senior Managers Regime focuses on individuals who hold key roles and responsibilities in relevant firms. Preparations for the new regime will involve allocating and mapping out responsibilities and preparing Statements of Responsibilities for individuals carrying out Senior Management Functions (SMFs). While individuals who fall under this regime will continue to be pre-approved by regulators, firms will also be legally required to ensure that they have procedures in place to assess their fitness and propriety before applying for approval and at least annually afterwards. On the other hand, the certification applies to other staff who could pose a risk of significant harm to the bank or any of its customers. These staff will not be pre-approved by regulators and banks' preparations will need to include putting in place procedures for assessing for themselves the fitness and propriety of staff, for which they will be accountable to the regulators.[452]

The Act also introduces a criminal offence in relation to causing a financial institution to fail. In terms of this provision, a senior manager commits an offence if he or she takes or agrees to the taking of a decision by or on behalf of a financial institution as to the way in which the business of a group institution is to be carried on, or fails to take steps that he or could take to prevent such a decision being taken at a time he or she is aware of a risk that the implementation of the decision may cause the failure of the group institution.[453] Criminal liability also accrues in all the circumstances, the senior manager's conduct in relation to the taking of the decision falls far below what could reasonably be expected of a person in such a position, and the implementation of the decision causes the failure of the group institution.[454]

4.6. The BoE's Sterling Monetary Framework and the Discount Window Facility (DWF)

As earlier noted, the BoE's mandate is to maintain monetary and financial stability in the UK. The Bank's operations in the sterling money markets through its Sterling Monetary Framework

To show their commitment to the SMR going into effect, the FCA, the Prudential Regulation Authority (PRA) and the Payment Systems Regulator (PSR) have each applied the core principles of the SMR to their own senior staff. - See more at: http://www.natlawreview.com/article/senior-managers-regime-goes-effect-united-kingdom#sthash.V8eIVMIi.dpuf (last visited on 3/4/2016). The PRA Management Responsibilities Map and the PRA Statements of Responsibility reflect the current organizational structure of the BoE and the PRA.

[452] See guidance from the FCA accessible via https://www.fca.org.uk/news/fca-publishes-final-rules-to-make-those-in-the-banking-sector-more-accountable (last visited on 3/4/16).

[453] A group institution, in relation to a financial institution ("F"), means F or any other financial institution that is a member of F's group for the purpose of FSMA 2000 (also see section 421 of that Act).

[454] See section 36(1) of the Act. A person guilty of an offence under this section is liable on summary conviction in England and Wales, to imprisonment for a term not exceeding 12 months (or 6 months, if the offence was committed before the commencement of section 154(1) of the Criminal Justice Act 2003) or a fine or both.

(SMF) serve this mission through implementation of the Monetary Policy Committee's (MPC) decisions in order to meet inflation target, and reducing the cost of disruption to the critical financial services, including liquidity and payment services supplied by the SMF participants to the UK economy.[455] In October 2008, the BoE separated its bilateral Standing Facilities into Operational Standing Facilities (OSFs) and Discount Window Facility (DWF).[456]

The Discount Window Facility (DWF) is a bilateral on-demand facility which is aimed at institutions such as banks experiencing a firm-specific or market-wide shock.[457] It allows entities such as banks experiencing distress to borrow highly liquid assets in return for less liquid collateral in potentially large amounts for a variable period of time.[458] It is a form of liquidity insurance which allows an affected bank to borrow gilts (low-risk bonds issued by the UK government) against the full range of eligible collateral.[459]

The nature of the Bank's LOLR function has been radically transformed since the GFC. In terms of providing liquidity support to distressed banks, a large part of the emergency liquidity assistance (ELA) has now been institutionalized in the DWF.[460] The DWF is designed to provide liquidity to distressed banks and enables banks to borrow UK government securities, or in certain circumstances, cash, against a wide range of acceptable collateral such as bonds and portfolios of unsecuritized loans.[461] In practical terms, an affected bank can contact the BoE to request for a

[455] The Bank of England's Sterling Monetary Framework, also called the "Red Book" (updated June 2015) accessed via http://www.bankofengland.co.uk/markets/Documents/money/publications/redbook.pdf#page=13 (last accessed on 10/12/16).
[456] The OSFs are designed to support the BoE's monetary policy mandate by ensuring that short-term interest rates do not deviate too far from the Bank Rate, but also provide liquidity insurance support to banks experiencing unexpected (frictional) payment problems arising from the bank's internal functioning or the market-wide payments and settlements infrastructure.
[457] Pg.12 of the "Red Book".
[458] The facility is also available to building societies, broker-dealers and central counter parties (CCPs).
[459] The BoE provides three forms of liquidity insurance facilities- the Indexed Long-Term Repo (ILTR), which is a market-wide facility aimed at banks, building societies and broker-dealers with a predictable need for liquid assets. The Central Bank will normally offer funds under this arrangement with a six months maturity period once each calendar month. The second form of liquidity insurance is the DWF where the market participants may borrow gilts against acceptable collateral. Participants can then raise cash by lending these gilts in the market, or using them as collateral for the ILTR facility. The third form of liquidity insurance is the Contingent Term Repo Facility (CTRP) which the BoE can activate in response to an actual or anticipated market-wide stress of an exceptional nature. This facility enables the Central Bank to provide additional sterling liquidity to banks, building societies and broker-dealers (the participants) against eligible and acceptable security.
[460] In circumstances where the Bank determines that ELA will not cure the distress, the regulator now has the Special Resolution Regime (SRR) to resolve the distressed bank in an orderly and cost-efficient manner.
[461] DWF drawings are meant to be extended for a maximum of 30 days, however, they can be rolled over at the BoE's discretion.

DWF drawing, and arrange for collateral movements to the DWF pool through established SMF Operating Procedures.

By and large, the introduction of the DWF gives the BoE a level of operational readiness that was not available prior to and during the GFC to deal with distressed banks. A combined approach of this facility and bank administration is an example of systematic planning for bank rescue/recovery arising from lessons learnt from the GFC. The traditional criteria to extend such assistance is that the potential failure of a bank in need of such emergency liquidity should be judged as a threat to systemic stability; the bank receiving support should be solvent; and there should be a feasible exit strategy by the affected bank from this emergency support, because ELA is meant to be a temporary bridge back to a stable state in which the bank can meet its obligations without stress and pay back any facility obtained from the Central Bank.

4.7. Cross-border implications and implications of the European Union framework for bank rescue on the UK

The financial crisis had an unprecedented impact on the EU financial system. A number of firms that were considered 'too big to fail' were bailed out by the member states in which they operated.[462] This resulted in a perception that such firms in effect benefit from a state guarantee. At EU level, one of a number of initiatives taken with the aim of reducing future threats to financial stability was the adoption of the Recovery and Resolution Directive (RRD) in May 2014, which establishes a comprehensive recovery and resolution regime.[463] This section of the research entails an analysis of the ramifications of this Directive in light of the UK banking and financial regulatory framework reforms.

The EU recovery and resolution regime consists of three key elements. These are: preparation, early intervention and resolution. In this research, I will focus on recovery plans and early

[462] According to The Economist, State-aid figures from the European Commission show that between October 2007 and the end of 2011, European governments injected €440 billion ($605 billion) into their teetering banks and also provided guarantees of €1.1 trillion. See "European banks: From bail-out to bail-in accessed via http://www.economist.com/blogs/freeexchange/2013/12/european-banks (last visited on 10/4/2016).

[463] See commentary by the FCA to the effect that the RRD requires each Member State to designate a resolution authority that is to develop resolution plans and take resolution actions when required. In the UK, the Bank of England has been designated as the resolution authority accessible via https://www.fca.org.uk/firms/markets/international-markets/eu/rrd (last visited on 10/4/2016).

intervention in times of bank distress.[464] The preamble to this Directive acknowledges that the financial crisis has shown that there is a significant lack of adequate tools at Union level to deal effectively with unsound or failing credit institutions and investment firms. Such tools are needed, in particular, to prevent insolvency or, when insolvency occurs, to minimize negative repercussions by preserving the systemically important functions of the institution concerned. During the crisis, those challenges were a major factor that forced Member States to save institutions using taxpayers' money. The objective of a credible recovery and resolution framework is to obviate the need for such action to the greatest extent possible.[465]

Additionally, the review of the regulatory framework, in particular the strengthening of capital and liquidity buffers and better tools for macro-prudential policies, should reduce the likelihood of future crises and enhance the resilience of institutions to economic stress, whether caused by systemic disturbances or by events specific to the individual institution. It is not possible, however, to devise a regulatory and supervisory framework that can prevent those institutions from ever getting into difficulties. Member States like the UK should therefore be prepared and have adequate recovery and resolution tools to handle situations involving both systemic crises and failures of individual institutions. Such tools should include mechanisms that allow authorities to deal effectively with institutions that are failing or likely to fail.[466]

[464] This is entailed in Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012.

[465] See page 1 of the Directive. It goes ahead to observe that financial crisis was of systemic dimension in the sense that it affected the access to funding of a large proportion of credit institutions. To avoid failure, with consequences for the overall economy, such a crisis necessitates measures aiming to secure access to funding under equivalent conditions for all credit institutions that are otherwise solvent. Such measures involve liquidity support from central banks and guarantees from Member States for securities issued by solvent credit institutions. In terms of challenges, there was no harmonization of the procedures for resolving institutions at Union level. Some Member States apply to institutions the same procedures that they apply to other insolvent enterprises, which in certain cases have been adapted for institutions. There are considerable substantial and procedural differences between the laws, regulations and administrative provisions which govern the insolvency of institutions in the Member States. In addition, the financial crisis has exposed the fact that general corporate insolvency procedures may not always be appropriate for institutions as they may not always ensure sufficient speed of intervention, the continuation of the critical functions of institutions and the preservation of financial stability.

[466] See page 2 of the Directive. The exercise of such powers and the measures taken should take into account the circumstances in which the failure occurs. If the problem arises in an individual institution and the rest of the financial system is not affected, authorities should be able to exercise their resolution powers without much concern for contagion effects. In a fragile environment, on the other hand, greater care should be exercised to avoid destabilizing financial markets. The Directive also acknowledges that rescue of a banking institution which maintains it as a going concern may, as a last resort, involve government financial stabilization tools, including

4.8. Recovery plans and their role in cross-border bank rescue operations

Member States must ensure that each institution, which is not part of a group subject to consolidated supervision pursuant to Articles 111 and 112 of Directive 2013/36/EU, draws up and maintains a recovery plan providing for measures to be taken by the institution to restore its financial position following a significant deterioration of its financial situation. Recovery plans shall be considered to be a governance arrangement within the meaning of Article 74 of Directive 2013/36/EU.[467]

The authorities must also ensure that the institutions update their recovery plans at least annually or after a change to the legal or organizational structure of the institution, its business or its financial situation, which could have a material effect on, or necessitates a change to the recovery plan. The authorities may require institutions to update their recovery plans more frequently.[468] The Directive further empowers Member States to assess recovery plans submitted by the banks. The national authorities must within six months of the submission of each plan, and after consulting the competent authorities of the Member States where significant branches are located insofar as is relevant to that branch, review it and assess the extent to which it satisfies the recovery objectives.[469] This is intended to promote information sharing and coordinated bank recovery action by the EU authorities.

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temporary public ownership. It is therefore essential to structure the resolution powers and the financing arrangements for resolution in such a way that taxpayers are the beneficiaries of any surplus that may result from the restructuring of an institution that is put back on a safe footing by the authorities. Responsibility and assumption of risk should be accompanied by reward. Authorities should take into account the nature of an institution's business, shareholding structure, legal form, risk profile, size, legal status and interconnectedness to other institutions or to the financial system in general, the scope and complexity of its activities.

[467] See Article 5(1) of the Directive. Additionally, recovery plans shall not assume any access to or receipt of extraordinary public financial support. The plans should also include, where applicable, an analysis of how and when an institution may apply, in the conditions addressed by the plan, for the use of central bank facilities and identify those assets which would be expected to qualify as collateral.

[468] Article 5(2) of the Directive. Furthermore, Member States shall require that recovery plans include appropriate conditions and procedures to ensure the timely implementation of recovery actions as well as a wide range of recovery options. Member States shall require that recovery plans contemplate a range of scenarios of severe macroeconomic and financial stress relevant to the institution's specific conditions including system-wide events and stress specific to individual legal persons and to groups.

[469] Articles 6(1) & (2) of the Directive. Under the same article, the competent authority shall provide the recovery plan to the resolution authority (in the case of UK, the BoE). The resolution authority may examine the recovery plan with a view to identifying any actions in the recovery plan which may adversely impact the resolvability of the institution and make recommendations to the competent authority with regard to those matters. Where the competent authority assesses that there are material deficiencies in the recovery plan, or material impediments to its implementation, it shall notify the institution or the parent undertaking of the group of its assessment and require the

Of further importance in line with preventing bank failure, national authorities are given powers to direct a financial institution (in this case, a bank) to reduce its risk profile, including liquidity risk; enable timely recapitalization measures; review its strategy and structure; make changes to its funding strategy so as to improve the resilience of the core business lines and critical functions; and make changes in its governance structure.[470]

In terms of group recovery plans, Member States must ensure that Union parent undertakings draw up and submit to the consolidating supervisor a group recovery plan. Group recovery plans shall consist of a recovery plan for the group headed by the Union parent undertaking as a whole. The group recovery plan shall identify measures that may be required to be implemented at the level of the Union parent undertaking and each individual subsidiary.[471] This means that for banking group structures whose parent holding is in another Member State, the UK has to liaise with that Member State and the European Central Bank in times when the parent or the subsidiary bank is in financial distress.

The group recovery plan must aim to achieve the stabilization of the group as a whole, or any institution of the group, when it is in a situation of stress so as to address or remove the causes of the distress and restore the financial position of the group or the institution in question, at the same time taking into account the financial position of other group entities.[472] This further buttresses the argument that the spirit of the Directive is first and foremost concerned with bank rescue through mechanisms such as intra-group financial support.[473]

institution to submit, within two months, extendable with the authorities' approval by one month, a revised plan demonstrating how those deficiencies or impediments are addressed.

[470] In terms of Article 6 of the Directive, this power is available if the institution fails to identify such changes within the timeframe set by the competent authority, or if the competent authority assesses that the actions proposed by the institution would not adequately address the deficiencies or impediments, the competent authority may direct the institution to take any measures it considers to be necessary and proportionate, taking into account the seriousness of the deficiencies and impediments and the effect of the measures on the institution's business. It is important to note that the list of measures referred to in this paragraph does not preclude Member States from authorizing competent authorities to take additional measures under national law, and when the competent authority requires an institution to take these measures, its decision on the measures shall be reasoned and proportionate.

[471] Article 7(1) of the Directive. In accordance with Article 8, competent authorities may require subsidiaries to draw up and submit recovery plans on an individual basis.

[472] Article 7(4) of the Directive. The group recovery plan shall include arrangements to ensure the coordination and consistency of measures to be taken at the level of the Union parent undertaking, at the level of the entities referred to in points (c) and (d) of Article 1(1) as well as measures to be taken at the level of subsidiaries and, where applicable, in accordance with Directive 2013/36/EU at the level of significant branches.

[473] Intra-group financial support is addressed in Article 19. Member States are mandated to ensure that a parent institution in a Member State, a Union parent institution, or an entity referred to in point (c) or (d) of Article 1(1)

The early intervention framework is also critical while assessing the ramifications of the EU model on the UK legal arrangement in respect of distressed banks. Where an institution infringes its statutory regulatory solvency and/or liquidity requirements, or due, *inter alia*, to a rapidly deteriorating financial condition (including deteriorating liquidity situation, increasing level of leverage, non-performing loans or concentration of exposures, as assessed on the basis of a set of triggers, which may include the institution's own funds requirement), the national authorities are empowered to require the management body of the institution to implement one or more of the arrangements or measures set out in the recovery plan or in accordance with Article 5(2) to update such a recovery plan when the circumstances that led to the early intervention are different from the assumptions set out in the initial recovery plan and implement one or more of the arrangements or measures set out in the updated plan within a specific time frame.

Other actions that may be taken include: requiring the management body of the institution to examine the situation, identify measures to overcome any problems identified and draw up an action program to overcome those problems and a timetable for its implementation; requiring the management body of the institution to convene, or if the management body fails to comply with that requirement convene directly, a meeting of shareholders of the institution, and in both cases set the agenda and require certain decisions to be considered for adoption by the shareholders; requiring one or more members of the management body or senior management to be removed or replaced if those persons are found unfit to perform their duties; requiring the management body of the institution to draw up a plan for negotiation on restructuring of debt with some or all of its creditors according to the recovery plan where applicable; requiring changes to the institution's business strategy; requiring changes to the legal or operational structures of the institution; and acquiring, including through on-site inspections and providing to the resolution authority all the information necessary in order to update the resolution plan and prepare for the

and its subsidiaries in other Member States or third countries that are institutions or financial institutions covered by the consolidated supervision of the parent undertaking, may enter into an agreement to provide financial support to any other party to the agreement that meets the conditions for early intervention pursuant to Article 27, provided that the conditions laid down in this Chapter are also met. However, the provision of the financial support should not create a threat to financial stability, in particular in the Member State of the group entity providing support.

possible resolution of the institution and for valuation of the assets and liabilities of the institution in accordance with Article 36.[474]

Where there is a significant deterioration in the financial situation of an institution or where there are serious infringements of law, of regulations or of the statutes of the institution, or serious administrative irregularities, and other measures taken in accordance with Article 27 are not sufficient to reverse that deterioration, Member States are obliged to ensure that competent authorities may require the removal of the senior management or management body of the institution, in its entirety or with regard to individuals.[475]

With specific reference to appointment of a temporary administrator, where replacement of the senior management or management body as referred to in Article 28 is deemed to be insufficient by the competent authority to remedy the situation, Member States are further obliged to ensure that competent authorities appoint one or more temporary administrators to the institution.[476] Member States are further empowered to specify the powers of the temporary administrator at the time of the appointment of the temporary administrator based on what is proportionate in the circumstances.[477]

[474] See Article 27(1) (a)-(h) of the Directive for these powers. For each of these measures, competent authorities shall set an appropriate deadline for completion, and to enable the competent authority to evaluate the effectiveness of the measure.

[475] Article 28 of the Directive addresses removal of senior management and management body. However, the appointment of the new senior management or management body shall be done in accordance with national and Union law and be subject to the approval or consent of the competent authority.

[476] See Article 29 of the Directive. Competent authorities may, based on what is proportionate in the circumstances, appoint any temporary administrator either to replace the management body of the institution temporarily or to work temporarily with the management body of the institution and the competent authority shall specify its decision at the time of appointment. If the competent authority appoints a temporary administrator to work with the management body of the institution, the competent authority shall further specify at the time of such an appointment the role, duties and powers of the temporary administrator and any requirements for the management body of the institution to consult or to obtain the consent of the temporary administrator prior to taking specific decisions or actions. The competent authority shall be required to make public the appointment of any temporary administrator except where the temporary administrator does not have the power to represent the institution. Member States shall further ensure that any temporary administrator has the qualifications; ability and knowledge required to carry out his or her functions and is free of any conflict of interests.

[477] Such powers may include some or all of the powers of the management body of the institution under the statutes of the institution and under national law, including the power to exercise some or all of the administrative functions of the management body of the institution. The powers of the temporary administrator in relation to the institution shall comply with the applicable company law. The role and functions of the temporary administrator shall be specified by competent authority at the time of appointment and may include ascertaining the financial position of the institution, managing the business or part of the business of the institution with a view to preserving or restoring the financial position of the institution and taking measures to restore the sound and prudent management of the

In terms of co-ordination of early intervention measures and appointment of temporary administrator in relation to banking groups, where the conditions for the imposition of requirements under Article 27 or the appointment of a temporary administrator in accordance with Article 29 are met in relation to a Union parent undertaking, the consolidating supervisor shall notify the European Banking Authority (EBA)[478] and consult the other competent authorities within the supervisory college.[479]

By and large, the UK emergency/crisis bank recovery framework lends much to and borrows much from the EU bank regulatory framework as one of the major Member States. At the heart of all these interdependent and complimentary frameworks is the notion of rescue of distressed banks due to the critical importance of the banking industry to the public and to the Member States. With the UK's impending exit (Brexit) from the EU following the success of the "leave campaign", it remains to be seen as to what implications this will have on the regulatory framework concerning cross-border bank rescue mechanisms for the various bank conglomerate groups interlinked and interconnected within the EU, and the relationship between the BoE and the European Central Bank (ECB).

4.9. Chapter Conclusion

The banking industry has undergone a number of major reforms since the financial crisis. Over 80 pieces of legislation and regulations have been passed in the UK alone to make the financial system more stable and secure, and preserve the pre-eminence of London as the major banking and finance city. Banks have substantially increased the amount of capital they hold to ensure

business of the institution. The competent authority shall specify any limits on the role and functions of the temporary administrator at the time of appointment.

[478] The European Banking Authority (EBA) is an independent EU Authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. Its overall objectives are to maintain financial stability in the EU and to safeguard the integrity, efficiency and orderly functioning of the banking sector. The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking whose objective is to provide a single set of harmonized prudential rules for financial institutions throughout the EU. The Authority also plays an important role in promoting convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector. The EBA was established on 1 January 2011 as part of the European System of Financial Supervision (ESFS) and took over all existing responsibilities and tasks of the Committee of European Banking Supervisors. More information about the EBA can be found via its website link http://www.eba.europa.eu/about-us;jsessionid=0511765EA3F759FCAB0C598BC63BAF3A (last visited on 6/4/2016).

[479] See Article 30 of the Directive. Following that notification and consultation the consolidating supervisor shall decide whether to apply any of the measures in Article 27 or appoint a temporary administrator under Article 29 in respect of the relevant Union parent undertaking, taking into account the impact of those measures on the group entities in other Member States. The consolidating supervisor shall notify the decision to the other competent authorities within the supervisory college and EBA.

that the taxpayer never again has to bail out a bank.[480] These reforms, alongside a new regulatory regime both in the UK and Europe, are key steps in restoring public trust and confidence in the banking sector.

To create a more resilient bank regulatory system, a number of reforms have been undertaken as discussed in the body of the research. To have a brief re-cap, these include: banks have rebuilt their balance sheets in the wake of the global financial crisis and are now much safer. UK banks have increased the amount of the highest quality capital they hold by five times compared to the beginning of the financial crisis. They are also holding significantly more high quality liquid assets which would enable them to survive a liquidity induced stress as happened in 2007. By 2019, when Basel III is fully implemented, they will be even more robust.[481]

Some of the most prominent changes are the ring-fence principles and bail-in. Under the requirement of ring-fencing, the UK's largest banks have their investment arms separated from their retail arms. This improves the resilience and emergency intervention in times of distress by protecting retail banking services from risks elsewhere in the financial system. Furthermore, the UK is one of the first banking regimes to adopt a statutory bail-in power which enables the BoE to expose certain creditors of a failed bank to loss by writing down or converting their interests into new capital. This type of orderly resolution ensures that the critical functions a bank provides to the economy can be continued in the event of its failure. This is a key tool to end the problem that banks are considered too big to fail.

Alongside these regulatory interventions, the government took steps to improve the system of financial services legislation through enactment of the Financial Services Act 2012, thus replacing the discredited tripartite system with two new, focused regulators: the Prudential Regulation Authority (PRA), focusing on firm-level stability, and the Financial Conduct

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[480] See the British Bankers' Association (BBA) bulletin entitled "Reforms since the Financial Crisis" at pg. 1. The BBA is the leading trade association for the UK banking sector with 200 member banks headquartered in over 50 countries with operations in 180 jurisdictions worldwide. Eighty per cent of global systemically important banks are members of the BBA. More information can be accessed via their website link https://www.bba.org.uk/ (last visited on 6/4/2016).

[481] According to BoE Governor Mark Carney, capital requirements for banks are much higher, as are risk weights and the quality of bank capital. In all, new capital requirements are at least seven times the pre-crisis standards for most banks. For globally systemic banks, they are more than ten times. Large internationally active banks are on course to meet the new requirements 4 years ahead of the 2019 deadline. See speech given at the 2014 Monetary Authority of Singapore Lecture accessible via http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf (last accessed on 8/4/2016).

Authority (FCA) focusing on market conduct. Additionally, the role of the BoE in addressing system-level stability risks was widened, including by the creation of the Financial Policy Committee. Since their statutory creation in April 2013, these new regulatory bodies have worked towards creating a financial system that is less likely to result in disorderly failure, less likely to draw on taxpayer funds, and less likely to operate against the interests of its own customers with impunity.[482]

However, the UK government acknowledges that ring-fencing will not solve all of the problems in the financial sector.[483] One major criticism of the new regime especially on ring-fencing is that it pays much attention to structural composition of the banks, yet banking structures or models were not *per se* major factors behind the global financial crisis.[484] It is also acknowledged that bail-in is not a silver bullet that can work in isolation from other regulatory mechanisms. By itself, it cannot guarantee that the rescue of a distressed firm will be successful. However, it is an essential component of a wider framework that, taken together, will allow authorities to intervene to manage the rescue process of large, complex firms in an orderly way.[485]

Positively, the Banking Reform Act 2013 was enacted by Parliament to implement the recommendations of the Independent Commission on Banking (ICB), set up by the government in 2010 under the chairmanship of Sir John Vickers to consider structural reform of the banking sector. It also implements key recommendations of the Parliamentary Commission on Banking Standards, which was asked by the government to urgently review professional standards and

[482] See a publication by the UK Treasury, 'Banking for the 21st Century: driving competition and choice' at pg. 11 accessed via https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/416097/Banking_for_the_21st_Century_17.03_19_40_FINAL.pdf (last visited on 8/4/2016).

[483] See a publication by the UK Treasury, 'Banking reform: a new structure for stability and growth', at pg. 7 accessible via https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/228995/8545.pdf (last visited on 8/4/2016).

[484] See Jacques de Larosière, *Structural Banking Reforms: an illusionary solution*, LSE FINANCIAL MARKETS GROUP PAPER SERIES, SPECIAL PAPER 237 (July 2015) accessed via http://www.lse.ac.uk/fmg/workingPapers/specialPapers/PDF/SP237.pdf (last visited on 8/4/2016).

[485] See Avinash D. Persaud, 'Why Bail-In Securities Are Fool's Gold', Peterson Institute for International Economics Policy briefing paper No. PB 14-23 (November 2014) at pg.1 accessible via https://www.piie.com/publications/pb/pb14-23.pdf (last visited on 9/4/2016). The author makes the argument that bail-in securities may make sense for an idiosyncratic bank failure—like the 1995 collapse of Baring Brothers, which was the result of a single rogue trader. But they do not make sense in the more common and intractable cases where many banks get into trouble at roughly the same time as the assets they own go bad.

culture in the banking industry following revelations of attempted LIBOR[486] manipulation in 2012.[487]

From the EU perspective, the PRA has built on its approach to recovery and resolution planning through the European Union (EU) Bank Recovery and Resolution Directive (2014/59/EU) (BRRD). The BRRD provides authorities with a common set of tools and powers for dealing with failing banks, and requires banks to facilitate this process by providing information for recovery and resolution planning purposes as well as meeting resolvability requirements. In June 2014, the BRRD was finalized and published in the Official Journal of the EU, creating a harmonized framework across Europe for dealing with the problem of 'too big to fail' through bank recovery and resolution. The BRRD contains provisions relating to recovery and resolution planning, intragroup financial support, early intervention, resolution tools and powers, cross-border group resolution, relations with third countries and financing arrangements. This forms part of larger reforms under the BoE's wider emergency recovery and resilience agenda.[488] As UK's bank recue framework is still new and untested, it remains to be seen as to whether the regulators will enforce a more pro-bank rescue intervention approach in the event of bank distress.

[486] According to Investopedia, LIBOR (London Interbank Offered Rate) is a benchmark rate that some of the world's leading banks charge each other for short-term loans and serves as the first step to calculating interest rates on various loans throughout the world. It serves as the primary indicator for the average rate at which banks that contribute to the determination of LIBOR may obtain short-term loans in the London interbank market.
[487] See the UK Government news story, 'Government completes banking reforms' (5 March 2015) accessible via https://www.gov.uk/government/news/government-completes-banking-reforms (last visited on 9/4/2016).
[488] See the BoE notice on UK compliance with the BRRD accessed via http://www.bankofengland.co.uk/pra/Pages/supervision/banking/recoveryresolution.aspx (last visited on 9/4/2016). On 16 January 2015, the PRA published final policy, detailing its final approach to implementing the BRRD. The rules contained in the final policy require the industry to be better prepared for future financial stress through credible and robust recovery and resolution planning. The rules help the BoE in its role as the resolution authority by requiring firms to provide key data to be used in resolution plans which will set out how the firm will be resolved in an orderly manner without causing systemic disruption. See 'Supervisory tools: Recovery and resolution plans – PS1/15, SS18/13 and SS19/13' for further details on the implementation of the BRRD.

CHAPTER FIVE

BANK OF UGANDA AND THE REGULATION OF BANKS IN UGANDA: EMERGING TRENDS

5.1 BACKGROUND AND HISTORICAL EVOLUTION OF CENTRAL BANKING IN UGANDA

Bank of Uganda (BoU) is the Central Bank of Uganda. It is a creature of statute.[489] In terms of the enacting framework, the BoU established under the Bank of Uganda Act, 1966 was designated as the Central Bank of Uganda.[490] It is a body corporate with perpetual succession and a common seal and may sue or be sued in its corporate name.[491] In general terms, the functions of BoU are to formulate and implement monetary policy directed to economic objectives of achieving and maintaining economic stability.[492] It is governed by a board of directors consisting of the Governor, who is the chairperson; the Deputy Governor who is the deputy chairperson; the Secretary to the Treasury; and not less than four and no more than six other directors.[493]

The duties and powers of the board are to be responsible for the general management of the affairs of the bank; ensure the functioning of the bank and the implementation of its functions;

[489] BoU is created by the Bank of Uganda Act, Cap. 51 Laws of Uganda, which operationalizes Article 161 of the Constitution of the Republic of Uganda, 1995 (as amended). The purpose of the BoU Act as can be gathered from its long title is to amend and consolidate the BoU Act of 1966 and the BoU Statute 5/1993 for regulating the issuing of legal tender, maintaining external reserves and for promoting the stability of the currency and a sound financial structure conducive to a balanced and sustained rate of growth of the economy and for other related purposes. The central bank is a symbol of national economic sovereignty, having replaced the colonial monetary management of the East African Currency Board that had been set up in 1919 by the British Secretary of State for the Colonies. In 1906, a branch of the National and Grindlays Bank was opened at Entebbe. This was the first commercial bank in Uganda and it played the role of banker to the Government from 1913 until 1966 when Bank of Uganda opened and assumed that function.

[490] Section 2(1) of the BoU Act, Cap. 51.

[491] Section 2(2) of the BoU Act, Cap. 51. In terms of subsection 3, BoU may, subject to the limitations contained in the Act relating to the business which the bank may carry on, purchase, hold, manage and dispose of real and movable property, and may enter into contracts that may be expedient.

[492] Section 4 of the BoU Act spells out the functions of the bank. Without prejudice to the generality of subsection (1), the bank is also mandated to maintain monetary stability; maintain an external assets reserve; issue currency notes and coins; be the banker to the Government; act as financial adviser to the Government and manager of public debt; advise the Government on monetary policy as is provided under section 32(3) of the BoU Act; where appropriate, act as agent in financial matters for the Government; be the banker to financial institutions; be the clearinghouse for cheques and other financial instruments for financial institutions; supervise, regulate, control and discipline all financial institutions and pension funds institutions; and where appropriate, participate in the economic growth and development programs.

[493] In terms of section 7(1) of the BoU Act, the board of directors is the governing body of the bank. The directors referred to under subsection (1)(d) are appointed by the Minister of Finance.

formulate the policies of the bank; do anything required to be done by the bank under the BoU Act; and do anything that is within or incidental to the functions of the Bank.[494] Both the Governor and Deputy Governor are appointed by the President of Uganda acting on the advice of the Cabinet.[495] In terms of the Central Bank's relationship with the government, the Minister of Finance may direct the bank to render advice to the government on financial or other related matters, and the Central Bank is required to advise and inform the government through the Minister on any matter which is within its functions and powers.[496] Another crucial aspect under the BoU's mandate relates to development financing. The Central Bank is legally allowed to participate in development financing through refinancing facilities to financial institutions; management of loans and grants for development projects through commercial banks; and closely supervising the outcome of the funds dispersed to commercial banks.[497]

The legal framework of BoU also defines its relationship with the designated financial institutions.[498] The Central Bank may provide facilities for clearing financial instruments generally on terms that may be determined by the Bank.[499] In order to foster institutional harmony between the regulator and the regulated financial institutions, the BoU is given the mandate to cooperate with the financial institutions in order to promote and maintain adequate and reasonable banking services for the public; ensure high standards of conduct and

[494] Section 10 of the BoU Act. In terms of section 13, the board is empowered to make byelaws to regulate conditions of service of its members; and the byelaws shall be submitted to the Minister for approval, which approval shall be given in a period not exceeding thirty days from the date of submission of the proposed byelaws.
[495] In accordance with section 27(1) & (2) of the BoU Act, both the governor and the deputy governor must be people of recognized financial or banking experience. They are appointed for a period of five years and are eligible for reappointment. To preserve their independence and avoid scenarios of conflict of interest, the governor and deputy governor are not while holding the office of governor or deputy governor allowed to occupy any other office or employment whether remunerated or not. However, any of them can become a trustee of any staff, pension, provident or superannuation fund or scheme; with the approval of the Minister of Finance, the governor or deputy governor can act as a member of any commission or committee appointed by the Government to inquire into any matter affecting currency or banking or other matters; and with the consent of the Minister and the approval of the board, the governor or deputy governor can become a director, governor or member of the board, by whatever name called, of any international bank or an international monetary authority to which the Government shall have adhered or given support or approval.
[496] See section 32 of the BoU Act. The Government may seek advice from the bank on monetary policy, and it shall be the duty of the bank to formulate such monetary policy and advise the Government accordingly. The government is also enjoined to consult with the bank from time to time on its domestic or foreign credit requirements or any other relevant matter.
[497] This mandate is bestowed on the central bank by section 35 of the BoU Act. The bank shall not directly finance any development project with the exception of development funds established under section 29(6) of the same Act.
[498] In terms of section 1(d) of the BoU Act, financial institution includes a bank, credit institution, building society and any institution classified as a financial institution by the central bank.
[499] See section 36 of the BoU Act. BoU is also given the discretion to allow a commercial bank to participate in the activities of the clearinghouse on the recommendation of the Uganda Bankers Association.

management throughout the banking system; promote such policies not being inconsistent with any provision of the BoU Act; provide facilities for the clearing of financial instruments for financial institutions generally on terms determined by it; and vet directors of the financial institutions.[500]

BoU is further given express powers to prescribe for each bank or group of financial institutions the minimum cash reserve balances inclusive of vault cash which may be required to be maintained in the form of deposits at the bank or any other method laid down by the central bank.[501] It is further given authority to impose on a financial institution which fails to maintain the minimum cash reserve balances a penalty not exceeding one-tenth of 1 percent per day on the amount of the deficiency for each day during which the deficiency continues, and the amount of any such penalty may be recovered by deduction from any balance of or monies owing to the financial institution concerned or as a civil debt.[502]

A very critical BoU mandate is the exercise of control over credit and interest rates. The Central Bank may in consultation with the Minister of Finance by statutory instrument, prescribe the maximum amounts of investments, loans, advances and bills and promissory notes discounted, whether applied in total or to any specified class or classes of such investments, loans, advances and bills and promissory notes discounted, which each financial institution may have outstanding during the period that may be specified by the Bank. It may also prescribe the purpose for which loans and advances may be granted and the class of business underlying investments and bills and promissory notes discounted; the maximum period of loans and advances and the type and minimum amount of security which shall be required and the maximum tenor of bills and promissory notes discounted; the maximum or minimum rates of interest and other charges which in the transaction of their business financial institutions may pay on any type of deposit or

[500] Section 37 of the BoU Act.
[501] See section 38 of the BoU Act. The central bank is also given powers to prescribe various ratios for different kinds of liabilities and shall prescribe the methods of computing the amount of cash reserve balances. The total amount of the cash reserve balances shall not exceed 25 percent of the financial institution's deposits and other liabilities; but within this overall limit the bank may impose incremental reserves up to 100 percent on any increase of any kind of liability from a date prescribed by the central bank.
[502] For the purposes of this section, the liabilities of a financial institution mean its liabilities in Uganda whether these are payable within or outside Uganda.

other liability and impose on credit extended in any form; and the maximum charges which in the transaction of their business financial institutions may impose on any banking transaction.[503]

Banks are further required to furnish to the BoU in a manner prescribed by statutory instrument all information that may be required by the Central Bank for the proper discharge of its functions.[504] The Central Bank may also appoint any financial institution as its agent for the issue, reissue, exchange and withdrawal of notes and coins or for any other purpose on terms and conditions that may be agreed upon by the bank and the institution appointed agent.[505] Like any other institution expected to practice prudent corporate governance principles, BoU is tasked to keep proper books of accounts and financial statements.[506]

In relation to confidentiality, the members of the board, officers and employees of the Bank are bound by a declaration of secrecy and must not, except as may reasonably be in the performance of their functions, disclose to any person any material information acquired in the performance of their functions unless called upon to give evidence in a court of competent jurisdiction or to fulfill other obligations imposed by law.[507] BoU enjoys tax immunity.[508] It is also worth noting

[503] See section 39 of the BoU Act. Any prescription made by the central bank under this part must have regard to commitments which financial institutions may have entered into with their customers at the time of the coming into force of the statutory instrument and shall take effect after the period of grace as the bank may specify in the instrument; and shall not discriminate between one financial institution and another. The section also imposes a penal sanction not exceeding a fine of one million shillings to any financial institution which contravenes any prescription made by the central bank.

[504] In terms of section 40 of the BoU, the central bank may publish in whole or in part information furnished to it as the board may determine. However, the bank must not publish or disclose any information regarding the affairs of a financial institution or of a customer of a financial institution unless the consent of the institution or the customer has been obtained.

[505] Section 41 of the BoU Act.

[506] These are requirements under part viii of the BoU Act. In terms of section 44, the bank shall as soon as may be practicable after the end of each quarter, make a quarterly return of its assets and liabilities, and the return shall be published in the Gazette and a copy submitted to the Minister of Finance. The bank may also submit to the Minister from time to time, information on the exercise and performance of its duties or on its assets and liabilities in a form that is determined by the board. In accordance with section 43 of the Act, the accounts of the bank shall be audited, at least once every financial year by the Auditor General or an auditor appointed by him or her to act on his or her behalf. The financial year of the bank shall be the same as the financial year of the Government.

[507] In accordance with section 45 of the BoU Act, this declaration of secrecy also applies to every former member of the board, officer or employee of the bank. Where the bank unreasonably withholds permission under this section, the aggrieved party may appeal to the High Court whose decision shall be final. Any person who contravenes this section commits an offence and is liable on conviction to imprisonment for a term not exceeding five years or to a fine not exceeding five hundred thousand shillings or to both such imprisonment and fine.

[508] Under section 46 of the BoU Act, the bank is exempted from the payment of income tax and profits or capital gains tax in respect of its functions under the Act.

that the Minister of Finance has powers of direction to the Bank in terms of general financial and economic policy of the Central Bank.[509]

In terms of annual reporting, BoU must, not later than three months after the end of each financial year, present to the Minister of Finance a report generally on the activities and operations of the Bank during the preceding financial year and in particular, with regard to the procedures and policy of the Bank as the Bank considers may properly be given without detriment to the interests of its activities; and a copy of the audited accounts.[510] BoU's board is also empowered, with the approval of the Minister of Finance, to make bye-laws regulating the terms and conditions of service by board members; the structural establishment of the Bank; the terms and conditions of service for officers and employees of the Bank; retirement and other service benefits of the employees and officers of the Bank; or any other matter falling within the scope of the board's functions.[511] It is a criminal offence to contravene a provision of the BoU Act; or knowingly make an incorrect statement in a document submitted by any person; or for any person to knowingly make a false reply to a question asked of him or her for the purposes of the Act.[512]

5.1.1. Setting the scene: Bank failures in Uganda and the earlier reforms in bank regulation in the early 2000s

Uganda's banking industry has evolved significantly from the time when the first commercial bank was established in 1906.[513] The sector has also undergone several policies, legal and regulatory reforms to bring it in line with the market developments both locally and globally.

[509] Under section 48 of the BoU Act, the Minister may, after consultation with the governor and subject to the Act, give directions of a general nature in writing, relating to the financial and economic policy of the bank. If, after consultation with the governor, the Minister is of the opinion that the policies being pursued by the bank are not adequate for, or conducive to, the achievement of the functions of the bank, the Minister may, with the approval of Cabinet, by directive in writing determine the specific policy to be adopted by the bank; and the bank shall give effect to that policy while the directive remains in force. The Minister must lay before Parliament any directive issued within fifteen sitting days after issuing that directive to the bank.

[510] The Minister shall lay before Parliament the report received under section 49 of the BoU Act within three months after the end of the financial year.

[511] This power is given by section 50 of the BoU. The bye-laws must not be inconsistent with the Act.

[512] A person commits an offence is liable on conviction to a term of imprisonment not exceeding twelve months or to a fine not exceeding four hundred thousand shillings or to both the fine and imprisonment. Where an offence is committed by a body of persons, every person who at the time of its commission was a director, manager or partner of that body shall be deemed to have committed the offence unless he or she proves that the offence was committed without his or her knowledge; and that he or she took all reasonable steps to ensure compliance with the Act.

[513] The first bank to be established was the National Bank of India, which later became the Grindlays bank and is now Stanbic bank, a member of the Standard Bank Group.

This evolution has been influenced by bank closures, mergers and acquisitions.[514] The political developments of the country have also largely influenced the banking industry, notably the political instability of the 1970s under Idi Amin, the resultant economic collapse of the 1980s and the economic reconstruction of the early 1990s.

In the late 1980s with the coming into power of the Museveni government, the IMF and the World Bank took renewed interest in giving technical and monetary assistance to reconstruct the Ugandan economy after years of war and civil conflict, mainly through the Policy Framework Papers (PFPs), which were the major instruments of economic reform in Uganda starting from 1988.[515] Other reforms were the Structural Adjustment Programs (SAPs). In 1987, the new Museveni Government, which had captured state power in 1986, launched a comprehensive Economic Recovery Program (ERP) with an aim of bringing down the triple digit inflation and reducing economic imbalances.[516]

The donor community such as the German Technical Cooperation (GTZ), the Swedish International Cooperation for Development Agency (SIDA), the Danish International Development Agency (DANIDA) and others influenced the economic policy reforms through providing technical advisors, training of local staff and provision of loans and grants. The IMF set performance benchmarks such as interest rate market liberalization, foreign exchange market liberalization, closure of failing banks, creation of the Non-Performing Assets and Recovery

[514] Both before and after Uganda's Independence in 1962, the banking industry has been traditionally dominated by foreign owned banks. In addition to the pre-independence National Bank India, Standard Bank opened shop in 1912 followed by the Bank of the Netherlands which opened in 1954 and later merged with Grindlays Bank. Bank of Baroda (which still exists up to today) was established in 1953, but officially recognized as a commercial bank regulated by the Bank of Uganda in 1969 upon enactment of the Banking Act. Uganda Credit and Savings Bank was established in 1965 by an Act of Parliament and it later became the Uganda Commercial Bank (UCB) in 1969. It was the first local bank in Uganda. Therefore, through historical lenses, the Banking Act of 1969 was the first legislative instrument to cater for bank regulation in post-independence Uganda. This law supported the now repealed Bank of Uganda Act of 1966, which had established the BoU. In 1972, the Uganda Development Bank (UDB) was established under the UDB Decree by the Amin regime. The establishment of UCB and UDB marked domination of government-owned banks with UDB receiving all foreign loans and channeling them to local companies for development financing. UCB, with the largest branch network of about 67 handled most of the public deposists, while the East African Development Bank (EADB) established earlier in 1967 was in charge of the East African Community (EAC) transactions. By 1970, Uganda had over 290 commercial bank branches throughout the country, but they declined to 84 between 1970 to the 1980's due to political instability and rapid economic decline.(See: Lawrence Bategeka and Luka Jovita Okumu, *Banking Sector Liberalisation in Uganda: Process, Results and Policy Options*, SOMO (December 2010) at pg. 10)

[515] See IMF, *Experimental IMF Report on Observance of Standards and Codes: Uganda*, Washington D.C. (1999).

[516] Kibirango and Kasekende, *Economic and Financial Sector Issues*, Uganda Journal for Institute of Bankers, p. 29. Uganda Institute of Bankers Kampala, Uganda (1992).

Trust (NPART), development of a new legal regime for bank regulation, privatization of the Uganda Commercial Bank, and implementation of international banking standards per the Basel accords.[517]

In the 1990s and early 2000s, Uganda's banking sector suffered numerous bank failures. In total, eight banks failed, forcing the BoU to intervene in their management. In some instances, the failed banks were closed, while others were sold to new owners.[518] According to Governor Emmanuel Tumusiime-Mutebile, the primary cause of bank failure was poor corporate governance.[519] In many of the failed banks, a dominant shareholder or group of shareholders would exert undue influence over the management, which would result in abuses such as pervasive insider lending.[520] The losses incurred on bad insider loans were the single most leading cause of bank collapse. Poor and abusive management flourished because boards of directors were usually weak, lacking the professional expertise, values and competence; and

[517] See Government of Uganda, Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding, Kampala (9/6/2003). As the economic reform and restructuring was going on, financial sector liberalization followed in 1988. Also see Martin Brownbridge, *Financial Repression and Financial Reform in Uganda*, Institute of Development Studies (IDS), 1996. On 21st May 1997, Government and the BoU developed an intervention policy. This policy had a contingent plan to the effect that intervention would take place if a bank fails to meet BoU requirements and to agree with BoU on corrective measures to be taken within an agreed timetable, not to exceed 6 months. Failure to meet interim targets during such period would justify immediate intervention. Once intervention had taken place, the intervened bank would be closed while an auditing firm nominated by BoU reviewed the bank's financial position and identified its assets and liabilities. The list of deposits eligible for protection under the Deposit Insurance Scheme, excluding depositors that have debts to the bank, shareholders (other than holders of a small number of shares with non-influence in the bank conduct of business), the bank directors and officials, would be established and steps taken to repay depositors their protected deposits within 90 days from intervention. The collection of all debt and safe of assets would be undertaken by a liquidator that would then repay residual amounts of deposits and other liabilities (according to the priorities decreed by Uganda laws) of the intervened bank in instalments when the revenue from the sale of assets and collections of loans would provide enough funds after all funds provided from the Deposits Insurance Scheme were repaid. If the liquidator would find that the policy of selling the bank as a going concern to new owners is feasible and would result in better financial outcome, the bank would then be sold and opened for business under the management of the new owners, once the sale and the new owners had been approved by BoU. Prompt legal action would then be taken against the intervened bank major shareholders, directors, officials and auditors for any fraudulent actions.

[518] Governor Emmanuel Tumusiime-Mutebile address to the Kenya Commercial Bank (KCB) Board of Directors Retreat held at Kampala on 2/11/2012 entitled, "Corporate Governance and banking regulation in Uganda".

[519] Regulation 3 of the Financial Institutions (Corporate Governance) Regulations, 2005 defines corporate governance within the context of financial institutions as the process and structure used to direct and manage the business and affairs of a financial institution with the objective of ensuring its safety and soundness and enhancing shareholder value. This covers the overall environment in which the financial institution operates comprising a system of checks and balances which promotes a healthy balancing of risk and return.

[520] Ibid note 30. Corporate governance in banking has certain features which distinguish it from corporate governance in non-financial firms. This is because of the unique characteristics of banks, in particular the fact they are very heavily leveraged and that most of their liabilities are owed to a large number of atomized depositors who have the most to lose from abusive or negligent management. Consequently, a priority of corporate governance in banking is the protection of the interests of depositors. In addition, the corporate governance of banks attaches particular importance to the veracity and reliability of financial information.

often wanting in terms of independence to provide any effective oversight required for prudent bank management.[521]

In 1998 and 1999 alone, four commercial banks which held a combined 12.1% of the Ugandan public deposits were closed by the Central Bank. These banks involved two which were locally owned by private investors (the International Credit Bank-ICB and Greenland Bank), one owned by the cooperative movement (the Co-operative Bank) and a subsidiary of a Kenyan Bank (Trust Bank). ICB and Greenland had been subjected to special audits by international accounting firms under the supervision of the BoU in July/August 1998 after realizing that the banks had experienced financial hemorrhaging.[522]

Central Bank scholars like Martin Brownbridge have noted that intervention in distressed banks is often the most difficult aspect of Central Bank regulatory policy because it involves far reaching economic, budgetary and political ramifications.[523] In an analysis of the failed Ugandan banks by Brownbridge,[524] he observes that ICB was found to be heavily insolvent and was put under liquidation in September 1998 with minimal delay.[525] Greenland Bank was also found to be insolvent, although not to the magnitude of ICB, but was in violation of insider lending and single loan exposure limits under the banking laws. It was not closed down immediately, but had to undertake an agreement with the BoU in September 1998 to enforce corrective measures.[526]

However, the illiquidity problem worsened and by November 1998, Greenland Bank was on the verge of collapse and requested BoU for more capital injection. BoU intervened with liquidity support amounting to about half of the bank's deposits in early December and also replaced the Managing Director, Suleiman Kigundu (who was later arrested, charged and remanded for causing the bank a Shs. 75 million loss on the same day Greenland Bank was shut down). Upon intervention, BoU discovered that Greenland bank had substantial liabilities and assets not

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[521] Ibid.
[522] See Brownbridge as cited below.
[523] Brownbridge, Martin, *Resolving Bank Failures in Uganda: Policy Lessons from Recent Bank Failures*, Development Policy Review, Vol. 20, No. 3, pp. 279-291, 2002. Available at SSRN:http://ssrn.com/abstract=318625 (last accessed on 30/4/2016).
[524] Martin Brownbridge is currently an economic advisor to Governor Mutebile.
[525] This is fortified by litigation in the case of *Robert Mwesigwa and Others v Bank of Uganda, HCT-00-CC-CS-0588 of 2003* accessible via http://old.ulii.org/ug/judgment/commercial-court/2005/33-0 (last visited on 30/4/16).
[526] Corrective measures are imposed by Bank of Uganda with a view of enforcing compliance with statutory and regulatory conditions.

disclosed on its balance sheet.[527] In January 1999, Greenland Bank was put under statutory management by BoU, but remained open under liquidity support until April 1999 when it was closed down.[528]

Co-operative Bank was closed in May 1999. It had a long history of financial distress going back to the 1980s owing to political instability and economic collapse leading to decline of co-operative societies in Uganda, but was being kept afloat by foreign donor funds. A BoU onsite supervision in September 1998 had revealed that the bank was limping and on the verge of collapse. It was not closed down in hope that foreign donors would bail it out again. However, by May 1999, the decision to close it was inevitable because donors did not inject more capital to rescue it because it had serious governance and management deficiencies.[529]

Trust Bank, a local subsidiary of a Kenyan parent bank was the smallest of the four failed banks during this time. It had closed down on its own initiative in September 1998 due to liquidity shortfalls. The BoU allowed it to reopen in January 1999 but it was closed down again in November 1999 due to illiquidity.[530]

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[527] It was discovered that the MD had lent out at least sh31 billion, above the bank's sh6b core capital, to Greenland subsidiary companies according to Buganda Road Chief Magistrate's Court Criminal Case No. 718 of 1999.

[528] The BoU closed down all the bank branches, freezing more than 150,000 customers' deposits pending the Greenland's liquidation and compensation of some depositors. By the time Greenland bank was founded in 1993, it had 18 staff members and a deposit base of Shs 1 billion at the end of its first year in operation. However, at the time of its closure, it had been in existence for six years and had staff of about 400 members, with a deposit base of Shs 78 billion. It had also opened up a branch in Tanzania. No local bank had opened up a unit outside Uganda until Crane Bank opened shop in Rwanda in 2014. The closure of Greenland triggered off one of the most litigious bank closures in Ugandan history. In one of the cases, *Larb (U) Limited & 2 others v Greenland Bank (in liquidation) & Another, Misc. Application No. 490 of 2010*, Justice Madrama restated that under section 30 of the repealed Financial Institutions Act (Cap. 54) which was the law in operation at the time, Greenland bank Ltd had been closed. Bank of Uganda as the central bank followed sections 30, 31 and 32 and seized the bank and finally wound it up. Section 30 (1) of the Financial Institutions Act gave powers to the central bank to take possession of a financial institution under certain situations which were spelt out therein. Section 30 (2) applied certain conditions to the financial institution that is seized under the section. Section 31 dealt with management of the seized financial institution. Finally section 32 (1) provided that the central bank or an appointee of the central bank upon a financial institution becoming insolvent, shall be the receiver of the financial institution. The learned judge further held that that section 10 of the old Financial Institutions Act gave the bank of Uganda discretionary powers to revoke the licence of Greenland bank.

[529] See Martin Brownbridge (supra).

[530] In the 1999 budget speech which was delivered just after the closure of the Co-operative Bank, the then Finance Minister Gerald Ssendaula announced that in the event of more bank closures, only the deposits protected under the deposits insurance fund would be the only ones to be re-payed in full. Thus, when Trust bank was closed down later that year, only the protected deposits under the insurance scheme were fully paid out. The uninsured deposits were transferred to another bank at an adjusted discount reflecting the losses incurred by Trust bank.

The BoU intervened in the affairs of Uganda Commercial Bank (UCB) by injecting more liquidity soon after closing Greenland Bank. UCB held 22.8% of the total Ugandan banking system's deposits. It was bigger than the other failed banks and had extensive branch network coverage throughout the country and thus was considered systemically important. Its failure was linked to that of Greenland Bank because the latter had lent money to a Malaysian company, Belmont Limited, to purchase a 49% stake in UCB, in return for a secret deal under which Westmont would assign its shares in UCB back to Greenland bank. UCB then lent money to Greenland. So, it was inevitable that when Greenland sneezed, UCB caught the contagion. However, unlike Greenland, the failure of UCB was not an option both economically and politically.[531] In the end, UCB was sold to the South African investment bank, Standard Bank, to form part of Stanbic Bank Uganda Limited.[532]

In 2000, a judicial commission of inquiry into the closure of commercial banks under Justice James Ogoola was set up and it recommended an overhaul of Uganda's bank regulatory framework.[533] The bank failures of the 1990s and early 2000s prompted the BoU and the Government to strengthen the regulatory structure of the banking industry. Parliament enacted new legislation – the Financial Institutions Act (FIA) – in 2004.[534] This Act, *inter alia*, raised the

[531] UCB remained open after the BoU intervention because of its size and importance in the banking market. The regulatory policy interventions underpinning its recapitalization were very different from the smaller banks. It is also worth mentioning that deposits up to a maximum cover of Shs 3 million (about $2,000 in 1999) were guaranteed under the deposit insurance fund (DIF) in Uganda. However, after the closure of Greenland Bank, the government undertook to repay all of its depositors, including the unsecured creditors. Subsequently, government paid all of the private sector customer deposits in the failed ICB, Greenland and the Co-operative bank. Some of co-operative bank deposits were transferred to two private sector banks under a purchase of assets and assumption of liability agreement, with the remaining of the deposits transferred to UCB. All of Greenland's private sector account deposits were transferred to UCB apart from the very small deposit claims which were paid out to the customers in cash. UCB received BoU securities to cushion the deposit liabilities it had assumed, while the two private sector banks which had assumed deposits from Co-operative bank received a mixture of BoU securities and liquid assets from the Co-operative bank. The administrative processes involved caused a lot of delay in depositors receiving back their money between the time of bank closures and the time when deposits were transferred to the receiving banks that had assumed the respective accounts. The ICB had a very small bulk of private sector depositors who were paid directly by BoU. UCB was acquired by the Stanbic group in a privatization arrangement in February 2002 and subsequently merged in September the same year.

[532] The sale of UCB divested the Uganda government of ownership and controlling interest in the bank.

[533] This report concluded that a strong, but secondary cause of bank failures in Uganda was the consistently weak supervision by BoU. There was laxity in decision making and lack of decisiveness in using the existing remedial powers. See IMF Country report, *Uganda: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, and Payment Systems* at pg. 38 (10/4/03), Washington, D.C.

[534] The FIA, by its long title, is an Act intended Ac to revise and consolidate the law relating to financial institutions; provide for the regulation, control and discipline of financial institutions by the central bank; repeal the Financial Institutions Act, Cap. 54 and provide for other related matters. A number of other actions were taken, for example;

minimum bank capital requirements, tightened restrictions on insider lending and mandated BoU to intervene promptly and swiftly in failing banks before total a wipe out of their capital to the detriment of depositors.[535]

The BoU embarked on a number of reforms during 2011 to further strengthen the regulatory framework in light of the new post-global financial crisis regulatory reforms.[536] For example a pilot project to modernize liquidity regulation by introducing the Liquidity Coverage Ratio of Basel III was launched. The BoU also initiated the development and implementation of a National Strategy for Financial Inclusion, under which financial consumer protection guidelines were issued to financial institutions in 2011.

Efforts were also devoted to enhance the Central Bank's capacity to manage a systemic financial crisis and enhance coordination of the regulatory bodies through technical assistance from the World Bank.[537] In March 2011, the Central Bank also issued Consolidated Supervision

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following the unraveling of the April 30, 1998 sale of a 49 percent interest in UCB, the Government moved forward with its plan for re-privatization. The board of directors and senior staff of UCB were replaced by a BoU appointed board and managing director. Legal action was initiated against Westmont Land (Asia) in connection with irregularities in both the purchase and sale agreement and its management contract for UCB. BoU also took a number of decisive steps to ensure that weak banks either operate in compliance with the terms of remedial memoranda of understanding, or are promptly closed to minimize the losses incurred by depositors and creditors. Following a determination by the BOU that recapitalization was unlikely; ICB was closed in September 1998. The BOU intervened in Greenland Bank in November 1998. Greenland Bank was closed on April 1, 1999 following the discovery of improper off-balance sheet assets and liabilities, the emergence of severe liquidity problems, and a continued deterioration in its capital position. A reputable liquidator with international experience was appointed. The Cooperative Bank (Coop) was closed on May 20, 1999 due to its capital deficiency and the withdrawal of the support of USAID. Its assets were offered for sale with the expectation that this would facilitate a rapid payment of depositors' claims through an assumption of deposits by a well-capitalized bank. In both cases, the government announced its commitment to pay all deposit claims net of depositors' liabilities to the banks. The BoU also stepped up its program of on-site examinations. In the first half of 1998/99, the BoU completed nine on-site bank examinations (including follow-up examinations of three banks). Through May 1999, the BOU had completed four additional on-site bank examinations (thereby meeting the June 1999 benchmark under the program), with a fifth in progress. It also completed one examination of a credit institution (Imperial Investments Finance Ltd) in January 1999.

[535] For instance, part v of the Act creates a bar on lending where liquid assets are insufficient. It restricts lending against own shares and debt instruments and creates stringent restrictions on credit concentration, reduction of capital, puts restrictions on reduction of capital, prohibits insider transactions, and restricts externalization of assets.

[536] The reforms were also motivated by development of new banking and financial products. For example, during 2011, mobile money services registered significant growth compared to the previous year. The number of registered customers increased from 1,683,713 in 2010 to 2,879,968 during 2011, while the amount transferred by customers rose from Ushs.962.7 billion to Ushs.3.7 trillion over the same period. In terms of volume, the service registered a 204 percent increase in number of transactions from 28.8 million transactions in the year to December 2010 to 87.5 million transactions in December 2011. In addition to mobile money services offered by MTN Uganda, Uganda Telecom (UTL) and Airtel also began offering mobile money transfer services.

[537] The supervisory authorities have been broadly effective in managing the risks involved in the growth of and development of the financial sector. In particular, the BoU has played a leading role in using regulatory oversight to

Regulation to all banks.[538] All banks are required to report under these regulations as by 31st December of every year. Elements of consolidated supervision were also incorporated in on-site inspections such as the activities of related party transactions that could have a bearing on the banking institution.[539]

5.1.2. The financial stability mandate: Creation of the Financial Stability Department (FSD) at BoU and the current state of the banking industry from turbulent times to relative stability

An important lesson that was drawn from the 2008/09 global financial crisis is that the financial system can become vulnerable to a systemic crisis even though the macro-economy is stable and major financial and banking institutions within the system are able to comply with all prudential regulatory requirements. It is therefore crucial for the regulatory authorities to strengthen their analysis and surveillance of systemic risks to the financial system and to devise policy instruments which can mitigate these risks. Consequently, in 2009, BoU established the FSD

maintain stability and foster innovation. It has made significant progress in implementing risk-based supervision processes, exercises strong off and on-site supervisory practices, and the Basel Core Principles (BCPs) assessment shows the sector to be more than adequately regulated and supervised. The BoU has been proactive in fostering outreach of financial services by licensing new banks with an explicit retail strategy and enabling development of innovative mobile payments products. BoU further implemented three key measures to reduce the effects of the bank failure risk challenges. First, banks are required to hold higher paid up capital of Ushs.25 billion from March 2013 to provide additional capital buffer. Second, the central bank introduced a liquidity coverage ratio (LCR) in 2012. The LCR is one of the Basel III measures which is meant to ensure that banks hold sufficient high quality assets to meet their projected cash outflows over a 30-day period. Third, BoU intends to adopt in the medium term some of the Basel III international standards for banking regulation. These standards are aimed among other things at reducing the pro-cyclicality of bank capital by strengthening capital requirements for banks through the introduction of macro-prudential measures such as a capital conservation buffer, a countercyclical buffer and higher on going capital for systemically important financial institutions, over and above the current minimum capital requirements. This process is currently ongoing.

[538] This is in terms of the Financial Institutions (Consolidated Supervision), Regulations officially cited as Statutory Instrument No. 44 of 2010.

[539] Many financial institutions operating in Uganda are part of a wider banking group. Understandably, the relationship of financial institutions to other entities in a group can create risks that generally do not arise for institutions that are not part of groups. Some of the issues commonly arising in banking groups are: conflicts of interest; contagion; group exposures to particular counterparties where loans may be advanced by other members of the group to avoid regulatory limits; opaque legal and management structures that may be deliberately used to impair effective supervision and regulatory arbitrage where transactions may be booked in an unsupervised related entity to escape prudential requirements. These cases underscore the importance of consolidated supervision, which involves an overall evaluation, both quantitative and qualitative, of a financial institution and the group to which it belongs.

whose primary function is to monitor and analyze systemic risks to the Ugandan financial system.[540]

The FSD prepares a bi-annual Financial Stability Report (FSR), which is made public. The report provides analysis of the current state of the financial system and its vulnerability to systemic risk. It also highlights potential sources of vulnerability in the short to medium term. The objective of the FSR is to contribute to the understanding of financial system vulnerabilities among policymakers, financial market participants and the general public. It is hoped that better public awareness of financial system vulnerabilities may itself serve to encourage financial institutions to curb activities which might exacerbate systemic risks and will also help to promote awareness of the need for policy reforms to strengthen the resilience of the financial sector.[541]

The extent to which individual countries were affected by the crisis depended mainly on their financial structures, their integration with global financial markets and their balance of payments positions. Growth in the Ugandan economy slowed in 2008/09, largely due to external shocks, which affected both the current and capital accounts of the balance of payment and reduced growth in aggregate demand. Slower growth in aggregate demand pulled real GDP growth below potential, with GDP growing by 5.5 percent in 2008/2009, lower than the 9.5 percent growth projected in mid-2007.[542] Uganda's financial markets were also affected by the volatility in global financial markets, mainly through falls in asset prices and a reversal of portfolio capital flows.[543] The Uganda shilling faced sustained depreciation pressures, falling by 21 percent against the US dollar for the year ending October 2009.[544]

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540 See BoU Financial Stability Report, Issue No. 1 (Dec 2009) accessible via https://www.bou.or.ug/bou/bou-downloads/financial_stability/Rpts/All/FSR_Issue1_Dec09.pdf (last visited on 6/5/16). The FSD works closely with other BoU officials, notably the supervisors of commercial banks and non-bank financial institutions, with those responsible for macroeconomic analysis and for the payments system. The FSD also collaborate with the agencies responsible for regulation of the capital markets (Capital Markets Authority) and insurance companies (Insurance Regulatory Authority).

541 The terms systemic risk and macro-prudential risk are often used interchangeably and are essentially synonymous: the vulnerability of the financial system to a systemic crisis. A systemic crisis involves the failure of major financial institutions or a number of financial institutions, which together comprise a major part of the financial system, as a consequence of which key functions of the financial system such as the payment system and the extension of credit are impaired, which can have significant costs for the real economy.

542 BoU Monthly Review of Reserve Money Programme, (November 2009). The drop in GDP growth was mainly due to dampened global demand for commodity exports, depressed commodity prices on the world market, drop in remittances, reduced demand for construction activity and a downturn in the tourism sector.

543 Capital markets in emerging and developing markets are integrated with capital markets elsewhere in the world. The Uganda Stock Exchange (USE) All Share Index has a correlation coefficient of 0.83 with the S&P500, a proxy

In terms of impact on the banking sector, liquidity pressures increased as overseas investors sought to leave the domestic markets between August and October 2008. There was also an increase in liabilities owed to foreign banks between September 2008 and January 2009, which reflected a temporary build-up of placements in the banking system as overseas banks liquidated their government securities and exited the securities market. The repatriation of these funds over the following months slightly raised liquidity pressures in some banks.[545] The main indicator of banks' asset quality is non-performing loans (NPLs) as a proportion of the total gross loans. This ratio rose to 4.1 percent in September 2009 from 3.1 percent in March 2009.[546]

The threats to the global financial system continued during 2010. The global economy continued its recovery from the impact of the financial crisis in 2007/08, although output growth was still unevenly spread around the world. The banking system in Uganda remained in a financially sound condition, with a capital adequacy ratio of 22 percent as of June 2010, almost double the statutory minimum. After a dip in performance in 2009, many indicators of the performance of the banking system improved in the first half of 2010.[547]

for the largest listed companies in the US, and 0.75 with the FTSE 100, a proxy for the largest listed companies at the London stock exchange.

[544] The depreciation of the Shilling was triggered by the large outflow of portfolio capital in mid-2008 as offshore investors rapidly sold local assets as they sought to exit the domestic market and persisted over the next twelve months, driven by weaker export earnings and reduced remittance inflows in the current account of the BOP. This further increased liquidity pressures on banks. To stem the depreciation of the shilling, the BOU intervened in the interbank foreign exchange market (IFEM), selling US$235 million on a net basis during the year to June 2009. The depreciation of the Shilling began to be reversed in May 2009.

[545] The central bank took several actions to provide adequate liquidity to the banking sector and the economy. First, BoU reduced the policy margin and hence the Bank rate (the rate at which banks borrow from the central bank) to 3.4 percent in March 2009 and later further down to 3 percent in September 2009. Reducing the policy margin was aimed at making it easier for banks to access liquidity from the BoU in cases where they were unable to access their normal funding channels including the interbank market.

[546] The bank lending surveys for December 2008 and June 2009 showed that banks tightened their lending standards. Overall, 57 percent of lenders tightened lending to SMEs, while 40 percent tightened credit for large enterprises. In addition, 43 percent of the banks reported a decline in the availability of long-term loans (more than 12 months). The tightening in the standards and credit terms and conditions was generally associated with falling interest margins and stricter collateral requirements. The trends that were observed in liquidity levels continued and the expectations regarding general economic activity remained constrained in the short term. These factors contributed to tighter credit conditions, which eventually affected economic growth. Banks' asset quality deteriorated, with the level of non-performing loans (NPLs) increasing to Ushs.156.4 billion in June 2010 from Ushs.146.2 billion in June 2010.

[547] There was acceleration in the growth of bank assets and deposits. Bank profitability, which had declined in 2009, recovered in the first half of 2010, with returns on both assets and equity increasing. Profitability was boosted by an improvement in asset quality, due to a fall in non-performing loans. However, nearly half of the commercial banks reported losses in the first half of 2010, mainly due to rising operating costs, although the market share of the loss making banks was relatively small. The banking system remained highly liquid and the cost of funding in the domestic interbank market declined. The overall assessment was that, in the short term at least, there were no major

As of 2010, while Uganda, like most African countries, adopted the Basel I capital adequacy framework for bank capital regulation, most advanced economies had moved on to Basel II.[548] In 2011, Bank of India received regulatory approval to establish a subsidiary in Uganda to operate as Bank of India (Uganda) Limited. NIC Bank Kenya Limited applied to establish a subsidiary in Uganda under the name NC Bank Limited. UGAFODE Microfinance Limited was licensed to operate as an MDI in September 2011 and started operations in October 2011.[549] There was also increased development of electronic banking.[550]

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threats to the systemic stability of the Ugandan banking system. Furthermore, the banking sector held substantial levels of capital and liquidity which provided a buffer against shocks to its balance sheet. Nevertheless, the financial system is evolving rapidly and its risk profile is not static; hence it is essential to monitor closely the condition of the financial system and to remain alert to any threats to its stability which might emerge in the future. It is the imperative scholarly contribution of this research to provide this cutting edge in terms of policy recommendations through comparative study.

[548] The financial crisis of 2007-09 led to a number of proposals at the global level aimed at enhancing the resilience of the financial system and strengthening the regulatory framework. The Basel accords became increasingly questioned, with inquiries focusing on whether the Basel capital accords are pro - cyclical and also criticized for encouraging regulatory arbitrage, thereby contributing to the build-up of systemic risks in the financial systemIn December 2009, the Basel Committee on Banking Supervision (BCBS) issued for consultation, a package of proposals for strengthening global capital and liquidity regulations with the goal of promoting a more resilient international banking sector. In September 2010, the Group of Governors and Heads of Supervision, the oversight body of the BCBS approved the reforms. The financial crisis of 2008/09 generated the impetus for reforms to the regulatory framework to strengthen banking systems and improve their resilience to shocks. Overtime, it has also become clear that such reforms have not only to address the regulation of banks, but also to encapsulate other elements of the financial system that pose systemic risk. The requirement that Tier 1 capital should be composed predominantly of common shares and retained earnings had little effect on Ugandan banks, since this was already the norm. Also the Ugandan Capital Regulations issued under the Financial Institutions Act, 2004 already required that goodwill and other intangible assets such as intellectual property rights, minority interests, and deficiencies in provisions to be deducted from Tier 1 capital. This was in line with the Basel 1 recommendations which BoU was implementing. The ratio of Tier 1 capital to risk weighted assets for Ugandan banks was 19.2 percent at end June 2010, far above the requirement of 6 percent under the Basel 1 accord that was operational at the time.

[549] Banks continued to set up new branches and ATMs in a drive for wider representation and service provision. Accordingly, there was an increase in outlets, with 455 branches and 637 ATMs as at 31 st December 2011, compared to 393 branches and 598 ATMs as at 31st December 2010. During the same period, the money remittance market comprised 22 foreign exchange bureau outlets, 15 direct entrants, 3 MDIs (68 outlets) and three credit institutions (42 outlets). The total number of branches for licensed foreign exchange bureaus and money remitters was 184, compared to 158 as at the end of December 2011.

[550] During 2011, banks focused increasingly on the development of electronic banking products as a move towards cheaper alternatives to branches for service provision. These services allow customers to use their computers and cell phones to carry out limited transactions outside the confines of a normal bank branch. There were also increased partnerships between banks and mobile network operators for the provision of mobile money transfer services. Several banks exploited their liquidity advantage over other agents and took on the role of Mobile Money Agent or Super-Agent. Some banks fine-tuned the product further to introduce a mobile payment solution which is also accessible through the use of biometrics, Near Field Communications (NFC) cards, as well as the internet. In a bid to strengthen controls around the mobile money transfer services, a national working group was formed comprised of BOU and Uganda Communication Commission (UCC) to enhance cooperation and joint oversight of the mobile money services. Enhancements were also issued to the "No Objection Letters" that had earlier been given to banks partnering with mobile network operators (MNOs). The enhancements were aimed at closing identified gaps including the need for back-up, replication of data and information at the partner banks, Know Your Customer

For the first time, Financial Consumer Protection Guidelines were issued and circulated to commercial banks and credit institutions. The guidelines aim to promote fair and equitable financial services practices, and apply to all financial services providers regulated by Bank of Uganda as well as their agents in respect of business conducted in Uganda. There was also increased consolidated supervision.[551] There was also a release of results on the Uganda Financial Sector Assessment Program (FSAP) in 2011.[552] In terms of legal aspects of the recommendations, it was observed that given the growing importance of cross-border banking and related risks, renewed effort is required to strengthen cross border collaboration with regulators/supervisors of banks in other jurisdictions. It was also proposed that financial outreach should be enhanced and placed under stronger regulatory oversight through amendments of various banking sector regulations.[553]

An interesting policy debate regarding regulatory aspects of the Ugandan bank system arose in 2011 between BoU and the Basel Committee on Banking Supervision (BCBS) on the proposal for implementation of a countercyclical capital buffer (CCCB) for banks.[554] The CCCB is a

(KYC) requirements, transaction limits, complaint handling and liquidity management by agents. BoU now monitors the operations of the licensed mobile money transfer services in Uganda because they are interlinked with banks.

551 Many financial institutions operating in Uganda are part of a wider banking group. Understandably, the relationship of financial institutions to other entities in a group can create risks that generally do not arise for institutions that are not part of groups. Some of the issues commonly arising in banking groups are: conflict of interest; contagion; group exposures to particular counterparties where loans may be advanced by other members of the group to avoid regulatory limits; opaque legal and management structures that may be deliberately used to impair effective supervision and regulatory arbitrage where transactions may be booked in an unsupervised related entity to escape prudential requirements. These cases underscore the importance of consolidated supervision, which involves an overall evaluation, both quantitative and qualitative, of a financial institution and the group to which it belongs. There are plans to draft other implementing regulations to cover reporting requirements from banks to the Central Bank, internal audit, mergers and acquisitions, and prompt corrective actions.

552 The Financial Sector Assessment Program (FSAP) is a joint IMF-World Bank initiative launched in 1999 to provide member countries that request participation with a comprehensive assessment of their financial systems. It provides in-depth examinations of countries' financial sectors and has two main components: financial stability and financial development assessments. A joint International Monetary Fund (IMF)/World Bank mission visited Kampala from 17 th to 29th August 2011 to conduct the Financial Sector Assessment Program (FSAP). The main focus of the mission was to update the findings of the 2005 FSAP assessment, to assist the Ugandan authorities in identifying strengths and systemic vulnerabilities of the financial sector and to identify priority measures for improving the operation and oversight of the system, and its contribution to economic growth and development. The FSAP focused on the whole financial sector and worked with various stakeholders including Bank of Uganda, Insurance Regulatory Authority (IRA), Capital Markets Authority (CMA), Uganda Securities Exchange (USE), Ministry of Finance, Planning and Economic Development (MFPED) and various financial institutions.

553 A final report on this assessment was finalized in early 2012. An implementation plan of the recommendations under the purview of BOU was approved by the Financial Stability Committee in December 2011 and is being put into action.

554 In 2010, the Basel Committee on Banking Supervision (BCBS) issued a consultative document which included a proposal for a countercyclical capital buffer (CCCB) for banks. The proposed buffer is part of a package of Basel III

measure under Basel III which is intended to be imposed on a discretionary and temporary basis by national bank regulators during periods when, in their judgement, credit growth is excessive. National regulators must first make an assessment to determine whether credit growth is excessive and if so, whether it may lead to a system-wide build-up of risk which could materialize in a credit contraction. This assessment must be based on both quantitative indicators of credit expansion and judgment exercised by supervisory authorities who will take guidance from underlying principles as recommended by BCBS.[555]

Upon data analysis, it was found that the methodology recommended by the BCBS in its guidance on the CCCB as well as their analysis is based mainly on data for credit cycles in developed and emerging countries. The financial sector in developing countries such as Uganda exhibited different characteristics.[556] This is an interesting insight for this research because it

reforms intended to strengthen the resilience of the banking sector to systemic shocks. The CCCB arose from the empirical observation that for a range of economies studied by the BCBS, periods of excessive aggregate credit growth have been associated with the system-wide build-up of risks, which eventually lead to increased financial distress among banks, a contraction of the credit supply and, economic crises. The primary objective of the CCCB is to protect the entire banking system from the adverse consequences that follow periods of excessive credit expansion. The CCCB is a macro-prudential tool developed as part of BCBS's efforts to dampen procyclicality of credit in the financial system, in particular the procyclical movement of credit aggregates which amplifies the economic cycle. The measure aims to ensure that banks build up capital buffers over and above their minimum capital requirements during the upswing of the credit and business cycle, which buffers can then be used to absorb losses during periods of financial stress. Banks can, therefore, avoid having to deleverage their balance sheets, and thus contract the supply of credit to the economy, in order to comply with minimum capital adequacy requirements. The overall objective of the CCCB is not simply to ensure that individual banks remain solvent15, rather, it is to ensure that the banking sector in aggregate has sufficient capital to maintain the flow of credit to the economy without its solvency being questioned, when the broader financial system experiences stress after a period of excess credit growth. Thus, the countercyclical buffer is designed to ensure that banking sector capital requirements are consistent with the objective of maintaining macro-financial stability. A macro-prudential measure is an essential component of Basel III reforms because the Basel I and II capital accords, which are essentially micro-prudential in nature, were criticized for imparting a degree of pro-cyclicality to bank lending and risk taking which potentially exacerbates macroeconomic fluctuations. The proposal for the CCCB was motivated in part by the global financial crisis and the consequent recession in the advanced economies, which was partly caused by deleveraging after a prolonged period of excessive credit growth and expansion of the financial system, as well as by banking and financial crises in emerging markets over the last three decades.

[555] To assess the applicability of the CCCB to Uganda required answering two questions: (i) Is there any evidence that economic slowdowns in Uganda have been caused by the consequences of excessive credit growth? Addressing this question helped BoU establish whether the BCBS's methodology is suitable for evaluating Uganda's credit cycles. This required reliable historical data and ideally, of quarterly frequency such that BoU could first identify such periods of excessive growth. Therefore, the next question to be addressed was (ii) does the available data enable BoU to do the following using the methodology recommended by BCBS?: (a) to identify periods of excessive credit growth in Uganda, (b) to evaluate whether the credit-to-GDP gap is a reliable forward-looking guide for making decisions regarding the level of CCCB in Uganda.

[556] Compared to the other economies the BCBS studied, Uganda's economy is at a relatively early stage of financial development. To put this in perspective, the credit-to-GDP ratio in Canada in 2010 was 160 percent. Comparatively, Uganda's credit-to-GDP ratio has never exceeded 20 percent over the last three decades due to a low credit trajectory arising from a huge part of the informal economy and the unbanked economy, coupled with a big youthful

shows the considerations for limited harmonization of banking and finance regulatory rules as opposed to full harmonization due to the developing countries and developed countries divide in the quest for globalization and unification in the rules of banking, trade and commerce.

As of June 2014, the Ugandan banks continued to be well capitalized and most banks comfortably met the Basel III capital requirements. They exceeded regulatory liquidity requirements, including the liquidity coverage ratio (LCR). In addition, the cost of funding, both from offshore sources and domestic sources, had reduced. Private sector credit had picked up, and the banking sector was well placed to support an increase in economic growth. However, the banking system had some challenges which affected interest income and profitability including; the continued losses among small and new banks, high loan-to-value ratios in the face of high house price inflation, and the rapid capital outflows due to monetary policy tightening in developed countries.[557] BoU further conducted a stress test for liquidity risk, in which a simple bank run was simulated to determine the impact of adverse uniform shocks to banks' liquidity, brought on by a sudden withdrawal of customer deposits. The resilience of banks to liquidity risk is judged by the number of days banking institutions would be able to withstand a liquidity drain without resorting to external liquidity support.[558]

population that utilizes informal methods of credit access (like dependence on friends and family), of which statistical data on credit history and consumption is hard to capture.

[557] Small commercial banks in Uganda are defined as those banks whose total assets fall below Ushs.450 billion. Medium banks hold assets between Ushs.450 billion and Ushs. 1.0 trillion, while large banks hold assets above Ushs.1.0 trillion. New commercial banks are banks that have been licensed within the last five years.

[558] The results from the test revealed that liquid assets of eight banks would be depleted over a 7-day period of distress, assuming a daily withdrawal rate of 6.3 percent of total deposits. Compared to June 2013, the results suggest that as at the end of June 2014, banks were less sensitive to liquidity risk since the bank run test resulted in less bank failures and a higher ratio of liquid assets to total deposits. Going forward, the BoU had to ensure that the banking system's resilience does not deteriorate in response to cyclical economic changes, growth in asset prices and global financial conditions. It has taken several steps to address these concerns. First, regarding rising loan-to-value (LTV) ratios, BoU started an exercise to collect data on and monitor loan-to-value ratios for property loans. Starting September 2014, all banks were required to compile and send data to BoU on LTV ratios for residential, commercial and land mortgages. This is one area of the more intrusive and added disclosure requirements on banks arising from effects of global financial regulatory reforms. The BoU also benchmarks practices at other central banks that are collecting LTV data. Secondly, BOU implemented micro-prudential measures to address weaknesses in several banks. BOU engaged small and new banks, as well as a number of systemically important banks, to enhance their loan quality and liquidity. In addition, Global Trust Bank (GTB), which had incurred significant losses was closed and wound up. Thirdly, as mentioned in the Report for June 2013, BoU brought forward the implementation of Basel III capital measures to January 2014 in order to strengthen bank resilience. The amendments to the revised Financial Institutions Act (2004) which include the Basel III capital measures were submitted to Parliament.

The Minister of Finance, Planning and Economic Development issued a statutory instrument in May 2013 to introduce Basel III capital measures, including a capital conservation buffer of 2.5 percent of risk-weighted assets. The instrument also allows the BoU to impose a countercyclical capital charge in periods of excess credit growth, to dampen volatility in the credit cycle, and to impose additional capital charges on domestic systemically important banks (D-SIBs).[559] By June 2015, the BoU had started implementing the Net Stable Funding Ratio (NSFR).[560] The NSFR is important in order to minimize a bank's overreliance on short-term wholesale funding by encouraging better assessment of funding risk and promoting funding stability, reducing the extent of maturity mismatch and, in theory, lowering a bank's probability of experiencing liquidity runs and associated default.[561] The fundamental role of banks in financial intermediation makes them inherently vulnerable to liquidity risk, of both an institution-specific and market nature. However, private incentives to limit excessive reliance on unstable funding are weak. The NSFR is intended to reduce funding risk over a longer time horizon by requiring

[559] The strong rise in the overall level of capital was a result of higher regulatory capital requirements; BoU required all banks to increase their minimum unimpaired paid-up capital from Ushs.4 billion to Ushs.25 billion effective 1st March 2013, to which all banks complied. In addition, new minimum capital requirements were due to come into effect as part of the Basel III package to improve the soundness and resilience of the banking system. This followed the signing of The Financial Institutions (Enhancement of Minimum Ongoing Capital Requirements) Instrument on 24th May 2013, by the Minister of Finance, which will requires all banks to hold a capital conservation buffer and for domestic systemically important banks (D-SIBs), an additional loss absorbency capital buffer. From January 2015, all banks were required to hold an additional 2.5 percent of common equity above the minimum requirements in the form of a conservation buffer, while D-SIBs will have to hold an additional 1 percent of common equity. This resulted into higher minimum ratios; the tier 1 capital ratio rose from 8 percent to 10.5 percent (11.5 percent for D-SIBs), and the total regulatory capital ratio rose from 12 percent to 14.5 percent (15.5 percent for D-SIBs). These are more forward-looking and proactive interventions resulting from the criticism that the existing safeguards available before the global financial crisis with more reactionary than preventative in approach. When referring specifically to banks, the term systemically important bank is used rather than SIFI. The Basel Committee on Banking Supervision (BCBS, 2012) differentiates between global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs). D-SIBs are defined as banks that may not be significant from an international perspective, but nevertheless have an important impact on their domestic financial system and economy.

[560] Following the Global Financial Crisis of 2007, the Basel Committee on Banking Supervision (BCBS) developed new liquidity rules for banks in an effort to promote a more resilient banking sector. The BCBS set out these rules in its paper on Principles for Sound Liquidity Risk Management and Supervision (Sound Principles), which strengthened bank's liquidity standards by introducing two minimum standards for funding and liquidity. These included the Liquidity Coverage Ratio (LCR), which was rolled out by Bank of Uganda in 2014, and the Net Stable Funding Ratio (NSFR). The BCBS set out the final standard for the Net Stable Funding Ratio (NSFR) on October 31, 2014. The NSFR is defined as the amount of available stable funding relative to the amount of required stable funding. This ratio should be equal to at least 100 per cent on an ongoing basis (BCBS 2014). Available stable funding refers to the portion of capital and liabilities expected to be reliable over the time horizon considered by the NSFR, which is one year. Required stable funding of a specific institution is a function of liquidity characteristics and residual maturities of the various assets held, and off-balance sheet exposures, at that institution.

[561] IMF (April, 2011). "*How to address the systemic part of liquidity risk*", Global Financial Stability Report, (pp. 75-110).

banks to fund their activities from sources that are sufficiently stable to mitigate the risk of future funding stress.[562] By moving to implement the NSFR, the BoU will comply with the BCBS deadline of 1st January 2018 for implementing the NSFR globally.[563]

The introduction of the NSFR is likely to have several implications for Ugandan banks. First, banks that do not meet the minimum requirement of 100 percent, will have to increase either their stable funding sources or reduce their illiquid assets. While this can be achieved by taking several banking business actions, under normal circumstances each of the potential adjustment actions is likely to negatively affect profitability, as it requires the bank to continuously hold sufficient stable liabilities that support long and medium-term assets.[564]

Secondly, in banking business terms, a retail bank's business model rests upon the transformation of short-term and cheap borrowing (savings account and wholesale funding) into long-term and more profitable investments (loans). Banks then generate profits through the interest margin gained from difference between the interests paid and the ones received. This business model is based on the maturity mismatch between the assets (long-term at high interest rate) and the liabilities (short-term at low interest rate). By requiring banks to match the maturities of assets and liabilities, the NSFR is bound to impact this model and could result in

[562] The NSFR will require banks to maintain a stable funding profile in relation to the asset composition and off balance sheet activity with a view to ensuring a stable funding structure. It is designed to complement the Liquidity Coverage Ratio, which is intended to ensure that banks can withstand a 30 day liquidity stress scenario.

[563] A preliminary estimation of the NSFR for Domestic Systemically Important Banks (D-SIBs) and other banks in Uganda based on financial data as at March 31, 2015 was undertaken. It revealed that five banks would fail to meet the minimum NSFR standard and all the D-SIBs would meet the standard.

[564] On one hand, to increase the Amount of Stable Funding (ASF), a bank has to increase capital and/or such other liabilities that have higher ASF factor such as secured or unsecured borrowings and term deposits with maturities of one year or more and deposits with residual maturity of less than one year provided by retail and small business customers. On the hand, to decrease the Required Amount of Stable Funding (RSF), the bank would have to hold a greater proportion of assets assigned lower RSF factors i.e. assets that are very liquid in nature for instance cash, investments in government and other approved securities and reduce their exposures to assets like loans and non-performing loans that attract a higher RSF factor. However, such measures to achieve the minimum standard for NSFR have a cost. Increasing capital would have a bearing on return on equity, assuming all other factors remain the same. Long-term deposits and borrowings come at a cost resulting in higher interest expenses while increasing investments in government and other approved securities and reducing other investments could impact interest income. Second, the impact of the NSFR requirement on profitability can be measured through Net Interest Income (NII). Net interest income is defined as the difference between interest income and interest expense. The NII will decline if a bank raises long-term deposits and long term borrowing keeping all other items the same. By expanding investment in government and other approved securities and reducing other investments (like investments in corporate bonds and shares) a bank's interest income is likely to decline and hence less NII (as the rate of interest on government and other approved securities is bound to be lower than that available on other investments due to association of higher risk with the latter). To maintain NII at least at the same level, a bank would have to increase its interest income, possibly through an appropriate increase in its lending rate in order to maintain the same level of profitability.

unintended consequences, since stable funding tends to be relatively expensive, which may drive down the profitability of their lending activities.[565]

The NSFR aims to reduce funding risk over a longer term horizon by requiring banks to fund their activities with sufficiently stable sources of funding to mitigate the risk of funding stress. It will also help with identification of less stable funding structures among banks without unduly hampering their traditional role of maturity transformation and encourage them to develop more robust funding profiles, improving the stability of a bank's funding profile and reducing its exposure to the risk of maturity mismatches that outweighs the potential impact on profitability following adoption of the minimum standard for funding. This will subsequently help to bolster confidence in individual banks and reduce the probability of financial crises. In summary, the NSFR is intended to ensure that banking organizations have a more stable, longer-term funding profile to support assets and off-balance sheet activities.[566]

5.2. THE 2015 BoU FINANCIAL CRISIS MANAGEMENT FRAMEWORK

In March 2015, the BoU Financial Stability Department formulated the Financial Crisis Management Plan to provide a framework for the decision-making process in the event of a systemic shock to the banking sector.[567] The primary objective is to facilitate the orderly resolution of a crisis, while minimising losses to depositors, the government and the real

[565] Other potential impacts include a) modest decrease in loans: with the net interest margin decreasing, banks could reduce their lending activities and focus on other more profitable activities. Banks may also increase the interest rates on loans in order to maintain profitability. This would, in turn, decrease demand for loans. b) Risk of financial disintermediation: when banks reduce their lending activity, the demand for loans is likely to shift outside the formal sector to other financial players. c) Recapitalization: adoption of the NSFR may require some banks to recapitalize or to find more stable funding to meet the minimum standard. This may necessitate the issuance of bonds or deposit mobilization. d) Concentration in some asset classes: banks could be tempted to liquidate assets that require more stable funding and invest in those that require less stable funding. For instance, mortgage loans require less stable funding than corporate loans; this could lead to a decrease in corporate loans and an increase in mortgage loans. The studies undertaken by BoU, indicate that while there is potential for the above impacts, their impact on Ugandan banks is likely to be modest.

[566] The estimate results for banks' NSFR obtained by BoU show that with the exception of five banks, the majority of banks in Uganda meet the minimum standard for funding. Banks will be expected to meet the NSFR requirement on an ongoing basis, disclose the ration and publish this disclosure with the same frequency as the publication of financial statements. Again, this underpins the increasingly intrusive nature of bank regulation and disclosure obligations arising out of the global financial crisis and the need to build more robust banking institutions in terms of enhanced capital adequacy requirements.

[567] This plan was developed by BoU in partnership with the World Bank after the former undertook to effect measures to enhance Uganda's crisis preparedness. This involved a crisis simulation conducted in 2012. This exercise highlighted some gaps in the ability of BOU to respond quickly and effectively to the onset of a financial crisis, and made recommendations to improve crisis response. One of the recommendations arising from the crisis simulation exercise was to prepare a 'Financial Crisis Management Plan' or 'Contingency Plan'.

economy, by stabilising market confidence and reducing the risk of bank runs. This plan covers three stages. First, the plan covers detection of a financial crisis. The crisis can be detected through the payments system, market operations, supervision or the media. Secondly, the plan addresses crisis management by the crisis management team.[568] Thirdly, the plan considers financial crisis resolution. The crisis management team is tasked to ensure that the distressed bank meets its existing obligations and its core functionality is retained, in order to prevent distress to the financial system and wider economy if the services are lost.[569]

In broad terms, the plan seeks to provide guidance to BoU staff regarding the basics of a banking crisis management plan.[570] When alerted to the existence of a systemic crisis, the BoU must respond promptly. Responsibility for financial crisis management ultimately resides with the Governor.[571] The framework identifies some of the guiding circumstances in bank distress

[568] The Crisis Management Team is chaired by the Governor and its responsibilities include: determining the solvency and liquidity positions of the troubled bank(s); considering cross-border implications when foreign-owned banks are involved; and coordinating with the Ministry of Finance, Planning and Economic Development and other financial sector regulators through the Financial Sector Surveillance Committee (FSSC). The Financial Crisis Management Plan provides a framework for the decision-making process in the event of a systemic shock to the banking sector. The primary objective is to facilitate the orderly resolution of a crisis, while minimising losses to depositors, the government, and the real economy by stabilising market confidence and reducing the risk of bank runs. In developing the plan, reference has been made to Financial Stability Board's "*Key Attributes of Effective Resolution Regimes for Financial Institutions"* wherever applicable. At a later stage, BoU will work with other financial sector regulators to prepare crisis management plans for the sectors they regulate, and have them incorporated in the Financial Crisis Management Plan.

[569] The crisis management plan acknowledges that in some circumstances, this may be achieved with liquidity support from the BoU. In others, it may involve a radical restructuring of the bank using BoU corrective actions and receivership powers. BoU receivership powers under Section 95 of FIA 2004 allow the central bank to arrange a merger with another financial institution, arrange to sell the financial institution, or arrange for the purchase of assets and assumption of all or some of the liabilities by other financial institutions without requiring shareholder or creditor consent.

[570] Crisis detection is concerned with responding to any warning signs of a financial crisis detected during the course of market operations, through the payments and settlements system or through BoU's supervisory activities. The warnings may come from other regulatory authorities, through the media or from the general public. Crisis management entails the management process within the BoU for handling a systemic financial crisis once detected, and the information needed to facilitate sound decision-making. Crisis resolution encompasses the options for resolving a systemic crisis including through the provision of liquidity or restructuring so that an ailing institution is returned to health and remains in business (bank rescue).

[571] See pp. 9-10 of the BoU Crisis Management Plan. Once a disturbance has been detected Executive Director Supervision must determine the likely systemic consequences of an emerging crisis to assess whether the problems of the distressed bank have the potential to inflict damage on the financial system and, ultimately the wider economy. Guidance on identifying systemic importance of banks can be found in the *"Framework for Identifying Systemically Important Financial Institutions in Uganda"* approved by BoU Financial Stability Committee. In case the disturbance is judged not to result in systemic consequences, it will be resolved by the Executive Director Supervision in consultation with Governor's office. A crisis management team will be constituted to resolve disturbances with systemic consequences. The Executive Director Supervision is responsible for informing the Governor about the existence of a potential systemic financial crisis. The Governor will discharge the responsibility of resolving the crisis with the assistance of the crisis management team consisting of selected BOU Financial

identification to include: a rapid deterioration in the financial health of a bank already under close surveillance; news of a large unexpected loss; operational problems including systems-related issues; and a loss of confidence due to contagion from other distressed financial institutions.[572]

An important element in terms of the framework is the establishment of the Financial Sector Surveillance Committee (FSSC).[573] It is a high level policy organ whose purpose is to provide a mechanism for the Ministry of Finance, Planning and Economic Development and all the financial sector regulators to discuss issues pertaining to the stability of the Ugandan financial system. It will provide policy advice to members and ensure coordinated actions on reducing systemic risk, enhancing the stability of the financial sector and coordinating financial crisis management arrangements. FSSC meetings will be held semi-annually, but extraordinary meetings will be held when need arises. The mandate of the FSSC is drawn from the Memoranda of Understating (MOUs) between the members.[574]

5.2.1 BoU'S power to impose corrective action measures in times of bank distress

In terms of legal implications, part IX of the FIA 2004 empowers BoU to intervene in the affairs of a bank when BoU believes or finds that the affairs of the financial institution are conducted in a manner that is detrimental to the interests of the depositors, prejudicial to the interests of the financial institution or in contravention of the Act. In terms of section 82 of the FIA, if the

Stability Committee (FSC) members, the Executive Director Finance and specialist staff. The Governor will also ensure that the BOU Board is kept informed of developments and, where appropriate, seek their approval for remediation plans. The Governor will also keep the Government informed as, and when, appropriate and ensure that the BOU also engages with FSSC members. Once a material event is identified, BOU will be required to intensify supervisory activities until the matter is resolved. The crisis management team will comprise of the following FSC members or their alternates: Governor; Deputy Governor; Executive Director Supervision; Economic Advisor to Governor; Executive Director Operations; Executive Director Research; and Executive Director Finance.

[572] Where the problems are already known to the market, the time-table for assessing the magnitude of the problem and for decision-making will be extremely tight. The Executive Director Supervision will be charged with providing the crisis management team with a summary of the known facts and for providing a preliminary assessment of the distressed bank(s) liquidity and solvency positions. In the discussion under this chapter, I use "bank" and "financial institution" synonymously.

[573] The Chair of the Committee is the Minister of Finance, Planning and Economic Development. The Alternate Chair is the Governor BoU. The Executive Director Supervision at BoU is the secretary. The membership of the High Level Policy Committee includes the heads of the Capital Markets Authority (CMA), Insurance Regulatory Authority (IRA), Uganda Retirement Benefits Regulatory Authority (URBRA) and other regulatory agencies invited by the Committee.

[574] Appendix 2 of the BoU Financial Crisis Management Framework outlines the Financial Sector Surveillance Committee (FSSC) Terms of reference. It will have a Technical Sub Committee, which will implement the decisions of the High Level Policy Committee, analyse developments in the financial sector and prepare relevant reports.

Central Bank has reason to believe or finds that the affairs of the financial institution are conducted in a manner detrimental to the interests of the depositors, prejudicial to the interests of the financial institution or in contravention of the FIA, or any other written law or that the financial institution has refused to submit to inspection, or has provided false information, the BoU may order in writing that the financial institution takes remedial action to comply with the FIA or regulations, notices or orders issued under the Act.

The Central Bank may also issue directions regarding measures to be taken to improve the management, financial soundness or business methods of the financial institution; require the directors or management of the financial institution to execute an agreement concerning their implementation of orders or directions issued by BoU; or perform or appoint an agent to perform a special examination of the financial institution to determine the financial condition of the institution and evaluate resolution options, at the cost of the financial institution. Where the financial institution fails, refuses or neglects to comply with an order, directive, or agreement issued or made above, then the BoU has further powers, *inter alia*, to appoint a person suitably qualified and competent in the opinion of the BoU to manage the affairs of the financial institution for such period as shall be necessary to rectify the problem.

As pointed out above, the BoU has wide discretionary powers in its tool kit in the event of bank distress. It further retains the mandate to modify, cancel or uphold any of the orders issued above.[575] Another novel provision that pertains to the Ugandan bank regulatory regime is the legislative intervention of prompt, mandatory corrective actions taking precedence over any discretionary corrective actions available to the BoU under the FIA or any other law.[576] It is submitted that this provision could be informed by the history of bank failures in Uganda and the lessons learnt from the exercise of BoU's resolution mandate as discussed in the introductory section of this research chapter. These prompt mandatory corrective actions are discussed hereunder.

[575] In terms of section 83 of the FIA, the central bank may, upon representation made to it or on its own motion, modify or cancel or uphold any order issued under section 82, and upon such modification or cancellation, impose such conditions as are necessary subject to which the modification or cancellation shall have effect.
[576] In terms of section 84 of the FIA, the prompt, mandatory corrective actions prescribed in sections 85 to 87 of the Act take precedence over any discretionary corrective actions available to the central bank under the Act or any other law.

In terms of section 85 of the FIA, where a financial institution which is adequately capitalized has incurred or is likely to incur large losses within any financial year, the BoU must prohibit the financial institution from declaring and distributing any dividends which are in the opinion of the central bank likely to cause the financial institution not to comply with the capital requirements and undertake more frequent inspection of that financial institution.[577] According to the 2016 amendment to FIA, the BoU is mandated to prohibit the financial institution from making any other distributions, bonuses, or increments in the salary, emoluments or other benefits of all directors and staff of the affected financial institution.[578] In addition to these prompt and mandatory corrective powers in respect of adequately capitalized banks, BoU may require the directors or management of the financial institution to provide a written explanation detailing the causes of those losses and the measures to be taken by the financial institution to rectify the position and avert future losses.[579]

If the bank is under-capitalized, the BoU must take all of the actions prescribed in section 85(1), that is to say, prohibit the financial institution from declaring and distributing any dividends which are in the opinion of the central bank likely to cause the financial institution not to comply with the capital requirements, undertake more frequent inspection of that bank and prohibit salary increments, emoluments, bonuses and other benefits to management and staff; order the financial institution to submit to the central bank within forty five days after the making of the order, a capital restoration plan to restore the financial institution to capital adequacy within one hundred and eighty days of making such order; and prohibit the bank from awarding any bonuses or increments in the salary, emoluments and other benefits of all directors and officers of the financial institution.[580]

In additions to the above powers, the Central Bank may appoint a person who in the opinion of the BoU is suitably qualified and competent to advise and assist the financial institution in designing and implementing the capital restoration plan, and the person appointed must regularly

[577] The capital requirements are prescribed in sections 26 and 27 of the FIA. The Financial Institutions (Revision of Minimum Capital Requirements) Instrument No. 43 of 2010 in accordance with section 26(5) of the Financial Institutions Act 2004 revised the minimum capital threshold requirements.
[578] Section 85(1)(c) is inserted by section 29 of the Financial Institutions (Amendment) Act, 2016.
[579] Section 85(2) of the FIA. Section 29(b) of the 2016 amendment to the FIA defines large losses as any loss that constitutes twenty five percent of the financial institution's core capital.
[580] In terms of section 86(1) of the FIA, an under-capitalized financial institution is one which does not comply fully with any or all of the capital requirements prescribed in sections 26 and 27 of the Act or any of the ministerial statutory instruments modifying the capital requirements made under the auspices of these provisions.

report to the BoU on the progress of the capital restoration plan.[581] In terms of section 83(4) of the FIA, where a distressed bank has been ordered by the central bank to submit a capital restoration plan or to recapitalize and the financial institution fails, refuses or neglects to comply with the order, or to implement the capital restoration plan, the BoU must prohibit the financial institution from opening new branches; impose restrictions on growth of assets or liabilities of the financial institution as it shall deem fit; and restrict the interest rate on savings and time deposits payable by the financial institution to such rates as the BoU shall determine.

In addition to the above powers, the BoU may remove officers of the financial institution responsible for the financial institution's noncompliance with the Central Bank's directives and order the financial institution to do any or such other action that the Central Bank may deem necessary to rectify the capital deficiency of the financial institution.[582] The law also addresses what the BoU must do in scenarios of significantly undercapitalized banks.[583] In such circumstances, the BoU can take any or all of the actions discussed above.[584] It can also enter into an agreement with the board of directors of the financial institution requiring the financial institution to rectify its significant under-capitalization within ninety days, and to restore capital adequacy within one hundred and eighty days, or within such shorter periods as the central bank shall order.[585] In addition to these powers, the BoU may also restrict the financial institution from engaging in new foreign exchange business and/or prohibit the financial institution from engaging in new off balance sheet transactions.[586]

It is important to note that if, after the given period of days, the financial institution fails to raise its capital to the levels necessary to rectify its significant under-capitalization, or before expiry of the given time period, BoU can close the financial institution and place it under receivership. In the alternative, where the closure of the financial institution would pose a systemic risk to the

[581] Section 86(3) of the FIA.
[582] Section 86(4) (d) of the FIA.
[583] In terms of section 87(4) of the FIA, a significantly under-capitalized financial institution is one which does not hold the minimum capital funds unimpaired by losses of at least fifty percent of the legally required capital; or does not hold core capital of at least fifty percent of the requirement prescribed in section 27 of the FIA or any other modifying statutory instrument; or where a financial institution does not hold total capital of at least fifty percent of the requirement prescribed in section 27 of the FIA.
[584] Reference is made to any or all of the actions prescribed in sections 86 and 87 of the FIA. However, the 2016 amendment to the FIA expressly repeals section 86(2) (c) of the Principal Act.
[585] Section 87(1) (b) of the FIA.
[586] Section 87 (2) of the FIA.

stability of the financial system, the central bank can take the financial institution into statutory management in order to mitigate the systemic effects of bank collapse and ensure depositor protection if the financial condition of a distressed bank continues to deteriorate.[587]

5.3 BoU's statutory management powers in times of bank distress

The most intrusive rescue-based provision under the FIA is the Central Bank's power to exercise a management take-over in respect of a bank or financial institution under section 88 if, *inter alia*, the continuation of its activities is detrimental to the interests of depositors. It is imperative to note that in relation to the topic under discussion, bank distress can be categorized as detrimental business conduct prejudicial to interest of depositors, thus warranting exercise of statutory management control by the central bank.

Where the Central Bank takes over the management of a financial institution under this provision, the law imposes certain conditions to smoothen the managerial transition period. These statutory conditions are that: any term, whether statutory, contractual or otherwise, on the expiration of which a claim of right of the financial institution would expire or be extinguished, must be extended by six months from the date of the central bank taking over management; any attachment or lien existing six months prior to the take-over by the central bank of the management of the financial institution shall be vacated and no attachment or lien except a lien created by the central bank shall attach to any property or asset of the financial institution as long as the central bank continues to manage the financial institution; any transfer of any asset of the financial institution made six months before the take-over by the central bank of the management with intent to effect a preference or at less than the appraised book value is voided; any gratuitous transfer of any asset of the financial institution made within one year before the take-over by the central bank of the management is revoked and all such assets must be surrendered to the central bank; any lending or credit accommodation to any officer, director or any related person of an officer or director on preferential terms or without adequate security made within

[587] In terms of section 87 (3) (b), the central bank shall not have to wait for the expiry of the statutory period to mature or lapse in order to close the financial institution and place it under receivership. Where the closure of the financial institution would pose a systemic risk to the stability of the financial system, the central bank must take the financial institution into statutory management in accordance with section 88 of the FIA; except that subsection (6) of section 89 of the Act which is to the effect that where the financial institution does not comply with prudential standards within six months after being placed under statutory management, the central bank shall close the financial institution and place it under receivership shall not apply to a statutory management sanctioned under the auspices of this section.

six months prior to the take-over by the central bank of the management of the financial institution must be rescinded; and that officer, director or related person to the officer or director must immediately refund the moneys advanced and the interest accrued at the going rate in the bank.[588]

In aspects of legal implication of BoU management take-over action, the Central Bank shall, on taking over management of a distressed bank under section 88 of the FIA, have exclusive powers of management and control of the affairs of the financial institution. This includes powers to continue or discontinue any of its operations as a financial institution notwithstanding the revocation of its license; stop or limit the payment of the bank's or financial institution's obligations; employ any necessary staff; execute any instrument in the name of the financial institution; initiate, defend and conduct in its name any action or proceeding to which the financial institution may be a party; reorganize or liquidate the financial institution in accordance with the FIA; appoint a statutory manager to manage, control and direct the affairs of the financial institution; assume or reject any executory contracts; cancel any leases or tenancy agreements entered into by the financial institution as lessee or tenant; appoint an advisory board of directors; close the financial institution; sell the financial institution; or do any other act which is necessary to enable the central bank to carry out its obligations.[589]

Imperatively, the FIA also outlines the practical elements of what should be done upon a take-over of the management of a bank or financial institution by the Central Bank. BoU must as soon as possible after taking over management of a financial institution, appoint an auditor at the cost of the financial institution to make an inventory of the assets and liabilities of the financial institution and submit a report to the central bank.[590]

Upon appointment of a statutory manager, the board of directors of the affected bank is suspended.[591] The statutory manager takes over the functions of the members of the board of

[588] Section 31 of the 2016 amendment to the FIA amends and substitutes section 88(2) (e) of the Principal Act.
[589] Section 89(2) of the FIA.
[590] Section 89(3) of the FIA. In terms of section 89(4), the central bank shall upon taking over management of a financial institution immediately inform the public. Section 89(5) makes it mandatory for the BoU to exercise statutory management over a financial institution for the minimum time necessary to bring the financial institution into compliance with prudential standards. In terms of sub-section 6, where the financial institution does not comply with prudential standards within six months after its being placed under statutory management, the central bank shall close the financial institution and place it under receivership.
[591] Section 89(8) of the FIA.

directors collectively and individually, including the board's powers of delegation and use of the seal until such a time as the central bank shall appoint an advisory board.[592] A statutory manager, upon assuming the management, control and conduct of the affairs and business of an institution, must discharge his or her duties with diligence and in accordance with sound banking and financial principles and, in particular, with due regard to the interests of the institution, its depositors and other creditors.[593]

Where a financial institution complies with the prudential standards within the period specified, the central bank shall request the shareholders of the financial institution to appoint an interim board of directors, charged with the management and control of the financial institution.[594] The interim board of directors appointed in terms of this provision shall hold office on such terms and conditions as may be prescribed in the instrument of appointment, and at the cost of the financial institution.[595] Where, within six months of its appointment, the central bank is of the opinion that the interim board of directors is managing the financial institution in accordance with prudential standards, the central bank shall request the shareholders of the financial institution to confirm the appointment of each eligible individual director.[596]

In terms of duties, the statutory manager is mandated to trace and preserve all the property and assets of the institution; recover debts and other sums of money due and owing to the institution; evaluate the capital structure and management of the institution and recommending to the Central Bank any restructuring or re-organization which he or she considers necessary and which, subject to the provisions of any other written law, may be implemented by him or her on behalf of the institution; enter into contracts in the ordinary course of the business of the institution, including raising of funds by borrowing on such terms as he or she may consider reasonable; obtain from any officers or employees of the institution any documents, records, accounts, statements or information relating to its business; issuing a new balance sheet and profit and loss accounts; and perform any other duties that may be assigned to him or her by the

[592] In terms of section 89(9) of the FIA, this power shall obtain where a statutory manager is appointed under the ambit of paragraph (g) of subsection (2) of this section.
[593] Section 89(10) of the FIA.
[594] Section 90(1) of the FIA is subject to sections 52 and 53 of the same Act.
[595] Section 90(2) of the FIA.
[596] Section 90(3) of the FIA is subject to section 52 of the same Act.

central bank.[597] For the purposes of discharging his or her functions above, the statutory manager may declare a moratorium on the payment by the institution of its liabilities to depositors and other creditors.[598]

However, there are some legally imposed factors the statutory manager must observe while exercising this mandate. The declaration of a moratorium must be applied equally and without discrimination to all classes of creditors. The moratorium declaration limits the maximum rate of interest which shall accrue on deposits and other debts payable by the institution during the period of the moratorium to the minimum rate as may be prescribed by the central bank by notice for the purposes of this provision except. However, this position must not be construed so to impose an obligation on the institution to pay interest or interest at a higher rate to any depositor or creditor than would otherwise have been the case. The declaration of a moratorium must also suspend the running of time for the purposes of any law of limitation in respect of any claim by any depositor or creditor of the institution, and must cease to apply upon the termination of the manager's appointment.[599] A statutory manager may for the purposes of exercising his or her duties require any person who has at any time been an officer or director of the financial institution to provide the statutory manager with information relating to business of the financial institution.[600]

Another interesting legal ramification relates to statutory conditions attached to the commencement of legal proceedings against a financial institution under management of the central bank. There is a legal bar on court action against the financial institution, except if the claimant seeks leave of court on the ground that he or she would be caused exceptional hardship if leave were not granted, or where the claimant obtains prior written consent of the central bank to commence or continue with any legal proceeding in any court against a financial institution

[597] Section 90(4) of the FIA.
[598] Section 90(5) of the FIA.
[599] Section 90(6) of the FIA. In case of a declaration of moratorium ceasing to apply by reason of termination of the manager's appointment, the rights and obligations of the institution, its depositors and creditors shall, except to the extent provided in paragraphs (b) and (c) of this section, be the same as if there had been no declaration under this subsection. Section 90(6)(b) of the FIA is amended and substituted by section 32 of the 2016 amendment to the FIA.
[600] Section 90(7) of the FIA. Any person who willfully fails, refuses or neglects to provide any information requested under subsection (4) of this section commits an offence and is liable on conviction to a fine not exceeding two hundred and fifty currency points or imprisonment not exceeding two years or both.

while the financial institution is under management of the central bank.[601] A party to a contract with a financial institution is not relieved of his or her obligations on the ground that the financial institution is under management of the central bank.[602] All costs of management by the central bank are payable by the affected bank or financial institution and are designated as a debt due from the financial institution to the BoU.[603]

The FIA provides for the liquidation of distressed banks by the BoU and also gives the option of financial institutions applying for voluntary liquidation under part XI of the Act. However, the scope of this power is outside the ambit of this research, whose major primacy relates to rescue procedures and mechanisms for distressed financial institutions. It is also imperative to note that there are recent case studies where the BoU has used statutory management take over, and liquidation of distressed financial institutions such as the National Bank of Commerce (NBC), Global Trust Bank (GTB) and Imperial Bank. I will briefly examine these few case studies.

a) National Bank of Commerce (NBC)

In exercise of its powers under Section 88(1) (a) and (b) of the FIA, BoU took over the management of NBC and suspended its management and the board on 27th September 2012 after BoU determined that the continuation of NBC's activities was detrimental to the interests of its depositors. All the accounts of the depositors were transferred to Crane Bank.[604] Interestingly from a legal perspective, this matter turned contentious and on 28th September 2012 the Constitutional Court issued an interim order seeking to restrain the sale of the assets or business of NBC (in liquidation), temporarily halting the BoU from implementation of the winding up order of NBC dated the 27th September 2012 and the suspension of the Managing Director of NBC.[605]

On 2nd October 2012, BoU issued a clarification in regard to the closure of NBC, in which it reasoned that an interim order, being negative in nature, can as a matter of law only maintain the

[601] Section 91 of the FIA. An application for leave under subsection (1) shall not be filed unless the central bank receives thirty days' notice of the intention to apply. The central bank may apply to the court to be joined as a party to the proceedings where leave to commence of continue legal proceedings is being sought.
[602] Section 92 of the FIA is to the effect that management by central bank does not offer relief from contractual obligations.
[603] Section 93 of the FIA.
[604] See press statement issued by Dr. Louis Kasekende, Deputy Governor BoU, accessible via https://www.bou.or.ug/bou/media/from_the_bank/BoU_Takes_Over_NBC.html (last visited on 9/5/16).
[605] *Humphrey Nzeyi vs Bank of Uganda & Attorney General, (Constitutional Application No. 1 of 2013)*.

status quo but cannot reverse it. It stated that NBC was closed by BoU as the regulator on the 27th September 2012 at 1.00 pm and all its three branches, being the Cargen House (Kampala Road), the Kabale branch, and the Head Office on Yusuf Lule Road, Kampala were physically seized, closed and put in the possession of BoU. NBC's banking license was eventually revoked by BoU pursuant to Section 17(f) of the FIA and, therefore, NBC could no longer carry out financial institutions business. Selected assets and all deposits of NBC were sold and assumed by Crane Bank Limited, which was duty bound to allow former NBC depositors to access their deposits. In light of the above, the Interim Order, in the circumstances, was incapable of any practical implementation other than restraining the calling for and payment of other creditors as aforementioned.[606]

It is imperative to note that the main case out of which the interim Application arose is still pending final disposal before the Constitutional Court of Uganda.[607] Its determination will give further guidance on the central bank powers of management take over and liquidation *viz aviz* the constitutional right to property enshrined under Article 26 of the Constitution of Uganda.

b) Global Trust Bank (GTB)

In 2014, it was discovered by BoU that GTB had made significant losses and was trading in violation of the FIA. Following take over by the central bank, its license was revoked on 25 July,2014 in accordance with sections 17(f), 89(2) (f) & (7)(c), and Section 99(1) of the FIA. In exercise of its powers as liquidator, BoU concluded a purchase and assumption agreement with dfcu Bank, in which dfcu took over all the deposits of GTB in full. The depositors were able to access their deposits and operate their accounts from any dfcu branch and the former GTB

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606 The press statement in which BoU clarified on the closure of the National Bank of Commerce (U) Ltd can be accessed via https://www.bou.or.ug/bou/media/statements/Status_of_NBC_Closure.html (last visited on 9/5/16). BoU further emphasized that the order was cast in doubt by Section 101(1) of the FIA, which is to the effect that notwithstanding anything to the contrary in any other law, a court shall not entertain any application for stay of proceedings in relation to the liquidation or winding up of a financial institution under the Act.

607 *Humphrey Nzeyi V Bank of Uganda & Attorney General, Constitutional Petition No. 44 of 2012*. Without determining the matters in the Constitutional Petition, the Uganda High Court has observed that The FIA does not have very elaborate provisions at what point the bank as a company is considered to have been dissolved following liquidation' however section 107 of the FIA does provide for the release of a liquidator after the BoU is satisfied that the liquidation process is complete. (See the ruling of Kiryabwire, J (as he was then) in *Hon. Justice Prof. Dr. George Kanyeihamba & 320 Others vs Amos Nzeyi & 2 Others, HCT-00-CC-CS-361-2010* accessible via http://old.ulii.org/ug/judgment/commercial-court/2013/78 (last visited on 9/5/16).

branches at Owino, Bwaise, Pallisa, Phaida, Nateete and Kikuubo the first working day of the week after the closure.[608]

c) Imperial Bank

On 13th October 2015, BoU invoked sections 88 and 89 of the FIA and took over the management of Imperial Bank Uganda Limited following the suspension by the Central Bank of Kenya (CBK) of the operations of Imperial Bank Ltd Kenya, who was the majority shareholder of Imperial Bank Uganda Ltd. The main purpose of the decision to take over the management of Imperial Bank Uganda was to safeguard the interests of the bank's customers in Uganda. This was initially a temporary statutory measure to allow for seamless operations as the affairs of the majority shareholder in Kenya were being resolved.[609]

However, after realizing that Imperial Bank Kenya had suffered massive insider fraud and would not resume soon, BoU ended its statutory management in Imperial Bank (Uganda) Ltd on 7th March 2016 and invoked its powers under sections 88 and 89 of the FIA to sell 58.6% ordinary shares of Imperial Bank (Uganda) Ltd, formerly held by Imperial Bank (Kenya) Ltd, to Exim Bank (Tanzania) Ltd. With this transaction, Imperial Bank (Uganda) Ltd changed its name to Exim Bank (Uganda) Ltd. Exim Bank (Uganda) Ltd also appointed a new Board of Directors. BoU informed the customers of Exim Bank (Uganda) Ltd, formerly Imperial Bank (Uganda) Ltd, and the public that the operations and services of Exim Bank (Uganda) Ltd were to continue normally.[610] The Imperial Bank scenario is interesting because it involved cross-border collaboration and information sharing between the Kenya Central Bank and its Ugandan counterpart. The lack of a cross-border distressed bank rescue plan between the two regulators could have played a role in taking the liquidation route as opposed to trying to salvage Imperial Bank. It is also imperative to note that all of the three case studies discussed above involved very small banks that were not systemically interconnected, and did not hold substantial deposits to pose any systemic threat to Uganda's banking sector.

[608] Refer to the Press Release issued by the Governor accessible via https://www.bou.or.ug/bou/bou-downloads/press_releases/2014/Jul/Closure-of-Global-Trust-Bank_July-25-2014.pdf (last visited on 9/5/16).
[609] See press release by the BoU Governor accessible via https://www.bou.or.ug/bou/bou-downloads/press_releases/2015/Oct/Imperial-Bank.pdf (last visited on 9/5/16).
[610] See BoU Governor's press release "Exim Bank (Uganda) Limited Takes over Imperial Bank (Uganda) Limited" accessible via https://www.bou.or.ug/bou/media/statements/Exim-Bank-Takes-over-Imperial-Bank.html (last visited on 9/5/16).

d) Crane Bank (U) Limited

On 20th October 2016, BoU took over management of Crane Bank in exercise of powers under sections 87(3), 88(1)(a) & (b) of the FIA upon determination that Crane Bank was a significantly under-capitalized financial institution whose operations posed a systemic risk to the stability of the financial system and continuation of the bank's activities would be detrimental to the interests of its depositors.[611] A statutory manager was appointed and the bank's Board of Directors was suspended. The bank's problems mainly arose from under-capitalization as a result of posting a consolidated pre-tax loss of 7.353 billion shillings ($2.14 million) in 2015, largely accruing from its fully-owned subsidiary in Rwanda.

It is noteworthy that unlike the most recent bank failures examined above, which involved small banks, Crane Bank is a domestically systemically important bank (D-SIB).[612] It is the country's third largest commercial bank by assets, which accounted for Ush1.2 trillion ($342 million) by the end of December 2015. At the time of completion of this research, Crane Bank is still under statutory management. However, there is an assurance from the BoU that the bank will remain open and its operations will continue normally after an injection of UGx. 200 billion by the government.[613] However, this bail out was done without a proper rescue framework and viability assessment as to whether Crane Bank will be rescued as a going concern. Presently, the Lombard window acts as the lender of last resort (LOLR) facility at BoU.[614] In the event of distress, the affected bank can apply to borrow from the Central Bank through the office of the Director of Operations. A copy of the application must also be submitted to the Director Financial Markets

[611] See Governor's press release accessed via https://www.bou.or.ug/bou/bou-downloads/press_releases/2016/Oct/PRESS-RELEASE-Crane-Bank-Oct-20-2016.pdf (last visited on 22/10/16).

[612] The D-SIBs at December 2015 were Stanbic bank, Standard Chartered bank and Crane bank. In 2015, Ugandan D-SIBs accounted for 35.9 percent of total banking sector assets. (See BoU Annual Supervision Report December 2015, pg. 17).

[613] Mark Keith Muhumuza (Daily Monitor), 'Government rescues Crane Bank with Shs200b' http://www.monitor.co.ug/News/National/Government-rescues-Crane-Bank-Shs200b/688334-3434320-e7cwpyz/index.html (last visited 1/11/16).

[614] Lombard credit refers to granting of credit to banks by Central Banks against pledged collateral such as securities or insurance policies. Further guidance on collateral eligible for borrowing from BoU beyond the standing facilities is the "Policy Paper on Levels of Collateral that Bank of Uganda Can Accept During a Financial Crisis" approved by BoU's Financial Stability Committee. The eligible collateral for borrowing BoU lending includes Government securities, Corporate bonds, promissory notes and Bills of exchange, reserves with BoU, Cash assets
ware house warrants, balances with banks abroad, bank loans, fixed assets, and income producing and cash flow positive real estate.

for monitoring purposes.[615] However, it is not clear whether the statutory manager can utilize this facility to rescue a distressed bank under statutory management.

In conclusion, the above case studies show that the approach of the BoU does not support rescue of distressed banks. Statutory management is done in haste, with a view of taking over management of the distressed bank and liquidating it. There is therefore a need to adopt a more rescue-oriented procedure whereby the BoU undertakes a deliberate intervention plan to revive a distressed bank and nurse it back to normal health as a going concern, just like the SARB did with African Bank.

5.4. THE EAST AFRICAN COMMUNITY (EAC) AND CROSS-BORDER BANK RESCUE: TOWARDS A REGIONAL CENTRAL BANKS' FAMEWORK

5.4.1. Bank regulation in an age of regional blocs: EAC regionalism and economic integration

The East African Community (EAC) is a regional intergovernmental organization of 6 Partner States: the Republics of Burundi, Kenya, Rwanda, South Sudan, the United Republic of Tanzania, and the Republic of Uganda, with its headquarters in Arusha, Tanzania. The work of the EAC is guided by its Treaty which established the Community. It was signed on 30 November 1999 and entered into force on 7 July 2000 following its ratification by the original three Partner States - Kenya, Tanzania and Uganda. The Republic of Rwanda and the Republic of Burundi acceded to the EAC Treaty on 18 June 2007 and became full Members of the Community with effect from 1 July 2007. The Republic of South Sudan acceded to the Treaty on 15 April 2016, making it the newest member to join the Community.[616] At the moment, the regional integration process is being implemented as reflected by the progress of the East African Customs Union, the establishment of the Common Market in 2010 and the implementation of the East African Monetary Union Protocol.[617]

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[615] In a BoU document entitled, "Rules Governing the Lombard and the Rediscount Window", certain conditions are laid out for any bank seeking to apply for this facility. For example, the applicant bank will only have access to the facility where the amount being applied for is not more than 25 percent of the Cash Reserve Requirement (CRR) of the commercial bank for that maintenance period. However, where the amount exceeds the CRR, the Governor may use his or her discretion to grant or reject the loan application. The term of the loan does not exceed three months.
[616] See the overview of the EAC accessed via http://www.eac.int/about/overview (last visited on 9/5/16).
[617] The East African Monetary Union (EAMU) is a project with potentially large long term benefits for all of the economies in the EAC but which also entails considerable risks. The long term success of EAMU will be dependent upon major changes to public policy and in the way in which public policy is made in all partner states of the EAC.

The East African Monetary Union (EAMU) Protocol was adopted in accordance with the EAC Treaty and signed on 30th November 2013. It lays groundwork for a monetary union within 10 years and allows the EAC Partner States to progressively converge their currencies into a single currency in the Community. In the run-up to achieving a single currency, the EAC Partner States aim to harmonize monetary and fiscal policies; harmonize financial, payment and settlement systems; harmonize financial accounting and reporting practices; harmonize policies and standards on statistical information; and establish an East African Central Bank.[618]

As discussed in the context of UK central bank and EU crisis resolution directives, this process will have legal implications for the EAC. For example, the comprehensive study on EAMU, conducted by the Consultants from the European Central Bank (ECB) and National Experts from the EAC Central Banks was concluded and validated in March 2010. The study designed model Monetary Union Protocol, a model East African Central Bank Statute, and a Model Statute for the EAC Monetary Institute, which is a precursor of the EAC Central Bank.[619] However, there is a need to develop a regional distressed bank rescue framework for cross-border banks originating from EAC member States.

A successful monetary union is only possible if each partner state is prepared to accept the pooling of its economic sovereignty. Many economic decisions which are now made at the national level will have to be made at the regional level. (See Remarks by Emmanuel Tumusiime-Mutebile, Governor of the BoU, at the opening of the East African Legislative Assembly Consultative Workshop on the East African Monetary Union, Kampala, 9 September 2013). This speech can be accessed via the Bank of International Settlements portal http://www.bis.org/review/r130923a.pdf (last visited on 10/5/16).

[618] Article 5(2) of the EAC Treaty stipulates that "....the Partner States undertake to establish among themselves and in accordance with the provisions of this Treaty, a Customs Union, a Common Market, subsequently a Monetary Union and ultimately a Political Federation in order to strengthen and regulate the industrial, commercial, infrastructural, cultural, social, political and other relations of the Partner States to the end that there shall be accelerated, harmonious and balanced development and sustained expansion of economic activities, the benefit of which shall be equitably shared...."
The signing of the protocol for the East African Common Market, which came into effect on July 1st, 2010, has incr eased the importance of harmonizing financial regulations at the regional level and strengthening cooperation be tween the financial regulators in the EAC. Within the EAC, responsibility for the harmonization of financial sec tor policy and regulation lies with the Monetary Affairs Committee (MAC). Under the program which MAC ini tiated to harmonize supervision methodologies within the EAC, supervisors from each central bank participa ted in on-site bank inspections carried out by their counterparts in other EAC countries.

[619] These instruments were adopted by the EAC Council of Ministers as a basis for the EAC Monetary Union negotiations. The High Level Task Force (HLTF) to negotiate these legal instruments was constituted and negotiations commenced in 2010/11. During the year, a client-based RTGS system was upgraded to a web-based system with richer functionality, local foreign currency clearing (LCFF) was implemented and the user requirements for the East African Cross Border Payment System (EAPS) were finalized in 2009/10. Implementation of EAPS has become a strategic imperative in view of the increasing regional economic integration and the planned establishment and operationalization of the EAMU. BoU also successfully upgraded the Real Time Gross Settlements (RTGS) system used to effect interbank payments in real time. The new system became operational in August 2009 and will be the basis for regional initiatives to facilitate cross-border payments in the EAC.

5.5. Chapter Conclusion

By and large, Uganda's banking sector regulation has evolved from a history characterized by bank failures and poor corporate governance. The reforms in the crisis management framework are constantly evolving as the banking population increases and the industry grows. It is important to observe that the BoU Crisis Management Plan is still a work in progress. It still needs to continue to be reviewed and updated as the financial crisis management framework is enhanced to include tools for working with other financial sector regulators to expand the scope to other financial sectors such as insurance, capital markets and pensions.[620] Other enhancements include reviewing the eligible collateral for BoU exceptional liquidity assistance (ELA), to clarify the policies for perfecting BoU's interest in the collateral, and the maturity of ELA lending in times of bank distress.[621]

BoU will also develop a policy requiring Domestically Systemic Important Banks (D-SIBs) to prepare firm specific recovery and resolution plans to supplement the regulators Financial Crisis Management Plan.[622] D-SIBs are required to hold an additional loss absorbency capital buffer of 1-3.5 percent of risk weighted assets (RWAs).[623] The 2013 Ministerial Instrument empowers the BoU to designate a commercial bank as a D-SIB and impose, remove and/or vary the level of the

[620] This is critically important because the 2016 amendment to the FIA introduces bancassurance. Allowing banks to do insurance business calls for proper regulation and supervision of the financial institutions to check market abuse and systemic contagion spread building up from one department and spreading to the entire financial system. The ongoing debates about pension sector liberalization and reforms at the Uganda Retirement Benefits Regulatory Authority (URBRA) and the National Social Security Fund (NSSF) also call for more coordinated approach in regulation, mixed with adequately trained and specialized human resource to execute the important mandate that comes with the growth, opportunities and challenges in the finance sector. Also, the other institutions such as the Financial Intelligence Authority (FIA) introduced under the Anti Money Laundering Act, 2013 are critical players in oversight of the integrity of the financial sector.

[621] There is a *"Policy Paper on Levels of Collateral that Bank of Uganda Can Accept during a Financial Crisis"* approved by BoU's Financial Stability Committee. It lists Government securities, corporate bonds, Promissory notes and Bills of exchange, Reserves with BoU, Cash assets, Ware house warrants, Balances with banks abroad, Bank loans, fixed assets and Real estate (income producing and cash flow positive) as the assets banks can collaterize to secure liquidity during a financial crisis.

[622] The Financial Stability Board (FSB, 2010) defines a systemically important financial institution (SIFI) as a firm, market or instrument whose failure, because of its size, complexity and systemic interconnectedness, would cause significant disruption to the financial system and economic activity. Similarly, under the Dodd-Frank Act, the US Financial Stability Oversight Council (FSOC) can designate an institution as a SIFI if its material financial distress or whose scope, size and scale of activities could pose a threat to the financial stability of the United States. A non-bank financial company can be designated a SIFI if it predominantly engages in financial activities that either: (i) its annual revenues derived from financial activities represent 85 percent or more of its consolidated annual gross revenues, or (ii) its assets related to financial activities represent 85 percent or more of its total consolidated assets.

[623] Risk-weighted asset is a bank's assets or off-balance-sheet exposures, weighted according to risk. This sort of asset calculation is used in determining the capital requirement or Capital Adequacy Ratio (CAR) for a financial institution. Under Basel III, banks should hold enough capital to equal at least 8% of risk-weighted assets.

SIBs capital requirement based on its assessment of the systemic importance of the bank. The Instrument also requires the BOU to prescribe the framework it will use to identify and designate SIBs. In June 2013, the Bank's Financial Stability Committee (FSC) discussed and approved the publication of the proposed criteria for designating D-SIBs.[624]

Study of the FSB's 'bail-in capital' proposals for possible adoption to increase the available funds for resolution of systemic institutions will also be undertaken. Presently, the BoU has recourse to the Deposit Protection Fund (DPF).[625] This fund is a deposit insurance scheme for customers of contributing financial institutions, can act as a receiver or liquidator of a financial institution if appointed by BoU, and can perform any other functions conferred by law.[626] Every financial institution contributes to the Fund.[627] Another crucial aspect discussed above is the harmonization of the crisis management framework with those of other countries in the EAC region.

CHAPTER SIX

6.1 RECOMMENDATIONS AND CONCLUSION

Generally, Central Banks have been viewed as the appropriate authorities to oversee bank rescue, especially in view of their inherent Lender of Last Resort (LOLR) powers. Post GFC, the comprehensive financial stability mandate assigned to Central Banks also puts them in a prime position to deal with the issue of bank rescue and recovery. In the UK and South Africa, the BoE

[624] The policy measures pertaining to D-SIBs are intended to enhance the BoU's macro-prudential toolkit for mitigating systemic risk. The broad aims of the policy are threefold; to reduce the probability of the failure of D-SIBs by requiring them to hold more capital, to reduce the cost of failure of D-SIBs by improving recovery and resolution planning and, to improve the resolvability of D-SIBs through early intervention, bail in tools and crisis recovery and management arrangements. Reforms by the Basel Committee and other authorities to reduce moral hazard are underway internationally. It is a Basel Committee regulatory requirement that all jurisdictions should put in place a policy framework to reduce the risks and externalities associated with domestic and global systemically important financial institutions in their jurisdictions. In addition, SIBs resolution regimes and supervisory frameworks and policies will be the subject of FSB thematic or country peer review assessments for all member jurisdictions and they will also be assessed as part of the IMF/World Bank Financial Sector Assessment Program (FSAP) (FSB 2010). The BoU utilizes an indicator framework based on the guidelines issued by the BCBS (2010) and IMF (2011) to measure the systemic importance of Ugandan banks and to designate D-SIBs. This framework will utilize four indicators; size, degree of substitutability, interconnectedness and complexity. It should be noted that while the Basel Committee proposed an additional indicators such as cross-jurisdictional activity in identifying G-SIBs, it is excluded in identifying D-SIBs because it is not directly relevant since it measures the degree of global (cross-jurisdictional) activity of a bank, which is not the focus of the D-SIBs framework.

[625] This Fund is established in terms of section 108 of the FIA. The 2016 amendment saves its existence and designates it as a separate legal entity from the BoU with capacity to sue and be sued in its own name.

[626] Section 109 of the 2016 amendment to FIA establishes the purpose of the Fund.

[627] The criterion for contribution is spelt out by section 111 of the 2016 amendment to the FIA.

and the SARB will play this role in collaboration with the Prudential Authorities. In assessing the jurisdictions that entail the scope of the research, I will make specific recommendations on how BoU can learn from the South African and the UK legal dispensations to foster the required regulatory change from a bank liquidation culture to a rescue culture in deserving circumstances. The reason for advocacy on bank rescue is rooted in the notion that modern insolvency law recognizes rescue procedures for companies (which are private entities in nature and may not even be systemically important). Therefore, there is need for such procedures to be available to distressed banks that have temporary liquidity problems because there is a wider public interest in banks, and they play crucial socio-economic roles in the economy.

6.1.1 General observations and benchmarks of a suitable bank rescue regime

As earlier noted, the major objective of this procedure is to rescue the bank as a going concern. The rationale for this intervention is public interest. It is generally acknowledged that banks are public companies in the sense that they deal with funds mobilized from the general public. Banks also carry out their business in a wider financial market, whose stability is of concern to the wider public. Therefore, there is a need to protect not only depositors, but also the public interest. In discharging this mandate, Central Banks have to look at a wider multi-stakeholder approach that puts into consideration the financial stability mandate, interests of bank employees and concerns of the creditors.

Furthermore, it is also important to note that in such bank distress scenarios, time is of the essence because any further delays can lead to greater loss and cause deterioration of the financial system through contagion spread. This calls for more legal certainty and more specific attention in regard to the proper benchmarks, hallmarks and features of a suitable bank rescue regime. The guide formulated here is based on the comparative study undertaken in the course of this research. However, it is acknowledged that practical implementation of the rescue powers might differ depending on the size or complexity of the affected financial institution, and the nature of the distress. Generally, an ideal rescue regime must have the major essential features discussed here below.

The law must clearly define the entrance requirement that must be existent in any bank to benefit from this rescue remedy. The test of “financial distress” such as inability to pay depositors or meet other financial obligations such as payment of creditors and other contractual obligations must be clearly defined. For solvency assessments, the cash-flow test and the balance-sheet test as are customarily known in insolvency practice can be applied to situations of bank distress.[628]

Secondly, a suitable rescue regime must have a filter mechanism that aids the Central Bank staff in determining or assessing the entities that qualify for such intervention. Basing on the comparative study undertaken in the course of this research, I would recommend the existence of reasonable prospect or viability that the affected bank can be rescued as a going concern as one of the major tests because scarce Central Bank resources should not be expended in vain. If the distress is a result of massive capital and liquidity impairments that the bank is at the point of no return, then resolution is a more prudent course of action than rescue.

Related to the above, the legal framework should encompass determining factors of which entities will be beneficiaries of the rescue powers. It is acknowledged that not all banks are systemically important. However, as the case of African Bank indicates, even the non-systemically important small financial institutions can have a unique role in the market, for instance providing credit access to low income earners in a market segment that the other banks might consider too risky to operate in. Therefore, an ideal rescue policy must be all encompassing and factor in all the relevant socio-economic considerations such as need for credit access and financial inclusion. The rescue remedy must not be deployed as an exclusive tool for only the large and complex institutions considered as “too big to fail”.

A proper rescue mechanism should also provide for legal bars or prohibitions that disentitle a financial institution from benefiting from this special remedy. For instance, a bank may not benefit from bank rescue where there is evidence of fraud, egregious imprudent conduct in violation of banking laws and hiding or concealment of material information concerning the bank’s governance, assets and liabilities. The law does not condone fraud and illegality. This would strengthen compliance within the institutions and reduce moral hazard.

Like any other legal remedy, there must be an outlined procedure on how the rescue regime should work and the major role players in the process. Most fundamentally, there must be a

[628] Under the cash flow test, the bank is unable to pay its debts or depositors claims as they fall due. According to the balance-sheet test, the value of a bank’s assets is less than the amount of its liabilities, taking into account the bank’s contingent and prospective liabilities.

process on who can trigger the remedy. Basing on the comparative analysis undertaken in the course of this research, the respective legal dispensations have kept this as a preserve of the Central Banks. In South Africa, it is the Registrar of the SARB who triggers the curatorship procedure. In Uganda, the BoU's Supervision Department has powers to recommend invoking of statutory management powers. However, in my view, the process must also be open to the top managers of distressed banks to come up and disclose how the entities they are presiding over have financial difficulties, the nature of the distress, and expressly indicate that they are desirous of entering a rescue procedure by submitting a rescue plan to the Central Bank. Such voluntary action would ensure better co-operation and disclosure between the Central Banks and the affected banks. It would end the stigma surrounding rescue applications and reduce bank failure.

Other procedural aspects that must be considered include proper designation of a suitable person or persons to manage the rescue process. These should be qualified insolvency practitioners with expertise in business rescue, restructuring and turn-around. The orientation of a practitioner whose approach has transitioned from a liquidation culture to a rescue culture is very crucial in this process. Secondly, there is a need for a multi-disciplinary approach involving a skills mix of various professionals working together to rescue the distressed entity. In the African Bank case, the skills pool of accountants, auditors, lawyers and underwriters was very critical to ensure that the curatorship was implemented in a compliant manner that considered all the rights and interests of the various stakeholders involved. The mode of appointment (whether by letter or ministerial instrument) and the appointing authority must also be addressed together with all the attendant legal requirements such as public notice through the gazette and/or media of wide circulation.

The duties of the rescue practitioner must be codified to ensure legal certainty. Usually, these would be the general duties. For specific duties, the law should empower the appointing authority to assign to the rescue practitioner specific duties that he or she must undertake in relation to the process of rescue. But generally, the rescue practitioner must have the duties of collecting all the bank's assets, summoning meetings of creditors, keeping the requisite books of accounts and records as are necessary during the rescue period, and co-operate with the people appointed to help him and Central Bank staff to ensure smooth running of the institution during the rescue process.

Another very important benchmark aspect is specific provision for the powers of the rescue practitioner as he or she exercises his or her mandate. The rescue practitioner must have the authority to:

(a) Take possession of all the bank's assets.
(b) Make and receive payments for and on behalf of the bank.
(c) Cancel, terminate or postpone any contractual obligations of the bank under rescue if such course of action is in the best interest of the bank.
(d) Convene meetings of creditors from time to time to ascertain the nature and extent of the bank's indebtedness.
(e) Enter into compromises and set-offs with creditors and depositors with a view of stabilizing the business flow of the bank.
(f) Propose restructuring and rescue plans to the Central Bank to aid the business turnaround process.
(g) Negotiate with any creditor or bondholder of the bank with a view of obtaining a full and final settlement of claims.
(h) Initiate and defend legal proceedings on behalf of the bank.
(i) The rescue practitioner must also have power to declare moratoriums on payments, dividends, legal proceedings and other claims so as to give the bank some "breathing space" to re-organize its operations and meet the pending obligations at a later date.
(j) He or she must also have the power to free up the bank's assets that might have been transferred, sold or disposed of in a manner detrimental to the bank's operations.
(k) The power to summon any manager or employee of the bank to provide information, records and data relating to the bank's business must also be provided for.
(l) Because the bank is an entity in distress, the rescue practitioner must be given power to raise funds from the Central Bank in exercise of its lender of last resort function after furnishing security for such funds.
(m) Perhaps the most important aspect relates to provision for the curator's power to transfer assets and liabilities of a bank in its ordinary course of business. Without such powers, the rescue practitioner would be constrained in his or her operations to rehabilitate the bank. The rescue practitioner must have the mandate to create a "bad bank" and a "good bank". The non-performing loans should be bundled up in the "bad bank" and the

performing loans put in the "good bank". The "good bank" is the entity to be rescued, while the "bad bank" is written off.

In order to safeguard against the abuse of such powers, there must be proper checks and balances to ensure accountability on the side of the rescue practitioner. The law must address how this power should be exercised. For instance, there should be proper guidelines on the exercise of the oversight function by a designated senior official in the Central Bank, requirements on the issuing of directives to be followed by the rescue practitioner, duty to report on any actions taken by the rescue practitioner during meetings and through written reports. The basis for any managerial action must be reported and the rationale or justification as to how it is in the best interest of the affected bank, its depositors, creditors or shareholders must be stated. Approval of the Finance Minister on matters relating to expenditure of any monies from the fiscus must be sought so as to create political oversight. The process should not be clogged too much with political functionaries so that political influence and interference are minimized.

It must be emphasized that a bank rescue procedure is a means to an end (rescuing the bank to operate again as a going concern), but not an end in itself. Therefore, any liquidity assistance provided must be to support this objective. To reduce moral hazard, it must augment bail-in. There must be adequate cram down powers given to the rescue practitioner to enable the creditors to roll over their short-term claims or to engage in a formal debt restructuring and burden sharing with a troubled bank. The aim of this process must be to avoid a bank bail-out where the costs of the losses are transferred to the tax payer. Rescue should be a process to underwrite bail-in.

The success of the "Good Bank" and "Bad Bank" restructuring plan depends on critical factors such as the nature and extent of the distress, the skills available to handle such instructions, and public confidence in the entire banking system. Therefore, Uganda should expressly define the proper parameters of government intervention required. The Central Bank must also have a contingency plan on how the toxic assets will be valued, managed and removed from the affected bank's system without contaminating other financial institutions or the financial system as a whole. A proper legal regime must be set up to ensure predictability in cost, liability, incentives and risk allocation in regard to distressed bank rescue emergency intervention programs.

Concerning the term or the duration a rescue procedure should last, different jurisdictions have taken different approaches in regard to timelines imposed on regulators to handle the affairs of a distressed bank. For example, Uganda has capped it at six months. However, this may be too restrictive especially where the bank involved is large and complex. There is a need for flexibility in regard to timing. The rescue practitioner and the Central Bank should have enough discretion to report on the affairs of the bank and provide a monthly basis as to why they believe there is viability that the entity will be rescued as a going concern. The case of African Bank shows that once a loss mitigation plan is in place, the restructuring and curatorship process can be long and arduous. The size of the entity, the nature and extent of the distress that it is suffering from must be put into account so as to create enough time to produce the desired outcomes.

The process should be an out of court process to save costs and time. The essence of moratoriums on legal proceedings and creditors' claims is to give the company some "breathing space" to re-organize internally and meet these obligations at a more favorable future date. The parties and various stakeholders involved should not be allowed to interfere with the process, and the execution of the rescue practitioner's mandate through court procedures. The court's role should be minimal and restricted to aspects such as the removal of an inefficient rescue practitioner. After the lapse of the moratorium, creditors can also approach the court if they desire to challenge an administrative decision of the rescue practitioner on any of the grounds available under contract law or public administrative law.

The legal framework should specify circumstances under which the appointment of the rescue practitioner lapses. Instances such as incompetence, dishonesty and conflict of interest should bring to an end his or her role in the process. The procedure to follow to trigger this exit must also be specified, and the designated officer of the Central Bank who can invoke it must be ascertained. The procedure by way of an Application brought by the Registrar before the High Court specifying the grounds for an order of removal or termination of the rescue practitioner's mandate is ideal. This must be done in a manner that does not delay or jeopardize the rescue process. Withdrawal of the mandate from the rescue practitioner by the Central Bank, and winding up of the bank are some of the instances under which the rescue practitioner may be discharged of his or her obligations.

Uganda should consider creating an independent prudential regulation authority within BoU to specifically handle the prudential regulation of banks and the ring fencing of bank business structures. The prudential authority can be carved out of the existing Bank Supervision Department. Bank supervision is a very wide concept, and thus, creation of a specialized regulator to handle prudential regulation will bring closer scrutiny, monitoring and enforcement of standards to ensure the prevention of bank distress, and where such distress has occurred, a specialized regulator would be more responsive. This should be augmented by training and refresher courses of staff in order to enhance knowledge and foster attitudinal change to adopt evolving trends in modern bank rescue procedures.

It is further proposed that BoU should issue a directive for the large banks to separate corporate and investment banking from personal or consumer banking in order to easily monitor the financial soundness of banks. Ring-fencing also helps with easy identification of the cause of distress so that the regulatory authorities can save the "good" part that can be saved, and dispose of or resolve the "bad" portfolio that cannot be saved. There must be an elaborate legal framework that governs capitalization or underwriting of the bad book, asset selection, valuation, asset management and disposal.

Bank rescue must be supported by other procedures, such as a commission of inquiry into the affairs of a distressed bank as it is under the South African law. The objective of this is to bring persons liable for the distress to book. In the case of fraud, criminal prosecution can be considered. Where there is gross negligence by the directors or management, the named culprits can be discontinued from the affairs of running the bank and/or banned from managerial and/or directorship roles for a specified period. Using such reports as evidence, the claimants would be empowered to bring damages claims against the negligent managers and directors. This would in turn have a deterrent effect on future reckless business conduct and/or fraud. An inquiry would also come up with solutions to the root cause of the distress.

By and large, the rescue process must not be too rigid. The curator must have a flexible mandate in order to cater for specific situations likely to occur as a result of this process because not all bank rescues will be alike. The practitioner must therefore have the requisite powers and mandate to implement structural and business changes in order to achieve a successful rescue.

A TABULAR REPRESENTATION OF THE DISTRESSED BANK RESCUE MECHANISMS IN SOUTH AFRICA, UK AND UGANDA

Country	**South Africa**	**UK**	**UGANDA**
Nature of the rescue powers	Curatorship	Administration	Statutory management
Conditions under which the rescue powers will be	Inability of a bank to repay customers' deposits when legally obliged to do so or probability that it will be unable to meet any other of its obligations. The appointment is done by the Registrar of Banks.	Process triggered by bank's inability to pay its debts. A bank liquidator who thinks that administration would achieve a better result for the bank's creditors as a whole than bank insolvency can apply to the court for an administration order. The administrator must make the application after satisfying three	BoU may exercise the statutory management power on its own, or appoint a statutory manager. In the context of rescue, this power is exercised if the continuation of the bank's activities is detrimental to the interests of depositors.

invoked		conditions- firstly, the liquidation committee must have passed a full payment resolution. Secondly, the liquidation committee must have made a resolution that moving to administration might enable the rescue of the bank as a going concern. Lastly, the bank liquidator must be satisfied, as a result of arrangements made with the FSCS that any depositors still eligible for compensation under the scheme will receive their payments or have their accounts transferred during administration. In terms of normal	

		administration, the administrator's objectives are to rescue the residual bank as a going concern, or achieve a better result for the residual bank's creditors as a whole than would be likely if the residual bank were wound up without first being in bank administration	
Legal effect of appointment of a rescue practitioner	The management of the bank concerned vests in the curator, subject to the supervision of the Registrar, and any other person vested with the management of the affairs of that bank is divested thereof. The curator recovers and takes possession of all the assets of the	Dismissal of pending winding-up petition. Dismissal of administrative or other receiver. Moratorium on insolvency proceedings. Moratorium on other legal processes.	Management powers vest in the statutory manager or the Central Bank, which assumes exclusive powers of management and control of the affairs of the financial institution. Any term whether statutory, contractual or other-wise on the expiration of which a

	bank.		claim of right of the financial institution would expire or be extinguished is extended six months from the date of taking over management. Any attachment or lien existing six months prior to the takeover by the Central Bank of the management of the financial institution is vacated and no attachment or lien except a lien created by the Central Bank, shall attach to any property or asset of the financial institution as long as the Central Bank continues to manage the financial institution.

			Any transfer of any asset of the financial institution made six months before the takeover by the Central Bank of the management, with intent to effect a preference or at less than the appraised book value is void. Any gratuitous transfer of any asset of the financial institution made within one year before the takeover by the Central Bank of the management is revoked and all such assets must be surrendered to the Central Bank. Any lending or other credit accommodation to any officer, director or any related person

			of an officer or director on preferential terms or without adequate security made within six months prior to the takeover of the management is rescinded; and that officer, director or related person to the officer or director must immediately refund the moneys advanced and the interest or other economic return accrued at the going rate in the bank. There is requirement for leave of court or prior consent of BoU for anyone to bring legal proceedings against a bank under statutory management.
	The curator must		The statutory manager

Powers and duties of the rescue practitioner	conduct the management as the Registrar may deem to best promote the interests of the creditors of the bank concerned and of the banking sector as a whole and the rights of employees. Curator has the power to bring or defend in the name and on behalf of the bank any action or other legal proceedings. The curator can dispose of any of the bank's assets, transfer any of its liabilities, or dispose of any of its assets and transfer any of its liabilities in the ordinary course of the bank's business.	A bank administrator must aim to rescue the bank as a going concern unless he or she is of the opinion either that it is not reasonably practicable to achieve it, or winding up the bank without first placing it in administration would achieve a better result for the residual bank's creditors as a whole. A bank administrator may do anything necessary or expedient for the pursuit of the rescue mission or objective. Administrator must exercise management powers. Power to call	has the functions of the members of the board of directors collectively and individually, including the board's powers of delegation and use of the seal until such a time as the Central Bank shall appoint an advisory board. The statutory manager must trace and preserve all the property and assets of the institution. He or she must also recover debts and other sums of money due and owing to the institution. It is the duty of the statutory manager to evaluate the capital

	The Minister of Finance may give the curator power to suspend or reduce the right of creditors of the bank concerned to claim or receive interest on any money owing to them. The curator may make payments, whether in respect of capital or interest, to any creditor or creditors of the bank concerned at such time, in such order and in such manner as he or she may deem fit. He or she may cancel any agreement between the bank concerned and any other party to advance moneys due or any agreement to extend	meetings of creditors. Taking custody of the bank's property. Effecting payments on behalf of the bank. Making distributions to creditors.	structure and management of the institution and recommending to the Central Bank any restructuring or re-organization which he or she considers necessary. Entering into contracts in the ordinary course of the business of the institution, including rising of funds by borrowing on such terms as he or she may consider reasonable is another assignment of the statutory manager. He or she has powers to obtain from any officers or employees of the institution any documents, records, accounts, statements

	any existing facility. The curator has power to convene a meeting of creditors of the bank concerned for the purpose of establishing the nature and extent of the bank's indebtedness to such creditors. He or she may also negotiate with any individual creditor of the bank concerned with a view to the final settlement of the affairs of such creditor with the bank. Power to cancel any lease of movable or immovable property entered into by the bank concerned prior to its being placed under curatorship may		or information relating to its business. The statutory manager may issue a new balance sheet and profit and loss accounts. The Ugandan law has a general provision that empowers the statutory manager to perform any other duties that may be assigned to him or her by the Central Bank. The statutory manager may declare a moratorium on the payment by the institution of its liabilities to depositors and other creditors.

	be allocated to the curator. He or she has power to cancel any guarantee issued by the bank concerned prior to its being placed under curatorship. The law gives the curator the mandate to raise funding from the Reserve Bank, or any entity controlled by the Reserve Bank, on behalf of the bank and to provide security over the assets of the bank in respect of such funding.		
	The curator must comply with any direction of the	A bank administrator is an officer of the court.	The statutory manager must control and conduct of the affairs

Checks and balances on the rescue practitioner	Registrar. The curator should keep such accounting records and prepare such annual financial statements, interim reports and provisional annual financial statements as the bank or its directors would have been obliged to keep or prepare if the bank had not been placed under curatorship. He or she must convene the annual general meeting and any other meeting of members of the bank provided by the Companies Act. The curator must not dispose of any of the bank's assets; transfer	The bank administrator must as soon as is reasonably practicable after appointment make a statement setting out proposals for achieving the rescue objective. The administrator's proposal statement must have been agreed with the BoE. The BoE has powers to make an application to the court challenging an administrator's conduct. Where a bank administrator requires the BoE's consent or approval to any action	and business of an institution, discharge his or her duties with diligence and in accordance with sound banking and financial principles and, in particular, with due regard to the interests of the institution, its depositors and other creditors. The declaration of a moratorium must be applied equally and without discrimination to all classes of creditors. The moratorium must limit the maximum rate of interest which shall accrue on deposits and other debts payable by the institution during the period of the

	any of its liabilities; or dispose of any of its assets and transfer any of its liabilities without seeking consent of the Registrar or the Minister. The curator must record the nature of and the reasons for each act performed by him or her under any power exercised by him or her. In seeking consent for a disposal of assets or transfer of liabilities or such disposal and transfer, the curator must report to the Minister or the Registrar on the expected effect on the bank's creditors and whether the creditors are treated in an	in accordance with this Part, the Bank may withhold consent or approval only on the grounds that the action might prejudice the rescue. A bank administrator may resign only by notice in writing to the court, copied to the BoE, or in the case of a bank administrator appointed by the creditors' committee, to the creditors' committee. The legal regime gives extensive provisions for removal, disqualification or replacement of the administrator.	moratorium to the minimum rate as may be prescribed by the Central Bank. The moratorium shall suspend the running of time for the purposes of any law of limitation in respect of any claim by any depositor or creditor of the institution. The declaration of the moratorium ceases to apply upon the termination of the statutory manager's appointment. Statutory management can be augmented by corrective action powers stipulated in section 82 of the FIA.

	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 been wound up. Most importantly, the curator must on a monthly basis furnish the Registrar with a written report containing an exposition of the affairs of the bank concerned and in which it is stated whether or not, in the opinion of the curator, a reasonable probability exists that the bank will be able to pay its debts or to meet its obligations	Upon a successful rescue, the bank administrator must make an application under paragraph 79 of Schedule B1 to the Insolvency Act 1986 to the court ending administration on achievement of objectives.	

	and to become a successful concern. Curatorship lapses upon issue by the Minister of written notification to that effect to the curator; or winding-up of the bank. The process is augmented by investigation of affairs of the bank under curatorship under section 69A of the Banks Act.		

6.1.2 Lessons for Uganda

Generally, BoU has enjoyed a lot of flexibility and little public scrutiny in its mandate of dealing with distressed banks. The most used tool has been directives to distressed banks to replenish their capital positions, as evidenced by the approach towards GTB, NBC and Crane Bank. Failure to restore the desired capitalization and unsustainable losses trigger the Central Bank to conclude transfer of assets and assumption of liabilities agreements with other banks to take over the distressed banks. However, this can have undesired effects on market competition and, as seen in the case of NBC, may stifle efforts to localize the banking industry by supporting local banks to adhere with compliance standards through regulatory tools aimed at distressed bank rescue.

In light of the above discussion, there is a need for BoU to develop a *sui generis* curatorship model based on the existing statutory management procedure to empower the Central Bank to appoint a curator or rescue practitioner to intervene in a distressed bank and take over the management with a view of rescuing the bank and restoring it as a viable going concern. It is noteworthy that there have been deliberate intervention efforts in addressing negative public perception and stigma of business failure in Uganda, such as the enactment of a business rescue procedure under the new Insolvency Act.[629] A curatorship framework would not only widen the scope of options available to the Central Bank to deal with distressed banks, but also harmonize the regulatory approach with the ongoing efforts to create a culture of business rescue and its associated benefits such as jobs preservation, tax base preservation, skills and talent retention, and entrenching market competition that drives innovation, favorable exchange and interest rates, new products and improved customer/depositor treatment.

Furthermore, apart from the Insolvency Act, Uganda has a new Companies Act of 2008 which governs the powers of companies to make arrangements and compromises with creditors and/or members.[630] It is universally agreed that banks are companies. In Uganda’s case, major banks such as Stanbic Bank, Centenary Bank and Bank of Baroda are publicly listed companies. Given that these new pieces of legislation became operational after the Financial Institutions Act of 2004, it is recommended that BoU harmonizes its framework in line with the new thinking. Interestingly, the BoU Crisis Management Policy Framework and the FIA do not have any provisions relating to depositor preference and hierarchy under the Depositor Protection Fund. This creates a legal ambiguity as to whether the Insolvency Act will be the applicable law in the circumstances, or whether the banking industry will have its own specific depositor hierarchy in times of bank failure. This ambiguity should be resolved.

[629] Under the Insolvency Act of 2011, there are various provisions relating to provisional administration and administration of companies with a view to business/corporate recue. These provisions reflect major amendments in Uganda’s Insolvency law and a significant attitudinal change towards breathing a new “kiss of life” in companies experiencing financial difficulty.
[630] See sections 234 and 235 of the Companies Act, 2008. In terms of section 234(5), "arrangement" includes a re-organization of the share capital of the company by the consolidation of shares of different classes or by the division of shares into shares of different classes by both or by both methods.

Furthermore, there is need for further checks and balances on the exercise of both the statutory management powers and the proposed curatorship powers. The Ugandan legal regime lacks the equivalent of section 69 2C(c) of the Banks Act, which is to the effect that seeking consent for a disposal of assets or transfer of liabilities or such disposal and transfer of assets and liabilities of a distressed bank, the curator shall report to the Minister of Finance or the Registrar of Banks, as the case may be on the expected effect of such transfer and/or disposal 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 been wound up on the date of the proposed disposal, transfer or disposal and transfer. This provision should also apply to BoU as a requirement to give such a report to the Minister of Finance when it triggers its statutory management powers to intervene in affairs of a distressed bank. This would be one of the statutory safeguards to prevent that inequitable and chaotic treatment of depositors such as was witnessed when Co-operative Bank and UCB failed.

There is also need for more transparency and public accountability from BoU in respect of distressed bank interventions. For example, the Annual Reports released by the Central Bank do not give full details on the causes of bank distress and failures. There is no provision under the Ugandan law that is equivalent to a section 69A investigation of affairs of a bank under curatorship in terms of the Banks Act. It is proposed that where a bank is in distress and BoU takes over the management or sanctions the proposed curatorship, there must be an investigation into the business, trade, dealings, affairs or assets and liabilities of that bank or of its associate or associates. The report from such an investigation should be made available to the public, just like the SARB did with Regal Bank and African Bank. This would not only enhance transparency and public information, but also help act as feedback to other banks to enable them resolve internal lapses that might trigger distress.[631]

Lastly, there is need for further stakeholder consultation and public sensitization about distressed bank rescue procedures embedded within the BoU financial stability mandate. This is a new area of Central Bank law and policy, and thus creates room for more dialogue and public engagement.

[631] Under the FIA, powers to sanction a forensic investigation into the affairs of a distressed or failed bank are only available in respect of liquidation in terms of section 100(4).

Currently, BoU Financial's Crisis Management Framework is an internal document held by the Bank. This secrecy creates "constructive ambiguity" because the banks are not certain about and cannot predict the BoU's decisions on which banks they will rescue, and this inadvertently influences the risk preferences of banks.[632] Through market asset and capitalization assessments, it is easy to predict the "too big to fail" and the "too important to fail" banks in Uganda. This might produce adverse or perverse incentives for banks to increase their leverage and complexity, thus entrenching more moral hazard. As observed, the Ugandan system's major problem is not the lack of an adequate legal framework, but the need for attitudinal change from a liquidation culture to a rescue culture.

6.1.3 Conclusion

In a nutshell, there are considerable success stories that justify distressed bank rescue as one of the policy objectives of modern Central Banking. The UK administration procedure and the South African curatorship model offer important lessons that can influence a new regulatory approach for Uganda's developing banking sector. The bail-in procedure would help BoU avoid the situation witnessed in the banking crisis, where the aggregate losses of the closed banks represented regressive transfer of resources from poor tax payers to rich bankers and borrowers through government pay-outs and BoU liquidity support.

To achieve the desired outcomes, it is proposed that Uganda's rescue framework should address three core areas-a stabilization phase (ensuring that the provision of critical financial functions is assured, through bail-in to re-capitalize the distressed firm), restructuring phase (this is a phase in which necessary changes effected in the re-organization plan are made to the structure and business model of the whole firm or its constituent parts/groups to address the causes of distress), and exit from recovery phase (where the Bank's/Statutory Manager's/Administrator's/Curator's involvement in running the affairs of the formerly distressed bank comes to an end).

It is not guaranteed that this process will always yield the desired results of rescue and resuscitation of entities back to normal health as successful going concerns. Therefore, the exit

[632] The term 'constructive ambiguity' is often attributed to the 56th US Secretary of State, Henry Kissinger and is a negotiating tactic used to cover up areas of disagreement through deliberate use of ambiguous language on a sensitive issue in order to postpone its resolution. See Goodhart, C. and H. Huang, *The lender of last resort*, Journal of Banking & Finance 29 (2005), pp. 1059-1082. Also see JR Tettey, Managing Bank Resolution in South Africa, Wits University Thesis, Master of Management (2014).

strategy should also envisage and put in place adequate measures to protect depositors and the financial system in case of failure. The goal of ensuring that the firm can operate unsupported means that the firm must be re-capitalized to a level that is sufficient to restore market confidence and allow the firm to access private funding markets and deposits.

Because of banks' high liquidity risk, they require a different approach to their rescue than other types of businesses. A non-bank corporate normally approaches insolvency over an extended period and the deterioration of its financials becomes apparent over time. However, even a relatively well-managed and profitable bank can experience liquidity problems, sometimes as a result of external factors. When the public or financial markets lose confidence in a bank or the banking sector, deposits are withdrawn and sources of short-term funding dry up. Even a solvent bank can fail if it cannot access funding with which to service its expenses, repay deposits and other liabilities as they become payable, and finance its longer-term loans and other assets. Resolving a bank in these circumstances requires immediate intervention, which is not provided for in the normal insolvency processes.[633]

It is submitted that a specific action to put a bank under curatorship does not necessarily mean that the entire banking system is not sound. Bank failure can happen even in a robust economic system depending on the business model of a specific bank. For example, as noted in the course of the discussion on the South African Chapter, African Bank's problems emanated from high instances of unsecured lending and the lack of a wide business diversification portfolio as streams of capital to mitigate losses. Once a new business plan was adopted, and the lending portfolio under the "Good Bank" taken over by better management appointed by the curator, bank failure was able to be contained.

[633] One of the key functions of banks in the economy is to facilitate the maturity transformation of money, that is, to turn short-term savings into long-term credit. Banks fund themselves mainly through deposits and deposit-like instruments with relatively short maturities. They use this short-term funding to provide longer-term credit, such as mortgages. This balance-sheet structure exposes banks to liquidity risk (the risk that short-term funding can be withdrawn instantly, while longer-term loans are only repaid over years). Another reason why banks, in particular, require specific resolution arrangements is because they are closely interconnected with each other, the rest of the financial system and the real economy. The failure of a bank, in particular a large bank, can have catastrophic socioeconomic consequences, cause severe hardship among depositors and disrupt financial stability. Unlike other types of companies, it is not only the shareholders and creditors that bear the losses of the institution, but also the broader economy and often the taxpayer. Therefore, a special resolution framework should be in place to enable and empower the regulators and authorities to intervene in a distressed bank at an early stage, without necessarily having to wait for the initiative and approval of shareholders or the Board of Directors (Board) or for the point of balance-sheet insolvency.

Finally, there must be an adequate framework to guide identification of entities that can benefit from this rescue framework in order to prevent abuse and perversion of the system. For example, rescue procedures should not be available to banks found to be perpetrating criminal activities such as money laundering and terrorism financing. Rescue should only be available to *bona fide* entities experiencing temporary liquidity problems. Furthermore, in order to reduce moral hazard, it is imperative that banks know from the very start that they can only have one chance of rescue in case of distress. This would be one of the measures to ensure effective banking business conduct and curtailment of illegal practices in the industry. It is very important to establish whether the distressed bank shows potential to be rescued, and thus, it should not be hopelessly insolvent to the point of no return. Therefore, not all banks will benefit from this remedy. Where this is the case, the rescue procedure must be flexible enough to enable the Central Bank authorities to sanction resolution procedures if it becomes clearly apparent that the affected bank, or a viable portion of it will not be successfully rescued as a going concern.

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