

**CAUSES OF BANK FAILURE
IN THE POST DEMOCRATIC
SOUTH AFRICA**

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DECLARATION STATEMENT

With the signature below I, Sipho Daniel Makhubela, hereby declare that the work that I present in this thesis is based on my own research, and that I have not submitted this thesis to any other institution of higher education to obtain an academic qualification.



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11/09/2007
Date

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Abstract

University of KwaZulu-Natal

Abstract

CAUSES OF BANK FAILURE IN THE POST DEMOCRATIC
SOUTH AFRICA

Sipho Makhubela

This dissertation explores and explains the reason why banks generally fail and more specifically why banks have failed since South Africa realized democracy in 1994. Bank failures are a global phenomenon and come at a high cost to the depositors, the fiscus and can lead to economic instability should the failure be systematic.

There are several causes of bank failures and theoretically, these include credit risk, market risk, liquidity risk, capital requirements, bank regulation, inefficient management and external economic factors.

The banks that failed during the period commencing from 1994 to date include Prima Bank, Sechold Bank, African Bank, Community Bank, Islamic Bank, FBC Fidelity Bank, New Republic Bank, Regal Treasury, Saambou and BoE.

Detailed analysis of the nine banks referred to above is done in Chapter Four wherein, in respect to each bank, the background of the institution, the analysis of the financial statement, where available or the banking returns lodged with the South African Reserve Bank, reasons for

the failure of the bank as well as the resultant outcome of the failure has been examined.

The causes of failure, the symptoms of failure and the recommendations for prevention of failure are finally considered and discussed in Chapter Five.

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TERMS AND ABBREVIATIONS

“Bank Failure”	Inability of a bank to repay its depositors and creditors and/or as the situation when the “market value of the bank’s assets declines below the market value of its liabilities”
“Reserve Bank” or “SARB”	South African Reserve Bank
“CAR”	Capital Adequacy Ratio
“Credit Risk”	Credit risk is the risk that credit advanced to borrowers will not be repaid in accordance with terms agreed upon at the outset.
“Market Risk”	It is the risk of the market since prices of all securities dealt in a particular market will be similarly affected by these factors. It is the portion of the total risk that is not unique to a bank.
“Liquidity Risk”	The risk of a bank being subject to being unable to repay its depositors on demand, or as and when due, through holding insufficient cash or near-cash assets.
“Systemic Risk”	It is mainly in the banking sector where the failure of one bank leads to the collapse of other banks in the absence of measures aimed at preventing such contagious effects.

CHAPTER 1

STATEMENT OF PROBLEMS AND RESEARCH DESIGN

1.1 Introduction

This chapter gives a background to Causes of bank Failure in South Africa. I present herein the problem, literature survey, motivation for the study, and objectives.

The purpose of this research report is to specify causes of bank failure in post apartheid South Africa i.e. for the period commencing 1994 to 2004. I also seek to obtain an understanding of the reasons behind the respective failures. The report also notes, without paying particular detail in this regard, at the number of bank licenses that have been returned to the Registrar of Banks, which may or may not have been returned due to pressures, which in the medium to long term could have resulted in bank failure.

I adopt a framework that considers a bank to have failed either through being put into administration or by being acquired by another bank, which acquisition was deemed more as a rescue.

1.2 Background of the Research

In any market economy, the financial sector is one of the key elements, acting as a vehicle for mobilizing savings and allocating them to investment by absorbing, intermediating and advising on risk and providing corporate governance. Major bank failures are of importance not only to depositors and other creditors of failed banks but also to management, scholars, consultants and practi-

tioners and provide ample examples for management in general, Understanding what causes the costly wave o banking failures is the key to preventing a recurrence (Fink and Haiss, 1999).

Banking plays a pivotal role in the economy of any country and as a result banking becomes a key pillar of the various economies. It therefore follows that every country would want to have a banking system that is strong and that can play a key role in supporting the growth of the country.

The soundness of a country's financial system goes a long way in laying the foundation for growth, it provides the basis of investor confidence which every developing country hopes will result in foreign direct investments. The transfer of funds from savers to borrowers allows for projects to be undertaken by entrepreneurs, and that in turn translates into investment, employment and production of output, all of which are important constituents of economic growth (Nel, 2003).

According to Kaufman (1995) Bank (depository institutions) failures are widely perceived to have greater adverse effects on the economy and thus are considered more important than the failure of other types of business firms. In part, bank failures are viewed to be more damaging than other failures because of a fear that they may spread in domino fashion throughout the banking system, felling solvent as well as insolvent banks. Thus, the failure of an individual bank introduces the possibility of system-wide failures or systemic risk. This perception is unfortunately widespread.

It has been widely accepted South Africa has a “first world” (developed economy) banking system in a “third world” (“developing economy”). It would not be too farfetched to assume that as a result of the sophistication levels of the South African banking system, bank failures should not be as wide ranging as they would be in other developing economies.

South Africa generally has a small banking system in comparison to developed nations where the five major banks or the “Big five” as they are generally referred to, have a very significant amount of market share.

South Africa has a population of approximately 45 million people and having a banking system that is serviced largely by around five banks seems anomalous. This makes the banking ratio to be approximately 8.4 million people per bank, ignoring the other banks in the system. Developed economies like the United States of America have a different structure to South Africa supporting their population, which is in excess of over 240 million, with well over 14,000 banks. This result in a much lower ration of bank per capital of just over 17,000.

The post apartheid South Africa has seen South Africa having to deal with a large number of what has been classified as the unbanked market which the “big five” has initially been reluctant to venture towards, hence the emergence of a burgeon tier, micro lending.

During the 1970s, nine (9) out of the fifty (50) banks that were registered failed or were taken over pending failure. In the United States of America during the 1970s, five (5) out of every ten thousand (10,000) banks failed per annum. The South African

bank failure rate during the 1970s was, therefore, forty (40) times greater than that of its USA counterparts.

1.3 Statement Of Problems

This section will consider the problem statement together with its related sub-problems.

1.3.1 Overall problem statement

At present it is not known why banks fail in general, and why some banks fail in particular in the post apartheid South Africa.

1.3.2 Sub-problems

Has the democratic change in the country introduced an increased risk in bank failure?

How much of a role does poor management contribute in causing bank failure?

Do poor credit lending decisions result in an increased risk of bank failure?

1.4 OBJECTIVES

The objective of this research is to identify the following:

- To establish causes of bank failure in South Africa
- To consider the contrast the causes of failure with other economies elsewhere in the world

There has not been a major study on the causes of bank failure in the post democratic South Africa. The post democratic South

African banking system is different from the apartheid South Africa. This is due to a number of reasons including the following:

The competitive landscape has changed significantly as the world opened up to South Africa in terms of trade due to the lifting of sanctions

The cast black market has been typically been unbanked or its banking has been restricted. With the post democratization of the country, there have been imperative changes like black economic empowerment presenting various dynamics.

South African banks have taken more credit risk in other parts of the continent and elsewhere in the world. This introduces a different sort of exposure than that which was dealt with in apartheid South Africa

1.5 Limitations

The study limits itself firstly to bank failures in South Africa. The limitation is therefore that the study does not consider failures in other countries, regions or continents.

Another limitation is that the study only considers a period between 1994 and 2004.

1.5.1 Interim Critical questions

At the end of the literature survey, these interim critical questions will be revisited to consider if any prior research has provided answers to these questions. If they have been answered they would be removed going forward. Should

they remain answered, they will be carried forward for consideration.

- Is bank failure a phenomenon that is as new as the “New South Africa”?
- Have any of the banks that failed during the period under review caused systematic failure?

1.6 Research design

1.6.1 How the literature survey will be conducted

Being a distance student based in Johannesburg, I will not have the full facility of the University of Kwa Zulu-Natal (“UKZN”) at my disposal and as a result will use the Library Facilities of the University of Witwatersrand (WITS) and the University of Johannesburg. I will also use UKZN’s Sabinet facility.

I will also use the Internet research tools particularly Nexus and Sabinet and Google Scholar research facilities.

1.6.2 How the research instrument will be designed and standardised

A research instrument will not be designed but an analysis of secondary data approach will be used.

Analysis of secondary data is normally allowed for use in either finance or economic research because experts already and that is applicable in this instance normally collect the data. According to Cooper & Schindler (2003) it is inefficient to discover anew through the collection of primary data or original research what has already been done and reported at a level of sufficient for decision making.

The researcher therefore will not have to collect the data himself.

1.6.3 How the selection process will be performed

Information in respect of all banking institutions that failed in the period 1994 to date will be obtained from the office of the Registrar of Banks within the South African Reserve Bank.

- Name of institution
- Year in which failure took place and/or the bank was placed in Curatorship
- Name of curator
- Causes of failure

For each of the banks, a general overview of the cause of the failure will be undertaken.

I will do detailed financial review on Saambou and BOE only. This is because these two banks failures are the most recent and the financial information is still available whereas the majority of the other failed banks do not have available financial statements.

Financial statements would be analyzed, as fully set out below with the intention of trying to establish the causes of the failure. Commentary from financial commentators would be explored.

1.6.4 How the data will be analyzed

There are various accounting ratios that are generally accepted as indicators of performance and these we used to gauge whether the failures were predictable.

Financial Ratio Analysis

PROFITABILITY	
INTEREST MARGIN (TOTAL ASSETS)	$\frac{\text{NET INTEREST INCOME}}{\text{AVERAGE TOTAL ASSETS}}$
NET MARGIN (AFTER TAX)	$\frac{\text{NET INCOME AFTER TAX (NPAT)}}{\text{REVENUE}}$
LIQUIDITY RISK	$\frac{\text{LIQUID ASSETS} - \text{SHORT TERM BORROWINGS}}{\text{TOTAL DEPOSITS}}$
ASSET UTILIZATION	$\frac{\text{GROSS REVENUES}}{\text{AVERAGE ASSETS}}$
RETURN ON ASSETS	$\frac{\text{GROSS REVENUES}}{\text{AVERAGE ASSETS}}$
LEVERAGE MULTIPLIER	$\frac{\text{ASSETS}}{\text{EQUITY}}$
RETURN ON EQUITY	$\frac{\text{NET INCOME AFTER TAX}}{\text{AVERAGE EQUITY}}$
EARNINGS POWER	$\frac{\text{EARNINGS ASSETS}}{\text{TOTAL ASSETS}}$
NON-INTEREST EXPENSES TO TOTAL ASSETS	$\frac{\text{NON-INTEREST EXPENSES}}{\text{AVERAGE TOTAL ASSETS}}$
NET NON-INTEREST EXPENSES TO TOTAL ASSETS	$\frac{\text{NON-INTEREST EXPENSES} - \text{NON INTEREST INCOME}}{\text{AVERAGE TOTAL ASSETS}}$
EFFICIENCY	$\frac{\text{NON INTEREST EXPENSE}}{\text{NET INTEREST INCOME} + \text{NON INTEREST INCOME}}$
YIELD ON EARNING ASSETS	$\frac{\text{INTEREST INCOME}}{\text{AVERAGE EARNING ASSETS}}$
COST RATE ON TOTAL ASSETS	$\frac{\text{INTEREST EXPENSES}}{\text{AVERAGE TOTAL LIABILITIES} + \text{AVERAGE EQUITY}}$
RISK	

CORE DEPOSITS TO ASSETS	$\frac{\text{CORE DEPOSITS}}{\text{TOTAL ASSETS}}$
LIQUID ASSETS TO EARNING ASSETS	$\frac{\text{SHORT - TERM INVESTMENTS (<1 YEAR)}}{\text{EARNING ASSETS - SHORT TERM INVESTMENTS}}$
NET LOANS - TO - DEPOSITS	$\frac{\text{NET LOANS}}{\text{TOTAL DEPOSITS}}$
NET LOANS - TO - CORE DEPOSITS	$\frac{\text{NET LOANS}}{\text{CORE DEPOSITS}}$
NET LOANS - TO - ASSETS	$\frac{\text{NET LOANS}}{\text{TOTAL ASSETS}}$
CREDIT QUALITY	
CREDIT RISK (THIS PERIOD)	$\frac{\text{PROVISION FOR BAD DEBT EXPENSES (THIS PERIOD)}}{\text{GROSS LOANS (THIS PERIOD)}}$
CREDIT RISK (ACCUMULATED)	$\frac{\text{ACCUMULATED PROVISION FOR BAD DEBTS}}{\text{ACCUMULATED GROSS LOANS}}$
CAPITAL ADEQUACY	
CAPITAL RISK	$\frac{\text{TOTAL CAPITAL}}{\text{TOTAL ASSETS}}$
EQUITY CAPITAL RISK	$\frac{\text{ORDINARY EQUITY}}{\text{TOTAL ASSETS}}$
ADJUSTED CAPITAL BASE - ADJUSTED ASSET BASE	$\frac{\text{ADJUSTED CAPITAL BASE}}{\text{ADJUSTED ASSET BASE}}$
CAPITAL ADEQUACY RATIO (ASSETS)	$\frac{\text{SHARE CAPITAL + UNIMPAIRED RESERVES}}{\text{TOTAL ASSETS}}$
CAPITAL ADEQUACY RATIO (LOAN)	$\frac{\text{SHARE CAPITAL + UNIMPAIRED RESERVES}}{\text{TOTAL LOANS}}$

MANAGEMENT QUALITY	<u>NET INCOME BEFORE TAX</u> TOTAL CAPITAL + UNIMPAIRED RESERVED <u>DIVIDENDS PAID</u> _____ TOTAL SHARE CAPITAL + UNIMPAIRED RESERVES
SIZE	<u>TOTAL DEPOSIT AND TOTAL ASSETS</u>
LIQUIDITY RATIO	<u>LIQUID ASSETS + PRESCRIBED INVESTMENTS + DEMAND</u> <u>PLACEMENTS + NEGOTIABLE INSTRUMENTS</u> TOTAL ASSETS

1.7 Overview of dissertation chapters

The research will be divided into chapters with each chapter focusing on key parts. The chapters are Introduction; Theoretical Framework; Empirical analysis and Review; Conclusion and Recommendations. Addenda are annexed together with references.

The Introduction initiates the subject matter and the format of the research. Furthermore, it discusses the background, notes the problem statement, the purpose of the study and remarks on limitations.

The second chapter will lay out the Theoretical Framework, giving analysis of the work already performed in this area of the study by other authors and researchers as I found it relevant.

The third chapter will provide an Analysis of the cases and presents the banks that failed in South Africa over the period covered as discussed above. A brief background on the South African economy would be provided including a brief description of the South African Banking Supervision platform.

The fourth chapter will include the Evaluation of the causes of bank failure.

Chapter five would comprise the Conclusion, Recommendations and Suggestions for further research.

1.8 Conclusion

In this chapter I introduced the subject matter being the causes of bank failure, considered the background to the research, noted the problem statement and limitations. We further considered the research design and how the research will be undertaken. We finally considered the overview of the dissertation chapters.

CHAPTER 2

LITERATURE SURVEY

2.1 INTRODUCTION

In this chapter the researcher considered the literature on bank failure. The researcher demonstrated how the literature survey was conducted and at the end of the chapter he revisited the interim critical question. The researcher also provided a description of the banking regulatory environment.

2.2 HOW THE LITERATURE SURVEY WAS CONDUCTED

The research is predominantly a secondary analysis and as a result the researcher did not undertake primary data analysis. Primary data analysis includes the production of original works of research or raw data without interpretation. Due to the fact that the research topic is Financial and there's a lot of primary data that is available, he researched the secondary sources. Secondary sources thus seek to interpret the primary data.

There are generally five types of information sources used in most literature searches, including indexes and bibliographies, dictionaries, encyclopedias, handbooks and directories, Each is useful to a literature search in a variety of ways (Cooper 2003).

The researcher primarily used bibliographies and indexes for my literature review. The process included:

- a. Selected a database appropriate to my topic;
- b. Constructed a search query (or search statement)
 - o Reviewed and evaluate the search results
 - o Modified the search query, if necessary.
- c. Saved the result of my search
- d. Retrieved articles not available in the database
- e. Supplemented my result with information from Web sources.

2.3 SURVEY OF LITERATURE THAT RELATE TO THE THEORETICAL FRAMEWORK OF THE DISSERTATION

Hereunder the researcher considered the literature survey applicable to bank failure.

Bank Failure: Historical context

Many banks either temporarily suspended operations or failed during the early 1930s (Cole & Gunther, 1995). Bernake's (1983) widely cited work shows that a number of banks that either closed temporarily or failed are a significant predictor of output during the Great Depression. Bank suspension and failures were higher during the Great Depression. About 0.5% of banks, measured by deposits, either suspended operations or failed during the Great Depression of 1921-1922, and about 0.2% of total deposits was ultimately lost. In comparison, an average of 2,6% of banks either suspended operations or failed between 1930-1932, and an average of 0.4% of total deposits were ultimately lost during that period. Both of these ratios rose significantly when the then U.S.

President Roosevelt declared a bank holiday (Cole and Ohanian, 2000)

Hunter (1996) estimated a split-population duration model for thrift institutions chartered between 1980 and 1986 and found that credit risk, adverse economic conditions, low capital stocks and cost inefficiencies all contributed to failure. DeYoung (1999, 2003) estimated a similar model for commercial banks chartered in 1985 and found that failure rates follow life-cycle pattern: low initial failure rates due to plentiful start-up capital, high failure rates next as fast growth and negative earnings erode capital, and finally normal failure rates as de novo banks reach financial maturity.

The term "bank failure" often evokes images of the Great Depression, but in reality banks collapse with alarming regularity. As Benton Gup, professor of finance and chairman of the banking department at the University of Alabama's College of Commerce, notes a 1996 International Monetary Fund study found the 133 of the IMF's 181 member countries had experienced significant banking sector problems. First, all of the G-10 countries have experienced significant problems in their banking sectors, but problems are much more widespread in Canada, Japan, Sweden and the United States. Second, most bank failures are due to credit problems, particularly bad real estate loans. Third, the popular notion that certain institutions are "too big to fail" is faulty. Last, but certainly not least, this era of globalization and emerging technologies makes change in regulatory methods essential. (Gup:2000)

Runs on banks, especially those driven by rumours, can result in bank failure. Runs that result from information asymmetry about the quality of bank assets lead to depositors' panic as they consider all banks to be illiquid or insolvent. Massive withdrawal of

deposits at banks ensues as a result of panics. These massive withdrawals of deposits may be limited to one bank only or can spread to other banks in the system via contagion, and these manifold failures of banks can have destabilizing effects on the financial system and the overall economy, because of the inherent systematic risk they present to the system (Hoggarth and Saporta, 2001).

It is incumbent on governors to warn that banks will fail; how better to keep financial markets on their toes? One legacy of the previous government is a tough attitude towards banks in distress. Over the last 15 years, 29 banks have failed and only two were rescued (Johnson Matthey Bankers and National Mortgage Bank) -- which marks the UK out from most industrialized countries, even the US, where vast amounts of taxpayers' money have propped up collapsing institutions. But there's also a huge fuss if the failing bank is riddled with crime (BCCI) or suffers from terminal bad management (Barings). The focus quickly switches from the failure of the institution to that of government. As a result the threat of bank collapse is a dull instrument: people expect government to prevent it. (Herring, 1993 citing Lascelles, 1998).

When banking conditions were troubled in the late 1980s and early 1990s, hundreds of banks failed because of troubled real estate markets, regional economic recessions, and lax lending standards (Basle Committee on Banking Supervision, Working Paper No. 13, 2004).

The Basel Committee on Banking Supervision has been working to help banks reduce their risk of failure since the 1970s. Stock market investors have learned to diversify. Financial institutions of all sorts have tried to create safeguards against tempestuous

market forces. Much of this effort has been successful. The recession of the early 70s, for example, passed without any large-scale bank failures, in contrast to earlier downturns that typically brought banking crises and collapses of financial firms. Yet it would be premature to think that market risk has been conquered altogether (Basel Committee on Banking Supervision, Working Paper No. 13, April 2004).

Losses accrue to shareholders and most likely to depositors, unsecured creditors and deposit insurer. Small loan customers may be particularly inconvenienced by changes in their loan offices, loan standards and other aspect of their ongoing bank relationship. Many highly developed economies that have sophisticated markets and long functioning banking systems have had significant bank failures or banking crises during the past 30 years. Central bankers fear widespread bank failures because they exacerbate cyclical recessions and may trigger a financial crisis. It is not surprising that these failure episodes have resulted in numerous legal and regulatory changes in the affected countries that were designed to decrease the probability of future bank failures and lessen the cost of the bank failures. Bank capital is meant to be a buffer during periods of economic instability and increasing capital levels or making capital more sensitive to the risks in banks should help stabilize the banking system, decreasing the incidence and cost of bank failures.

Bank failures are widely perceived by economist, bank supervision bodies and governors of central banks to have greater adverse effects on the economy and thus are considered more important than other types of business firms. In part, bank failures are viewed to be more damaging than other failures because of a fear that they may spread tin domino fashion throughout the banking

system, felling solvent as well as insolvent banks. As a result, bank failures have been and continue to be a major public policy concern in all countries and a major reason that banks are regulated more rigorously than other firms.

According to Kuaffman, bank fails economically when the market value of its assets declines below the market value of its liabilities, so that the market value of its capital (net worth) becomes negative. At such times, the bank cannot expect to pay all of its depositors in full and on time. The bank should be resolved as quickly as possible in order to treat all depositors fairly and not allow a run by depositors holding demand and short-dated deposits. The longer an insolvent bank is permitted to operate, the more such informed depositors have to withdraw their funds at par value and effectively strip the bank of its valuable assets. The entire loss will then be borne by less informed depositors and holders of longer-dated deposits.

In a major study of the U.S. banking crisis in the 1980s and early 1990s, the FDIC (1997) analyzed the causes of the banking crisis, the regulatory responses to the crisis and the lessons that could be learned. Five of the lessons identified in that study, which may be relevant, are: First, bank regulation can limit the scope and cost of bank failures but is unlikely to prevent failures that have systemic causes. Second, for most of the period studied, there were no risk-based capital requirements and therefore there was little ability to curb excessive risk taking in well-capitalized, healthy banks. Third, problem banks must be identified at an early stage if deterioration in the bank's condition is to be prevented. In the U.S. system, this required frequent, periodic bank examinations. Fourth, the presence of deposit insurance helped maintain a high degree of financial stability throughout the crisis,

but not without costs. The direct costs of the banking crisis were born by the industry. However, Curry and Shibut (2000) calculate that the Savings and Loan crisis during the same time period cost the U.S. taxpayers \$123.8 billion, 2.1% of 1990 GDP. Costs included those associated with moral hazard risk associated with deposit insurance. Chief among these was the funneling of vast sums of money into high-risk commercial real estate lending. In addition to moral hazard, this lending was also encouraged by ill-conceived deregulation and disruptive tax law changes.

Banks are viewed to be more fragile for three reasons. They have: (a) low capital-to-assets ratios (high leverage), which provides little room for losses; (b) low cash-to-assets ratios (fractional reserve banking), which may require the sale of earning assets to meet deposit obligations; and (c) high demand debt and short-term debt-to-total debt (deposits_ ratios (high potential for a run), which may require hurried assets sales of opaque and non-liquid earning assets with potentially large fire-sale losses to pay off running depositors.

In a recent review of the literature on bank contagion, five reasons were identified that have been cited for more serious contagion in banking. Contagion is perceived to (1) occur faster; (2) spread more widely within the industry; (3) result in a larger number of failures; (4) result in larger losses to creditors (depositors) at failed firms; and (5) spread more beyond the banking industry to other sectors, the macro economy, and other countries.

Government's role in the prevention of bank failure

On banking crisis resolution, the OECD (2002) recently compared (based on questionnaire response) the techniques and practices used in member countries. In addressing problems, typically the central bank or government agency stepped in fairly early to

supply liquidity, which in most cases helped to avert a panic by investors. Most governments protected depositors, in whole or part, up to the statutory minimum. Liquidations were used just occasionally and typically only for smaller institutions or where only a small part of the banking system was impaired. When large commercial banks have been in trouble, problems have been resolved usually through mergers and some mix of capital injection and increased government control.

A number of recent official working groups and academic studies have analyzed the causes and policy responses to bank failure across countries. According to the Basle Committee on Banking Supervision, a sub group referred to as "The Groupe de Contact" examined the causes of banking difficulties in the EEA since the late-1980s. Evidence was based on (117) individual bank problems in 17 countries and national country reports from a few countries (France, the UK and the Scandinavian countries). The majority of banking difficulties were manifest as credit problems and sometimes as operational risk. Market risk was rarely a significant problem. Management and control weaknesses were significant contributory factors in nearly all cases. However, 90% of the banks reported capital ratios about the regulatory requirement when difficulties emerged. The internal report of the Groupe de Contact concluded that this suggested loss provisioning did not accurately reflected asset impairment and thus capital ratios were overstated. And more generally, even where asset impairment had been properly measured, such quantitative measures might not capture qualitative problems, such as poor management.

The process of financial liberalization (though not the financial liberalization itself) was a major factor in Spain, Norway, Sweden, and the U.S. S&I. crisis. All four countries lifted interest rate

controls before the crisis, and all four had regulatory systems that were ill prepared for the crises that followed. The financial institutions in these countries were also poorly prepared to operate in the newly liberalized environment. Lax supervision made responding to the problems very difficult, but Norway, Sweden and Spain had dealt with their systemic crises within five years of its onset. In the U.S., the S&L crisis extended from 1981 to 1995 and required many attempts at legislative reform.

Macroeconomic instability, though it has an important domestic component, is often linked to external shocks (Vaubel, 1984). Microeconomic deficiencies are often tied in with foreign exchange and offshore transactions requiring close and trusting contacts between regulators in different countries. Relatively strong externalities mean that each country gains from the quality of regulation and of macroeconomic stabilization policy in its financial and trading partners. But our review also highlights the need to distinguish between technicalities and errors on the one hand, and abuse on the other. Policy errors have certainly played a part, and they can be addressed through better legislation and regulatory design, improved training of supervisors and adequate resources of the supervisory authority, and greater attention to the importance of avoiding macroeconomic overheating. But it is in the area of reducing what must, in conventional terms, be regarded as abuses that the most important reforms must be sought.

From the economist's perspective, such as Brownbridge, the most interesting way of curbing abuse is by altering the incentive structure faced by the various participants: bankers, depositors, regulators and the government itself. When it comes to the incentive structure for government, we move into the gray area between fiscal policies on the one hand and issues of governance

and even of political corruption on the other. These issues must be squarely faced if there is to be decisive progress in reducing the fragility of banking systems.

The stagnation or failure of banking systems that have been pressed too hard for quasi-fiscal resources will have brought home too much the short-term nature of the fiscal gains to be made. In some cases the politicians who undermined the banking system have still been in power when its collapse presented them with what was only a slightly deferred bill. But short-termism is not likely to be completely eliminated by such experience, and one must seek stronger institutional arrangements within which governments and politicians are less likely to act in such a way as to generate financial collapse.

Effectively the Basle Committee on Banking Supervision is seeking a mechanism whereby governments can constrain themselves and their successors to avoid short-termism and abuses, thereby strengthening the hand of the national bank regulators. It is in this context that the establishment of an international sanction or seal of approval becomes desirable.

As might be expected, the responses of supervisors and governments have been varied. Some crises extended over very long periods (Japan, U.S.) and forced the countries to make difficult and expensive changes to solve the problem. Others (Switzerland, U.K.) were resolved quickly. The types of resolutions used ranged from the closure and liquidation of the failed banks (Barings, and Herstatt) to government takeovers and recapitalization (Norway and Sweden). As a rule, governments tended to play an active role, sometimes even by injecting new capital, in cases where the causes of the crisis included a macro-economic shock, and when its reach was systemic. It seems, though, that the type of resolu-

tion, as far as the markets anticipate it, can have an impact on the crisis itself. The most salient example is the S+L crisis in the U.S., which was aggravated by insured depositors' confidence in their immunity from any losses. Regulatory change during or after the bank failures was very common. Widespread or systemic events usually resulted in some type of legislative response. Sweden, Norway, the U.S. and Japan all had major legislation enacted, with the U.S. and Japan both having numerous laws passes during their crises. Spain, Germany, and the U.K. (Barings, BCCI) responded to their bank failures with regulatory changes. Legislative and regulatory changes followed three main lines. First, supervisors tried to improve the risk adequacy of regulation.

General pattern of bank failure

The key role played by poor management in crises has also been highlighted by various academic studies. In a sample of 24 systemic banking crises in emerging-market and developed countries, Dziobek and Pazarbasioglu (1997) found that deficient bank management and controls (in conjunction with other factors) were responsible in all cases. In a study of 29 bank insolvencies, Caprio and Klingebiel (1996) found that a combination of macroeconomic and microeconomic factors was usually responsible. In particular, on the macroeconomic side, recession and terms of trade were found important. Also, on the microeconomic side, poor supervision and regulation and deficient bank management were often significant.

According to Latter, bank failures can be classified in many ways, including by risk type, the type of shock that precipitated the failures or crisis, the state of the banking system, what portion of the banking system was affected, how the crisis was resolved, and whether the failures resulted in regulatory changes. While each

country's experience has unique characteristics, looking across all of the banking crises can help reveal patterns of bank failures. For example, Spain, Norway, Sweden and the U.S. had very similar experiences when they liberalized their financial systems. In addition, in countries where there were a significant number of failures, real estate lending played a major role. The failure of large individual banks tended to be much more idiosyncratic. The Barings and BCCI failures both had significant fraud, but the Herstatt bank failure was more market related. Credit risk, particularly real estate lending, led to widespread banking problems in Switzerland, Spain, the United Kingdom, Norway, Sweden, Japan and the U.S. Market risk was the principal cause of failure in the isolated failure of Herstatt (Germany). Market risk also caused the first stage of the U.S. Savings and Loan failures. Financial liberalization (deregulation) was a common feature of major banking crises often combined with supervisory systems that were inadequately prepared for the change.

Credit concentration risk, usually in real estate, was cited in nine out of the 13 episodes. The breadth of the crises varied considerably. In Switzerland, the United Kingdom, and the recent U.S. case, only small banks were affected. In Spain, Norway, Sweden, Japan, and the U.S. in the 1980's, the whole banking system was affected. The speed of resolution and the rate of closures also varied greatly. Most of the widespread failures required some amount of public support, sometimes in very large amounts. All of the episodes that involved large amounts of public support were caused by credit risk problems. Most countries instituted regulatory changes following the failures, with the exception of the United Kingdom following the small bank crisis.

The widespread banking crises that involved credit risk were remarkably similar. A period of financial deregulation resulted in rapid growth in lending, particularly in real estate related lending. Rapidly rising real estate prices encouraged more lending, abetted by lax regulatory systems in many cases. When economic recessions occurred, inflated real estate prices collapsed, leading directly to the failures.

The one-off failures were exceptions to the pattern (Basle Committee on Banking Supervision). In the U.S., Continental Illinois failed due to losses in its commercial loan portfolio, and the string of failures of sub-prime financial institutions in the U.S. was caused by fraud and losses on loans to borrowers with sub-standard credit histories. While the failure of BCCI was caused by a mixture of fraud and commercial loan losses. The one-off failures were not as closely tied to the economic downturn as the widespread failure episodes.

Failures due exclusively to market risk were remarkably few. In 1974, Germany's Herstatt Bank failed due to massive losses in the bank's foreign exchange operation. The bank was speculating in the foreign exchange market that had been converted from a fixed exchange rate regime to a floating rate regime by the collapse of the Bretton Woods System. The Herstatt failure is well known in international finance. The Herstatt bank was closed at the end of the business day in Germany, it then suspended payments to banks in other countries that were still open. This left the open banks exposed to their Deutsche mark position they had paid for earlier in their business day. This type of settlement risk is referred to as Herstatt Risk.

The Barings failure is also infamous. The bank suffered market losses in its subsidiary in Singapore. A senior trader concealed

the losses until they were so massive that the banking organization failed. The bank's internal controls and management structure were inadequate'.

In their sample of 24 systemic banking crises, Dziobek and Pazarbasioglu (1997) analyzed the success of crisis resolution policies and which types of responses were most optimal. They found that resolution measures were more successful in improving the banking system's balance sheet (stock) positions than their profit (flow) performance. Balance sheets could more easily be improved through an injection of equity or swapping bonds for bad loans. But improving profits was more difficult and took longer because it requires operational restructuring. The most progress in restoring the banking system's financial strength and its intermediation role occurred when (i) countries addressed crises earliest, (ii) lender of last resort was strictly limited, (iii) firm exit policies were used, and (iv) owners and managers were given the right incentives.

Finally, resolving bank failures promptly by closing (or merging) banks when they fail and an insolvency rule returning the bank and/or its assets to the private sector as expeditiously as possible help to maintain market discipline for banks and to promote stability in the market for bank assets.

Theories on causes of bank failure

A study by Apea and Sizebera (2002) asserts that there are many competing theories explaining the causes of bank failure. One theory attributes the failure to government intervention while another says it is due to some endogenous instability. A study by Kindleberger (1989, cited by Hooks 1994: 37) showed that a bank failure results from rapid expansion of bank credit. Some other

causes of bank crisis include legislation, deposit insurance, lack of skills, mismanagement and lack of regulation (Palubinskas & Stough, 1999). Hempel & Simonson (1999) also believe that mismanagement; regulatory and legislative interference causes a bank failure. Fleming & Chu, et al (1996) adds free banking to the reasons why banks fail.

Since 1984, the number of commercial banks in the United States has fallen by one-third, reflecting first a wave of failures and then, more recently, unprecedented numbers of acquisition has exceeded the number of failures four-fold, even when acquisitions of insolvent banks are counted only as failures.

Why do some banks disappear and others survive? Several studies have sought to identify the characteristics that cause banks to fail. Sectoral shock, for example, a sharp decline in agricultural or commodities prices, brought increases in banks failures in regions hit adversely by the shocks. Not all banks would fail, however. Those with relatively illiquid, low quality assets or little capital were more likely to fail. And apart from excessive risk taking, or simply bad luck, banks that managed their operations inefficiently may also have been at greater risk of failing.

Inefficient management

According to the Basel Committee on Banking Supervision, the key role played by poor management in crises has also been highlighted by various academic studies (Working Paper No. 13, Bank Failures in Mature Economies, April 2004).

Dziobek and Pazarbasioglu (1997) found that deficient bank management and controls (in conjunction with other factors) were responsible in all cases under their review. Banks that managed their operations inefficiently may also have been at greater risk of

failing (Wheelock and Wilson, 1999). Hannan and Rhoades (1987), suggest that poorly managed banks are likely to targets for acquisitions by bankers who think they can better manage the target's assets, and hence generate increased profits and value. According to Hooks (1994) mismanagement, especially excessive risk-taking is the main cause of bank failure.

The South African Reserve Bank through Kruger (2003) noted the following typical qualitative early warning signs of bank weakness/failure:

- Weak or uninformed board of directors
- Late and inaccurate submission of bank return and reports
- Rapid staff turnover and changes in top management
- Inadequate reporting to top management
- Over emphasis on performance bonus system
- Depart from traditional business
- Poor quality of board, management and corporate governance

Apea and Sezibera (2002) cite Spollen's (1997) list of the following as underlying the failure of businesses is also relevant to bank failure:

Management's inability to appreciate and control the business.

Inability of management to ensure compliance with laid down procedures. In many situations where there is a loss of a business, the failure is attributed to either lack of policies, and if

policies existed at all, they are inadequate or existing policies are not observed.

Insufficient number of staff, particularly middle management, which can subject a small number of employees to over-time work, which could eventually result in the failure of a bank. The issue is whether an organization has adequate staff complement and whether it appreciates their interests and addresses them (Spollen 1997: 86, 94).

The situation when fundamental control procedures are ignored.

The situation when internal audit does not play its role in the formulation of a board of directors' policy and its procedures.

The situation when the board of directors does not effectively address audit queries.

Over-reliance on one member of staff. Most of the time organizations are defrauded by some of their own workers, mostly those who have been with organizations for long periods of time and whose work is not supervised. Excessive authority is given to an employee because he seems to be very effective on his schedule. Individuals in this category are trusted, devoted to duty and work extra hours under the guise of showing much commitment. Hefernan (1996) states a practical case of such a situation that contributed to the failure of Barings Bank.

External economic factors

In a study of 29 bank insolvencies, Caprio and Klingebiel (1996) found that a combination of macroeconomic and microeconomic factors was usually responsible. In particular, on the macroeconomic side, recession and terms of trade were found important.

The factors include interest rates fluctuations, exchange rate fluctuations, and spiraling inflationary conditions.

Also, on the microeconomic side, poor supervision and regulation and deficient bank management were often significant.

According to Brownbridge (1998) Macroeconomic instability would have had two important consequences for the loan quality of the local banks. First, high inflation increases the volatility of business profits because of its unpredictability, and because it normally entails a high degree of variability in the rates of increase of the prices of the particular goods and services which make up the overall price index. The probability that firms will make losses rises, as does the probability that they will earn windfall profits (Harvey and Jenkins, 1994). This intensifies both adverse selection and adverse incentives for borrowers to take risks, and thus the probabilities of loan default.

The second consequence of high inflation is that it makes loan appraisal more difficult for the bank, because the viability of potential borrowers depends upon unpredictable developments in the overall rate of inflation, its individual components, exchange rates and interest rates. Moreover, asset prices are also likely to be highly volatile under such conditions. Hence, the future real value of loan security is also very uncertain.

Bank regulation

Bank regulation has been found as a contributing factor to bank failure (Apea and Sezibera 2002) . In a major study of the U.S. banking crisis in the 1980's and early 1990's, the FDIC (1997) analyzed the causes of the crisis, the regulatory responses to the crisis and the lessons that could be learned. Five of the lessons identified in that study, which may be relevant, are: First, bank

regulation can limit the scope and cost of bank failures but is unlikely to prevent failures that have systemic causes. Second, for most of the period studied, there were no risk-based capital requirements and therefore there was little ability to curb excessive risk taking in well-capitalized, healthy banks. Third, problem banks must be identified at an early stage if deterioration in the bank's condition is to be prevented. In the U.S. system, this required frequent, periodic bank examinations. Fourth, the presence of deposit insurance helped maintain a high degree of financial stability throughout the crisis, but not without costs. Finally, resolving bank failures promptly by closing (or merging) banks when they fail and an insolvency rule returning the bank and/or its assets to the private sector as expeditiously as possible help to maintain market discipline for banks and to promote stability in the market for bank assets.

Apea and Sezibera (2002) citing Hempel & Simonson state that when governments intervene in saving banks from failing, creditors and customers tend to rely on the government to protect their interest. The intervention however, is a disincentive for other institutions, creditors and customers to effectively monitor their interests in banks in an independent manner. The further state that (i) too many stringent rules could cause banks to disregard the measures as they may be seen by the banking sector as superfluous; (ii) a rigid system of rules could inhibit banks from selecting the most efficient means of achieving regulatory goals set for them and may serve as a disincentive for improvement.

Market risk

Financial market risk reflects the inverse relationship that exists between maturity and liquidity and the difficulty that may arise as a result in attempting to reverse existing swap positions. The

longer the maturity of a swap arrangement the greater will be the uncertainty of the levels of future interest rates and their behaviour and the greater the potential effect on the parties concerned.

This means that in the event of one of the counter party defaulting at a time when market conditions are adverse, it might prove difficult for a new counterparty to be found by the remaining counterparty without incurring losses. If a banking institution acts as intermediary principal in a swap, the bank assumes the risk of a counterparty defaulting, as well as any loss that may result for the opposite counterparty.

Credit risk

Credit risk is the risk that credit advanced to borrowers will not be repaid in accordance with terms agreed upon at the outset. Credit provided by banks to individuals, organization and businesses takes on many forms: financing and term loans. Banks incur credit risk also when engaging in interest rate options and swaps with other institutions or large non-bank corporations. It is however, the business of banks to earn interest income by providing credit – not to incur credit risk would mean not doing business."

According to the Basle Committee on banking Supervision, working paper no. 12 (2004) Credit risk, particularly real estate lending, led to widespread banking problems in Switzerland, Spain, the United Kingdom, Norway, Sweden, Japan and the U.S. Market risk was the principal cause of failure in the isolated failure of Herstatt (Germany). Market risk also caused the first stage of the U.S. Savings and Loan failures.

Credit concentration risk, usually in real estate, was cited in nine out of the 13 episodes of bank failure. The widespread banking crises that involved credit risk were remarkably similar. A period of financial deregulation resulted in rapid growth in lending, particularly in real estate related lending. Rapidly rising real estate prices encouraged more lending, abetted by lax regulatory systems in many cases. When economic recessions occurred, inflated real estate prices collapsed, leading directly to the failures.

Experience from around the world indicates that poor credit quality coupled with weak credit risk management practices continues to be a dominant factor in bank failures and banking crises. Therefore, it is clear that information on banks' credit risk profiles, including the quality of their credit exposures and the adequacy of their credit risk management processes, is crucial in market participants' and supervisors' assessment of their condition, performance and ability to survive in the long-run. Such information is also important in assessments of the overall safety and soundness in banking systems.

Liquidity risk

Liquidity risk for banks is clearly the risk that a particular bank will not be able, in the first instance, to meet its commitments. Liquidity risk for a bank arises from a faulty structuring of assets and liabilities wherein no suitable cushion of liquid resources is present to provide the cash with which to cope with unexpected events. Often, excessive liquidity risk may arise from the mismanagement by a bank of one or more other financial risks, such as interest rate risk or credit risk¹¹.

Liquidity risk could become more important to the industry if banks invest more of their funds in thinly traded or illiquid as-

sets. Commercial banking and investment banking may become even more intertwined, possibly increasing the cyclicity of earnings.

Liquidity risk for banks is generally highest at times when confidence in a particular bank or banks, or the banking system as a whole, may be uncertain^{iv}.

Assessment of the liquidity risk of banks is clearly of interest to their own managements, to outside analysts such as stockbrokers and writers of the financial media, and to supervisory or regulatory authorities both domestic and foreign.

As compensation for banks' exposure to liquidity risk arising from their bridging of the time gap between borrowers and lenders, banks earn higher interest on long-term loans than what they pay deposits or loans, which, in the nature of things are of shorter term.

Banks attempt to estimate as accurately as possible, from experience, how much cash they are likely to have to pay out on demand by customers or reimburse depositors not rolling over maturing deposits (SARB, 2004). Such cash is then set aside, invested in liquid assets or placed on call until required, since uninvested cash earns no income.

Generally speaking the needs for liquidity on the parts of banks may be classified under four headings:

The need by a bank to replace net outflows of funds due to retail deposits being withdrawn, or wholesale funds (deposits and loans) not being renewed (distinguishable as the 'funding' aspect of liquidity risk);

The need of a bank to compensate for non-receipt of expected fund inflows, due to a borrower not meeting his commitments timeously (distinguishable as the 'time' aspect of liquidity risk);

The need by a bank to obtain further funds when contingent liabilities actually arise, as when existing overdraft facilities or lines of credit are suddenly more fully utilized, or when commitments resulting from endorsements of bills or promissory notes have to be met when the latter are dishonoured (distinguishable as the 'call' aspect of liquidity risk);

The need by a bank to be able to undertake new desirable transactions, as when an important customer requests further funds (also an example of the 'call' aspect of liquidity risk)

Capital requirements

Banking problems were more severe and/or more difficult to resolve when they hit weakly capitalized institutions. While Norwegian banks failed in the early 1990s, better-capitalized Danish banks were much more resilient to a similar period of economic stress. Where capital requirements were not risk adequate, banks sometimes did respond by taking risks that led them into difficulties, as is illustrated by some U.S. examples. The 1988 Basel Accord thus had beneficial effects. The introduction of risk-based capital standards forced supervisors and banks to begin examining the underlying risks in banks. The Accord allowed U.S. regulators to agree on uniform and increased capital standards for all types of banks and thrifts. The Accord also encouraged supervisors and bankers to more closely examine the underlying risks in banks and make portfolio changes based on those risks.

The observation made by the Groupe de Contact (1999) that the vast majority of failed banks showed intact capital positions when

problems emerged, thus has to be read with great care. First, banks' accounting capital fails to measure its true capital position if accounting and valuation are inadequate, as was the case with several banks that failed, most notably with BCCI or Barings. Second, even though regulatory capital may not always have prevented banking problems, sufficient capital did at least help the restructuring of banks as ongoing concerns. Third, the merits of regulatory capital cannot only be judged on the basis of failed banks alone, the main benefit of capital requirements being that some banks did not fail that might have done so in the absence of any capital standards.

Hasan and Dwyer (1994) provide evidence indicating the existence of contagious bank runs during Free Banking Era in the USA (1837 – 1863) that were caused by events exogenous to the banking system. Furthermore, evidence from the National Banking System (1863 – 1913) indicates that periods of bank failures were associated with macroeconomic instability (e.g. Bernanke, 1983; Friedman & Schwartz, 1963; and Kuafman, 1992). Studies by Saunders and Wilson (1996) stress the significant role of economic shocks.

Bougheas (1999) asserts that during periods of economic instability, solvent banks can indeed face liquidity problems caused by the reaction of depositors to news about the financial insolvency of other banks.

Banks with relatively illiquid, low quality assets or little capital were more likely to fail (Wheelock and Wilson, 2000). They went on to find that banks with capital adequacy problems (highly leveraged banks), poor management, low earnings, low liquidity, or risky asset portfolios are more likely to fail.

First, banks' accounting capital fails to measure its true capital position if accounting and valuation are inadequate, as was the case with several banks that failed, most notably with BCCI or Barings. Second, even though regulatory capital may not always have prevented banking problems, sufficient capital did at least help the restructuring of banks as ongoing concerns. Third, the merits of regulatory capital cannot only be judged on the basis of failed banks alone, the main benefit of capital requirements being that some banks did not fail that might have done so in the absence of any capital standards.

Capital requirements

Moral Hazard (or Adverse Incentives) is a concept with relevance to a variety of principal agent relationship characterized by asymmetric information (Brownbridge, 1998). In banking this would mean adverse incentives on bank owners to act in ways which are contrary to the interests of the bank's creditors (mainly depositors or the government if it explicitly or implicitly insures deposits), by undertaking risky investment strategies (such as lending at high interest rates to high-risk borrowers) which, if unsuccessful, would jeopardize the solvency of the bank. Bank owners have incentives to undertake such strategies because, with limited liability, they bear only a portion of the downside risk but stand to gain, through higher profits, a large share of the upside rewards. In contrast, the depositors (or deposit insurers) gain little from the upside but bear most of the downside risk. The inability of depositors to adequately monitor bank owners, because of asymmetric information and free rider problems, allows the latter to adopt investment strategies, which entail higher levels of risk (not fully compensated for by deposit rate risk premiums) than depositors would prefer. (Apea and Sizebera, 2002).

Moral Hazard on bank owners can be exacerbated by a number of factors. First, an increase in the interest rate may lead borrowers to choose investments with higher returns when successful but with lower probabilities of success (Stiglitz and Weiss, 1981): Hence, a rise in deposit rate could induce banks to adopt more risky investment strategies. A rise in bank lending rates can have similar incentive effects on the bank's borrowers.

Second, macroeconomic instability can also worsen adverse incentives, if it were to affect the variance of the profits of the bank's borrowers, especially when there covariance between borrowers' profits (e.g. of a large share of borrowers are in the same industry) or if loan portfolios are not well diversified among individual borrowers (McKinnon & Pill , 1998).

Third, the expectation that the government will bail out a distressed bank may weaken incentives on bank owners with a reputation for prudent management. Deposit insurance also reduces incentives for depositors to monitor banks.

Forth, moral hazard is inversely related to bank capital. The owners of poorly capitalized banks have little of their own money to lose from risky investment strategies. By implication, financial distress in the bank itself worsens moral hazard, because, as the value of the bank's capital falls, the incentives on its owners to pursue strategies, which might preserve its solvency, are reduced (Berger et al, 1995). For similar reasons, intensified competition in banking markets can also encourage moral hazard, by reducing the franchise value of banks: the present value of a bank's future profits (Caprio and Summers, 1993).

Moral hazard becomes even more acute when the bank lends to projects connected to its own directors or managers (insider lend-

ing). In such cases, the incentives for imprudent (and fraudulent) bank management are greatly increased in that all of the profits arising from the projects are internalized (in the case of loans to unconnected borrowers the project returns are split between lender and borrower), whereas that part of the losses borne by depositors or taxpayers are externalized. Not surprisingly, insider lending is a major cause of bank failure around the world (Caprio, 1997).

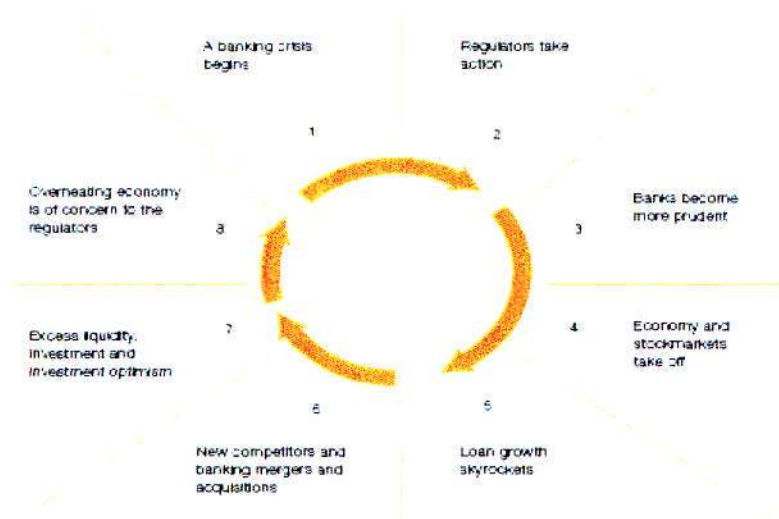
2.4 BANKING SUPERVISION ENVIRONMENT

The third chapter provides a brief description of the South African Banking Supervision environment. The information is largely an extract from the annual report of the Supervision Department of the South African Reserve Bank.

2.4.1 STAGES OF BANKING CYCLE

Banking generally progresses through various stages of what is commonly referred to as “Stages of a Banking Cycle” (SARB, 2004). It is those banks that proactively plan (during good times) for the hard times of the cycle that survive. The broad eight stages of the cycle can simplistically be depicted as in Figure 1 below.

FIGURE 1: STAGES OF A BANKING CYCLE



Source: SARB, 2004.

Working through the various stages of the cycle, one can easily identify the corresponding events in South Africa. The country experienced stage 1, a banking crisis, during the period from late 1999 to 2002. Regulatory actions were taken by the Supervision department and implemented during stage 2, and normality returned to the banking sector. Stage 3 dawned when the surviving banks were still extremely aware of those events, and many bankers became more prudent. This stage involved, amongst other actions, down- or rightsizing of businesses, curtailment and critical evaluation of cost structures, disposal of previously acquired non-core and non-performing assets and investments, evaluation of the required staff complements, reconstitution of management and board structures and an overhaul of the risk-management practices and structures in place at the time.

The fourth stage that of the economy and stock markets taking off, has been very prevalent in South Africa in recent times, resulting in all macro-economic indicators moving into positive ter-

ritory. Similarly, the all-share index touched an all-time high of 12 681 points at the end of December 2004. Increased loan growth, characteristic of stage 5, was at the forefront of banking activity during the year under review, and demand for credit surged to a 13-month high in December 2004/January 2005, whilst consumer spending remained strong. Signs of stages 6 and 7 - new competitors and excess liquidity and investment optimism are beginning to emerge. By the end of 2004, interest in acquiring a stake in South African banks had been expressed by some international players. Barclays saw the culmination of this interest in acquisition of a controlling shareholding in Absa. Also, reports, by some banks, of a build-up of excess cash were beginning to surface.

It can thus be seen that South Africa has progressed to stage 5 of the cycle's eight stages, whilst signs of stages 6 and 7 are becoming apparent. The vexing question is obviously whether or not the cycle will be completed. Unfortunately, no amount or extent of banking regulation and supervision can ever prevent the occurrence of problems at banks. It is, however, the regulator's responsibility to be proactive by assisting banks to identify which stage of the cycle has been reached and to encourage banks proactively to take appropriate steps and actions in preparation for the leaner periods that may follow.

Accordingly, without in any way detracting from the long-term sustainable and sound macro-economic fundamentals that are in place in South Africa, bankers should be aware that cycles do turn. Prudent bankers are those who carefully plot the cycle and, during the good times, put in place suitable measures to ensure that their banks can survive, with a minimum of additional or drastic action, the effects of any downturn that may present itself.

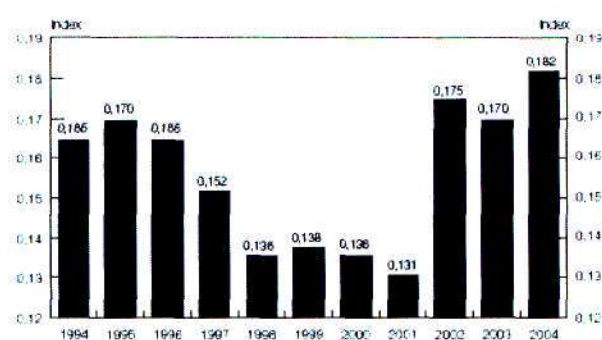
2.4.2 CONCENTRATION IN THE SOUTH AFRICAN BANKING SYSTEM

Several indices may be used to measure concentration and competition in a banking system. The most widely used index in the literature is the Herfindahl-Hirschman index, commonly referred to as the H-index (Rhoades, 1993).

According to SARB's annual report, 1994, South Africa had 36 banking institutions at the end of that, the H-index deteriorated from 0,170 in 2003 to 0,182 in 2004, as illustrated in figure 2 below.

Since the number of banks has decreased by only one bank since 2003, the deterioration in the H-index can be attributed mainly to the four largest banking groups constituting a larger proportion of the total banking system. These four banks constituted 83,7 percent of the banking sector in December 2004, compared to 80,8 percent in December 2003.

Figure 2: H-index for the South African banking system (1994-2004)



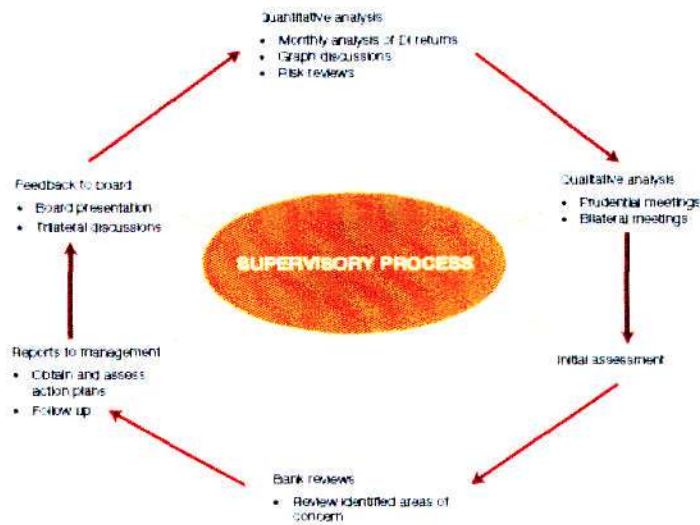
Source: SARB.

2.4.3 OVERVIEW OF THE SUPERVISORY ACTIVITIES

The South African banking industry has been highly competitive, particularly after the Asian contagion of the late 1990s. The increased competitiveness resulted in a change in the banking environment and thus related risks changed. The Supervision department of the SARB has to respond and has accordingly tailored its framework in order to effectively monitor the related risks.

The Supervision department's modified framework included, among other things, six steps in the supervisory process as shown in figure 3 below.

FIGURE 3: SIX STEPS IN SUPERVISORY PROCESS



Source: SARB

Quantitative analysis

According to SARB's Supervision Department, the supervisory approach and processes are primarily risk focused. From the perspective of quantitative analysis, all statutory returns and other financial information submitted by banks entail detailed analysis, including time-series analysis, and interpretation of the trends reflected in graphic material prepared from the financial and risk information of banks submitted to the Department. This analysis and the information gathered through prudential meetings, that is, budgets and management-account information, form the basis of further and regular interaction and discussions, at a micro level, with the appropriate risk managers of banks. As a result, the Department is able to risk rate individual banks as high, medium or low risk.

Qualitative analysis

During 2004 financial year, the Department's relationship teams undertook qualitative assessments of each individual bank, by holding, amongst other things, prudential, bilateral and ad hoc meetings with the various stakeholders. These qualitative assessments formed an intrinsic part of the Department's supervisory programme for each individual bank and banking group and included structured meetings with the chief executive officer, external and internal auditors, risk managers and other executive officers.

The main objective of the Department's qualitative analysis is to gain a thorough understanding of each individual bank's and banking group's strategic objectives, business plans, governance processes and levels of general risk management and internal controls. The supervisory process is supplemented by a review of each bank's and group's internal management and board reports, as well as internal and external audit reports, with a view to ensuring appropriate attention to and action on supervisory concerns.

Initial assessment

Based on the above-mentioned quantitative and qualitative analyses, the Department makes initial assessments of banks' and banking groups' main risk areas. These assessments, in turn, are used to revise and update the Department's supervisory plans for each individual bank and banking group proactively and on an ongoing basis, whilst also enabling the relationship teams objectively to identify any further supervisory intervention that may be required. In summary, the assessment process ensures ongoing appropriate attention to and action on supervisory concerns and further facilitates regular communication and liaison between the

Department and the appropriate representatives of banks and banking groups.

Bank reviews

Flowing from the above initial assessments, specific bank reviews in terms of the Bank Act were undertaken during the annual supervisory cycle when deemed appropriate. These reviews were bank specific and focused primarily on the activities and risk areas that posed the greatest risk to the soundness of the particular banks. The Department implemented close coordination between the review and the relationship teams, in order to ensure that, in the main, the same staff members were involved in all facets of supervising individual banks and banking groups. This approach ensured that the relationship team for a particular bank remained conversant with the bank's financial condition, management structure, business model, overall operations and adequacy of its management systems, in order to identify, measure and monitor the respective risks, as well as to address control of these risks with the bank (SARB, 2004).

The reviews referred to above focused mainly on assessing the effectiveness of individual banks' risk-management frameworks for their credit and trading activities. The assessments also included evaluations of the asset quality of credit- and trading-counterparty exposures, as well as the application of sound corporate-governance standards during the conduct of such activities. In some instances, however, the Department also requested specific ad hoc reports from banks' external auditors. Other reviews related to the monitoring and examination of banks' progress with special projects aimed at addressing specific issues or areas of concern that had been identified as requiring corrective action (SARB, 2004).

Reports to management

The reviews that the Department undertakes culminated in discussions on the findings and recommendations arising there from with the management of each particular bank. The Department then sent a formal report to the particular bank, and the bank's management was required to furnish the Department with an action plan, with time frames, on the remedial action to be taken within 30 days of receipt of the report.

Significant issues arising from the reviews undertaken were also discussed with the respective banks' board risk committees during the annual trilateral discussions. This included discussion of the board risk committee's monitoring and follow-up procedures with regard to the bank's remedial action plan.

Feedback to board of directors

For a sound banking system, it is of great importance that all members of a individual bank's board of directors are fully informed of and conversant with the risk profile of the bank, as reflected in both the management accounts and the statutory risk returns submitted to the Department. In the case of a banking group, it is also important for the directors to have not only a group perspective, but also an understanding of the risks of a bank forming part of the group. In such cases, therefore, the Department includes discussion of information on the consolidated group in meetings with a bank's board of directors.

A bank's board of directors is the most important key player in the supervisory process and accepts ultimate responsibility for the risk profile of a bank. Consequently, it is essential for the Department to hold meetings with a bank's board of directors, in order to obtain, amongst other things, directors' views and perspectives on the relevant risk profiles, risk management and risk

appetite of the bank. Such meetings also enable the Department to put forward its views and opinions on the risk profile of a bank, based on the information received from the bank, and to give feedback to the directors on current supervisory issues. The supervisory programme for each individual bank, therefore, required the relevant relationship team and a senior member of the Department to hold at least one meeting with the bank's board of directors during the 2004 supervisory cycle.

Trilateral discussions

The supervisory programme for each individual bank also requires the relationship team and a senior member of the Department to hold at least one joint meeting with the bank's audit committee and external auditors during each annual supervisory cycle. The purpose of these meetings is to address a particular facet of a bank's business in some depth and to evaluate the bank's risk management in that area. In general, the discussions cover the management letters produced by a bank's external auditors, internal and external audit reports and the statutory functions of a bank's audit committee.

During a supervisory cycle, the scope of the trilateral discussions was broadened to include the activities of both the Directors' Affairs Committee and the Board Risk Committee of each bank. Since the objectives of these committees are to assist a bank's board of directors to fulfill its duties and to enhance corporate governance within the bank, the Department deemed it necessary to discuss the issues emanating from the said committees with the committee members.

The above-mentioned two committees are mandatory statutory committees in terms of amendments to the Banks Act, 1990, and have specific responsibilities. Overall, the Department's findings

were that these two committees were yet to become fully functional. Therefore, it is incumbent on the chairpersons of boards to ensure that the two committees become fully functional and effective during 2005.

Internal governance arrangements, focus on business plans and alignment to risks, operating structures and management information

During the prudential meetings held with individual banks and banking groups in 2004, the Department's relationship teams placed specific focus, at a micro level, on the internal governance arrangements within a bank and banking group. The Department deemed it appropriate to discuss, identify and highlight possible weaknesses within banks' internal governance arrangements. In view of the potentially negative consequences of poor corporate governance, the objective was to add value. During these meetings, the Department also focuses on strategic objectives, business plans, risk-management processes and practices, the alignment thereof with operating structures, systems and the flow of management information. Among the issues addressed were the sustainability of business models, balance-sheet structures, asset diversification, effectiveness of boards of directors and their involvement in setting business and strategic objectives. Other issues of importance that were addressed included the risks and consequences of any potential lack of appropriate governance structures and lack of ongoing risk management, since shortcomings in these areas might result in capital erosion, with far reaching consequences for banks, their depositors and their employees.

The Department emphasizes that, in most cases, situations of distress were due primarily to an avoidance of responsibility and accountability throughout organizations and groups as a whole. In practice, a lack of responsibility and accountability was usually more difficult to detect as a result of banks' complex group

structures and disparate business units. For example, business units might involve themselves in non-core operating activities and be allowed to drift into different strategic directions, causing them to operate in separate silos. This was likely to create numerous pockets of significant, unmanaged risks, without centralized oversight, which could impact severely on banks' and banking groups' profitability.

According to SARB, the Department's relationship teams also raised and discussed issues relating to whether the allocation of capital was aligned to banks' business activities and whether the returns on the allocated capital were being measured appropriately. It was stressed that another factor that could lead to a distressed environment was non-alignment of reporting entities to operating entities. It was pointed out that a lack of reliable, integrated systems would result in fragmented management reporting, usually necessitating significant manual intervention and leading to manipulation of available information and, ultimately, inappropriate decisions. In such situations, a common factor would appear to be a lack of appropriate board oversight and a lack of compensating controls. These, in turn, were likely to result in problems at all operating levels of banks and banking groups.(SARB,2004)

In some instances, the Department was uncomfortable with, firstly, some banks' culture of non-compliance and, secondly, the quality of some banks' statutory information. The Department undertook in-depth analyses of all available information and identified certain areas of concern. In particular, credit risk and the lack of adequate and effective information systems were identified as areas requiring swift action.

The above analyses resulted in focused discussions with the management of the relevant banks and culminated in internal reviews and self-assessments by these banks.

The action plans implemented by the banks concerned included, amongst others, the following:

- Rationalization of the group structures of banks and their controlling companies

This rationalization included appropriate management of intra-group exposures.

- Proactive capital management and appropriate capital allocation
- Alignment of banks' strategies to operating structures
- Production of appropriate management information, aligned to operating structures

According to the Registrar, the Department regards the availability of accurate, integrated and reliable management information as absolutely essential. It was found that poor management-account information was a common weakness, which hampered appropriate decision-making. Once the said problem had been addressed, significant value was unlocked at all levels in banks.

Overall, the Department found that, when required, appropriate and timely action plans and remedial actions were put in place by banks' and banking groups' management.

This demonstrated what could be achieved if the supervisor and banks worked in partnership to maintain financial stability in the banking sector.

Interaction with banks' external auditors

The same focused approach was followed in the Department's interaction with banks' external auditors (SARB, 2004). In addition to the bilateral meetings held in terms of the directives of regulation 45 of the Regulations relating to Banks, the Department held various ad hoc meetings with banks' external auditors. This resulted in information being shared timeously with the external auditors and fostered open and interactive participation, as well proactive cooperation.

The above culminated in various projects being undertaken by banks and their external auditors, in order to rectify weaknesses and deficiencies in a proactive and focused manner. Throughout the year under review, the Department was kept up to date on progress made, actions taken and milestones achieved.

Trading activities (market risk)

On a regular basis during the year, the Bank Supervision Department visits the major trading banks and reviewed the day-to-day management of their trading activities. The main objective was to obtain updated information on how banking institutions were managing their treasury operations and to gain a better understanding of some industry-specific issues. Among these issues were the different risk measures and methodologies used, specifically the following:

- Standardized approach to completion of DI returns.
- Banking-book versus trading-book capital allocation.
- Large-exposure requirement in respect of trading-book capital.
- Regulatory treatment of risk margin.

- Bilateral netting.
- Regulatory arbitrage.

Banks' trading activities within the South African banking sector are reported to the Department in terms of the Regulations relating to Banks and the Regulations relating to Capital-adequacy Requirements ("CAR") for Banks' Trading Activities in Financial Instruments (CAR Regulations), which require the boards of directors of trading banks to approve and allocate capital for trading activities. The CAR Regulations also require capital to be held in respect of position risk, counterparty risk and large exposures.

The Department monitored trading banks' compliance with the minimum capital requirements in respect of the above-mentioned risks on a daily basis and compared each particular bank's figures to those of its peer group and all trading banks on a monthly basis.

Overall, the Department's assessment was that the risk management of South African banks' trading activities was comparable to that of international banks and that South African banks adhered to best practice. Most trading banks in South Africa were using value-at-risk (VAR) methodology internally or were moving towards that methodology. (SARB, 2004)

More importantly, however, all assessed banks had sensitivity and stress limits in place, in order to supplement the measurement of VAR exposures.

It was decided that the CAR Regulations would be reviewed and updated together with the Regulations relating to Banks.

Review of corporate governance in South African banks

Sound corporate governance for banks remains critical for several reasons, among them that:

- Globalization, technological advances and sophisticated financial instruments are constantly increasing the risks within the banking sector.
- Most of the funds used by banks belong to depositors.
- The failure of a bank can impact on the financial system as a whole.

This reality was brought home in South Africa by the demise of several banks, key among them being Regal Treasury Private Bank Limited, Saambou Bank Limited and BOE Bank Limited.

The lessons learnt from these and other failures, locally and internationally, resulted in the appointment of Adv John Myburgh SC, together with a team from the Bank Supervision Department, in August 2002 to review the status of corporate governance within South Africa's five largest banks. These banks, being, in alphabetical order, Absa Bank Limited, FirstRand Bank Limited, Investec Bank Limited, Nedbank Limited and The Standard Bank of South Africa Limited, at the time accounted for 86 per cent of bank assets in South Africa. The purpose of the review was broadly to evaluate the standard of corporate governance applied in the aforementioned five banks. The basic premise was that sound corporate governance was an essential element of a healthy risk management process and crucial to any bank. The outcome of the review was presented in a report to the Registrar of Banks during the first quarter of 2003.

The following generic findings were made:

- The banks were committed to adherence to and application of high standards of corporate governance.
- Acting on the advice of specialists in corporate governance, the banks on their own initiative reviewed their corporate governance from time to time, to ensure compliance with accepted corporate-governance principles.
- In general, the corporate governance of the banks was sound.
- Vigilance was nevertheless required to ensure continued compliance with the standards of governance constantly evolving in South Africa and internationally.

The Bank Supervision Department had always intended to extend the review to the remainder of the banks registered in South Africa.

The purpose of the review was to investigate the banks' compliance with corporate governance best practices, as laid down, for example, in the Banks Act, 1990, the Regulations relating to Banks and the recommendations of the Myburgh Report on the Standard of Corporate Governance in the Five Largest Banks in South Africa and of the second King Committee on Corporate Governance. In particular, the objective was to establish, firstly, the extent to which an adequate and effective process of corporate governance had been established and was being maintained within a controlling company, a bank and its subsidiaries and, secondly, the extent to which the overall effectiveness of the process was monitored by the board of directors.

The scope of the review was to establish, describe and express an opinion on the adequacy of the following areas:

- Structure, composition, role and functions of the board of directors.
- Role and functions of the risk-management committee, audit committee, remuneration committee, directors' affairs committee, chief executive officer, external auditors.
- Status, role and scope of the risk function, internal audit function, compliance function and company secretariat function.
- Director selection, career path and development.
- Independence of directors.
- Leadership.
- Management-accountability structure.
- Systems of control.
- Decision-making process and decision-making capability of the board.
- Reports from management to the board.
- Board monitoring of management activities reported to the board.
- Disclosure to stakeholders.
- Related-party lending, conflicts of interest and related matters.

Corporate-governance structures and processes alone, however, cannot prevent situations of distress.

Corporate governance – as properly understood – describes the framework of rules, relationships, and systems and processes

within and by which authority is exercised and controlled in corporations. Understood in this way, the expression 'corporate governance' embraces not only the models or systems themselves but also the practices by which that exercise and control of authority is in fact effected.

Right and wrong are moral concepts, and morality does not exist in a vacuum. I think all those who participate in the direction and management of public companies, as well as their professional advisers, need to identify and examine what they regard as the basic moral underpinning of their system of values. They must then apply those tenets in the decision-making process. The education system – particularly at university level – should take seriously the responsibility it has to inculcate in students a sense of ethical method.

In an ideal world the protagonists would begin the process by asking: is this right? That would be the first question, rather than: how far can the prescriptive dictates be stretched? The end of the process must, of course, be in accord with the prescriptive dictates, but it will have been informed by a consideration of whether it is morally right.

In corporate decision making, as elsewhere, we should at least aim for an ideal world.”

2.5 SURVEY OF LITERATURE THAT RELATE TO THE RE-SEARCH METHODOLOGY USED IN THE DISSERTATION

The research is predominantly a secondary analysis and as a result I did not be undertake primary data analysis. Primary data analysis includes the production of original works of research or raw data without interpretation. Due to the fact that the research top-

ic is Financial and there's a lot of primary data that is available, thus I researched the secondary sources. Secondary sources thus seek to interpret the primary data.

There are generally five types of information sources used in most literature searches, including indexes and bibliographies, dictionaries, encyclopedias, handbooks and directories, Each is useful to a literature search in a variety of ways (Cooper & Schindler,2003).

I chiefly used bibliographies and indexes for my literature review.

The process I used included:

- a. Selected a database appropriate to my topic;
- b. Constructed a search query (or search statement)
 - Reviewed and evaluate the search results
 - Modified the search query, where necessary.
- c. Saved the result of my search
- d. Retrieved articles not available in the database
- e. Supplemented my result with information from Web sources.

As an overall analysis, I considered the following three themes:

- a) What is the most appropriate theoretical framework to interpret the results?
- b) Which is the most appropriate research method?

The research method used and considered the most appropriate research method, as detailed above is the secondary analysis. Thus the researcher did not undertake primary data analysis. Primary data analysis includes the production of original works of research or raw data without interpretation. Due to the fact that the research topic is Financial and there's a lot of primary data that is available, he researched the secondary sources. Secondary sources thus seek to interpret the primary data.

- c) The extent to which other researchers solved the problem

2.6 Survey of literature that relate to the elimination of problems that relate to the elimination of problems solved by other researchers

The researcher used various internet search sites for dissertations including obtaining a dissertation over Sabinet from WITS Business School. The foremost dissertation that the researcher found useful were the following:

- Bank Failure in South Africa by Stephen Kosseff, 1984 from the Graduate School of Business, University of Witwatersrand.
- A case for the introduction of deposit insurance in South Africa by Jake Ngau, 2005 from the University of Johannesburg (RAU).

- *Some Causes of Bank Failure* by Constance Apea and Jemime Sizebera, from the Graduate School of Business, Goteborg University.
- *The Causes of Financial Distress in Local Banks in Africa and Implications for Prudential Policy, 1998* by Martin Brownbridge, United Nations Conference on Trade Development.

The sub-problems were noted as the following:

- Is bank failure a phenomenon that is as new as the “new South Africa”?

According to the study undertaken by Kosseff, as noted above, during the 1970's, nine (9) out of fifty (50) banks that were registered failed or were taken over pending failure. Of the nine banks, seven were general banks and two were savings banks. In most cases, the Registrar of Banks was successful in ensuring that depositors did not lose any funds, as liabilities of the failed banks were taken over by some of the major banks. In only two cases did depositors lose part of their capital. These were Trans-Drankensberg Bank in which creditors received 95 cents in the Rand and Rand Bank in which creditors received 98 cents in the Rand. In both cases, it took a number of years before the creditors were actually paid out and no interest was earned on these funds.

According to the study by Ngau, the following failures were noted between 1990 and 1994:

Alpha Bank failed in 1990 due to fraud and insider lending and was in Curatorship for a 4 year period.

Cape Investment Bank failed in 1991 due to fraud and disclosure and was in Curatorship for a year.

Pretoria Bank failed in 1991 due to poor strategic management linked to the Masterbond demise and was in Curatorship for six months

The phenomenon of Bank Failure is therefore not as new as the New South Africa as proved in the research noted above. The sub-problem will therefore not be carried forward further in the research.

- Have any of the Banks that failed during the period under review caused systematic failure?

The studies by Kosseff and Ngau did not show any evidence of systematic risk as a result of any failed bank. This sub-problem will be carried forward in the research to determine if any of the banks that failed in the post apartheid South Africa led to any systemic risk.

2.7 Conclusion

This chapter covered literature review relevant to causes of bank failure and explored the South African banking regulatory environment. Furthermore, it explored what other research has been undertaken for the same problem statement in order to eliminate some of the sub-problems.

CHAPTER 3

RESEARCH METHODOLOGY

3.1 INTRODUCTION

The researcher in this chapter provided the basis for the methodology chosen. Details of the selection criteria and the process of analysis used to test each of the stated assertions are presented. Data collection methods and measuring instruments are also explored.

3.2 RESEARCH METHOD

In seeking answers to the problem statement presented in Chapter one, the researcher studied the causes of failure of ten failed banks since South Africa realized democracy, in the light of existing literature on some of the causes of bank failure.

A research instrument will not be designed but an analysis of secondary data approach will be used.

Analysis of secondary data is normally allowed for use in either finance or economic research because experts already and that is applicable in this instance normally collect the data. According to Cooper and Schindler (2003) it is inefficient to discover anew through the collection of primary data or original research what has already been done and reported at a level of sufficient for decision making.

The researcher therefore will not have to collect the data himself.

Secondary data analysis was used as the principal approach through theoretical and empirical analysis. According to Zeijersborger, the preference of a methodology influences the results of the research (Zeijersborger, 2000).

The theoretical analysis included an in depth examination of some causes of bank failures.

The empirical analysis included the detailed investigation of the 10 failed banks since 1994. Further detailed empirical analysis was performed on the last three banks to fail since 2000 and these included Regal Treasury Bank, Saambou and BoE. The reason for doing detailed work on these three failed banks particularly was that financial information was somewhat available whereas was very little financial information available on the other banks especially those that occurred in the mid 90s. The researcher also related the actual causes of the failed banks.

As part of the theoretical framework, the researcher also provided an overview of the regulatory framework within the South African banking industry.

In conclusion, the researcher provided recommendations for the prevention of causes of bank failure to assist in the prevention of history repeating itself.

3.3 THEORETICAL FRAMEWORK AND RESEARCH APPROACH

According to Apea and Sezibera, citing Javefors(2002), a positivist framework permits for an objective research. The researcher

thus used a positivist framework and collected, analyzed, reviewed and interpreted existing theories based on empirical studies on causes of bank failure.

Apea in their research cite that according to Yin, there are five distinguishing research approaches, namely: experimental, survey, archival analysis, history and case study. Furthermore, he states that that the guiding variable to the chosen strategy depend on types of research questions, the extent of control over behavioral events and the relative focus on contemporary versus historical events (Yin,1994).

This research is therefore a case study. Yin further distinguishes between explanatory, descriptive or exploratory case studies.

3.4 SELECTION PROCESS

Information in respect of all banking institutions that failed in the period 1994 to date was obtained from the office of the Registrar of Banks within the South African Reserve Bank.

- Name of institution
- Year in which failure took place and/or the bank was place in Curatorship
- Causes of failure

For each of the banks, a general overview of the cause of the failure was undertaken.

The researcher did a detailed financial review on Regal Treasury, Saambou and BOE only. This is because these banks failures are the most recent and the financial information is still available

whereas the majority of the other failed banks do not have available financial statements.

Financial statements would be analyzed, as fully set out below with the intention of trying to establish the causes of the failure. Commentary from financial commentators would be explored.

The following is a schedule of failed banks since 1994, which were obtained from the Registrar of Banks.

List of failed Bank

Institution	Year	Cause of failure
Prima Bank	1994	Liquidity risk Credit risk Market risk
Sechold Bank	1994	Market risk
African Bank	1995	Liquidity risk Credit risk Operational risk
Community Bank	1996	Liquidity risk Credit risk
Islamic Bank	1997	Liquidity risk Credit risk
New Republican Bank	1999	Liquidity risk Reputational risk Credit risk
FBC Fidelity Bank	1999	Liquidity risk Reputational risk Credit risk
Regal Treasury	2001	Liquidity risk Operational risk Credit risk
Saambou	2002	Liquidity risk Reputational risk

Institution	Year	Cause of failure
BOE Bank	2002	Liquidity risk

Source: Tim Store (Deloitte & Touche)

3.5 DATA ANALYSIS IN RESPECT OF SELECTED BANKS

The following financial ratio analysis was used as a measure of comparison between the three banks selected for detailed analysis (Regal, Saambou and BoE).

PROFITABILITY	
INTEREST MARGIN (TOTAL ASSETS)	$\frac{\text{NET INTEREST INCOME}}{\text{AVERAGE TOTAL ASSETS}}$
NET MARGIN (AFTER TAX)	$\frac{\text{NET INCOME AFTER TAX}}{\text{REVENUE}}$
LIQUIDITY RISK	$\frac{\text{LIQUID ASSETS} - \text{SHORT TERM BORROWINGS}}{\text{TOTAL DEPOSITS}}$
ASSET UTILIZATION	$\frac{\text{GROSS REVENUES}}{\text{AVERAGE ASSETS}}$
RETURN ON ASSETS	$\frac{\text{GROSS REVENUES}}{\text{AVERAGE ASSETS}}$
LEVERAGE MULTIPLIER	$\frac{\text{ASSETS}}{\text{EQUITY}}$
RETURN ON EQUITY	$\frac{\text{NET INCOME AFTER TAX}}{\text{AVERAGE EQUITY}}$
EARNINGS POWER	$\frac{\text{EARNINGS ASSETS}}{\text{TOTAL ASSETS}}$

NON-INTEREST EXPENSES TO TOTAL ASSETS	$\frac{\text{NON-INTEREST EXPENSES}}{\text{AVERAGE TOTAL ASSETS}}$
NET NON-INTEREST EXPENSES TO TOTAL ASSETS	$\frac{\text{NON-INTEREST EXPENSES} - \text{NON INTEREST INCOME}}{\text{AVERAGE TOTAL ASSETS}}$
EFFICIENCY	$\frac{\text{NON INTEREST EXPENSE}}{\text{NET INTEREST INCOME} + \text{NON INTEREST INCOME}}$
YIELD ON EARNING ASSETS	$\frac{\text{INTEREST INCOME}}{\text{AVERAGE EARNING ASSETS}}$
COST RATE ON TOTAL ASSETS	$\frac{\text{INTEREST EXPENSES}}{\text{AVERAGE TOTAL LIABILITIES} + \text{AVERAGE EQUITY}}$
RISK	
CORE DEPOSITS TO ASSETS	$\frac{\text{CORE DEPOSITS}}{\text{TOTAL ASSETS}}$
LIQUID ASSETS TO EARNING ASSETS	$\frac{\text{SHORT} - \text{TERM INVESTMENTS} (<1 \text{ YEAR})}{\text{EARNING ASSETS} - \text{SHORT TERM INVESTMENTS}}$
NET LOANS – TO – DEPOSITS	$\frac{\text{NET LOANS}}{\text{TOTAL DEPOSITS}}$
NET LOANS –TO – CORE DEPOSITS	$\frac{\text{NET LOANS}}{\text{CORE DEPOSITS}}$
NET LOANS – TO – ASSETS	$\frac{\text{NET LOANS}}{\text{TOTAL ASSETS}}$
CREDIT QUALITY	
CREDIT RISK (THIS PERIOD)	$\frac{\text{PROVISION FOR BAD DEBT EXPENSES (THIS PERIOD)}}{\text{GROSS LOANS (THIS PERIOD)}}$
CREDIT RISK (ACCUMULATED)	$\frac{\text{ACCUMULATED PROVISION FOR BAD DEBTS}}{\text{ACCUMULATED GROSS LOANS}}$

CAPITAL ADEQUACY	
CAPITAL RISK	$\frac{\text{TOTAL CAPITAL}}{\text{TOTAL ASSETS}}$
EQUITY CAPITAL RISK	$\frac{\text{ORDINARY EQUITY}}{\text{TOTAL ASSETS}}$
ADJUSTED CAPITAL BASE – ADJUSTED ASSET BASE	$\frac{\text{ADJUSTED CAPITAL BASE}}{\text{ADJUSTED ASSET BASE}}$
CAPITAL ADEQUACY RATIO (ASSETS)	$\frac{\text{SHARE CAPITAL + UNIMPAIRED RESERVES}}{\text{TOTAL ASSETS}}$
CAPITAL ADEQUACY RATIO (LOAN)	$\frac{\text{SHARE CAPITAL + UNIMPAIRED RESERVES}}{\text{TOTAL LOANS}}$

3.6 CONCLUSION

The chapter provided a description of the basis for the research methodology chosen for this dissertation.

The researcher in this chapter provided the basis for the methodology chosen. Details of the selection criteria and process of analysis used to test each of the stated assertions are presented. Data collection methods and measuring instruments were also explored.

CHAPTER 4

DATA ANALYSIS

4.1 INTRODUCTION

This chapter provides a detailed analysis of the bank that failed during the intervening period.

4.2 LIST AND PRIMARY CAUSES OF FAILURE

INSTITUTE	YEAR	CAUSE OF FAILURE
PRIMA BANK	1994	LIQUIDITY RISK CREDIT RISK MARKET RISK
SECHOLD BANK	1994	MARKET RISK
AFRICAN BANK	1995	LIQUIDITY RISK CREDIT RISK OPERATIONAL RISK
COMMUNITY BANK	1996	LIQUIDITY RISK CREDIT RISK
ISLAMIC BANK	1997	LIQUIDITY RISK CREDIT RISK
NEW REPUBLICAN BANK	1999	LIQUIDITY RISK REPUTATIONAL RISK CREDIT RISK
FBC FIDELITY BANK	1999	LIQUIDITY RISK REPUTATIONAL RISK CREDIT RISK
REGAL TREASURY	2001	LIQUIDITY RISK OPERATIONAL RISK CREDIT RISK
SAAMBOU	2002	LIQUIDITY RISK REPUTATIONAL RISK
BOE BANK	2002	LIQUIDITY RISK

4.2.1 PRIMA BANK - 1994

The causes of Prima Bank's ("Prima") failure as summarized above are due to liquidity risk, credit risk and market risk. We consider these risks hereunder in more detail.

In the three (3) years to 1993, Prima's published profits rose fourfold and the capital base rose six fold. Risk weighted capital adequacy was at a satisfactory 19%, which at the time was the highest in South Africa and more than double the statutory requirements

Republic Ratings (Pty) Ltd ("Republics"), a then South African based rating company led by businessman Dave King went public with its speculative grade rating for Prima bank and shortly thereafter the bank sought Curatorship. Republic Ratings had been seeking to perform and on-site rating but were not provided access by management; hence they resorted to doing the speculative rating.

Republics found that 30% of Prima's advances book was non-performing but despite this and the 470% rise in advances, the bank only increased its provisions through the income statement by only R1.4 million in the three years to 1993, thus bolstering profits. By June 1993, Republics had calculated that the capital value of loans against which provisions would have to be made for future losses totaled R50 million. Against this, general provisions totaled R3 million. Republics believed potential write-offs could eradicate Prima's entire capital base. Furthermore, Republic's noted problems with accounting practices and lack of internal controls as other contributing factors to the speculative grade rating. In the end, a rating of B2 was given to the bank.^{vi}

Prima continued to account for interest income on its largest exposure to a property development despite the property development company being in severe difficulties and unable to sell units. Prima effectively controlled 65% of this company and its results were not consolidated into Prima's. This further gives credence to Republic's comments about the dubious accounting practices at Prima.^{vii}

Historical fee-based income had been overstated as the bank effectively shielded its income statement from realized future losses. This was done by acquiring assets from dealers concerned and reflecting these assets (at face value of losses incurred) on the face of the balance sheet. Material contingency liabilities of R10 million were not disclosed on the financial statements.

The curator also found that internal controls were lacking as trading units exceeded budgets and regulatory return forms (DI forms) were incorrectly filed with the Reserve Bank.

Shortly after the speculative grade rating was issued by Republics, the directors of Prima requested the Reserve Bank to place the bank under Curatorship and Tim Store of Deloitte & Touche was appointed by the bank in terms of section 59 of the Bank Act. They cited possible run on deposits as the main factor resulting from Republic's grading. At the time, the bank had over R190 million in deposits.

Banks generally have an A grade with the big four (Absa, Standard, FNB and Nedbank) having an A1 grade. Smaller bank would have a lesser grade than the big four and on average this would be A2. Grading of less than an A for banks is detrimental and depositors, especially corporate depositors and fund managers would seek to safeguard funds under management with the major-

ity of them having mandates to deposit funds with A graded institutions only. The reason for management, i.e. possible run on the bank was therefore reasonable and it was highly likely that a run on deposits would have followed.

Various attempts were made to salvage the bank and avoid liquidation with Unibank coming much closer than any other party in acquiring Prima. It sought to acquire the instalment finance book for R30 million and R20 million negotiable securities including assuming an equal amount of liabilities.

The various efforts were not successful and Prima was eventually put into final liquidation early in August 1994.

In summary the factors raised as the Primary Causes of Prima's failure by Tim Store are as follows:

Liquidity risk

The speculative grading report would have led to investors, especially corporates and institutions to withdraw their deposits and this would have led to a run on its deposit. The bank would not have had sufficient liquidity to repay all deposit and still stay afloat to deal with its other obligations. This was the main reason the directors approached the Reserve Bank to put the bank under a curator. The curator would have the powers to freeze deposits and put a halt to the run and thus the liquidity shortages.

Credit risk

The credit risk was also a main factor that caused the failure of Prima in that whilst the advances book was rising at a much faster rate, a larger portion of the book was not performing and at 30%, that is approximately a third of the book. This led to the conclu-

sion by Republics that if the loans against which provisions would have to be were calculated, a significant portion of the bank's capital would be wiped out. This would have rendered the bank falling foul of the capital adequacy requirements needing cash injection and in the process, a run on deposits would have been inevitable unless the capital injection was immediate.

4.2.2 SECHOLD BANK

Sechold had three operating constituents: Banking (four banking licenses – Secfin, NDH, Securities Investment, District Securities); Portfolio Management; and Other – where the damage took place (Sechold Finances, Theta Securities, Securities Management ad Securities Equities).

The problems were traced to Securities Equities (“SE”), which was operated by one man, Louis Ehrlich, and a half-day assistant. SE was Sechold's vehicle for taking positions in the futures and options markets that was managed and operated exclusively by Ehrlich, who reported daily to the Managing Director, Arthur Kelly.

It is reported that Ehrlich believed that at the time, the market was in a state of comparative neutrality and was therefore unlikely to move significantly in any direction. SE freely wrote deep-out-of-the-money call and put options. That means he bought and sold at particularly low premiums because he believed the market would remain stable. Ehrlich positioned his book so the premiums received would be highly profitable if the All Share Index traded consistently between 3200-4800.

The downside to this is that if the book is positioned without limiting the losses, as SE did, without limiting the losses and, unthinkable the market goes against you, you are by definition ex-

posed to limitless losses. The technical name for this positioning of an investment book is “the Short Strangle”. The number of actual contracts bought and sold by SE was never fully disclosed as their clearing member, Rand Merchant Bank refused to divulge the numbers citing confidentiality. SE had bought and/or sold contracts, which would not be exercised between 3200 – 4800, enabling the company to keep premiums paid to it by investors who became entitled to buy or sell securities at predetermined price. If the index moved outside the range in which the option had been written, these investors could clam the benefits attached to the underlying assets. SE vulnerability arose because he did not choose to cover these transactions through countervailing positions.

After months of pedestrian performance, the market suddenly caught fire – and not in SA alone. Around the world, equities stirred, investors poured in, the great hunt for instant profit was on again. Around the world, equities stirred, investors poured in, the great hunt for instant profit was on again. What gave others joy caused Ehrlich and SE consternation.

It appears that the extent of the positions was not communicated to either the board or to management. Instructions given either weren't implemented or couldn't be. Information provided was selective and misleading. The daily mark-to-market of risk positions as reported by Kelly in his report to shareholders the year before proved to be either inefficient or non-existent as the positions weren't limited timeously.

The SA Futures Exchange (Safex) in the mean time, reportedly noticed the unusually large margin calls against Sechold positions (margin calls are made daily by Safex to ensure the integrity of the market and its players). With increasing desperation, Sechold

traders tried to cover the exposed positions, but it was a bad time. It was over the holidays, Kelly and Ehrlich were on their respective holidays and so were the many other dealers and fund managers. The prices to be paid for covering the exposure escalated rapidly.

The market moved extraordinarily over the period, with a move of 500 points in five days. At times the futures market opened close to 300 points above the previous nights close and then started driving the spot price. Ehrlich returned before Christmas and bought further options to limit and contain the losses. This wiped out millions from the balance sheet.

The reluctance of the shareholders to inject more cash resulted in Investec coming into the picture. A due diligence was conducted over a weekend, resulting in an offer that must have seemed a pittance. It was a classic maneuver of giving Sechold shareholders almost no time to accept before threatening to withdraw the offer. The offer included a requirement that RMB should absorb Sechold's open position.

In the end Investec took Sechold for an effective R1,52 a share or a nominal injection of R125 million. What's more, Investec paid for it by issuing shares in effect to the major shareholders of Sechold.

4.2.3 AFRICAN BANK - 1995

The bank was founded in 1975 by Dr. Sam Motsuenyane as the first truly black controlled bank and flagship of black economic empowerment. Initially it stuck to retail banking but on 24 June 1987 it got a Reserve Bank permission to trade foreign exchange, solely for the purpose of providing services for individual over-

seas trips. In 1983, the division was authorized to arrange export deals as well.

It had 35 branches at the time of its difficulties.

In August 1994 it reported a 49% increase in assets to R625 million, a 47% increase in home loan advances and announced plans to issue cheque books and credit cards and roll out its ATM estate.

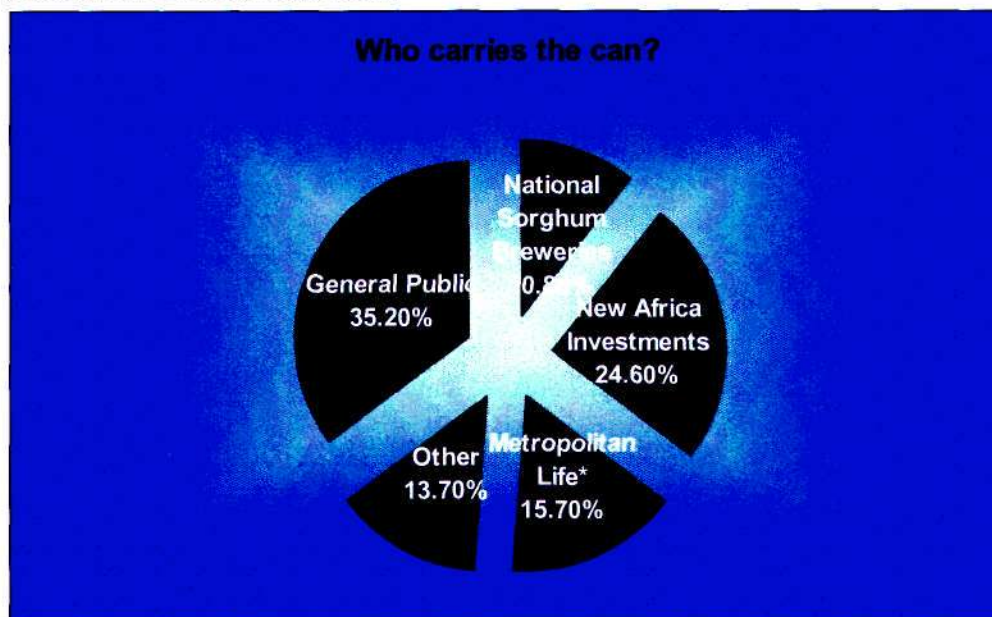
The first signs of danger appeared in March 1995 when it reported R2,9 million in losses.

It's auditors, Deloitte & Touche warned the Reserve Bank in terms of section 63 of the Bank Act in March 1994. Deloitte also informed the audit committee of potential crippling problems. In the beginning August 1995, Deloitte sent out another section 63 warning to the Reserve Bank.

Early in 1995, New Africa Investment Limited ("NAIL") and Metropolitan injected R9 million after the bank fell short of the capital adequacy requirement. (NAIL and Metropolitan were 25% and 17% shareholders respectively).

As at 31 March 1995, the shareholding in African Bank was as follows:

AFRICAN BANK'S SHAREHOLDING



* Subsequently increased to 17%

Over sixty (60%) loan book in the low end of the housing market with over 4,700 loans. African Bank nearly doubled its assets to R625 million in just three years prior to its demise. Whilst its capital adequacy ratio was at 8.1% when it went into Curatorship, shareholders would not pick up the problems early because of partial disclosure. The bank gave an indication on 1993/94 results stating “difficult economic conditions meant borrowers had difficulty making timeous payments”^{viii}.

In 1995, African Bank made a R20 million provision for bad debts against the R6,2 million that was made the year before. It had over 12,000 individual loans at an average of R70,000 per loan. Between September 1991 and March 1994, deposits grew from R273 million to R600 million, in the same period, advances grew from R196 million to R359 million.

In the 18 months prior to the Curatorship, there had been no new provisions, though the 1994 financial statements showed the bank was carrying accumulated provisions of just under R6 million. In the report the directors called the bad debt provisions “prudent and a firm basis for future profitability has now been set”. “Management has instituted appropriate measures and will continue to monitor the arrears situation to prevent a recurrence of this situation” The same accounts also showed that loans to directors had increased from R1,7 million in 1993 to R5,9 million. The bank’s CEO, Theron had taken out a R3 million loan for an apple farm, using the farm, apparently worth R5 million at the time, as a bond.

4.2.4 COMMUNITY BANK

Community bank was floated early in 1994 with funding obtained from a number of sources including the Development of Bank of Southern African (“DBSA”), Industrial Development Corporation (“IDC”), Industrial Development Trust (“IDT”) and a consortium of banks. It had Capital of R200 million, seventy five percent (75%) of it in loans at interest of eight (8%) from DBSA, IDC and the banks⁸. It was the first bank to be registered under the then new Mutual Banks Act.

The capitalization was going to be as follows:

DBSA –R110 million; IDC – R40 million; IDT – R25 million; consortium of banks (Standard Bank, First National Bank, NBS, ABSA, Nedbank) - R25 million.

Community bank was established to provide housing, business and personal loans to low-income earners. The bank aggressively grew its loan book and its branch network. Within its first eighteen months of existence, the bank had 17 branches, over 2,500

housing loans averaging R45,000 per loan. In its first 18 months the bank had R20 million in deposits raised from 2,200 clients.^x

Each branch was projected to have 2,500 housing and 800 business loans. By the fifth year, assets were expected to over R1,5 billion and it was projected it would be profitable within five years. Bad debts were projected to be no more than 3%-4% of assets and they were counting on peer pressure to guarantee the low ratio. This was despite the low-income grouping in which the bank operated when the major banks were avoiding entry into this space.^{xi}

The feasibility study assumed the R200 million would be available in the first month and the bank would invest the capital at 5% above the cost of funds and earn R10 million in its first year of operation. Lending operations would only start in July 1994 upon registration. Interest and investment income and transaction fees would cover operating costs. Meanwhile the bank has been opening branches and hiring staff. The Botshabelo Accord was on signed in November 1994 and the delivery of operations only started in June 1995. Community Bank thus more lost one year of interest income.^{xii}

The first signs of the distress emerged in July 1995 when the annual report indicated a R20,1 million loss for the eight months to March that was higher than expected. The bank had opened 3 branches, paid out over R2 million in housing loans and had committed over R17 million. In May 1996 it reported losses of over R50 million.

Community bank's capital structure was strenuous on its cash flow and did not give the bank much of a chance. 40% of its losses were made up of interest expenses on the loan capital from

its funderssm. It also had a R2,5 million monthly operating expense to content with.

One of the distresses that caused the bank to fail was management's decision to have a substantial formal branch network. Effective lenders in other countries tend to have low cost infrastructure. Heavily loaded infrastructure banks have to be supported by sufficient business volumes and the volumes at Community bank had not reached critical mass by the time its problems begansm.

The bank also spent a significant amount of its resources on installing a sophisticated computer system and marketing costs spiraled out of control and were greater than budgeted. Marketing expenses of R5 million were more than double and operating expenses at R6 million were more than the budget of R3,7 million

The DBSA, out of concern with the expenses incurred by the bank, refused to release the second part of its loan, R50 million and was soon joined by the IDC in withholding their second part of R20 million. They wanted Community Bank to find other alternative sources of funding and then they would release their second tranches as well. The DBSA insisted that whilst it served out its development mandate, it needed to safeguard its investment and ensure that the funds would be returned. The IDC was concerned about the bank's management in comparison to major banks.

This had a domino effect and other investors began withdrawing their support. In trying to find other alternatives, the bank tried to change the mutual bank status so that funders could convert debt to equity but got no approval from the Reserve Bank. Furthermore, they tried to negotiate with funders for the suspension of

interest payments but also without success. The bank continued to lend until the 'cupboard was bare'. It had an acute liquidity crisis but maintained a solid loan book with a respectable repayment rate.

When the efforts to get the DBSA and IDC to release the funds, the Reserve Bank put it into Curatorship on 13 May 1996 with Stewart Patterson of Price Waterhouse appointed as the curator. The implications were dire and felt by the vast number of low-income earners who had deposits with the bank. As a result, SARS agreed to fund the withdrawal by depositors of only R500 each.

Community bank was finally bought by Unibank Savings and Loan for R50 million in December 1996. Its status was changed from a Mutual Bank to an Equity Bank.

In summary the factors raised as the Primary Causes of Prima's failure by Tim Store are as follows:

Liquidity risk

The decisions taken by the DBSA and IDC led Community Bank's *coffer to run dry*. With the much needed R70 million that the two institutions had to inject not forth coming, the bank could not continue to hold the depositors from withdrawing their deposits and to avoid an inevitable run, it was put into Curatorship.

Credit risk

Whilst credit risk played a role in Community Bank's failure, its role was more secondary than the liquidity risk factor. The mere fact that the bank operated in the low-income earning sector of the market does not of itself render this risk as unmanageable.

The bank had not been realistic about operating in this space and their budgeted provisioning was not realistic and indicative of what was to come at them.

4.2.5 ISLAMIC BANK

Islamic Bank was founded on the basis of the Sharia Law as an alternative to conventional banking and financing models. According to Business Day (13 Feb 2006), there are more than 50 large Islamic financial institutions, measured by asset value, operating in various parts of world. It further states that the successful operation of Islamic banks in several parts of the world over the past 30 years – including the recent launch of “Islamic windows” in conventional South African banks – have led to a growing interest in Islamic finance.

Thought it is widely recognized that Islam does not permit *riba* - loosely translated as interest - one of the greatest misconceptions regarding Islamic financing is that, by the exclusion of interest the finance in question operates on charitable or non-profitable grounds. Contrary to conventional financing, Islamic financing is not based on the notion of a predetermined fixed return on capital. The Islamic prohibition against interest does not, however, imply in any way that is free of charge or that there should be no return on capital provided that capital participates in the productive process and is exposed to business risk.

Islamic Bank was formed on the same principles as stated above and Ebrahim Kharbany, the chief executive, owned the majority of the shares bank. According to a KPMG report, he owned more than R20 million of the bank’s R22 million share capital.

The bank suffered a run on its deposit based on rumours in September/October 1995 that it was invested with African Bank

which was in financial anguish. A number of attempts were made to try to get the Reserve Bank to declare that Islamic Bank did not have any exposure to African Bank and that it did not have debt as well. The Reserve Bank declined to make the declaration stating confidentiality. The panic led to a liquidation squeeze, which saw the outflow of funds of nearly R20 million of the R150 million they held in deposits roll out of the doors in a matter of days.

The bank ran newspaper advertisements, dismissing rumours concerning African Bank, bad debts and non-performing assets. The advertisements quoted letters from the Reserve Bank, African Bank's curator KPMG, and Islamic Bank's own auditor Khan, Salajee & Company to back its own case. The panic wave led to some Muslim political and business leaders to offer Islamic Bank R30 million to underpin its finances.

According to Business Day (24/11/97), the Islamic Bank lost large sums of money by investing heavily in property developments such as townhouses in Mayfair, Johannesburg, which did not pay off.

Its solvency two years prior to the failure with debts estimated at between R50 and R70 million meant near disaster for mosques, widows and orphanages that being of Muslim background invested all life savings into Islamic Bank.

When the bank was put into Curatorship, it had approximately 11,000 creditors, about 90% whose deposits did not exceed R50,000.

Furthermore, the bank made poor investment decisions and had management problems. These led to the Council of Muslim Theo-

logians, which helped for Islamic bank in 1985 to terminate its relationship with the bank. The termination of the relationship also fuelled the withdrawal of funds by some within the Muslim community who viewed the termination as signaling a departure by the bank from the rules of Islam.

The CEO gave himself R20 million worth of shares and millions more in loans to himself, his companies, friends and relatives at discounted rates leading up to the bank's liquidation.

The Reserve Bank offered a final reimbursement deal of up to a maximum of R50,000 to depositors. The R50,000 offer covered up to 90% of the depositors.

The bank was liquidated in December 1997.

4.2.6 NEW REPUBLIC BANK

New Republic Bank ("NRB" or "New Republic") was controlled by well-known Malaysian businessman Samsudin Adu Hassan ("Samsudin"). His company, NRB Holdings acquired Sabvest's 41,9% interest in NBH in 1996. In December 1998, Samsudin announced that Mzi Khumalo's Mawenzi Resources will acquire his stake in the bank for R490 million. The deal fell through after it was alleged that Khumalo failed to raise the cash.

Mawenzi had employed KPMG to perform a due diligence report for the transaction. Aspects of the report were leaked to Business Day, raising questions about NRB's liquidity because of a non-performing loan to NRB subsidiary Merchant Trade Finance in the amount of R213 million (Khumalo cites the report as the reason for withdrawing from the deal).

According to court summons filed by NRB suing Mawenzi, KPMG and Business Day, the KPMG in their report stated that the loan to MTF, at that time a subsidiary of Samsudin's SMG Holding, should be excluded in the calculation of NRB's legally required CAR. MTF had allegedly suffered losses and could not service its debt and was classified a non-performing loan bearing no interest and repayable in full in 2014. The KPMG report also carried reservations about the quality of other assets and the effect of the cost of the interest-free loan on the bank's ability to generate profit.

In January 1999, NRB asked the SARB to place it under Curatorship after a run on the bank. Peter Strydom was duly appointed as a Curator of the bank. The bank was not liquidated but a scheme of arrangement was etched resulting in Saambou acquiring NRB and being responsible for collecting, over a seven year period, NRB's remaining assets worth about R1,2 billion.

In the end depositors were paid R1,04 to every R1 held, which included the interest over the period of the Curatorship.

In summary the factors raised as the Primary Causes of African Bank's failure by Tim Store are as follows:

- Credit risk

The loan of R213 million that NRB made to a fellow subsidiary, Merchant Trade Finance turned out to be non-performing and as a result new terms were put in place that would have seen it non-interest bearing and repayable in 2014. KPMG's report noted that this would have significantly prohibited the bank from being profitable for the foreseeable future.

- Liquidity risk

When the KPMG report was leaked through to Business Day, the run on the bank was unstoppable and NRB did not have sufficient cash or near-cash resources to payout the depositors and continue in its normal course of business.

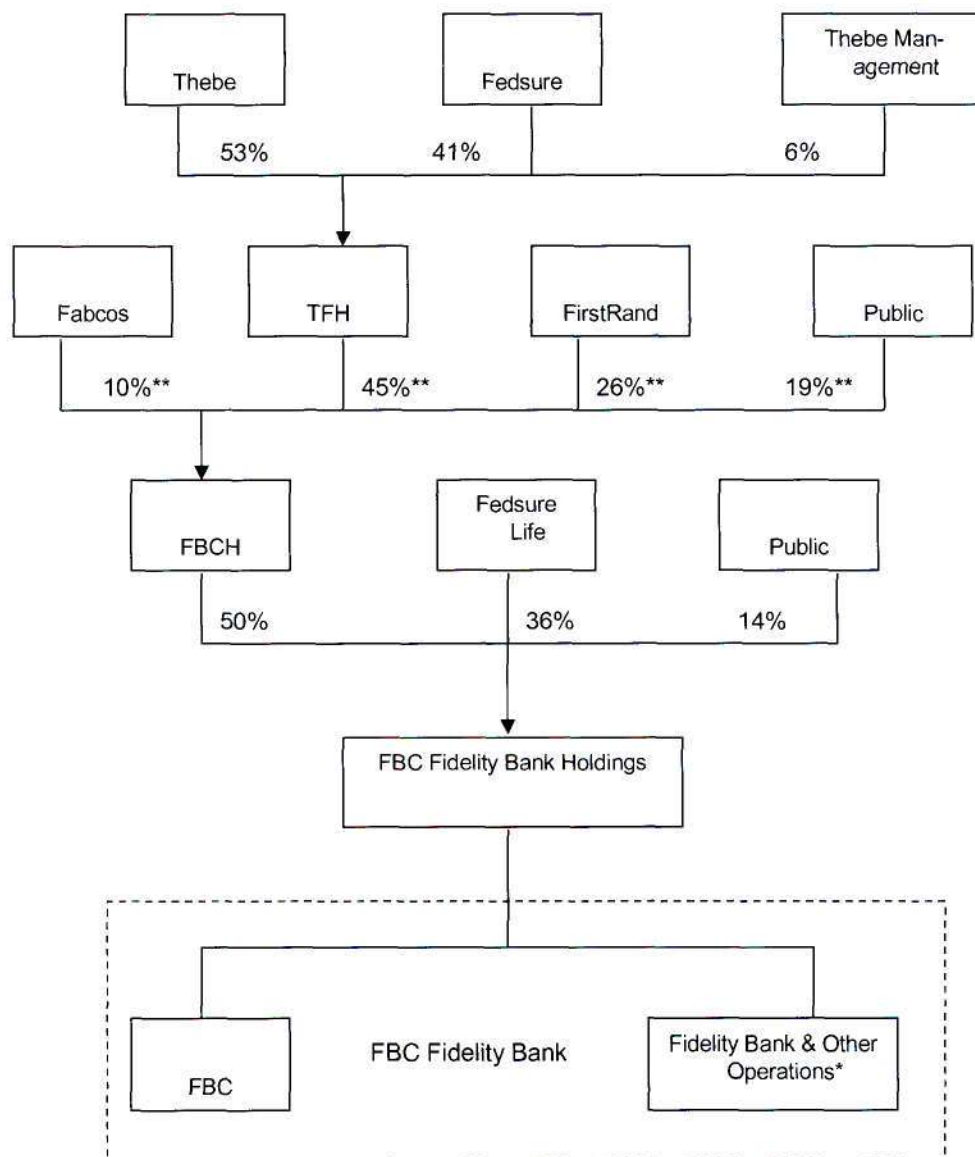
- Reputational risk

The reputation of the bank took a severe knock as a result of the leaked information such that there was not sufficient reputation in the market to quell the run on the bank.

4.2.7 FBC FIDELITY BANK

FBC Fidelity Bank (“FBC” or “Fidelity” or “bank”) was formed out of a merger that combined Future Bank Corporation and Fidelity bank in April 1998. The merged entity was to focus on emerging markets with substantial presence in banking, insurance and broking.

Company structure:



* These operations were merged in terms of Section 54 of the Banks Act

** Effective interest of shareholders ignoring their FBCII "N" shares

(Source: Listing Statement – Business Day 24 May 1998)

On the 5th May 1999, Fedsure announced a transaction in which:

- Fedsure proposed to acquire all shares and loan stock units in FBC not already owned by it and recapitalize the bank by R200 million
- Saambou Holdings proposes to acquire FBC's bank business units
- Thebe Financial Services proposes to acquire the investment banking division

Not long after Fedsure announced the transaction, it emerged that FBC had an unsecured exposure in Macmed, a failed health care group and the liquidity crunch befell the bank as depositors started withdrawing funds.

Fedsure provided R600 million of liquidity but notwithstanding this support, FBC's ability to maintain adequate resources of liquidity have been impaired by the adverse market conditions and uncertainty aggravated by negative publicity.

At the request of the directors, the bank was put into Curatorship.

Fedsure let the deal lapse four (4) days after the bank was placed in Curatorship. Saambou walked away from the deal, citing confi-

dence issues and none of the big four banks expressed any interest.

Tim Store noted that FBC, the only black managed empowerment bank in South Africa was solvent with a total capital reserve of more than R600 million and there was R6 billion in depositors' money.^{xv} It's R6 billion deposits was spread across 82,000 depositors and had over 600 employees, 20 branches and a head office in Sandhurst.

At the time, FBC had a healthy capital adequacy ratio of 13% compared to the then legal minimum of 8%. The bank was growing its loan book faster than its capital. It adopted a capital efficient approach from the start. When a bank grows rapidly, there's potential for a liquidity squeeze.^{xvi}

There are several common threads between two South African banks that have found themselves in difficulty. Both New Republic Bank and FBC are small institutions. Neither appeared to have a serious capital impairment when its problems initially surfaced. Both were hit by liquidity shortages. FBC was hit by reports of heavy exposure to Macmed, the failed health care group. Lesson: small banks are more vulnerable to crisis of confidence than big ones. Their ability to withstand a sudden withdrawal to crisis of funds is more limited and they lack the contacts and networks to get their own message out to the markets. What is more is that small banks are unlikely to be able to make a case, as big ones often can, that their failure poses a threat to the entire banking system and that authorities should therefore come to their rescue.^{xvii}

4.2.8 REGAL TREASURY PRIVATE BANK

Regal Treasury Private Bank (“Regal Bank” or “Regal”) was formed in 1997. The bank was listed during the listing euphoria of 1998/99 in February 1999. Before the collapse of the bank on June 26 2001, Regal employed more than 120 people.

Regal Bank collapsed in June 2001 after a run on deposits resulted in R250 million being withdrawn in two days following the rescinding by auditors Ernst & Young of the 2001 financial statements of the bank’s holding company. Tim Store of Deloitte was appointed as curator of the bank on June 26. A Business Report article further exacerbated the run on Friday, June 22, which said Regal was involved in a pipe bomb placed near the offices of Sasfin and in a fire at Polaris Shipping, an importer near Sasfin.

On Monday June 25, an announcement was made that Jeff Levenstein, the CEO, would retire, that Ernst & Young had withdrawn their consent for the publication of the bank’s results; and that Investec had acquired Regal’s advance book for a R50 million. Over June 25 and 26, depositors withdrew about R250 million in more than 900 transactions, leaving Regal with just over 1,100 clients with total deposits of R600 million.

Former Judge John Myburgh subsequently headed a three-month commission of inquiry into Regal Bank as appointed by the Registrar of Banks. Myburgh’s findings said there was a prima facie evidence that the auditors – one of whom is well-known Ernst & Young senior partner Tom Wixley, co-author of the book *What You Must Know About Corporate Governance* – had “failed” to perform their duties with care and skill or acted negligently” in not reporting a fraud in 2000 preliminary results.^{xviii}

Since its listing, Regal had been dogged by attention from regulators. The JSE Securities Exchange conducted an investigation into price manipulation. The Financial Services Board conducted an “inspection” of the bank’s investment and unit trust companies. The JSE investigated share price manipulation shortly before the collapse of the bank. The Reserve Bank’s bank supervision department conducted two investigations of its own^{xix}.

INCOME STATEMENT

	<i>28-FEB-01</i>	<i>28-FEB-00</i>
	R 000s	R 000s
INTEREST AND DIVIDENDS RECEIVED	145,192	117,281
INTEREST PAID	(97,573)	(59,445)
<i>NET MARGIN INCOME</i>	<u>47,619</u>	<u>57,836</u>
LESS: MOVEMENT IN BAD AND DOUBTFUL DEBTS PROVISION	3,169	339
	<u>44,450</u>	<u>57,497</u>
NON-INTEREST INCOME	88,036	27,045
	<u>132,486</u>	<u>84,542</u>
EXPENDITURE	52,940	28,981
NET INCOME FROM CONTINUING OPERATIONS	<u>79,546</u>	<u>55,561</u>
EXCEPTIONAL ITEMS	7,351	-
DISCONTINUED OPERATION	657	-
<i>INCOME BEFORE TAXATION</i>	<u>71,538</u>	<u>55,561</u>
PROVISION FOR TAXATION	4,531	4,608
<i>RETAINED INCOME FOR THE PERIOD</i>	<u><u>67,007</u></u>	<u><u>50,953</u></u>
<i>EARNINGS PER SHARE</i>	70	50
FULLY DILUTED EARNINGS PER SHARE	78	50
<i>HEADLINE EARNINGS PER SHARE</i>	65	50
FULLY DILUTED HEADLINE EARNINGS PER SHARE	73	50

BALANCE SHEET*ASSETS*

CASH AND SHORT-TERM ASSETS	31	1,032
MONEY MARKET ASSETS & FUNDS	669,218	568,899
ADVANCES	728,455	318,732
LESS: PROVISION FOR BAD AND DOUBTFUL DEBTS	(11,178)	(657)
NET ADVANCES	717,277	318,075
OTHER RECEIVABLES	21,239	41,725
INVESTMENTS	90,360	26,415
PROPERTY AND EQUIPMENT	117,074	39,103
DEFERRED TAX ASSET	4,867	2,826
TOTAL ASSETS	<u>1,620,066</u>	<u>998,075</u>

LIABILITIES

DEPOSITS	1,133,003	557,614
OTHER LIABILITIES	6,578	7,032
SHAREHOLDERS FOR DIVIDENDS	-	13,310
TAXATION	3,826	3,838
TOTAL LIABILITIES	<u>1,143,407</u>	<u>581,794</u>
<i>SHAREHOLDER FUNDS</i>		
SHARE CAPITAL	339,581	346,209
RESERVES	137,078	70,072
TOTAL SHAREHOLDER FUNDS	<u>476,659</u>	<u>416,281</u>
TOTAL LIABILITIES AND SHAREHOLDER FUNDS	<u>1,620,066</u>	<u>998,075</u>

Regal's performance prior to its demise was strong as shown above. The group's balance sheet had strengthened, with its total asset base growing by more than R620 million, an increase of over 60%.

The advances book more than doubled in during the year with an increase of close to R400 million.

The deposit book more than doubled as well with an increase of more than R575 million.

There are signs of possible over trading, where the business grows too much too quickly and in the process over extends itself.

Further detailed analysis would be performed in the next chapter.

4.2.9 SAAMBOU BANK

Saambou's business was essentially constructed in four areas. It ran a large mortgage book (+/- R9bn), it operated a corporate loans book, a micro-lending book (through Thuthukani) and a retail-lending book (+/- R4bn).

Its shareholding had been changed just in 2001, with the demise of Fedsure resulting in Investec, as the buyers of majority of Fedsure, having an effective forty percent (40%) shareholding in Saambou.

At the time when the Minister of Finance, placed Saambou under liquidation on a Saturday, 9 February 2002, it was the eighth largest bank in the country with assets of approximately R20 billion under management.

What became a mini-banking crisis had begun in mid-January when Absa announced a huge bad debt problem at its micro lending subsidiary, Unifer. Saambou, which had also ventured into micro loans in a major way, had been looking fragile for some months at that stage but after Unifer, it faced a run on deposits that speedily brought it down. Saambou was SA's seventh-largest bank but its failure proved systemic.

Not only did all SA's smaller banks face trouble, but Saambou's demise was soon followed by a run on deposits at BoE, then SA's sixth-largest bank. The bleeding was halted only when government, which declined to bail out Saambou, stepped in with a guarantee of BoE's deposits. That put an end to the mini-banking crisis, though the repercussions were felt long afterwards

in the end, the system withstood the crisis, though it was left without any smaller banks to speak of. And, ultimately, Saambou's depositors didn't lose a cent. The bank's curator sold off the assets and taxpayers put some money in, but in the bigger scheme of things it was not that much. In a way, then, all ended well^{xx}.

A week before Saambou was put into Curatorship, two rating agencies, Fitch and Global, downgraded their assessment of Saambou, with Fitch issuing a more scathing downgrade across the A2 graded bank. A quickly arranged meeting was held over the weekend in which Saambou was placed under Curatorship and to avoid systemic risk on other A2 banks, Fitch pulled its downgrade on other A2 banks.

The share price of Saambou has been spiraling downwards for the few months prior to its demise such that market commentators have been indicating that it was priced for a fire sale. In the nine months leading to February 2002, the share price plummeted by over 90%.

Saambou management approached the Reserve Bank on Friday to request that a curator be put in place after it emerged that the group faced severe liquidity problems. On Saturday 9 February, Christo Wiese, the Registrar appointed curator John Louw from KPMG to take over running the bank. The run on the bank was so severe that it was estimated that over R1 billion was withdrawn over a two day period before the weekend.

FirstRand has been the single biggest beneficiary of the Saambou collapse, achieving what an analyst has described as the "bargain of the year" when it picked up the home loan book and the agreed to take on the deposit books and its potential liabilities for a no-

minal R1. That transaction saw FirstRand assume the deposit book with liabilities of R12.8bn and the substantial residential home loan book. It gave FirstRand 20% of the home loan market, a figure that has doubled in less than five years. The acquisition of the Housing Finance division, which is aimed at families with household income of between R30 000 to R80 000 a year, will further entrench the group as the country's dominant mortgage lender. The 23 000 individual loans on the book show average borrowings of R65 000. FirstRand took over only about 65% of the R1.4bn Saambou Housing Finance book for R984m. The balance, or the 'excluded assets' was collected and administered by the bank for a market related commission.

Saambou Life was disposed to Capital Alliance and the curator managed to sell off other parts of the business including the bank, Property Finance division, Saambou International Insurance division, the micro lending book as well as other small parts of the business. As a result, depositors were fully compensated together with accrued interest (ex. the FirstRand transaction) with a liquidation dividend being declared to shareholders, a much better outcome than some of the other failures where shareholders lost it all.

Saambou's demise was therefore caused by the unfavourable sentiments with regards to micro lending businesses following the blow out at Unifer and the 20Twenty business that was siphoning cash out of the business.

**SEVEN YEAR FINANCIAL RE-
VIEW**

	1995	1996	1997	1998	1999	2000	2001
RESULTS							
NET INCOME BEFORE EQUITY ACCOUNTED INCOME AND TAX	45.3	53.3	66.1	94.1	149.6	232.8	332.1
NET INCOME	26.8	36.1	48.0	101.9	92.9	157.9	219.3
HEADLINE EARNINGS	26.8	36.1	48.4	68.1	96.0	146.6	213.2
EARNINGS PER SHARE (CENTS)	20.0	27.0	35.9	76.2	65.6	104.2	137.6
HEADLINE EARNINGS PER SHARE (CENTS)	20.0	27.0	36.2	50.9	67.8	102.5	145.7
DIVIDENDS PER SHARE (CENTS)	4.2	5.6	7.4	10.3	13.4	21.0	29.0
FINANCIAL POSITION							
TOTAL ASSETS	5,619.1	6,505.7	7,787.5	10,006.0	11,593.0	15,269.6	20,289.2
ORDINARY SHAREHOLDERS' FUNDS	212.2	245.4	282.0	388.0	583.9	707.7	1,016.4
NET ASSET VALUE PER SHARE	169.6	196.1	225.4	306.6	425.7	495.6	654.1
ADVANCES	4,786.3	5,513.3	6,850.7	8,225.7	9,776.5	13,021.3	15,348.1
DEPOSITS	5,110.9	5,860.0	7,050.0	8,215.7	10,099.8	12,748.9	16,379.6
SELECTED RETURNS AND RATIOS							
HEADLINE RETURN ON AVERAGE SHAREHOLDERS' FUNDS	13.4	15.8	18.4	20.3	19.8	22.7	24.7
HEADLINE RETURN ON AVERAGE ASSETS	0.5	0.6	0.7	0.8	0.9	1.1	1.2
NET INTEREST INCOME/AVERAGE ASSETS	4.2	4.0	4.2	4.0	3.6	3.9	3.9
NET INTEREST INCOME/AVERAGE ADVANCES	4.9	4.7	4.9	4.7	4.3	4.6	4.9
NET INTEREST MARGIN	4.5	4.3	4.4	4.1	3.8	4.1	4.3
INSURANCE PREMIUM/AVERAGE ADVANCES	N/A	N/A	N/A	N/A	1.2	1.9	2.3
INSURANCE COVER/ADVANCES	N/A	N/A	N/A	N/A	4.5	4.1	4.3
NON-INTEREST INCOME/TOTAL INCOME	23.0	26.0	23.7	23.1	25.8	37.1	43.7
OPERATING EXPENSES/TOTAL INCOME	61.1	60.7	59.0	53.8	51.9	46.1	47.4
OPERATING EXPENSES/AVERAGE ASSETS	3.4	3.2	3.3	2.8	2.5	2.9	3.5

INCOME STATEMENT

	<i>31-MAR-01</i>	<i>31-MAR-00</i>
	<i>RM</i>	<i>RM</i>
INTEREST INCOME	2,593.8	2,138.4
INTEREST EXPENSE	1,859.6	1,613.6
<i>NET INTEREST INCOME</i>	734.2	524.8
PROVISION FOR LOSSES IN ADVANCES	33.9	0.4
NET INTEREST AFTER PROVISIONS	700.3	524.4
NON-INTEREST INCOME	569.7	309.3
<i>OPERATING INCOME</i>	1,270.0	833.7
EXPENSES	937.9	600.9
OPERATING EXPENSES	618.4	384.3
COST OF INSURANCE COVER	319.5	216.6
<i>NET INCOME BEFORE TAX AND EQUITY AC- COUNTED INCOME</i>	332.1	232.8
INCOME FROM EQUITY ACCOUNTED INVEST- MENTS	3.5	12.3
<i>NET INCOME BEFORE TAX</i>	335.6	245.1
TAX	101.6	87.2
<i>NET INCOME AFTER TAX</i>	234.0	157.9
MINORITY INTEREST	14.7	-
<i>NET INCOME</i>	219.3	157.9

BALANCE SHEET

	<i>31-MAR-01</i>	<i>31-MAR-00</i>
	<i>RM</i>	<i>RM</i>
ASSETS		
PROPERTY AND EQUIPMENT	216.3	85.7
GOODWILL	38.5	-
INTANGIBLE ASSETS	22.7	7.2
EQUITY ACCOUNTED INVESTMENTS	17.9	4.4
INVESTMENTS	1,087.3	811.2
OTHER ASSETS	369.3	193.6
DEFERRED TAX	4.4	-
ADVANCES	15,348.1	13,021.3
INTEREST BEARING SECURITIES	196.5	71.5
CASH AND CASH EQUIVALENTS	2,988.2	1,074.7
TOTAL ASSETS	20,289.2	15,269.6
SHAREHOLDERS' FUNDS AND LIABILITIES		
SHARE CAPITAL	155.4	142.8

SHARE PREMIUM	220.3	106.5
PREFERENCE SHARE CAPITAL	141.1	141.1
RESERVES	640.7	458.4
TOTAL SHAREHOLDERS' INTEREST	1,157.5	848.8
MINORITY INTEREST	(0.7)	
LONG-TERM LOANS	1,024.7	903.8
INSURANCE FUNDS	435.6	294.2
DEFERRED TAX	-	31.8
DEPOSITS AND CURRENT ACCOUNTS	16,379.6	12,748.9
OTHER LIABILITIES AND PROVISIONS	1,292.5	442.1
TOTAL SHAREHOLDERS' FUNDS AND LIABILITIES	20,289.2	15,269.6

Saambou's position and performance prior to its demise was strong and had the following highlights:

The advances book grew by over R2.3 billion over the period, an increase of approximately 18%.

The cash position for the group was also significantly strengthened over the period as it more than doubles and grew by R1,913 billion. This represents an increase of over 178%.

The deposit base also grew significantly over the trading period by R3.6 billion, an increase of over 28%.

There was also a massive increase in the provision for losses to bad debts of almost R40 million compared to a provision of R400,000 in the preceding year.

Further detailed analysis is provided in the next chapter.

4.2.10 BoE LIMITED

BoE Limited ran into difficulty a month after Saambou was put in liquidation and therefore the focus on second tier banks put pressure on the bank.

Prior to its demise, BoE had a retail client base of approximately R16 billion in deposits while its wholesale money market book was about R30 billion.

BoE had an exposure of just more than R1.1 billion to the micro-lending market with only R400 million of the advance book secured. A few years prior to this episode, BoE bought NBS' home loan book and there were problems, which resulted in a R39 million loss in the year to September 2001 after a deterioration of the residential development, small commercial and industrial property loan books. There were rumours in the market of possible bids for the home loan division by FNB and Standard Bank.

The pressure that BoE faced resulted in depositors gradually withdrawing funds, putting pressure on the bank's liquidity. This manifested itself more in its corporate money market activities, where daily turnover had risen from about R200 million to between R500 and R600 million a day^{xxx}.

These institutional withdrawals reached an unacceptable high level on Wednesday, 13 March 2002 and forced the Finance Minister and the Reserve Bank Governor to intervene. They issued an unprecedented joint statement guaranteeing deposits in a bid to restore confidence in the sector. The government guarantee provided for the entire R46 billion-deposit base of BoE.

The provision of the guarantee for BoE drew lots of criticism from the market, given that just prior to the BoE demise, the authorities would not assist Saambou and Regal. The argument from the Minister and the Governor was that despite Saambou's size as the seventh largest bank, its failure would not have given rise to systemic risk whereas the failure of BoE would.

The joint statement read as follows:

“There has recently been an unprecedented level of withdrawals of deposits from BOE Bank Limited ("BOE"). The current apparent loss of confidence in BOE is without foundation, as BOE is a well-managed, sound and solvent bank.

It has therefore become necessary to assure the public of the unequivocal commitment of the National Treasury and the South African Reserve Bank (SARB) to stand fully behind BOE, and the banking system as a whole.

Through the provision of an explicit government guarantee, all depositors of BOE are advised that their deposits are safe.

Accordingly, it is business as usual for BOE.”

The run on deposit forced FNB to accelerate plans to acquire the NBS home loan book. The deal was settled at R11.9 billion with R5 billion settled in cash up front to take away the pressure of NBS' liquidity.

A confidentiality agreement was entered into which prohibits the making the details of the extent of the run public.

INCOME STATEMENT

	<i>30-SEP-01</i>	<i>30-SEP-00</i>	<i>30-SEP-99</i>	<i>30-SEP-98</i>	<i>30-SEP-97</i>
	RM	RM	RM	RM	RM
<i>NET MARGIN INCOME</i>	1,956	1,924	1,959	1,490	57
<i>INCOME FROM NORMAL OPERATIONS</i>	4,033	3,177	3,457	3,194	346
<i>BAD AND DOUBTFUL DEBTS</i>	671	412	525	445	11
<i>OPERATING EXPENSES</i>	2,018	1,907	1,807	1,586	195
<i>PROFIT FROM NORMAL OPERATIONS</i>	1,344	858	1,125	1,163	140
<i>EXCEPTIONAL ITEMS</i>	(860)	(1,097)	(10)	-	8
<i>PROFIT/(LOSS) FROM NORMAL OPERATIONS</i>	484	(239)	1,115	1,163	148
<i>FINANCE COST</i>	102	103	80	40	-
<i>SHARE OF EARNINGS OF ASSOCIATE COMPANIES</i>	61	246	126	37	101

<i>PROFIT/(LOSS) BEFORE TAXATION</i>	443	(96)	1,161	1,160	249
<i>TAXATION</i>	160	159	170	200	31
<i>NET PROFIT/(LOSS) FOR THE YEAR</i>	283	(255)	991	960	218

BALANCE SHEET

	30-SEP-01	30-SEP-00	30-SEP-99	30-SEP-98	30-SEP-97
	R M	R M	R M	R M	R M
<i>ASSETS</i>					
PROPERTY AND EQUIPMENT, CASH AND OTHER ASSETS	5,864	4,224	4,008	5,251	367
GOODWILL	976	124			
INVESTMENTS	10,221	10,903	11,528	10,610	3,321
NET ADVANCES	47,458	43,366	40,923	35,247	2,436
LIQUID AND TRADING ASSETS	3,693	3,969	2,535	2,980	1,578
	68,212	62,586	58,994	54,088	7,702
<i>LIABILITIES</i>					
LIFE FUNDS	7,420	6,653	7,031	4,674	1,425
DEPOSITS AND OTHER ACCOUNTS	49,847	46,253	41,470	38,429	3,725
LOANS AND OTHER LIABILITIES	3,567	2,758	3,537	3,782	320
TOTAL LIABILITIES	61,778	56,614	52,038	46,885	5,470
<i>SHAREHOLDER FUNDS</i>					
TOTAL SHAREHOLDER FUNDS	6,402	6,798	6,956	7,203	2,232
TOTAL LIABILITIES AND SHAREHOLDER FUNDS	68,180	63,412	58,994	54,088	7,702

Financial Ratios	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
	%	%	%	%	%	%	%	%	%	%
Interest margin	n/a	1.8	2.1	2.9	3.6	2.9	7.9	5.1	4.3	4.3
Non-interest revenue to total income	n/a	70.0	69.0	61.0	68.0	84.0	53.0	43.0	48.0	52.0
Cost to total income	n/a	66.0	65.0	58.0	58.0	55.0	50.0	52.0	54.0	50.0
Bad debts as a % of advances	n/a	0.4	0.2	0.2	0.4	0.6	2.4	1.4	1.0	1.4
Effective tax rate, excluding associated income	18.0	25.0	25.0	26.0	24.0	25.0	17.0	15.0	15.0	13.0
Dividend cover	2.8	2.7	2.8	3.0	2.7	3.6	2.9	3.1	2.8	2.7
Headline return on equity	16.0	18.0	21.0	17.0	18.0	15.0	11.0	15.0	16.0	18.0
Return on total assets	1.3	0.9	1.0	1.3	2.1	3.1	1.1	1.7	1.8	1.8
Capital adequacy ratio	n/a	n/a	n/a	n/a	n/a	n/a				

BoE's liquidity problems appear to have been there for some time and appear to be due to mismatch in the maturity analysis between the advances book and the deposit book. The mismatch is as follows:

	Advances		Deposits	
Repayable on demand	2,350	5.0%	20,510	41.1%
Within 1 month	1,606	3.4%	8,630	17.3%
Between 1 and 6 months	4,362	9.2%	8,806	17.7%
Between 6 and 12 months	4,086	8.6%	7,221	14.5%
After one Year	35,054	73.9%	4,680	9.4%
Total	47,458		49,847	

Source: BoE Annual Report, 2001

The above was very key when the bank's liquidity position was under strain. 73.9% of the bank's advances were payable after one year and 41.1% of the deposits were due and payable upon demand. When depositors called on the bank to payout to their deposits, there were not enough readily available funds as the bank could use its cash and cash equivalents on hand and however much would have been available upon demand. This fuelled the need for the bank to fast track the sale of its home loan book to FNB to have access to immediate cash.

4.2.11 FAILED BANKS ANALYSIS

The focus of the financial analysis is on the three last failures that occurred since 2000. The information on these companies is relatively available, whereas detailed financial information is not as available on the other failed banks.

The detailed discussion will therefore focus on Regal Treasury, Saambou and BoE.

4.2.11.1 Financial Information

	Regal	Saambou	BoE
Profitability			
Interest margin (Total Assets)	6.08%	4.13%	3.36%
Net Margin (After tax)	29%	10%	3%
Liquidity Risk	0.58	0.10	-0.32
Return on Assets	10%	14%	14.0%
Leverage Multiplier	3.4	17.5	10.5
Return on Equity	5.5%	23.3%	4.3%
Non-interest expense to total assets	4%	5%	3%
Net non-interest expenses to total assets	-0.03	0.02	-0.09%
Efficiency	40%	74%	60%
Cost rate on total assets	7.5%	10.5%	7.8%
Risk			
Core deposits to assets	69.9%	80.7%	74.1%
Net loans - to – deposits	63%	94%	95%
Net loans -to – assets	44%	76%	71%
Credit quality			
Credit risk (this period)	0.8%	0.2%	1.4%
Credit risk (accumulated)	1.5%	0.1%	2.8%
Capital Adequacy			
Capital risk	29%	6%	10%
Capital Adequacy ratio (assets)	29%	5.7%	10%
Capital Adequacy ratio (loan)	42%	6.1%	11%
Management Quality	15%	29%	7%
Size	2,753,069	36,669	117,083

PROFITABILITY

It appears from the above that Regal was the more profitable based on the interest margin and the net margin (after tax). Reg-

al was however under-performing Saambou and BoE on 'sweating the assets' as its return on assets lagged the two banks whose returns was tied at 14% compared to the 10% of Regal.

BoE's liquidity risk (-0.32) appears to have been far inferior compared to Regal and BoE at 0.58 and 0.10 respectively. It appears that whilst BoE's financial resources were vast, they were largely tied up to in the advances book. The group had deposits of R49.8 billion versus advances of R47.4 billion. Whilst the group had liquid funds, the mismatch risk was high.

Saambou's leverage multiplier appears to be superior than that of its peers and at 17.5 times, they are using the resources at disposal more efficiently. The difference appears to be wider than that of Regal and BoE at 3.4 times and 10.5 times respectively.

The return of equity also supports the leverage multiplier notion that Saambou is better utilizing its assets. With a return on equity of 23.3% compared to 5.5% and 4.3% for Regal and BoE respectively, Saambou was performing commendably in comparison.

The efficiency ratio also supports the above at 74%, 40% and 60% for Saambou, Regal and BoE respectively.

The cost factors appear to be within the same band, however BoE appears to be slightly ahead of its peers at 3% compared to 4% and 5% for Regal and Saambou respectively.

RISK

These risk indicators appear to provide more insight into the liquidity pressures that resulted in the demise of these three banks. The core deposits to assets indicated the level at which deposit

are tied up to assets. The inverse of this indicator is that it depicts the level of assets that are not funded by deposits. The various maturity levels would differ but this gives an overall feel as a first level indicator of liquidity risk

Saambou, at 80.7% appears to have more of its assets backed by deposits compared to than BoE and Regal at 74.1% and 69.9% respectively.

The net loans to deposit ratio seems to indicate that the liquidity risk was very high for both Saambou and BoE at 94% and 95% respectively. The only saving grace in tough times would have been having a vast portion of the deposits maturing longer than the less than 30 day period or the advances having a significant portion that is callable on demand and within 30 days. As indicated above, this was not the case for both banks and when the deposits were called upon, there was no sufficient buffer of available resources to quell the run on deposit.

Regal's net loans to assets ratio appears to be much lower than that of its peers but it's operations are different as evidenced by the proportion of non-interest income it earns as a percentage of interest income.

CREDIT QUALITY

The provisions for bad debts as a percentage of gross loans are lower for the three banks and it appears that Saambou's provision is much lower. The ratios are much lower than what they were in the 90s when the average ratios were +3%. There have been technological advancements that have yielded positive results. The economy has been much more stable in comparison, interest rates

have been on the decrease over the period resulting in few non-performing loans over time.

These levels are supported by the fact that credit risk was no key in the demise of these banks but liquidity risk.

CAPITAL ADEQUACY

The legislated capital adequacy ratio was increased by the Registrar from 10% for a long time and was increased to 12%. CAR is a requirement that serves as both a confidence booster for depositors and other creditors and it's a legal minimum for a bank to obtain a license.

Both Regal and BoE had CAR's that met the criteria and Saambou's was below.

CHAPTER 5

CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

In this chapter the researcher concludes the dissertation and also provides recommendations to assist limit the recurrence of bank failures.

5.2 Conclusion

The researcher through this dissertation has provided theoretical and empirical answers to the research question: what are the causes of bank failure in the post-democratic South Africa. This research question was posed in Chapter one and has been answered in the subsequent chapters.

Chapter One provided the background to “Causes of Bank Failure”. Furthermore, it presented the problem statement, set the scope and limitations of the dissertation and concluded with the outline of the dissertation. The importance of the banking sector in the economy was considered together with the costly effects of bank failures. Different hypothesis that seek to give explanations to causes of bank failure were presented. This dissertation tests the hypotheses, using the nine banks that failed since 1994 as an empirical study.

Chapter Two provided the theoretical framework on some of the causes of bank failure. Included in the chapter was an overall introduction to how the banking supervision is performed by the

Registrar of Bank to monitor and where possible prevent failure of banks.

Chapter Three covered the research design that the dissertation followed. It provided the distinction between primary and secondary data analysis and why this dissertation is based on secondary data analysis.

Chapter Four included the detail of the empirical work undertaken on the failed banks since 1994. Background and causes of failure were provided. The nine banks were identified as Prima Bank, Sechold, Community Bank, African Bank, New Republic Bank, FBC Fidelity Bank, Regal Treasury Bank, Saambou and BoE. Detailed financial analysis including key ratio analysis was undertaken on Regal, Saambou and BoE. The detailed analysis also explored the relationships between the various failed banks and the theoretical literatures on causes of bank failure as covered in Chapter Two.

The relationship between the various theoretical causes of bank failure and actual reasons why the bank failed seems to be confirmed through the detailed work. The research thus conclusively proved that the causes of nine failed banks have already been subject to well-disposed theories on causes of bank failure.

5.3 Recommendations

It is clear that there are inherent risks in banking and some of these risks are not easily discernable by the ordinary man in the street that invariably stands to lose the most when banks fail. Corporate depositors have measures in place to monitor their deposits and are the ones who would withdraw or reduce their de-

posits when there are signs of distress. The ordinary man in the street is not as complicated and most often would not even recognize the warning signs until it is late. It is invariably the man in the street that stands to lose the most including lifesavings for some of the pensioners. An early warning mechanism that is available to all and takes into account the diversity of our nation and the ill effects of our past can only empower the depositors more and make the decision to deposit or withdraw an informed one.

The Finance Minister and the Governor of the Reserve Bank received sharp criticism on how differently they dealt with the Saambou and BoE failures that occurred a few weeks apart. They did not offer assistance to Saambou and a few weeks later they virtually guaranteed all of BoE's deposits. Their reasoning was that Saambou's run had not potential of systematic run on other banks whereas BoE's had the potential. It is the researcher's recommendation that predefined measures must be explored and implemented to limit the high levels of subjectivity with which the authorities deal with failed banks. Whilst it is not the researcher's recommendation that the authorities must be stripped of discretion, it is important to provide clarity and a level playing field for the benefit of depositors.

5.4 Suggestion for further research

Further research could be performed in exploring the effects of bank failure on the various grouping in South Africa including pensioners. In most cases depositors do not have access to their funds during period when the bank is under Curatorship and a study could be performed on these effects of this. This could possibly result in the Reserve Bank automatically making available

minimum amounts to some of the worst affected groupings that the research will hopefully identify.

Another suggestion for further research could be done on exploring the framework with which other countries deal with failed banks. This will ensure that South Africa benchmarks on best practice as well as provide our authorities with the best approach to dealing with the potential risk of bank runs. This could avoid the ill feelings on how the Saambou vs. BoE debacle.

5.4 Conclusion

Finally, an overall assessment of the causes of bank failure in the post democratic South Africa can be reduced to largely liquidity risk and credit risk that arose due to poor lending policies.

It is with a stroke of fortune that in the vast majority of the cases, the depositors and creditors recovered their funds in full in most cases. The opportunity losses of interest and the time it takes to recover just the capital invested were by far the worst side effects of these failures. With that as our context, it is fair that on average the Curatorship approach to bank failures has satisfactory successes.

Bank failures are part of everyday business but due to the importance of the bank system to a country and potential of systemic risk, it is important that they be limited as much as possible. It is highly likely that there will be other bank failures in the future, it therefore remains important that the environment continues to be better regulated and vigilant monitoring is upheld.

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11 JUNE 2007

MR. S MAKHUBELA (202519391)
GRADUATE SCHOOL OF BUSINESS

Dear Mr. Makhubela

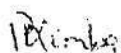
ETHICAL CLEARANCE APPROVAL NUMBER: HSS/0322/07M

I wish to confirm that ethical clearance has been granted for the following project:

"Causes of bank failure in the post democratic South Africa"

PLEASE NOTE: Research data should be securely stored in the school for a period of 5 years

Yours faithfully



MS. PHUMELELE XIMBA
RESEARCH OFFICE

→ cc. Post-Graduate Office (Christel Haddon)
cc. Supervisor (Mr. M Phiri)