THE REGULATION AND SUPERVISION OF COMMERCIAL BANKS IN ZAMBIA: A STUDY OF THE DESIGN, DEVELOPMENT AND IMPLEMENTATION OF PRUDENTIAL REGULATIONS BY THE BANK OF ZAMBIA BETWEEN 1980 AND 2000

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V LIST OF ABBREVIATIONS

BFSA	Banking and Financial Services Act, 1994
Bn	Billion
BoE	Bank of England
BoZ	Bank of Zambia
CST	Critical Systems Thinking
DFIs	Development Finance Institutions
FAI	Financial Analysis Inspector
FSSD	Financial System Supervision Department
GRZ	Government of the Republic of Zambia
IMF	International Monetary Fund
K	Zambian Kwacha
LoLR	Lender of Last Resort
MoF	Ministry of Finance
M/Finance	Minister of Finance
MPs	Members of Parliament
NBFI	Non-Bank Financial Institutions
NSCB	National Savings and Credit Bank
RPI	Regulatory Policy Inspector
RPSI	Regulatory Policy Senior Inspector
SI	Senior Inspector
SIDO	Small Industries Development Organisation
SITET	Special Investigations Team on Economy and Trade
UNZA	University of Zambia
WIC	Workshop Interview on Closure
ZCCM	Zambia Consolidated Copper Mines
ZNCB	Zambia National Commercial Bank
ZNPF	Zambia National Provident Fund
ZSIC	Zambia State Insurance Cooperation

VI ABSTRACT

This thesis provides a critical evaluation of the design, development and implementation of the prudential regulations and supervisory techniques employed by the Bank of Zambia between 1980 and 2000 when the banking system not only experienced the closure of nine banks, but also underwent significant changes to its regulatory and supervisory framework. Specifically, it addresses the extent to which regulatory failure, on the part of the Bank of Zambia, contributed to the occurrence of the 1995 and 1997/8 bank failures, and its inability to promptly resolve the problems.

Firstly, the study argues that the weaknesses in the licensing procedures for new financial institutions were significant factors that led to the bank failures of 1995 and 1996/97. Specifically, it asserts that there was insufficient regard given to the quality of new banks' owners, directors and managers, the minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners. Secondly, the thesis argues that the Bank of Zambia had the capacity and resources to detect financial mis-management, breaches of the law and financial deterioration in the banks that failed. Finally, the thesis argues that due to politically, economically and, most importantly, bureaucratically-institutionalised regulatory forbearance, the Bank of Zambia failed to enforce the required corrective action in a timely and consistent manner.

The objective of the study is to contribute to the current research on the design, development and implementation of prudential regulations and supervisory frameworks in developing countries. Its unique detailed institutional analysis of the Bank of Zambia provides significant insights into the working of a sub-Saharan African central bank that are often ignored in financial sector reform programmes, yet are key to the successful attainment of regulatory and supervisory reform programme objectives.

VII DECLARATION

I, **Samuel Munzele Maimbo**, hereby declare that this work is my own and that, except for Section 3.3.0 and Section 7.3.0, it has not been previously presented at this University or indeed any other for similar purposes. All work of other persons has been duly acknowledged.

IX COPYRIGHT

X DISCLAIMER

At the time of writing this thesis, the author was a Senior Bank Inspector in the Financial System Supervision Department at the Bank of Zambia. However, the findings, interpretations, and conclusions expressed in this thesis are entirely those of the author and should not be attributed in any manner to the Bank of Zambia. Any errors or omissions in the thesis are entirely the responsibility of the author.

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Khama and Vesta,
For teaching me that,
Faith is the substance of things hoped for,
The evidence of things not seen.

And

Mwaka
for showing me that,
Of faith, hope and love, the greatest is love.

CHAPTER ONE

INTRODUCTION

1.1.0 Introduction

This thesis provides a critical evaluation of the design, development and implementation of prudential banking regulations and supervision practices in Zambia between 1980 and 2000. Firstly, it evaluates the design, development and implementation of bank licensing policies and procedures by the Ministry of Finance (MoF) and the Bank of Zambia (BoZ) in the years 1984 to 1994. Secondly, it details the BoZ's tools and techniques for diagnosing, predicting and responding to the 1995 and 1997/8 bank failures. Finally, it identifies and explains the constraints facing BoZ in the timely, effective and consistent enforcement of intervention and closure policies and procedures. The thesis concentrates on the period 1990 to 2000. During that period, the banking system not only experienced the closure of nine banks, but also underwent significant changes to its regulatory and supervisory framework. The empirical research in this study contributes to an issue in the regulatory research agenda that has so far received only limited attention in the economic literature. Mostly, the economic literature on regulatory frameworks concentrates on linking financial fragility to the absence of sound regulatory frameworks. Such research has resulted in the, almost inevitable, conclusion that "stronger" and more detailed regulations are required. Few studies give specific attention to the environment within which regulators operate, and the decisions they have to make regarding financially-distressed banks during the banking crisis period. The principal motivation for undertaking this study is to help in filling this gap in the current literature by examining the regulatory environment and the specific decisions and sequence of those decisions *before* and *during* the banking crisis periods of 1995 and 1997/98.

Chapter 1 introduces the thesis with a background to the study, discussion of the research questions and an outline of the thesis chapters. Section 1.2 presents an overview of the recent events in the Zambian financial system that have led to increased criticism of the BoZs regulatory and supervisory performance. Section 1.3 discusses three core elements of the regulatory framework - licensing, monitoring of unsafe and unsound practices, and intervention and closure - that have been subject to particular criticism, to formulate the thesis objectives and research questions. Section 1.4 outlines the thesis chapter format.

1.2.0 Background to the Study

The BoZ is at the helm of the regulatory structure in Zambia. Its principal function of is to "formulate and implement monetary and supervisory policies that will ensure the maintenance of price and financial systems stability in order to promote balanced macro-economic development" (BoZ Annual Report 1997). During the 1970's and the 1980's, socialist-oriented government economic policies severely constrained the BoZ's execution of this role. The BoZs primary responsibility then, was to ensure compliance to foreign exchange, credit allocation and interest rate controls.

Although the BoZ created the Financial System Supervision Department (FSSD) in 1974, before 1992, it did not undertake rigorous monitoring of banks nor did it require banks to submit any prudential returns other than those required for monetary policy formulation and implementation. Instead, the FSSD placed greater reliance on foreign exchange, interest rate and credit allocation directives. This approach was acceptable at the time because the majority of commercial banks operating in Zambia were subsidiaries of reputable international commercial banks, which were subject to consolidated supervision by home country regulators. Through liaison with home country regulators, the BoZ found it relatively easy to monitor bank financial conditions and performance (Mwape: 1997a:6).

This method of regulation and supervision continued even as the first local banks entered the banking sector in the mid 1980's. In the mid 1980's, the MoF issued licences to Meridien BIAO Bank (1984), Bank of Credit and Commerce (1979), Indo-Zambia Bank (1985), Finance Bank (1988), African Commercial Bank (1987), Manifold Investment Bank (1987), and New Capital Bank (1989). During that period, the financial environment was not particularly conducive to private sector investment in banking, as tightly-controlled interest rates and high reserve requirements, depressed bank profit margins (Brownbridge, 1996:99; Muke, 1998b). However, the early 1990's financial sector reforms made investment in the sector more attractive and the resultant increase in the number of financial institutions entering the sector quickly exposed the inadequacy of the regulatory and supervisory framework.

The 1992/93 financial liberalisation encouraged an increase in the number of bank licence applications. The decontrol of foreign exchange, the liberalisation of interest rate controls and the introduction of the tender system in the sale of treasury bills on the open market had a profound effect on the profitability and competitiveness of the banking sector. In June 1993, the rise in inflation, from 40% in 1992 to 192% led to a sharp rise in interest rates on loans and government securities, and because banks did not pass on the increase in interest rates to their depositors in the form of higher deposit interest rates, there was an increase in the interest rate spread. Between 1992 and 1994, nominal banking profits were significantly higher than in previous years. Given the low capital required to establish a bank of only K20 million (US$ 30,000) at the time, the BoZ received an increased number of bank licence applications (Brownbridge 1996:9, Muke 1998a). New entrants were attracted and by December 1994, there were 19 registered banks operating with 188 branches. However, as inflation and the exchange rate began to stabilise, it became more difficult to maintain the same levels of profitability. Instead of curtailing activities in line with the declining profit margins, some banks took on greater risks to match previous results (Mwape: 1997b:3).

In the third quarter of 1993, and throughout 1994, adverse developments began to occur. In the quest to attract and retain customers, banks disregarded prudent loan application procedures and collateral arrangements, and reckless lending left banks with unrecoverable loans. Further, a rise in the cost of funds, shortages in liquidity, the erosion of earnings from treasury bills and foreign exchange operations, and shortages of capital, accelerated the financial deterioration of banks (Muke: 1996). These developments culminated in the closure of three banks in 1995. Meridien BIAO Bank, then the fourth largest bank in Zambia collapsed on 19 May 1995, African Commercial Bank on 17 November 1995, and Commerce Bank on 29 November 1995.

The crisis affected the remaining banks in different ways. There was a general loss of customer confidence in the banking system, which favoured the foreign banks over the local banks. The latter experienced unprecedented deposit withdrawals and, consequently, faced severe liquidity problems. A general "flight to quality" occurred as customers opened accounts with foreign banks, which depositors perceived to be more stable and better managed. Despite the efforts of the BoZ to redress the situation, the last quarter of 1997 saw yet another crisis emerge. Prudence Bank collapsed on 17 October 1997 followed by Credit Africa Bank on 2 December 1997, Manifold Investment Bank on 5 December 1997 and Firstly Merchant Bank on 2 February 1998. Between 1995 and 1998, a total number of nine commercial banks failed and several government-owned financial institutions were allowed to collapse as previously guaranteed financial subsidies were withdrawn.

The financial cost of the 1995 and 1997/8 bank failures on the economy is difficult to determine, as most of the information relating to these failures is not yet in the public domain. However, by the time Meridien BIAO failed in early 1995, it had received official support estimated at approximately 1.5% of Zambia's 1995 gross domestic product (Goodhart et al, 1998:30). Subsequently, the receivership and liquidation costs of the banks that are now closed have been substantial.

Although the bank failures in Zambia were a result of a number of different macro and micro factors, it is the weaknesses in the regulatory and supervisory framework that attracted the greatest interest and imagination of politicians, the government and the public. The BoZ came under severe criticism for its handling of the banking failures, and despite the absence of a formal enquiry addressing the BoZ's diagnosis, prediction and management of the 1995 and 1997/8 bank failures, it remains the general perception in Zambia that the BoZ failed in its regulatory responsibilities (Appendix 1, 2, 3, 4).

1.3.0 Research Objectives

For the above reason, the thesis addresses three related hypotheses which examine the extent to which the BoZ failed in its responsibilities when it came to licensing, monitoring, supervising and closing financially-distressed banks. Specifically, the hypotheses are:

1. The weaknesses in bank licensing policies and procedures were an important contributing factor to the 1995 and 1996/97 bank failures. There was insufficient regard given to the quality of the new banks' owners, directors and managers of new commercial banks, minimum amount of capital required, development of reasonable business plans and financial strength of the owners.

2. The BoZ had the capacity and resources to detect declining standards of corporate governance, financial deterioration and violations of banking regulations and laws in the banks that failed in 1995 and 1997/98.

3. Due to politically and economically-motivated regulatory forbearance, the BoZ failed to enforce the required corrective action in a timely and consistent manner.

Firstly, the thesis hypothesises that the weaknesses in the licensing procedures for new commercial banks were significant contributing factors to the bank failures of 1995 and 1996/97. In this connection, it questions the adequacy of regulatory tools and techniques for evaluating the quality of new banks' owners, directors and managers, minimum amount of capital required, development of reasonable business plans and the financial strength of the owners.

Secondly, the thesis hypothesises that the BoZ had the capacity and resources to detect financial mis-management, breaches of the law and financial deterioration in the banks that failed. The bank failures of 1995 and 1997/8 did not occur suddenly, but were a culmination of a long process of mis-management, breaches of the law and financial deterioration. The study seeks to establish the extent to which the BoZ was aware of the financial problems and violations of the law of the failed banks. It gives consideration to, amongst other factors, the availability of inspectors to conduct the required off-site and on-site examinations; the adequacy of available skills for detecting falsified bank returns and financial statements; and the adequacy of the accounting standards at the time.

Thirdly, this thesis hypothesises that due to politically and economically-motivated regulatory forbearance, the BoZ failed to enforce the required corrective action in a timely and consistent manner. If the BoZ was aware of the financial problems existing in the failing banks, there is a need to examine the effectiveness of the corrective measures, if any, that it recommended and implemented. A number of questions flow from this position: Did the BoZ have the necessary legal authority to force offending banks to address the problems that it identified? Were the banks able to ignore the BoZ because of their political connections? To what extent did the political and economic environment prevent the BoZ from resolving the emerging banking problems early? How long did it take the BoZ to close under-capitalised and insolvent banks? What were the reasons for the delay? Did it lack the legal authority to intervene and close the banks?

1.4.0 Chapter Outline

Chapter Two introduces the subject of regulation by defining banking regulation and identifying the different types of regulatory and supervisory instruments. The Chapter discusses the public interest, institutional and behavioural perspectives on the rationale for regulation. In its discussion of the appropriate role for regulation, Chapter two reinforces the argument that a strong case exists for the regulation of banks and the debate on regulations is not about whether there should be regulation or not. Rather, it is about how regulators should impose regulations and what form those regulations should take. The Chapter is a theoretical prelude to Chapter three.

Chapter Three examines how regulators have translated banking regulatory theories into regulatory and supervisory practice. The Chapter argues that despite the differences in the approach to regulation, all the existing regulatory models exhibit three common features, namely entry regulations for the licensing of banks, on-going bank supervision of prohibited and restricted banking activities, and policies and procedures for regulatory intervention in financially-distressed banks by regulators.

Chapter Four then discusses the research methodology and methods used in this study. It starts by highlighting the challenges facing prudential regulation and supervision researchers, then it discusses the key aspects of critical systems thinking - methodological pluralism, critical awareness, emancipation and boundary judgements - that make it a particularly appropriate methodology for regulation and supervision research in general, and this study in particular.

Thereafter, it presents the specific methods for the study's three research questions, explaining the data collection methods employed during the field visit to Zambia and the data analysis process used to ensure the study was representative of the practice of regulation and supervision in Zambia. Finally, the Chapter concludes by acknowledging the study's research limitations and the steps taken to mitigate their potentially negative effects on the findings, conclusions and recommendations.

Chapter Five details the recent history of the Zambian financial sector. Firstly, it traces how government interference during the 1970s and early 1980s resulted in the absence of an appropriate regulatory and supervisory framework for financial sector development. It evaluates how the political and economic environment influenced BoZ's regulatory and supervisory practices, and documents the 1992/93 financial sector reforms introduced as part of Zambia's Structural Adjustment Programme. A discussion on how the financial sector developed in response to those reforms follows. Importantly, it considers each of the 1995 and 1997/8 bank failures, reviewing the available literature on the causes of the bank failures and well as the BoZ's regulatory and supervisory effectiveness before and during the failures. Finally, the chapter concludes with a summary of the outstanding key research questions addressed in the subsequent chapters.

Chapter Six presents the thesis findings on the design, development and implementation of bank licensing policies and procedures in Zambia between 1984 and 1994 when the MoF, and not the BoZ, was responsible for issuing bank licences. This Chapter is particularly important because all the banks that failed in 1995 and 1997/8 obtained banking licences during this period. The Chapter provides evidence that there was insufficient regard to the new banks' quality of owners, directors and managers, minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners. The Chapter examines the methods used to establish whether the applicants met the minimum capital requirements; the procedures for evaluating the financial condition, resources and history of the applicants; the criteria used to determine the character and experience of major shareholders and directors; and the regulatory attempts to ascertain the convenience and needs of the community served by each banking licence. The Chapter concludes the analysis of the period between 1984 and 1994 with a review of the guidelines used to analyse the prospects of the profitable operation of the proposed banks.

Chapter Seven evaluates the method of financial analysis the BoZ employed to monitor banking activities during the 1994-1998 period. The chapter shows that despite weaknesses in its regulatory and supervisory polices and procedures, BoZ had the capacity and resources to detect financial mis-management, breaches of the law and financial deterioration in the banks that failed. It describes the structure of the FSSD and details the objectives of each of its four divisions - Bank Inspection, Non-Bank Financial Institutions, Management Information, Regulatory Policy and Financial Analysis - in operation at the time of the bank failures. Then it evaluates the method and quality of off-site bank monitoring tools and techniques during 1994-1995 and 1996-1998. Thereafter, the Chapter compliments the quantitative analysis with an analysis of the non-quantitative indicators of impending financial distress in the banking sector. It then presents the study's findings on the legal provisions available to the BoZ for dealing with failing banks. The issues examined in the Chapter include provisions for unsafe and unsound banking practices, the suspension and dismissal of directors and managers, the appointment of curators, the suspension and revocation of bank licenses, bank insolvency, fraudulent trading, wrongful trading, the seizure of financially-distressed banks and the appointment of receivers.

Chapter Eight presents the study's findings on the BoZs response to the 1995 and 1997/98 bank failures as they emerged. It classifies the different supervisory tools and techniques employed by the BoZ during the 1995 and 1997/98 bank failures, into three main activities – information-based activities, financial resources mobilisation activities, and direct central bank intervention activities. Firstly, the information-based activities discussed in this chapter include; holding meetings, on-site inspections and special investigations, audit reports, issuing letters of caution/reprimand/sanction and requesting for re-capitalisation/re-organisation plans. Secondly, the financial resource mobilisation activities include; providing banks with legal and accounting exemptions, encouraging and facilitating mergers and takeovers, granting lender of last resort (LoLR) support, and transferring Government deposits to failing banks. Finally, direct central bank intervention activities employed by the BoZ included the removal of management, the appointment of curators/receivers and liquidation managers, and the seizure/receivership of banks. Importantly, Chapter eight also undertakes a considered and systematic approach to explaining the BoZ's regulatory response to the 1995 and 1997/98 bank failures. It acknowledges the views and opinions of Members of Parliament (MPs), the then Minister of Finance (M/Finance), former and current BoZ Governors, Financial System Supervision Directors, Financial System Supervision Assistant Directors, Financial System Supervision Bank Inspectors and Former Bank Owners/Directors. In its conclusion the chapter presents the study's findings on the prevalence of *bureaucratically-institutionalised regulatory forbearance* with respect to violations of the law, deterioration of the banks' financial conditions, deteriorating corporate governance, regulatory meetings and effecting supervisory actions and the negative effect of the BoZ's decentralised responsibility with centralised decision-making management structures.

Chapter Nine presents the conclusions and response to the research hypothesis, and makes recommendations for policy as well as recommendations for further research on regulation and supervision in general, and for Zambia in particular.

CHAPTER TWO

BANK REGULATION AND SUPERVISION THEORY

2.1.0 Introduction

Following the seminal work of McKinnon (1973) and Shaw (1973), the financial sector economic literature has focused on the relationship between financial development and economic growth. In the wake of a proliferation of bank failures around the world in the 1980s and 1990s, an increasing body of literature on financial liberalisation and financial sector fragility began to appear. However, more recently, more literature concerned with the relationship between financial fragility and the quality of financial regulation and supervision, has emerged.

The last few years have witnessed an increase in the number of banking sector problems experienced internationally. A recent International Monetary Fund (IMF) review revealed that 133 out of 181 member countries experienced significant banking sector problems at some stage between 1980-1996, notably: Argentina, Chile, and Uruguay (1979-1983), the Nordic banking crisis (1987-1994), Japan (1992-1998), Mexico (1994) and more recently the Asian Financial Crisis (1997-1998). In Africa, few countries have not suffered some form of banking-related problems over the same period. Benin, Cameroon, the Central African Republic, Chad, Congo, Equatorial Guinea, Niger, Senegal, Somalia, South Africa, Tanzania, Uganda and Zambia have each experienced a significant banking crisis in recent times (Goodhart et al 1998).

For many years, academics viewed financial regulation as one of the "backwaters of academic study"(Quinn 1996:1). However, the recent spate of banking failures has provoked scholars, the media and politicians alike into expressing strong opinions on regulation. In many countries, regulators have been criticised for failing to minimise the risk of bank failures. Partly in response to this criticism, regulators, especially in developing countries, have prolifically issued new regulations with respect to capital, insider loans and large loans, fixed assets, interest rate disclosure and the classification and provisioning of loans. Academics, professionals, world bodies and governments alike are increasingly asking how to improve banking regulation and supervision (Dewatripont and Tirole, 1996;2). Because of the prevalence of inappropriate regulations and inadequate supervision, some favour minimalist government intervention, whilst others question the conventional wisdom of supervising banks in the first place, arguing that regulation has contributed to rather than stemmed, the fragility of the banking sector. "To regulate or not to regulate?" is the question that researchers must first address, especially in the face of the many failings of the existing regulatory theories.

Fry (1995) observed, however, that attempts to reform the financial regulatory environment in developing countries appear to be adopting the general banking model found in developed countries. This model, to the extent that Fry could generalise it, was based on a safety net in the form of government insurance for deposits, a prescribed minimum capital adequacy ratio, and government-supplied supervision. Not only did Fry express concern that this form of regulation contained unresolved problems, but he also noted that it required a rich institutional environment not necessarily capable of transplantation into a developing nation overnight or even in a few years, if at all. An urgent need thus exists for research into various aspects of banking regulations, not only to address unresolved problems in the general banking model, but also to ensure that developing countries adopting regulatory structures and regulations from developed economies, do so with their own local financial environments in mind.

However, before examining the regulatory practices in developing countries in general, and Zambia in particular, it is important to review the relevant regulatory and supervisory theory literature to establish an understanding of the appropriate role of regulation in banking. This chapter pursues that objective in three steps. Firstly, section 2.1 introduces the subject of regulation by defining regulation and identifying the different types of regulation and regulatory instruments. Section 2.2 and 2.3 then examine the rationale for regulation, comparing the arguments for and against, drawing attention in section 2.3 to differences in the approach to regulation by public interest, institutional and behavioural theorists. Finally, section 2.4 discusses what the literature considers as the appropriate role of regulation.

2.1.1 Definition of banking regulation

Because of the diverse nature of banking regulatory practices, trends and philosophies, international banking standards are only just beginning to emerge and the literature on the subject of regulation has hitherto been country-specific. The early literature largely focused on the U.S.A, where researchers have long recognised regulation as a unique type of policy, and developed a distinct theoretical and empirical literature. In the economics and political science literature, it has evolved as a distinct sub-literature. The study of regulation in European countries is a more recent phenomenon encouraged by the privatisation of major utility companies in transport, gas and electricity in the 1980s and 1990s (Giandomenico, 1996). Mitnick (1980:5), in a study of regulation in the USA, defined regulation as the "intentional restriction of choice by a party not directly involved in, or performing the regulated activity". Viscusi et al (1997:307) extended the definition by naming the regulatory authority and the regulated activities by defining regulations as, "government-imposed restrictions on firm decisions *over price, quantity, and entry and exit*". A fundamental element of this definition is the involvement of government as the ultimate body responsible for imposing and enforcing the regulation. Government involvement in the process of regulation, whether directly or indirectly, is important because it is only the government that has the ultimate legal power to coerce economic agents to comply with regulations. However, a useful definition that recognises the different forms of regulatory authority (private, self and international regulation) is provided by Lastra (1996;108) who defined banking regulations as "the rules established by either the legislator (Congress or Parliament) or *a competent authority* [italics added] for the purposes of influencing the behaviour and actions of banks operating within its jurisdiction." At a micro level, self-regulatory organisations can impose rules for their members. At a macro level, the government, through the central bank may enforce regulations. Finally, international organisations may require that banks in member countries comply with its regulations. Alternatively, non-member countries may voluntarily adopt the regulations in a bid to enhance their international standing as financial centres.

2.1.2 Types of regulation

Regulation is as old as the existence of societies and government. In her work, Giandomenico (1996) referred to studies and practices of regulation in Roman times arguing that what has changed since then is not the functions of regulation, but rather its modes. In a comparative study of regulatory developments between the U.S.A and Europe, she found that the type of regulation was dependent on prevailing political systems, ideas, ideologies and interpretations of economic welfare.

She identified three principal forms of regulation, namely, regulation through public ownership (nationalisation), statutory regulation by independent agencies (delegated regulation), and self-regulation. Nationalisation was commonly practised in Europe where welfare economics advocates argued for the nationalisation of companies in order to eliminate the concentration of political power and economic efficiencies arising out of pure monopolies. Publicly-owned companies were vested with the responsibility of maintaining national security, protecting consumers and stimulating economic growth, providing water, electricity, transport and telecommunications. Contrary to expectations, however, this model of regulation often resulted in higher levels of economic inefficiency, poor public accountability and low levels of consumer satisfaction with both price and quality of services and products. According to Giandomenico (1996), one reason for the failure of nationalisation was that it tended to confuse the role of manager and regulator, subordinating the latter to the former. Politically-appointed managers of utilities paid more attention to the political agenda of their appointing authorities, rather than government-appointed inspectors of price and quality standards.

Although delegated regulation is a new frontier in Europe, it has a long history in the U.S.A. There are more independent regulatory authorities with legislative, judicial and executive functions in the U.S.A, than in European Countries,. Many of these organisations such as the Inter State Commerce Commission, created in 1887, have a longer history. Their early existence in the U.S.A is primarily because of the continuing struggle between the U.S.A President who is in charge of executive departments of the government, and Congress (which is heavily influenced by powerful interest groups). Independent commissions, with each group appointing an agreed number of representatives, have been used to regulate economic activities where clearly conflicting interests of different interest groups exit. The advantage of this form of regulation is that it reduces direct government intervention in industry practices and it is easier for an independent organisation to recruit and retain professionals and experts. Giandomenico (1996) notes that self-regulation is advantageous where an industry requires a greater degree of expertise and technical knowledge. It ensures that the industry provides the requisite knowledge and skill (which regulators may not possess), reduces the cost of rule-making and facilitates quicker adaptation of rules to new technology and changing economic conditions. Self-regulation, however, suffers from self-monitoring problems and weak enforcement. Members are more likely to engage in anti-competitive practices against non-members and operate price cartels, just as they are also less likely to publicly discipline or punish one of their members.

Bank regulators use different types of regulation for purposes of promoting economic development, maintaining monetary stability, encouraging efficiency and competitiveness, and protecting depositors. Llewellyn (1986) provided a six-point classification of the forms of regulations, namely, economic, legal, self-imposed, moral suasion, self-regulation and external agency.

2.2.0 The Case for Free Banking

Some academics attribute the banking crises mentioned in Section 2.1, to the direct effects of regulation (Dowd, 1996; Benston and Kaufman, 1996). According to Goodhart et al (1998:2) supporters of free banking attribute banking crises to "the (indirectly malign) effects of regulatory efforts - perhaps the worst case of iatrogenesis (medically induced illness) ever known" and Dowd (1996) criticises the central bank regulatory intervention because it often comes with lender of last resort facilities (LoLR) support and explicit/implicit deposit insurance. Although both measures ought to stabilise the financial sector, Dowd argues that that they merely encourage that very behaviour, greater risk-taking and the maintenance of weaker capital positions, which a sound financial system should avoid.

The LoLR function primarily provides liquidity to institutions failing to obtain it from the market. By keeping weaker banks in operation, this facility "protects banks against their own bad actions" and reduces the incentive to adopt prudent management styles. Deposit insurance schemes have similar consequences. They reduce depositors' incentives to monitor bank management and management's need to maintain customer confidence; a level of moral hazard[1] emerges that would not exist in the absence of regulation. As managers begin to operate at lower capital levels, the financial health of institutions falls and they become more vulnerable to failure. The solution to this never-ending cycle of "regulation - financial fragility - more regulation" is to adopt a laissez-faire approach to financial institutions: no regulation, no LoLR support, and no deposit insurance. This view stems from the understanding that full disclosure of risky aspects of financial products, and of information about the banks offering them, enhances market efficiency. Market discipline would become a real force preventing imprudent behaviour by both managers and depositors. Contrary to expectations, such a financial system would actually be more stable than a regulated financial system.

[1] Moral Hazard refers to situations where one side of the market cannot observe the actions of the other. (Brownbridge and Kirkpatrick: 2000;21)

The "contagion argument[2]" lacks sufficient empirical evidence. The typical scenario is a flight of funds to quality, with substantial inflows of funds to stronger banks. In other words, if depositors withdraw all funds from one bank and deposit them in another, there is no reason why the financial system as a whole should become unstable. A shift of funds from banks with unsound portfolios to one with a sounder portfolio will only serve to encourage sound management.

Proponents of free banking place immense faith in market discipline, arguing that without any regulatory safeguards, depositors would be acutely aware that they stood to lose their deposits if a bank failed. Thus, they would be more demanding in their requests for reassurances from bank managers regarding the safety of their funds. Failure to provide such assurance would result in depositors withdrawing their funds. Because their long-term survival depends on retaining customer confidence, managers would pursue conservative lending policies, publish audited accounts and maintain adequate capital.

Dowd's (1996) argument for non-regulated banking is based on three factors, namely, the general acceptance of free trade in other sectors of the economy, educational conditioning, and empirical evidence. Firstly, "if economists are in agreement that free trade is generally desirable, then why should the financial sector be an exception to this general rule?" - is the question asked. Based on pure logic, if free trade is acceptable, it is not for the proponents of free banking to argue their case, but rather its critics to demonstrate its undesirability. Secondly, Dowd suggests that criticism of free banking results from educational conditioning that has led us to take the existence of certain institutional structures such as the central bank for granted, an unhealthy bias, which has left us unwilling or more problematically, unable, to consider the existence of a safe non-regulated financial system. Finally, historical evidence supports the free banking movement. In the U.S.A, for example, bank capital ratios were as high as 40% in the pre civil war period when they were subject to virtually no banking regulation, in comparison to 15% in 1934 when the legislature created the

[2] The contagion argument is the fear that the difficulties of one bank might induce the pubic to withdraw funds from other banks and threaten the stability of the financial system.

Federal Deposit Insurance Scheme. Also given as examples, are the lower failure rates and losses in other relatively unregulated systems such as those found in Scotland during the 18th century. Proponents of free banking use the Scottish experience to support the feasibility of the private sector developing and operating a self-regulated environment in the absence of a central bank. Krosner (1995) noted that Scottish banks operated a clearing system and, it appears, developed and enforced capital and liquidity standards without public regulation.

2.3.0 The Case for Regulation

Critics of free banking refute free banking arguments, maintaining that a case still exists against complete deregulation. The externalities that arise with financial products and markets are considered too important economically, socially, and politically for governments to entrust individual depositors' funds to the unregulated workings of market mechanisms (Quinn, 1996:2). Proponents of regulation like Dow (1996), contend that unless the evolutionary process of the entire banking system during which the nature of causal forces change, is considered, there is a danger of misinterpreting the evidence gathered.

While free banking may have been successful at a particular point in time, when external intervention was not required or desirable, this no longer applies. The basis upon which the public maintained their confidence in the banking sector during earlier periods has changed, being replaced by the public's confidence in the central bank's capacity to encourage prudent bank behaviour. Various theories on regulation attempt to explain its recent growth.

2.3.1 Public interest theories

The most enduring theory for the existence of regulation relates to market failure. Ultimately, regulation emanates from the assumption that unregulated markets will result in production and allocation inefficiencies, creating a negative net effect on society. Public interest schools of thought use this argument to suggest that regulation arises in response to the public's demand for the correction of market failure. There are three principal reasons for market failure, namely, the abuse of monopoly power, externalities and information failures. Monopoly power tends to curtail production so as to increase prices. The company has no incentive to increase production to the point where marginal costs equal marginal price in order to minimise production costs. The consequence of such behaviour is a distortion of resource allocation, which requires external regulation correction. Negative externalities occur when part of the costs of one party's activities is unwillingly borne by another party. For example, environmental pollution is borne by a wider segment of society than the company producing the pollution. External intervention is required to reduce the gap between the private costs of individuals and the true cost to society of the activity producing the pollution.

Information failure occurs when there is either inadequate information or inadequate understanding of the information provided by a company about its product or services, thus resulting in the abuse of consumers and customers. Although free banking would provide an incentive for depositors to acquire more information about banks, private sector depositors would have insurmountable difficulties in gathering adequate knowledge (Dow 1996, Caprio 1996, and Fry 1995). It is questionable, however, whether, even with complete information, depositors would achieve an appropriate analysis of risk. Informational problems arise due to the informational asymmetry between financial institutions and users of financial services regarding pricing and product information. It is difficult for non-experts to "assess the credit worthiness of banks and to distinguish the level of risk assumed by different bank strategies. Because of information problems, a need exists to protect depositors. The belief that governments should protect public deposits funds stems from the fear that losses to depositors due to the failure of one bank may precipitate an epidemic of bank failures" (Fry 1995:354).

The free banking dismissal of the contagion argument is described as being too simplistic since it ignores the potential systemic instability arising from the transfer of deposits from unsound banks to so-called sounder banks. At times of financial crisis, banks may begin to assign unrealistic asset values due to an overall change in conventional judgement - what others have referred to as the herd instinct. Without an increased supply of liquidity by the government into the system, instability will arise resulting in the banking system collapse. A banking market collapse would lead to a decline in intermediation, money transmission and liquidity services, which, in turn, would cause an inefficient allocation of resources in an economy (Llewellyn 1986, Fry 1995, Heffernan 1996).

Finally, the provision of pure public goods such as national defence, public health and environmental protection is often subject to government regulation (nationalisation) on the basis that there are insufficient incentives for the market to provide these goods. Dow (1996) argues that the fundamental error made by advocates of free banking is to treat money, as any other product on the market that can be subject to the whims of the market at will. This, he argued, is not the case. Money is a public good which is essential to the working of the monetary system and exists purely because of public confidence in its ability to retain value. Without this confidence factor, or an unjustifiably high risk in holding it, money is worthless. Should confidence disappear, the public would invest in non-monetary assets, leading to the collapse of the financial sector and monetary system. Just as the legal system exists to support the evolution and enforcement of contracts, banking regulation supports the evolution of financial systems and the use of money as both a medium of exchange and a store of value. Given their ability to create money through credit creation, banks are prime candidates for government regulation.

Apart from central banks seeking to prevent excessive monetary creation and inflation, they also see bank regulation as a means of using banks as conduits through which to manipulate money supply through various forms of market operations. (Sheng, 1990:262, Fry 1995:354).

Critics of the public interest theories, however, were dissatisfied with the simple notion of regulation arising out of the government's public interest. Part of their criticism stems from the normative, rather than the positive, approach that the public interest school adopts. The public interest theories, critics argued, focused on discussing situations in which government regulation ought to take place, rather than where it actually does occur. The dissatisfaction was also partly a result of the surrounding industrial evidence, which contradicted the theories. Many of the regulated firms had not experienced market failure, did not produce externalities such as pollution or price discrimination, nor were they natural monopolies. Furthermore, the need for regulation did not always arise out of public concern; rather, it was industry participants pushing for regulations. Posner (1974) criticised the public interest theories for failing to account for much of the evidence that the socially-undesirable results of regulation are frequently felt by groups influential in the enactment of the legislation establishing the regulatory scheme.

A reformulation of the theory attempted to correct this weakness by arguing that although regulation was originally intended to correct market failure, regulators mis-managed it. Three possible reasons exist for the possible deviation from public interest effects in public interest theories: the venality view, the incompetence argument and capture theory. The venality view argued that corrupt regulators regulated in favour of the interest group that provided the highest level of personal votes or funds. The incompetence view suggested that failure of regulation arose because of poor working conditions, salaries and status of regulators (Mitnick, 1980). The capture view suggested that regulators were "captured" by the industry, who chose to serve the interests of the industry rather than the public. Over time, the regulated parties took control or co-ordinated the activities of the regulatory agency.

Posner (1974), however, was critical of the early capture theories on three theoretical issues. Firstly, there is no evidence to explain why the regulatory agency should be the only interest group captured. Secondly, there are no reasons explaining why industries are able to capture only existing agencies and never to procure the creation of an agency that will promote their interests. Thirdly, there are no reasons to explain why an agency able to tame the regulatory agency is unable to prevent its creation in the first place. The evidence showing mis-management of the regulatory agency was also weak. Not every agency was characterised by a pristine virtue: often there was no occasion for conquest. The theory had no predictive power or explanatory power when a single agency regulates separated industries having conflicting interests (Posner, 1974). Additionally, there was no evidence to show why the theory expected regulatory agencies to be less efficient than other organisations. This approach merely provided hypotheses without providing any empirical evidence that regulatory agencies mis-manage the regulatory process.

Both the public interest theories and the different forms of the capture theories are not theories of regulation but hypotheses about empirical regularities (Viscusi et al, 1997). The economic theories of regulation result from the need for theory in the proper sense, which generates testable hypothesis as logical implications from a set of assumptions. Stigler's (1971) paper set about formalising the theoretical development of theories on regulation. His theoretical objective was to identify the factors which provided an indication of when regulation in an industry occurred. He proposed a number of assumptions about regulation, using these to predict which industries would attract regulation, what form regulation would take, and what its effects would be on the allocation of resources. Disagreeing with the normative theories of regulation that argued regulation was essentially the result of market failure, designed to protect the interests of industry consumers, he argued that, generally, industry acquired the regulatory agenda and operated it for its benefit. To explain the regulation phenomenon, Stigler (1971) initially analysed the potential uses of public regulation by economic groups in order to provide a schema of the demand for regulation. Then, he analysed the characteristics of the political process, which allowed relatively small groups to obtain regulation, to provide a theory of the supply of regulation. Stigler observed that with the use of its coercive power, the state was in a position to offer industries direct monetary subsidies, protection from adverse competition presented by new firms and substitute products, and prevent negative price fixing practices. As rational economic agents, industry participants see regulation as an avenue in which they can increase their income by having the state redistribute wealth from groups to them. To obtain this regulation, interest groups lobby using this power to improve their well-being.

The nature of lobbying varies from providing political support to regulators who want to remain in office, to providing personal financial incentives to those with a private remuneration agenda. Stigler noted that, at times, the benefits of regulation exceeded its accompanying costs. The additional financial cost of complying with public reporting requirements and the external interference in the operation of the industry were insufficient to prevent interested parties from campaigning for regulation. These costs, however, influenced the form that regulation took, its effectiveness and its lifespan.

After studying the process by which regulators, industry participants and consumers negotiated the benefits and costs of regulations, Stigler argued that it was possible to predict which industries were likely to receive regulation, and in what form. Peltzman (1976) expanded Stigler's model. In the Stigler/Peltzman model, there are three important assumptions. Firstly, regulatory legislation redistributes wealth. For example, direct subsidies are financed by taxes elsewhere, price-fixing protects industry at the expense of consumers, and entry restrictions may encourage unwarranted supernormal profits. Secondly, all interest groups, including regulators are utility maximisers. The model does not specify the utility function in detail, but it includes securing political support (votes and money) for regulators in exchange for favourable regulation. Thirdly, regulators, driven by their desire to remain in office, act as rational beings, maximising their political support by prescribing regulation favourable to influential interest groups.

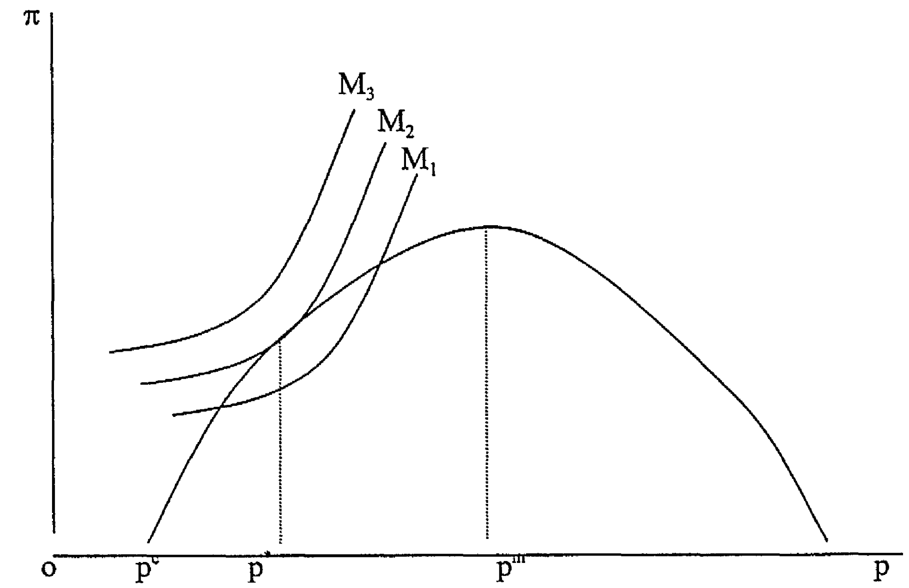
The implications of these assumptions were that regulation favoured well-organised groups. In reviewing industries in the U.S.A, Stigler observed that groups that received favourable legislation were smaller (compared to rival interest groups), had very strongly-felt preferences over the issues at hand, and were capable of delivering political support, either votes and money. He found that large groups were not as organised and consequently were disadvantaged in the formulation of regulation. Partially, this was because the larger groups did not feel as strongly over the same issues and because they suffered a 'free-rider' problem. Shared interests do not automatically lead to effective interest groups. The size and organisation skill of the interest group were important in determining its ability to influence regulators. For example, in his study of the regulation of weight limits on trucks in the US, Stigler (1971) identified three interest groups, namely, states with large numbers of trucks on farms, the railroad industry (concerned with increasing competition) and the general public interest in the potential damage to the highway system.

The study found that the regulations on weight were less onerous the larger the truck populations in farming; and the less competitive trucks were to railroads, the better the highway system. The relatively smaller trucking interest groups and railroad companies were able to influence regulations to the disadvantage of the large, unorganised public. In another study of occupational licensing, the important variables that influenced the outcome of regulation were the size of the occupation, the per capita income of the occupation, the concentration of the occupation in large cities and the presence of a cohesive opposition to licensing. In this study too, regulations were more favourable, the more stable the occupation and the higher incomes the groups had.

Posner (1974) observed, however, that most of the evidence produced by Stigler's model, for example, is consistent with any version of interest group theory. It was possible to use both public and private interest theories to explain regulatory behaviour in the same industries. This dilemma arose because of the unsystematic nature of the empirical research on theories of regulation. Most of the work was very selective and anecdotal in nature. The literature was in need of a more systematic research approach that would identify underlying assumptions and regulatory norms testable across different industries over different periods.

While he accepted the general premise of the Stigler model, Peltzman (1976) noted that the model assumed the strongest and best-organised single interest group captured regulators. The empirical evidence was strongly against such a notion. Instead, the beneficiaries of regulation were widespread amongst more than one single interest group and included, for example, consumers whose interests were subsidised by other interest groups with more money and political support to offer regulators. Peltzman argued that the Stigler model failed to explain this cross-subsidisation of interest groups. Peltzman's (1976) regulatory model attempted to explain the cross-subsidisation phenomenon, the premise being that regulators allocated economic benefits across producer and consumer groups so that "total utility" was maximised. In other words, regulators could not be very pro-producer in their design of regulations as long as some interests groups were able to offer more votes and money for some change to the regulation, than competing interest groups could (Figure 1).

Figure 1 Optimal Regulatory Policy: Peltzman Model



Where:

M (P,π) -Political support function: Assumed to be decreasing in price because consumers increase their political opposition when price is higher while it is increasing in industry profit because firms respond with greater support

P -Price

π -Industry profit

π(P) -Profit function: increasing in P for all prices less than P^m (the monopoly price) and is decreasing for all prices above P^m

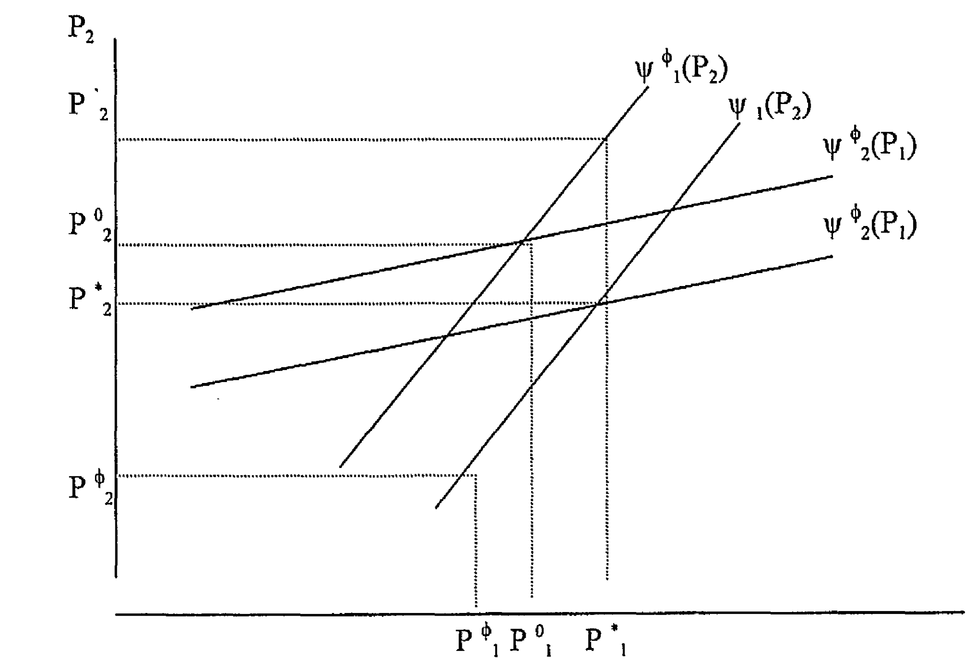
Source: Viscusi et al (1997:332)

The model suggests that a legislator/regulator chooses a price P^* to maximise political support. As long as $P< P^m$, increases in price lead to higher consumer opposition, since M (P,π) is decreasing in P, but also raises industry support, since $\pi(P)$ is increasing in P and M (P,π) is increasing in π (Viscusi, 1997). Because of the interplay between industry profits and consumer opposition to higher prices, regulators cannot set a price that maximises industry profit. Instead, the parties reach a compromise at p^*. Therefore, even if regulation becomes pro-producer, policy, especially price policy, will not always be set to maximise profit.

These findings were formalised by Peltzman in a model (Figure 1) which implies that interest groups will campaign against price regulation if the regulatory price differs substantially from the price that would exist in the absence of regulation. Therefore, if the equilibrium price that an industry can achieve in the absence of regulation is close to what would exist under regulation, P^* then regulation is unlikely. Peltzman (1976) thus reached the conclusion that industries that are likely to attract regulation are either highly-competitive with an unregulated equilibrium near P^c, or relatively monopolistic with an unregulated equilibrium is near P^m. At both these levels, some interest groups will gain considerably from regulation that pushes prices towards p^*. Firms gain in the case of a competitive industry while consumers gain in the case of a monopolistic industry (Viscusi et al, 1997). Finally, market failure makes regulation more likely because the gain to some interest groups is large relative to the loss of other interest groups.

Becker (1983) was dissatisfied with the Stigler/Peltzman overemphasis on the role of regulators and legislators in determining regulatory outcomes. Their models, he argued, focused too narrowly on the maximisation of political support by regulators when regulators were only one of the many interest groups in society. Instead, Becker (1983) chooses to emphasise the role of competing interest groups in the setting of regulations. The decisions of the regulators were a consequence of the rivalry between interest groups, not the driving force of regulatory outcomes seemingly suggested by the Stigler/Peltzman model. The Becker model assumes that the possible level of influence on regulators is fixed. However, the composition of that level of influence will vary amongst different interest groups according to the relative influence exerted by other interest groups. Therefore, in determining the outcome of regulations, the model suggests that it is more beneficial to focus on the extent to which interest groups use their resources to exert influence on regulators and the amount of influence that they are willing to concede to rival interest groups (Figure 2). The Becker model argues the possibility of deriving the optimal regulatory price level by considering the benefits and costs of pressure. The parties reach price equilibrium through a process of political negotiation and pressure application between the interest groups. The fight of regulatory influence ceased when both interest groups reached a point where neither group had an incentive to change the amount of resources they were exerting in the process. The intersection of two influence functions was, however, not Pareto optimal, because both groups could invest fewer resources but achieve the same level of influence.

Figure 2 Political Equilibrium: Becker Model



Where:

ψ Interest group interest function: Assumed to be decreasing in relative price of competing interest groups because interest groups increase their influence resources when influence exerted by other interest groups is higher.

P Price

Source: Viscusi et al (1997:335)

According to this theory, the relative efficiency of interest groups in applying pressure to legislators and regulators determined regulations, and not the welfare effects of regulation as Stigler/Peltzman suggested. Further, the free-rider problem, which is an explanatory variable in explaining the failure of large groups to influence regulation in other models, is not as important in the Becker model. Since it is inherent in all groups, the severity of free-riding amongst the group captured by the amount of pressure that is applied by each group was of importance.

In predicting the choice of regulations by a regulatory agency, Becker (1983) introduced the concept of "dead weight loss", being the difference between the winner's gains and the loser's losses induced by a change in output on account of a regulatory change. The dead weight loss was a measure of the inefficiency of income distribution between interest parties. Rising dead weight losses increasingly reduced the winner's influence over regulators as the pressure from losers to avoid losses increased. The regulatory process, Becker (1983) argued, moved towards efficiency-enhancing regulations as neither winners nor losers opposed changes to eliminate dead-weight losses.

Giandomenico (1996) argues that the early public interest theories and the later economic theories of regulation put forward by Stigler/Peltzman were complimentary rather than mutually exclusive. Both theories assume that market failure results in the demand for regulation. However, the two schools of thought then travel different routes to arrive at the equilibrium level of supply and demand for regulation. For public interest schools, Giandomenico (1996) provides a first best solution to the problem by only assuming one restriction, public interest. The economic school of thought provides a second best solution to the problem by only assuming more than one restriction, namely, public interest and private interest. Becker's (1983) model bridges the difference between these schools of thought by suggesting that regulators seek to satisfy the public interest by maximising the private benefits in all the interest groups affected by the regulation.

The weakness with the public interest theories and the economic theories of regulation is that they assume that groups directly influence regulatory policies. They tend to assume that once the different interest groups have had their "influence contest", regulators will succumb to the interests of the winner. The regulator's preferences, objectives and interests are simplistic and predictable. Both theories are essentially free of any discussions on the complex institutional environment in which regulators operate. They treat regulatory organisations as "black boxes" that can be programmed by different interest groups and public-minded political executives.

This view, however, can be contested. Regulators can have considerable discretion in setting policy because they hold privileged information. The personal ambitions, philosophies and emotions of the regulator also influence the exercise of this discretion. Furthermore, these theories ignore the important elements of the regulatory process that hinder the direct influence on policy of the different interest groups (Viscusi et al, 1997).

Giandomenico (1996) notes that the theories are criticised for being silent on the crucial aspects of the regulatory process. These aspects include; the limits on political control over regulatory discretion, the requirements of public accountability of regulatory actions, the entrepreneurial skills of key individuals within the regulatory bureaucracy, and the importance of reputation and credibility to regulators.

Mitnick (1980) argues that it is not enough to simply provide a theory of regulatory origin[3]. A complete theory of regulation should not stop at explaining regulatory origin but must also address the process of regulation, the effects of regulation, and the general aspects of bureaucratic behaviour. It must explain, almost by definition, all aspects of the regulatory process: policy formulation, policy implementation and policy evaluation. Mitnick (1980) identified five stages of the policy-making process that regulatory theories must at a minimum attempt to address. The stages included: access, decision-making, implementation, administration, and impacts/effects.

[3] The study of new regulatory organisations or of new regulations within existing organisations.

There was, in his opinion, insufficient attention being paid to the policy-making process, nor was a distinction being made between those seeking regulation and those served by regulation. Although presented as general theories of regulation, they were very limited in scope. Most theories are static and do not consider the strategies and processes of agenda building during access, decision-making, implementation, administration and effects.

Noll (1983) is even more dismissive of the capture theory literature and the early economic theories of regulation. He argues that the capture literature is tautological, assuming its conclusion by wrongly presupposing the existence of demand and supply for regulation capable of achieving equilibrium. Such theories are not theories of regulation but rather theories of legislation as a commodity, sold to the highest bidder.

2.3.3 Institutional theories

More recently, a new literature on regulation is emerging, focusing on concepts and insights from the fields of public choice, new institutionalism and the new economics of organisations. All these schools of thought originate from the desire to open or explain the "black box" of institutions that is assumed in the economic literature. Giandomenico (1996) identified two common elements of the new literature. Firstly, there is an assumption that political control of regulatory bureaucracies is possible. The key elements of study therefore are, a matter of establishing the extent and the means by which politicians are able to guide and control regulatory bureaucracies. Secondly, the studies recognise the central role played by political parties in the regulatory process and focus on the problem of establishing the appropriate level of delegation. They focus on trying to explain when politicians will delegate the policy-making process to regulators, and when regulators will choose to exercise that delegated power. The central issue for such studies is determining the appropriate level of rules that should be set for regulatory agencies as opposed to the amount of discretion required by regulators to enforce those rules.

In dealing with the above problems, "agency theory" is relevant to the study of regulation. Agency theory argues that principals contract agencies to perform certain duties. However, due to information asymmetries between the principal and the agent, the agent has an incentive to act in his/her own interest rather than that of the principal. In a regulatory environment, although bureaucratic regulatory agencies ought to obey democratically-elected politicians, over time, the interests of the politicians and bureaucrats diverge due to changes in the political environment.

Giandomenico (1996) notes one important limitation in the application of agency theory to regulation. Agency theory is most applicable to hierarchical relations between one subordinate and one superior. It is of limited use in the regulatory environment where a regulator faces multiple principals, each with possibly different and conflicting objectives. The implications for research of this multiplicity of principles is therefore, what is the relative influence of each principle, what is the effectiveness and efficiency of the various instruments and strategies of control, and what is the possibility of coalitions between subsets of principles?

2.3.4 Behavioural theories

In order to address some of the issues raised by behavioural problems identified by institutional studies, some theorists have taken a bureaucratic approach in deriving a theory of regulation, that concentrates on the regulatory organisations and the incentive system faced by organisational members. Behavioural theorists acknowledge that a comprehensive theory that includes all the aspects of access, decision-making, implementation, and administration and effects would be too complex to implement. However, they believe that it is possible to develop an analytical policy-making framework for developing the components of such a theory. Thus, their emphasis is on providing a modelling approach that is useful in understanding regulatory behaviour.

An example of the behavioural approach is the study by Bardach and Kagan (1982) of the individual encounters of regulators with members of regulated industries. They argued that general regulatory practices were the culmination of a series of individual relationships between members of regulated industries and regulators of the same industry. They used the term "regulatory unreasonableness" to describe the inefficiency arising from an unsatisfactory relationship between a regulator and a member of the regulated industry. This occurred whenever there was disagreement about the enforcement of regulations because the cost of doing so by the regulated party exceeded the expected benefits of compliance.

They further identified two types of unreasonableness. The first is "rule-level" unreasonableness occurring because of the aggregate economic inefficiency arising from the regulation's technical design. For example, this may occur where compliance with minimum capital adequacy requirements by a bank results in lower than market interest income margins for it. The second, "site-level" unreasonableness refers to particular encounters between the inspector demanding compliance and the regulated resisting compliance. This may occur if a bank inspector demands the closure of a bank because it has failed to meet capital adequacy requirements even though management has already imposed corrective action to rectify the problem within a few days.

In a study of 58 enforcement officials from 43 municipal regulatory agencies, Bardach and Kagan (1982) found that the way in which regulatory unreasonableness was resolved and the type of regulator in each given situation determined the outcome of regulatory decisions. "Enforcers" dealt with erring regulatees swiftly and harshly. They enforced regulations by the book with no recourse to any discretionary powers they had. "Reciprocators" were generally dedicated and hardworking regulators who were uncomfortable with coercion, and tended to sympathise with lawbreakers preferring to educate offenders into future compliance rather than deal with them uncompromisingly. "Professional" regulators acknowledged that the law was not the sole measure of morality, and offered a combination of options to violating regulates: responsiveness, forbearance and information.

Responsiveness acknowledges the fact that the government might be wrong in its application of the regulation, and that the regulations might be over inclusive. To be responsive regulators need the capacity to empathise with those subject to regulation. They need to know their concerns, problems and motivations. According to Bardach and Kagan (1982), forbearance comprises four aspects:

1. Overlooking violations that pose no serious risk under the circumstances.

2. Not enforcing regulatory requirements that would be too costly or disruptive in relation to the additional degree of protection they would provide.

3. Granting reasonable time to come into compliance and accepting measures that provide substantial if not literal compliance.

4. Making allowance for good faith efforts on the part of the regulated enterprise.

Behavioural studies like Bardach's and Kagan's (1982) concentrate on the behavioural characteristics of members of regulatory agencies in contributing to the search for an overall theory of regulation. Such an approach is extremely useful as it focuses research efforts on the type of individual factors that regulators consider in practice when making regulatory decisions. The difficulties of such an approach of course lie in the problems of gaining access to the usually exclusive world of regulators. Where regulators grant such access, however, the potential contribution of such studies is significant.

Although regulation ought to provide stability in the financial sector, there is, yet, no optimal regulatory model (Caprio, 1996). Different rules, laws and customs that regulate economic activities will accommodate different banking regulatory structures. It is this debate – the most appropriate role of regulation rather then whether banks need regulation - that is most beneficial to developing countries, especially in Africa.

2.4.0 The Appropriate Role of Regulation

Between the opposing arguments in favour or against regulation, is a continuum of moderates. Krosner (1995), for example, is careful in his endorsement of free banking. He remains critical of some of the aspects of its feasibility and admits to its impurities, but is nevertheless convinced that its principles are applicable to developing countries with characteristics that are akin to those prevailing in Scotland in the nineteenth century. These characteristics include: an initial low level of GDP per capita legal uncertainty over financial contracts, lack of experience with financial services, the importance of international trade, the dominance of a neighbouring financial centre, and the inclusion of substantial macro-economic shocks, including wars.

Benston and Kaufman (1996) are also unwilling to accept the wholesale imposition of free banking and instead advocate for less regulation and government intervention and more market discipline. Markets, they concede, are not perfect, but they have performed much better than governments in providing a banking system that serves the public well. They agree with Dowd's free banking position with some exceptions. Although they would prefer governments not to provide deposit insurance, and private institutions to manage the operations of a central bank, they concede that such a proposition is not possible in the contemporary world. The suggested solution, in their view, lies in creating or facilitating regulation that mimics free market operations.

Benston and Kaufman (1996) argue that the most important justification for government–imposed regulations is the presence of externalities, both positive and negative. They identify the use of money not only as a medium of exchange but also as a store of value as a positive externality that justifies government regulation. Uncertainty regarding a bank, for example, reduces the value of its bank cheques as money and the value of its deposits as stores of values. Hence reducing the likelihood that a bank might fail with prudential regulation could produce a positive externality that exceeds the cost of regulation. The negative externalities they identify include contagious runs on solvent banks; and economic distress or collapse due to bank failures. When banks fail it is the small depositors whi face the highest level of risk. Monitoring bank performance can be complex, expensive, and time-consuming, yet small depositors are often unsophisticated and usually have little incentive to perform monitoring functions (Dewatripont and Triole, 1994;32). It is in response to these externalities, Benston and Kaufman (1996) argue, that governments provides various forms of external regulation to the financial sector.

The wide variety of financial sector regulation can be classified into three major groups, namely, preventive regulations, regulations for depositor protection and systemic support regulations. Preventive regulations, seek to minimise the risk of bank failures and include, amongst others, market entry regulations, minimum capital requirements, maximum lending concentrations and foreign currency exposures. Depositor protection regulations refer to the existence and use of implicit and explicit deposit protection schemes to instil and maintain confidence in the banking system. Systemic support regulations are concerned with maintaining systemic stability using LoLR facilities by the central bank. This group of regulations is the last option for commercial banks and is usually only used in extreme circumstances.

Collectively, 'prudential regulations' is the term given to preventive regulations, regulations for depositor protection, and systemic support regulations. The main purpose of prudential regulations is to ensure a safe and efficient financial system that discourages undue risk-taking, minimises financial instability and the eventual need for government bailouts (Corbo and Hernandez, 1992:100). Prudential regulations deal with the safety and soundness of individual banks in respect of the public deposits they hold (Goodhart et al, 1998:5). They establish the outside limits and the constraints placed on banks to ensure the safety and soundness of the banking system (Polizatto, 1990:175).

The absence of, or weaknesses in, prudential regulations can lead to banking failures and systemic instability. Although prudential regulations aim at ensuring the safety of individual banks, eliminating the possibility of individual failing is not the primary objective of prudential regulations. This is a misconception often held by the public, which has led to their blaming regulators for bank failures when they occur, despite the fact that macro and/or micro-economic factors may have caused them. It is within this context that this thesis proceeds to study the design, development and implementation of prudential regulations by the Bank of Zambia between 1980 and 2000.

2.5.0 Conclusion

Chapter Two introduced the subject of banking regulation and supervision by noting how increasing financial sector fragility in the 1990s has removed financial regulation from the 'backwaters of financial study'. Following the recent spate of bank failures in both developed and developing economies, questions have been raised regarding the most appropriate model for banking regulation and supervision [2.1.0][4].

After adopting the definition of banking regulations provided by Lastra (1996), (the rules established by either the legislator [congress or parliament] or a competent authority for the purposes of influencing the behaviour and actions of banks operating within its jurisdiction) [2.1.1], the chapter identified the principal types of regulation with which the government has experimented in the past, namely, regulation through ownership, (nationalisation), statutory regulation by independent agencies (delegated regulation) and self-regulation. The study noted that the choice of regulatory model was determined by the prevailing political system, ideas, ideologies and interpretation of economic welfare [2.1.2]. Following a brief discussion on the merits of each model, the chapter considered a more fundamental question – whether there was a need for regulation in the first place. It discussed how proponents of free banking criticise state regulatory intervention in the banking system because of the moral hazard effects of institutions such as the lender of last resort and deposit insurance that often accompany government-supplied regulation. These institutions, they argue, encourage greater risk-taking and lower bank capital positions. Using examples from the USA in the pre-civil war period, and Scotland in the 18th century, it is argued that market discipline

[4] Parenthesis indicate the number of the section most relevant to the issues raised in the preceeding sentence or paragraph.

was a more effective tool for maintaining financial stability than government regulation [2.2.0].

The 'free banking' arguments were then contrasted with the arguments for regulation as presented in the 'public interest', 'institutional' and 'behavioural' theories [2.3.0]. The first school of thought contends that regulation is necessary to correct market power caused by the abuse of monopoly power, externalities and information asymmetries between depositors and bankers. While accepting this objective as the primary reason for regulation, there have subsequently been different interpretations on the reason why regulatory authorities fail in their duties – were regulators corrupted by influential interest groups, was it because of poor working conditions or were they 'captured' by bankers to work for the industry rather than the public [2.3.1]? Then, the chapter shows how, in an effort to understand regulatory behaviour, the 'institutional' and 'behavioural' schools of thought have introduced 'agency theory' and the study of personal 'behaviour characteristics' to the banking regulation literature. The former examines regulatory performance within the context of the level of the rules that are set for regulatory agencies by politicians and the amount of discretion available to regulators to enforce these rules. The information asymmetries between the principals (politicians) and the agent (the regulator) and their divergent objectives and interests can result in regulatory failure [2.3.3]. In the latter, the behaviour and personal characteristics are important. A distinction is made between 'enforcers', 'reciprocators' and 'professional regulators'. The first group deal with erring bankers swiftly and harshly. The second group are uncomfortable with coercion and tend to sympathise with lawbreakers, seeking to educate offenders rather than deal with them uncompromisingly. The third group acknowledge that the law is not the sole measure of morality and offer a combination of both the first and the second group's approach being more willing to (1) overlook violations that pose no serious threat to the banking sector stability, (2) ignore regulatory requirements that might be too costly or disruptive in relation to the additional degree of protection they offer, (3) grant bankers reasonable time to comply with regulations, and (4) make an allowance for good faith efforts on the part of bankers [2.3.4].

Having compared the arguments for and against regulation, the chapter concludes with what is considered by some, to be the appropriate role of regulation – encouraging a safe and efficient financial system that discourages undue risk-taking, and minimises financial instability. The discussion draws attention to the flaws in the 'free banking' position and argues that the issue is not whether banks should be regulated or not, but rather what type of regulations are suitable for minimising the risk of bank failures and maintaining the confidence in the banking system. Llewellyn (1986:19) draws a very apt conclusion about the essence of regulation:

> "In the final analysis regulation is ultimately about risk; the extent of allowable risks financial institutions should take and who should bear which risks. The risk-minimising role of regulation is based upon the premise that in an unconstrained competitive environment financial institutions will be induced to take 'excessive' risks to the detriment of their customers and/or society to the extent of any systemic risk."

The following chapter reviews how regulators have translated this position into specific regulatory and supervisory practice with respect to entry regulations for the licensing of banks, on-going bank monitoring for unsafe and unsound bank practices, and policies and procedures for regulatory intervention in financially-distressed banks.

CHAPTER THREE

BANK REGULATION AND SUPERVISION PRACTICE

3.1.0 Introduction

There is a strong case for the regulation of banks and the regulations debate is not about whether there should be regulation or not, but rather, about how much regulation to impose and the form it should take (Chaves and Gonzalez-Vega, 1994:60). No standard model of regulation and supervision has yet received worldwide acclaim as "best practice", and researchers continue to develop new models in response to financial crisis, economic events and political phenomenon. Frequently, the form of bank supervision reflects the philosophical and social differences in the role of government and in the organisation of society (Polizatto, 1990:183). The bank regulation and supervision literature discusses three traditional models of supervision:the British model, the European model and the American model. More recently, however, a fourth model based on the New Zealand approach to supervision is receiving increasing attention in the literature[5].

Despite the differences in the approach to regulation, all the models exhibit three common features, discussed in detail in this Chapter. Section 3.2 examines the entry regulations for the licensing of banks, Section 3.3 reviews on-going bank supervision of prohibited and restricted banking activities, and Section 3.4 considers the policies and procedures for regulatory intervention in financially-distressed banks by regulators.

[5] For a detailed discussion on the different British, US and European regulatory models see Polizatto (1990).

3.2.0 Entry Regulations in Banking

Bank licensing policies and procedures are an important aspect of the development of the financial sector. Effective entry regulations contribute significantly to the structure and quality of commercial banks in the financial sector. Although there exists an extensive literature on liberalising entry into the financial sector for purposes of fostering financial sector development, and in turn, economic development, there is a very limited academic literature on the implementation of bank licensing policies and procedures. Furthermore, this literature often does not extend the licensing debate beyond discussing desirable characteristics of potential banks and their owners. Although a subsidiary body of literature that considers the impact of foreign banks entering the domestic banking system of a developing economy (Classens et al, 1998; Brownbridge and Gockel, 1996; Brownbridge and Harvey, 1998) has emerged, that literature does not systematically consider the practical administrative difficulties, if any, that foreign banks undergo when obtaining bank licences.

The prudential regulatory process commences with the screening of individuals applying for a banking licence in order to prevent those without the appropriate professional qualifications, banking experience and financial capacity and ethical backgrounds from owning or managing banks (Lastra, 1996;110). Polizatto (1990:176) recommended that, at a minimum, prudential regulations on the criteria for entry should address the issues of capital, the management qualifications, the development of a reasonable business plan, and the financial strength of the owners. To reduce political interference, he further recommended that independent supervisory authorities and not agencies of government make decisions regarding licensing. Folkerts-Landau and Lindgren (1997:17) noted that the licensing process incorporated in the banking laws of IMF member countries verified five principal issues, namely, whether the initial capital was sufficient, the major shareholders and management were suitable, the corporate structure was transparent and the organisational structure was adequate, and in the case of a foreign bank, that the bank received adequate supervision in its home country and the home country approved the establishment of the branch. The Core Principles for Effective Banking Supervision, issued in

September 1997, by the Basel Committee on Banking Supervision recognise the importance of the bank licensing process in the regulatory and supervisory process. Principle 3 states, "The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process should consist of an assessment of the bank's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country should be obtained."

3.2.1 Minimum capital requirements

The literature on minimum commercial bank capital focuses on three principal issues, namely, the definition of capital, its cost and impact in banks, and the measurement of capital adequacy (Revell, 1979; Howard, 1980; Berger et al, 1995; Basel Committee, 1988, Llewellyn, 1992; Benston, 1992; Blum and Hellwig, 1995; Shah, 1996a; Jackson et al ; 1998, 1999; Basel Committee, 1999).

The most significant contribution to the literature on capital adequacy was the 1988 Basel Committee Capital Accord which the Basel Committee for Effective Banking Supervision circulated to its member countries; and which the majority of countries around the world subsequently adopted. The 1988 Capital Accord used a weighted risk ratio in its measurement of capital adequacy. The ratio was weighted according to broad categories of relative riskiness of the assets of the bank. The framework of the weights was kept as simple as possible with only five weights - 0%, 10%, 20%, 50% and 100% being used. The target standard ratio of capital to risk weighted assets was set at 4% for core capital (Tier 1) and 8% for total capital (Tier 1 + 2). By attempting to establish a standard definition of capital with specific proposals on its measurement, the Committee consolidated the research issues on capital adequacy into a single document which henceforth became a reference point.

Subsequent literature critical of the 1988 Capital Accord (Benston, 1992; Calomiris, 1992, 1998; Shah, 1996a, 1996b; Jackson et al 1999, Basel Committee, 1999), led to further amendments to the Accord by the Basel Committee, and later, a New Capital Adequacy Framework. It has been argued that the Basel Committee failed to define capital appropriately and its measurement of bank risk was flawed. As a result, the capital standard was misspecified and subsequent amendments were inevitable.

Benston (1992), for example, argued that the committee had inappropriately emphasised the role of equity over debt in the definition of bank capital. Equity capital was considered as "core" capital while debt was treated at "supplementary capital" that could only be used subject to certain restrictions. Only debt with an original maturity of five years could be included and the total supplementary debt could not exceed the level of core capital held by the bank. He also considered the inclusion of general loan loss provisions to have been erroneous. Banks were known to overstate the expected losses, either as an act of conservatism or in a bid to avoid income taxes. Inappropriately high general loan loss provisions overstated the banks regulatory capital.

The risk measurement categories (0%, 10%, 20%, 50% and 100%) have been criticised for being too crude and arbitrary to provide realistic assessment of the risk profile of the balance sheet of a bank. There is no reference to any theoretical or empirical work in the choice of ratios and allocation to the various asset categories by the committee. The risk weighting assigned to the different asset categories ignore the varying quality of the underlying asset.

The percentages as a measure of risk are seen as a crude way to measure of the actual credit risk posed by certain assets. The Accord's sole focus on credit risk (until it was amended to include some elements of market risk) has been another major weakness. Market risk, interest rate risk, operational risk, liquidity, legal and reputation risks were not explicitly addressed in the Accord (Benston; 1992, Philippe; 1997). The broad nature of the risk weightings also left plenty of scope for the arbitrage of capital requirements. Jackson et al (1999) found that the Basel Accord created a gap between the economic capital banks felt they needed to hold to support their loan portfolio and the regulatory capital they were required to hold. Their survey found that, innovations in the market enabled banks to avoid the limitations, which fixed capital requirements placed on their risk taking.

In June 1999, the Basel Committee proposed a new capital adequacy framework to replace the 1988 Capital Accord. The proposed capital framework goes beyond setting a minimum capital requirement. It supplements the capital requirements set in the 1988 Accord with a supervisory review process and a process for incorporating market discipline on banks.

Firstly, the new Accord proposes to use the same definitions, measures of risk exposure and rules specifying the required level of capital as provided for in the 1988 Capital Accord. However, risk is to be considered under three categories – credit risk, market risk and other risks (liquidity, legal and reputation.) The most significant change however, is the proposal to use external credit assessments provided by credit rating agencies in evaluating a banks capital position. It is hoped that this approach will encourage transparency, objectivity, independence and credibility. Secondly, the Accord includes a supervisory review process in the framework, which rests on four basic and complimentary principles.

(i) Banks are to be allowed to utilise their own means of assessing their own capital adequacy requirements in relation to its own risk profile

(ii) Supervisors should then proceed to review and evaluate the banks internal risk assessment process and access its compliance with the required ratio.

(iii) Supervisors will continue to retain the right to request banks to hold capital in excess of the minimum capital requirements

(iv) Supervisors should be encouraged to intervene at an early stage to prevent a bank from falling below the required regulatory capital levels.

Finally, the framework will seek to enhance the role of market participants, in the process of encouraging banks to hold adequate capital, by establishing high disclosure standards. By issuing guidelines on the public disclosure of bank information, it is expected that shareholders, investors, depositors, competitors and the general public will demand more prudent levels of capital.

The successful implementation of the proposed capital adequacy framework rests on three cardinal propositions. Firstly, banks operate in a well developed financial market where market participants are able to receive, understand and evaluate financial information provided by commercial banks. Secondly, that bank management is willing to honestly share information on its risk profile with regulators. Thirdly, bank regulators are in a position to review and evaluate the banks internal risk assessment process and the assessment provided by external credit assessment bodies for each and every bank. While these conditions may exist in some of the developed countries in the world, they are unlikely to exist in the majority of developing countries. Even where the above conditions are present in developed economies, the rapid pace of technological development, large number of credit rating agencies (all using different risk assessments and grading systems and the large number of commercial banks will exert substantial demands on the resources of most regulatory authorities. There is a real potential that the financial cost of effecting the proposed supervisory review process alongside efforts to promote market discipline will exceed the financial risk of allowing banks to determine their own capital levels in the way other commercial organisations do.

The debate on the new proposals emphasise that the literature is still struggling with the same issues that earlier research papers attempted to address. How should regulators define bank capital? What capital level is adequate for banks to remain safe and sound? What criteria should be used to assess the adequacy of capital? Establishing the appropriate levels of capital at the licensing stage and later during the bank's on-going operations improves the likelihood that managers will be properly incentivised to manage the bank. Llewellyn (1999;24) noted that capital serves three main roles as far as incentive structures are concerned; " ... a commitment of the owners to supply risk resources to the business and which they can lose in the event that the bank makes bad loans; an internal insurance fund and the avoidance of the bank becoming captive of its bad debts." Caprio (1996;12) observed that theoretically "higher capital gives depositors, shareholders and supervisors more time to detect unsafe practices, and increases the motivation of owners as they will want to protect their funds. However, in a later paper, Caprio (1997:20) rightly noted that it is by no means clear that raising capital standards is the best way of protecting depositors since there was not guarantee that the bank owners would maintain the quality of capital. The effect of higher capital on risk remains theoretically ambiguous (Goodhart et al 1998; 107-8).

3.2.2 Character, financial condition, history and experience of applicants

The most important, yet simultaneously the most difficult challenge for regulators, is the assessment and regulation of bank ownership and management quality. Despite the best risk management tools and techniques, banks will still fail under the weight of weak management teams. This being a subjective matter, it is difficult to assess and to set objective criteria for its assessment (Goodhart, 1995c:25). How can regulators impose regulatory standards on human quality and managerial culture? Mehran et al (1998), in a study of 32 selected sub-Saharan African countries, found that a large number of countries had enacted new legislation covering the licensing process. However, the study established that although the legislation was often quite detailed, the right of the supervisor to question a bank's proposed management on "fit and proper" grounds had been less than fully covered. One of the primary reasons for the lack of detailed guidelines is that the standards required in respect of licence applications vary considerably, depending on the nature of the institutions and the position to be held by an individual. The Bank of England's (BoE's) Schedule 3 of the Banking Act 1987 (Box 1) is a typical example of legislation incorporated in the regulatory framework for this purpose.

Box 1 Minimum Criteria for Authorisation of Bank Directors

(1) Every person who is, or is to be, a director, a controller or manager of the institutions is a fit and proper person to hold the particular position which he holds or is to hold.
(2) In determining whether a person is a fit and proper person to hold any particular position, regard shall be had to his probity, his competence and soundness of judgement for fulfilling the responsibilities of that position, to the diligence with which he is fulfilling or likely to fulfil those responsibilities and to whether the interests of depositors or potential depositors of the institutions are or are likely to be, in any way threatened by his holding that position.
(3) Without prejudice to the generality of the foregoing provisions, regard may be had to the previous conduct and activities in business or financial matters of the person in question and, in particular, to any evidence that he has: (a) committed an offence involving fraud or other dishonesty or violence; (b) contravened any provision made by or under any enactment appearing to the Bank to be designed for protecting members of the public against financial loss due to dishonesty, incompetence or malpractice by persons concerned in the provision of banking, insurance, investment or other financial services or the management of companies or against financial loss due to the conduct of discharged or undischarged bankrupts; (c) engaged in any business practices appearing to the Bank to be deceitful or oppressive or otherwise improper (whether unlawful or not) or which otherwise reflect discredit on his method of conducting business; (d) engaged in or been associates with any other business practices in such a way as to cast doubt on his competence and soundness of judgement.

Source: UK Banking Act 1987: Schedule 3

The problem with Schedule 3, and similar legislation in different countries, is that some sections are difficult to verify and thus left to the discretion and interpretation of the regulators. For example, Parts 3(a) and 3(b) of Schedule 3 are easily verifiable by a court search. But that is not the case with parts 3(c) and 3(d). The sentence "...engaged in any business practices appearing to the Bank (BoE) to be deceitful or oppressive or otherwise improper (whether unlawful or not)..." is subject to different interpretations. It is not surprising, therefore, that in some countries, bank licence applicants seek political influence before submitting their licence applications or offer financial incentives to regulators in order to ensure that such discretionary pieces of legislation are "interpreted correctly".

Another concern in the literature on bank ownership relates to the desirability and extent of foreign ownership of banks. In some countries, there is a lower minimum start-up capital requirement for local banks than for foreign banks in order to encourage local participation in banking business. In other countries, however, legislation prohibits foreign banks from entering the local banking sector (Brownbridge and Gockel, 1996; Brownbridge and Harvey, 1998). Classens et al (1998) examined the scale of foreign bank operations in 80 countries and considered how they affected the operations of domestic banks, concluding that although relaxing the restrictions on foreign bank entry reduced the profits of domestic banks, it had an overall positive welfare effect on the economy.

3.2.3 Convenience and needs of the community

The criteria established for granting a bank licence have implications for the value placed on that licence by bank owners and managers. If a community is in need of more banking services, regulators may lower the minimum licensing requirements. However, doing so may lower the franchise value of banking licenses as the number of banks in the community increase. If the value of the licence falls, then bank owners may engage in riskier business practices. It is therefore in the interest of the regulator to maintain a sufficiently high bank license franchise value so that bank owners and managers take actions to ensure that they keep it, the bank remains open, and they continue earning profits with it (Caprio 1996:15).

One way to preserve the franchise value of bank licenses is by limiting the number of licenses granted. In a study of the limited impact of financial sector reforms in Zimbabwe, Harvey (1996:21) found that regulators deliberately limited the number of banking licenses granted in order to protect the existing banks in the financial system. He refer to Zimbabwe where the licensing policy was deliberately conservative, the central bank being aware of the problems of newly-established banks elsewhere in Africa. The licensing process was deliberately long, involving the Registrar of Banks at the MoF, and a committee with representatives from the Inspector of Banks and the Economics Department of the Reserve Bank. It held many opportunities for the rejection of the banking application. However, it appears, that the concerns of the regulators were with the convenience and needs of the existing banks, rather than for the community, which might have benefited from a more competitive environment.

It is difficult to define the number of licences to grant, and some arbitrariness regarding who receives the licenses is unavoidable where regulators try to make such a decision. Inevitably, such an approach might lead to; a rise in corruption, as bribing officials in charge of licences can be expected where licences are both valuable and difficult to obtain; banks with licenses accumulating monopolistic rents (Caprio, 1996:15-16); or inadequate levels of competition (Lastra; 1996;110).

3.2.4 Prospects for profitable business operations

There is a consensus on the need for a rational business plan to accompany a bank licence application. Standard practice dictates that the business plan should include the applicant's banking policies, projected earnings, cash flows and rates of return. There are, however, a few exceptions to this practice. Harvey (1998:26) noted a different approach adopted by some regulators in evaluating business plans. The Bank of Botswana, for example, does not examine the commercial viability of the proposed financial institutions, in the belief that the investors, whose capital is at risk, must make market decisions and not the licensing authorities. In any case, the preparation of a business plan projecting excellent profits into the foreseeable future, is not a guarantee that it will be implemented or that its projected results will materialise. The evaluation of a bank applicant's business plan raises interesting questions for prudential regulatory policy. Is it possible to prescribe detailed regulations on what is an acceptable business plan? Who is better placed to analyse projected bank performance - the central bank, or market participants?

3.2.5 Political interference in the licensing process

Political interference affects the objective evaluation of licence applications, and regulators are often unable to exercise total and complete independence in evaluating them. Polizatto (1990, 176) noted that in many developing countries agencies of government and not those directly responsible for supervising banks granted banking licences. Mehran et al (1998) found that while the central bank had overall authority for regulating the banking sector, in some countries, the central bank shared responsibility for licensing with the MoF, or took licensing decisions in consultation with, or with the approval of, the M/Finance. The arrangement made accountability difficult, increasing the risk of using subjective criteria for granting licences and encouraging "rent seeking behaviour" in the process. In a study of selected Anglophone African countries, Brownbridge (1998:4) noted that political considerations influenced the granting and renewal of banking licences even when the applicants had not fulfilled the necessary minimum requirements. Instead, the M/Finance granted exemptions from some provisions of the Bank Act.

3.3.0 Monitoring Unsafe and Unsound Banking Practices

Bank supervisors have had a long history with models designed to detect possible financial distress, arising from external or internal events. Having traditionally relied upon annual inspections of commercial banks to determine their financial soundness, supervisors are increasingly finding this method to be inadequate in terms of timely supervisory actions, partly due to governments demanding that supervisors acknowledge responsibility for maintaining financial stability in the banking sector. This has resulted in a shift of emphasis from merely checking compliance with regulations to a more active monitoring of banks to minimise the risk of their involvement in unsafe and unsound banking activities. The objectives of prohibiting certain banking activities include avoiding a conflict of interest with bank customers, preventing a concentration of financial wealth and stopping banks from placing depositors' funds at risk (Sheng, 1990:268; Folkerts-Landau and Lindgren, 1997:69). Exceptionally, banks are allowed to invest in non-banking-related activities, but usually only as a means of recovering their loans. When banks invest in non-banking activities, they are usually expected to divest of their interests as soon as the specific loan has been recovered.

Numerous permissible activities are subject to regulatory restrictions. In an effort to control risk, there are limits set on credit growth, foreign exchange, interest rates and maturity risks that banks can assume. These limits include the size of loans which an individual borrower or group of related borrowers can take and the amount of single currency investments. Loans to owners, directors and associated companies of the bank attract special attention. Lending to related organisations is subject to restrictions because there is a lack of objectivity in assessing the granting of the loan, and subsequently, the monitoring and recovery of the loan (Sheng, 1990:268). Polizatto (1990:179) identified five reasons why connected loans resulted in abuses, and, ultimately, portfolio losses for banks.

1. Loans were made according to less rigorous criteria than those made to borrowers with similar characteristics;

2. Excessive credit was frequently extended in the form of loans and investments because of the relationship between the bank and other companies;

3. The managerial attitude of the related or subsidiary company deteriorated due to easy access to credit;

4. The personal relationships between the bank representatives on the related companies boards and the staff of the company prevented effective disclosure of information, supervision and control; and

5. The bank tended to prop up or support a connected company that was in trouble, rather than recognise that it was a problem borrower and stop any further extension of credit.

Polizatto (1990:178) recommended that connected lending limits should not only limit the amount of credit but should also require that the conditions of such credits not be on more favourable terms than credit extended to borrowers in similar characteristics. He found that often regulators did not adequately define permissible or prohibited activities, and banks were often engaged in commercial activities that were unsuitable for them because of the risks involved and the specialist expertise required. Polizatto (1990) noted that the lack of clear definitions for permissible and prohibited activities in Latin America resulted in the ownership of many banks by manufacturing firms. Although not entirely and always wrong, it increased the risks that a bank can assume in its quest for growth and profits. Folkerts-Landau and Lindgren (1997:68) contended that connected lending was an obvious breakdown of market discipline and posed considerable risk to banks. Many regulators reserve the right to deduct such loans from capital, when, in the opinion of the regulator, banks make non-arms length loans. Caprio (1997:17), however, questioned whether it was possible to avoid, or even control connected lending by merely stipulating limits. Although a number of countries impose such limits, it is very easy, he argued, to circumvent them. A number of banks in many developing countries have no option but to circumvent them because a few large families dominate the economy. Nevertheless, various models of bank monitoring exist in the literature aimed at monitoring bank performance. This section reviews some of those models, which have been broadly divided into macro-economic studies, micro-economic studies, and integrated models of bank failures.

3.3.1 Macroeconomic models

The primary objective of macro-economic studies is to identify those characteristics in the economy that are most likely to result in banking distress and the possible failure of some of the commercial banks. The most commonly-used indicators include cyclical output, trade shocks, asset prices, interest rates, inflation, foreign exchange reserves and capital flows. The majority of macro-economic models have been concerned with financial crisis in general with a bias towards currency crisis as opposed to banking crisis. The early models (Krugman, 1979) made a distinction between financial crisis precipitated by balance of payment problems and those that were essentially a systemic banking crisis. This is in part because it is easier to identify the former financial indicators and use them in economic models. It is not until the late 1990's that models started to merge factors relating to both balance of payment problems and systemic banking crisis problems.

Kaminsky and Reinhart (1996) undertook one of the most comprehensive empirical macro-economic studies on early indicators of banking distress. The study used a sample of 20 countries (fifteen developing and five industrial) over a 25 year period (1970-1995) to examine 76 currency crises. The indicators used in the empirical work included: export growth, bilateral real exchange rate deviation from trend, terms of trade changes, changes in reserves, money demand/supply, real interest rates, M2 money multiplier, M2/international reserves, growth in domestic credit/GDP, changes in stock prices, output growth and banking crises. The study established thresholds to signal impending failure by comparing two periods of analysis in the study. Thereafter it made a comparison of the behaviour of the indicator 24 months before the period of failure with a tranquil period between 1970 and 1995. The indicators' forecasting ability, the lead-time (the number of months before the crisis in which the first signal was issued) and the persistence of signals ahead of the crises formed the basis of evaluation. The study found that on average all the indicators sent the first signal anywhere between 12 and 18 months before the crisis occurred, with the real exchange rate offering the longest lead-time. Overall, external sector variables and those variables linked to financial liberalisation provided the most accurate signals before the crises. The initial model was criticised for failing to offer a systematic way of combining the information generated by the model (Demirguc-Kunt and Detragiache, 1999). As the study assessed the indicators individually, the possibility of conflicting signals was also high. Kaminsky et al (1998), however, did attempt to deal with this problem by developing composite indicies. Unfortunately, preliminary results using the revised model indicate a worsened predictive ability. In a subsequent study of the literature on early warning indicators of currency crisis Kaminsky et al (1998) found the studies utilised a large variety of indicators (Appendix 5).

While the literature on early warning systems generated by the macro-economic models on financial and currency crises is helpful in understanding why bank failures occur, in the macro context they are of less use to regulators monitoring the performance of individual banks. One of the weaknesses of these models is that they fail to explain individual bank failures. By focusing on general factors, they are unable to provide an explanation of the causes and timing on individual bank failures. Associated with this problem is the fact that they often do not sufficiently identify the channels through which the macro-economic shocks affect banks.

3.3.2 Microeconomic models

Microeconomic studies focus on individual bank statistics of performance. They aim to discern commonly-predictable patterns and trends in these statistics for use in predicting future banking failures. The ratios used reflect the position of a bank relative to its capital, asset quality, management, earnings and liquidity. There are three types of micro-economic models for the prediction of distress, namely, problem prediction models, outlier/peer group models or failure prediction models (Sinkey, 1979).

Problem prediction models replicate and predict bank examiners' "problem bank" classifications. The bank loan portfolio determines the classifications. High volumes of substandard loans relative to capital and reserves, have an adverse impact on bank performance, and raise the attention and concern of the regulators. The classification of a bank as a "problem bank" does not mean in itself that a bank is going to fail, rather that its problems may lead to failure.

Outlier prediction models, sometimes referred to as Peer Group Models, focus on statistical differences between banks. Once regulators establish benchmark measures of bank vulnerability, based on the industry average performance, such models identify banks with outlyer characteristics as being in need of supervisory actions.

Failure prediction models focus on identifying factors that lead to the seizure or complete failure of institutions' operations. The absence of a conceptual theory about corporate failure has led to diverse definitions and interpretations of what constitutes failure. Difference in definition naturally leads to different designs of the "optimal" failure prediction model. Beaver (1968), for example, operationalised failure as occuring when one of the following bankruptcy, preferred stock dividend arrears, bond default and/or having an overdrawn account. Other researchers have restricted their definitions of failure to include only those firms that have experienced insolvency or liquidation proceedings. Despite the different definitions of failure, the failure process is characterised by a systematic deterioration of the values of the ratios. Research into the use of ratios has centred, therefore, on identifying those with the most markedly different behaviour patterns before failure, and deciding how best to incorporate the selected ratios into a formal failure prediction model.

A fundamental assumption with univariate models is that the distribution of the selected ratios differs significantly between those firms heading for failure and those that are not. Univariate models have the potential to give conflicting predictions or indications about an institution's future because individual ratio trends may be heading in different directions. Multi-variate analysis is a direct attempt at dealing with this problem. Multi-variate financial analysis combines different ratios, usually by some form of weighting, to produce a single index.

Altman et al (1981) pioneered the work into the use of multivariate statistical analysis. A number of research studies in the 1970's concentrated on developing his initial accounting models. Foster (1978) identified the important issues of investigation at the time as being either deciding what form the model should take, deciding what variables should be included or deciding what weights to apply. A more recent study of bank level indicators based on the CAMEL model was undertaken to evaluate bank failures in developing countries. Rojas-Suarez (1998) found that the CAMEL indicators were not good measures of bank strength in emerging countries. What were required for them were simpler alternative measures that were more appropriate to the unsophisticated nature of developing countries. She recommended the use of four basic indicators, namely, deposit interest rates, the spread between lending and deposit rates, the rate of credit growth and the growth of the inter-bank debt.

While these measures might be inadequate for identifying systemic weaknesses of the banking sector, they may be adequate for identifying individual bank weaknesses. This criticism is in light of the use of banking system averages as warning thresholds for individual indicators of bank risk (Demirguc-Kunt and Detragiache, 1999). The difficulty for academics in utilising these models for research is that of obtaining data on individual banks, especially in developing countries. The required data on individual banks is often confidential, outdated or simply not of a comparable nature with other commercial banks. Cross-country studies may yield misleading results because of differences in accounting principles, standards and definition of ratios, which may render comparative studies misleading. The use of ratios in failure prediction models has persisted despite the weaknesses associated with their analysis. Argenti (1976), for example, expressed three reservations about the usefulness of ratio analysis in the study of corporate failures. Firstly, although ratios may demonstrate that something is wrong and a sequence of them over a period may show a deteriorating situation, it is questionable whether they can solely predict collapse or failure. Ratios, he argues, are useful as a symptom, but wholly inadequate as a measure of impending failure.

Secondly, inflation quickly erodes the value of financial ratios. Figures that appear to show an improvement may conceal deterioration in real terms. A ratio is essentially the comparison of one figure with another, and unless both figures are subject to the same rate of inflation, any comparison over time is invalid.

Thirdly, Argenti argued that, a deterioration of the financial ratios was actually one of the last indicators of financial distress when sequenced with other non- financial variables. Though Argenti's sequencing of events before failure has been criticised, the cause versus symptom issue that he raised is persuasive.

The absence of a conceptual theory upon which to build such models further complicates research into failure prediction models. A consequence of the theoretical vacuum caused by the different definitions of failure and different possible routes to failure, researchers have yet to develop an "optimal" model. However, attempts, at identifying financial ratios that better differentiate general patterns of behaviour before failure, continue. In banking, there is varying usage of ratios relating to capital, earnings, asset quality, earnings and liquidity are used in varying forms, either individually or by mathematically amalgamating them into a composite score.

3.3.3 Integrated models of analysis

Most studies in the economic literature focus on either macro-economic or micro-economic indicators of banking distress only or treat each set of indicators separately. Few studies seek to combine both these sets of indicators into one integrated model of analysis. Moreover, there have been even fewer attempts to incorporate non-quantitative factors into the process of analysis.

Honohan's (1997) paper on the diagnosis and prediction of banking system failures in developing and transition countries was a systematic evaluation of both macro- and micro economic indicators of bank failures. It also made a further distinction between epidemics of the macro-economic and micro-economic varieties and those that were associated with government involvement. The study used a sample of 24 countries, 18 countries that experiencing bank failures and six countries not doing so (Appendix 6). The study subjectively divided the countries into four groups and compared the seven indicators in each category. The macro-economic indicators, based on aggregate balance sheet data, included the growth in aggregate lending, the loan to deposit ratio and the ratio of foreign borrowing to total deposits. The same ratios were used to assess micro-economic indicators of bank failures. Further, the study included an indicator for bank discretion over the use of funds measured by share of reserves to deposits. Indicators for government involvement included: government share of lending, central bank refinancing of bank lending and the size of the government deficit. The study found that the macro-economic indicators correctly indicated potential banking distress in the group of countries where the banking problems were of a macro-economic nature, but failed to correctly identify banking failures in countries which exhibited micro-led banking crisis and crisis associated with government involvement. The government indicators of banking failure exhibited similar results.

Honohan concluded that the results confirmed the diverse nature of crises, and the need to tailor the indicators used to the type of structural weakness likely to be present. The key advantage of this model is that it acknowledges the importance of both macro and micro indicators of bank failures. However, its methodological approach limited its effectiveness as a practical early warning system. It is highly dependent on the user obtaining ex-ante knowledge of the likely structural nature of the next banking crisis, before selecting the appropriate micro, macro, government indicators. Additionally, there is potential for the model to produce conflicting results when applied to a single country as it offers no guidance on the importance or weighting of the different indicators.

The study by Gonzalez–Hermosillo (1999) attempted to deal with the above shortcomings. Gonzalez–Hermosillo undertook a macro-micro empirical exploration of some recent episodes of banking distress, namely, the US Southwest (1986-1992), Northwest (1991-1992) and California (1992-1993); Mexico (1994-1995); and Colombia (1982-1987) to identify ex-ante determinants of banking distress.

The study made two important contributions to the literature on early warning indicators of banking failures. Firstly, it focused on banking distress as opposed to actual bank failures, bringing the advantage of being able to assess the fragility of the banking system before a crisis actually occurs. The second novelty was in re-specifying the traditional macro and micro indicators of bank failures in terms of the different types of risk that banks face, namely, liquidity risk, market risk and credit risk (Appendix 7).

Apart from utilising proxies for these risks, the model included proxies for moral hazard (ratio of insider loans to total assts, ratio of interest income on loans, fees and leases to total assts). By focusing on these risks, instead on the specific indicators, the study was able to conduct comparative analyses of different countries. The model can use different ratios for different countries as long as they capture the same risks. The study found that both macro-economic and micro-economic factors were important in the determination of banking fragility. The tests, which used bank-specific factors centred on the different measures of credit, market and liquidity risk (including the moral hazard proxies but excluding capital and equity), performed well. The proxies for market risk and liquidity risk were particularly important in their significance while those for credit risk and moral hazard yielded conflicting results depending on the period of study. However, including the macro-economic variables enhanced the model's predictive power.

The problem of most economic studies in this area, including those discussed above, is that they tend rely on econometric methods of investigation which require a large sample of banks. In order to attain statistical significance a sufficiently large sample of healthy and failed banks is required. Comparable data for both sets of banks must also be available for a meaningful econometric study and analysis. Unless the study uses the U.S.A, single country studies lack sufficient sample sizes. The country must have experienced a number of bank failures, for its time series data to be reliable. Consequently, economic models tend to downplay the role of two important contributors to failure, namely, management failure and regulatory failure.

3.3.4 Exploring management failure

Although the banking supervision literature accepts the importance of management actions as indicators of corporate failure, the literature remains divided about the most suitable indicators to use. As Argenti (1976) indicated, management actions, not the deterioration of the financial ratios, are ultimately responsible for the demise of the company. Poor management leads to inadequate internal controls, ill-advised strategic decisions and inappropriate business risk assessments.

The difficulty for supervisors has been how to design objective criteria for evaluating management. How can a numerical ratio be set for management's ability to satisfy customer demands? While bank supervisors acknowledge the importance of strategic managerial decisions in determining failure for an institution, it is difficult to objectively assess the ability of management skill and expertise. In banking, officers in management are expected to be "fit and proper" for the positions they assume. Defining what is fit and proper, and more importantly assessing individual "fitness and propriety" is a subjective and difficult process. How can a bank inspector determine whether a bank manager's knowledge, experience, judgement, reputation, character and diligence will lead to the failure of a bank? Direct assessment of these qualities requires skills, which many regulators are without, who thus resort to indirect methods of assessing management quality. They continue to model the quality of management around financial ratios. Working on the assumption that efficient managers keep costs to a minimum, enhancing the bank's profits and its ability to survive in a competitive environment, various management ratios have been developed and used. Pantalone and Platt (1987), for example, selected four ratios for this purpose: (1) interest expense/total liabilities, (2) interest on deposits/net income, (3) compensation/total expense, and (4) occupancy expense/total expense. Though useful, such ratios identify symptoms of managerial deficiency rather than establish the reasons or causes of that deficiency such as weak loan approval procedures or incompetent management.

Vossen (1996) identified eight criteria for evaluating the quality of management.

1. The performance of the bank, in terms of the growth of the business, increased profits, and the growth of capital;

2. The quality of the loan portfolio, measured by the low level of provisions needed against bad debts, and by a sufficient diversification of risks;

3. The presence of, and compliance with policies on lending, internal controls, administrative procedures, etc;

4. Compliance by the bank with laws and regulations, specifically prudential regulations;

5. The quality and timeliness of the prudential reports submitted by the bank;

6. The quality of annual financial statements;

7. The reliability of the co-operation of the manager with the supervisory authorities, and

8. The professional opinion of fellow professional bankers.

Like management efficiency ratios, the above list would still leave a regulator with the unanswered diagnosis of the underlying problem. Why was bank performance so poor that management was being unco-operative and the quality and timeliness of the prudential reports and financial statements poor? Equally, why was the performance of one bank outstandingly superior to that of other banks? These are questions that schools of thought in the management literature have battled with, namely, what makes some companies succeed and other fail?

This thesis suggests that one method of resolving this problem is to incorporate strategic management tools of analysis into the study of bank failures. There are numerous studies in the strategic management literature that explore the link between the quality of management and corporate performance. Kay (1993) traced the use of corporate strategy models to the 1960's. Typically growing out of the budgeting process, the early models normally covered revenue and expenditures projections into the future. Subsequently, strategists developed planning procedures that incorporated market expectations of economic growth. The techniques for analysing and developing corporate strategy are many and varied. It is not the intention of this study to contrast one against the other. Rather, by selecting a few of the basic models in the literature, the aim is to illustrate that strategic management models are useful in the design and use of early warning systems.

Porter (1979) stipulated that the nature and degree of competition in an industry hinges primarily on five forces: the threat of new entrants, the bargaining power of customers, the bargaining power of suppliers, the threat of substitute products or services, and the level of competitive rivalry amongst industry participants. Porter's Five Forcese Model, probably his best known work in the area of management strategy analysis, presented a framework which, in his view, defined the basic posture of competition in an industry, thus providing a framework for a structured analysis of the banking industry. Consequently, it represents a concise analytical tool with which regulators can identify the important competitive issues facing the industry, and, subsequently, identify those banks that are pursuing inappropriate strategies in dealing with them. Porter's five forces model has been criticised for not providing an objective mechanism by which to determine the intensity of the five forces, either individually or collectively. However, this criticism has been dealt with by complementing the model with a comparative analysis of each force as evidenced by changes in the industry. Further, the intensity of each force is easier to understand when evaluated against a company's overal business strategy.

Determining the appropriateness of a strategy to a given market environment requires an understanding of the strategic options available to management. Porter (1981) operationalised the strategic choices of corporations into three generic choices: cost leadership, differentiation and focus. Each of these strategic choices bears certain risks, for which a bank must be prepared. A cost strategy is hard to sustain as competitors can easily imitate the strategy. Thus, for example, when a number of small banks choose to pursue this strategy in a market that is price sensitive, regulators should be concerned. However, not every bank is capable of successfully following a differentiation strategy. The additional cost of adding service attributes, the risk of customers deciding they do not want the extra features, and the cost of continual product innovation may prove financially onerous for a bank without adequate financial resources. Similarly, banks pursuing a focus strategy without adequate safeguards to protect themselves against the risks associated with such a strategy place themselves at the risk of failure. Banks focusing on specific types of customers or sectors expose themselves to the cyclical risks associated with those businesses. Portfolio strategy analysis is useful for regulators interested in establishing which of the banks they supervise have unbalanced product portfolios. Banks with a relatively larger proportion of unprofitable products are candidates for failure. Management which continues to invest in "problem" products, which repeatedly fail to deliver profitable returns, may create an unwarranted liquidity problem for the bank. By monitoring the changing portfolio structure of a bank and matching it to the profitability of different investment avenues, the regulators can easily notice the likelihood of banks experiencing declining income levels due to an unbalanced portfolio. Ansoff (1984) stipulated that a business could elaborate its activities in a number of ways. It can develop its market geographically or through new customers, or it can simply push the same products in the same markets. Like the portfolio strategy matrix, the product-market matrix is useful for regulators interested in identifying banks with inappropriate product-market portfolio strategies. In a tightly-contested market, smaller banks, without adequate financial resources to compete favourably with the larger banks, should pursue new markets rather than try to penetrate an existing market. Management that continues to invest in a saturated market may lead a bank to failure. As is the case with models based on classifications and categorisations, its key limitation is a definitional one. Sometimes, it is not clear whether a firm is pursuing a new market or merely penetrating an existing one. Likewise, with its products, when does the augmentation of an existing product lead to the creation of a new one? Nevertheless, as long as the researcher ensures that the definitions of products and markets are clear and uniformly applied, there is no reason why this model should not be a useful tool in the diagnosis and prediction of bank failures.

Using strategic management models as techniques in the diagnosis and prediction of corporate failure requires an analyst to consider environmental factors. Banks, like any other business, operate within the greater economy and their political and economic environments affect their performance. The political structures and traditions of a society are an important influence on the vulnerability of the banking system as a whole, and of individual banks. Honohan (1997) identified the two dimensions of political influence as the degree of concentration of political power in elite groups, and the freedom of the press. In practice, political indicators may be construed either through direct measurement of such political structure, or by relying on political judgemental risk indicators marketed by commercial firms.

Economies in developing countries tend to be more volatile than in industrial ones. Sharp fluctuations in real economic growth, inflation, nominal and real exchange rates, and nominal and real interest rates can disrupt the operations of even the most sound banks, especially those banks whose portfolio reflects the undiversified nature of the economy. As is the case with political indicators, establishing industry-wide indicators of financial distress for economic variables is not easy. Much depends on the specific asset and liability structure of the bank balance sheet at a given point in time, which, in turn, is dependent on the bank management's expectations of future inflation and interest rates. For example, a rise in interest rates will result in an increase in interest rate income for a bank with more assets than liabilities which are interest rate sensitive. A bank with more interest sensitive libiities than assets will experieince a fall in interest rate income, which may lead, ultimately, to a substantial and unabated fall in profits and, eventually, failure.

3.4.0 Exit Regulation and Supervision

A core prudential regulations pillar is concerned with setting rules for dealing with financially-distressed banks. This may take the form of providing liquidity support, changing management, restructuring the bank, merging it with another institution, privatisation/nationalisation of the bank, placing it under receivership or liquidating its assets in order to pay off its creditors. The way a regulators handles a bank failure affects the willingness of potential lenders to lend to the troubled bank and the willingness the bank managers to recapitalise the bank (Dewatripont and Triole, 1996;66) This section evaluates the recent literature regarding intervention and closure procedures for financially-distressed banks. It focuses on the remedial actions and rehabilitation options available to regulators for failing banks, particularly in developing countries. It examines the advantages and disadvantages of each option as discussed in the literature.

3.4.1 Definition and measurement of bank insolvency and illiquidity

Not all "bank failures" or "crises" are the same. Various terms are used to describe the magnitude and scale of a banking crisis in general and the condition of individual banks faced with a crisis: "banking problem", "banking insolvency", "systemic banking crisis". The choice of terminology is determined by, amongst other factors, the origin, duration, scope of the crises and the estimated losses. The variation in terminology is partly because crises, both at an individual and macro level, are difficult to quantify and measure. Generally, banks facing financial difficulties are those that are unable to meet all their financial obligations out of income over the long run.

Determining the extent to which a bank is insolvent is not an easy process. The literature provides at least four different ways to calculate bank solvency, namely, economic, market value, accounting or book value solvency and technical insolvency (Glaessener and Mas, 1996; Sheng, 1996). Economic insolvency, the net present value of expected cash flows, is the most difficult to calculate because it requires information about the bank's expected stream of cash flows under every possible scenario discounted in present terms. Market value insolvency, the current market value of a bank's assets less its current liabilities, is less problematic to calculate but it is highly dependent on the existence of a market for the bank's assets and the ability to calculate the bank's goodwill, if any. Accounting or book value insolvency, the historic value of assets (net of depreciation) less than the nominal value of liabilities, though the easiest to calculate, can easily be manipulated by a banks management to reflect a more favourable financial condition. To minimise the disparity between the three measures, regulators calculate a bank's technical insolvency, which is its accounting values adjusted for loan losses, provisions for probable losses, revaluations and off-balance sheet assets. Technical insolvency is a "compromise between the theoretically correct concept of economic solvency and the readily observable book-value solvency, effectively supplementing generally-accepted accounting principles with specific guidelines for banks " (Glaessener and Mas, 1996:55).

3.4.2 Regulatory options for insolvent/illiquid banks

Inevitably, some banks will face financial difficulties and the possibility of failure. Regulatory intervention will be required to facilitate their rehabilitation or orderly exit from the financial system. Regulators can implement bank-restructuring programmes at the level of individual banks, the banking system level or the macro-economic level. Normally, when banking problems emerge in a few banks, regulators need to assess the financial condition of each bank and determine the appropriate course of action. However, if the problems affect the entire financial system, a systemic banking-restructuring programme may be more appropriate (Brownbridge and Kirkpatrick, 1999:16).

Davis (1999) identified three broad categories, namely, bank failures following loan and trading losses, market price volatility after a shift in expectations, and, a collapse of market liquidity and issuance (Appendix 8). In the first instance, Davis (1999) observed that bank failures that follow loan losses could be particularly destabilising if followed by a general run on the banking system. The main characteristics of this type of crisis were large non-performing loans, bank runs and large bailouts which could take the form of government-led re-capitalisation, privatisation or nationalisation, or repayment of deposits. Such failures disturbed "normal" credit relationships and raised the cost of intermediation. They also weakened monetary and budgetary control because of the need to re-capitalise weak banks, which in turn, could complicate the task of promoting economic growth and stability. The second type of crisis is largely associated with stock market failures. A fundamental shift in market expectation may result in significant price volatility, leading to institutional "herding" precipitating a currency crash. A variety of indices are used to measure the size and scope of currency crises, including: changes in exchange rates, foreign exchange reserves and short-term interest rates. Simply measuring currency depreciations alone excludes the periods when a currency is under substantial pressure but authorities manage to successfully defend it by raising interest rates and/or intervening in the foreign exchange market (Davis, 1999). The last type of crisis involves a prolonged collapse of market liquidity and the issuance of securities. Davis (1999) distinguishes this form of crisis from the second by referring to the resilience and robustness of the country's market structure and the extent to which debt, rather than equity, is at the centre of the crisis. The effects of this type of crisis are more acute on economies where a significant proportion of the companies rely on the market for debt finance or liquidity.

The choice, sequencing, scale and pace of implementating regulatory options discussed in this section is highly dependent on the size and scale of the banking problem, regulatory environment prevailing the country, the legal provisions available to regulators, regulatory incentives for compliance and bank stakeholder incentives for compliance to regulatory directives.

3.4.3 Remedial actions

In the initial stages of emerging banking problems, regulators will invite or cause management to take remedial actions to redress their growing financial difficulties. Initially, the bank will be required to develop a detailed capital or management plan indicating how management intends to restore the bank's financial condition. Key aspects of the plan include, income enhancement activities, cost-reduction measures and measures to recover non-performing loans. In the event that management efforts fail to stem the bank's deteriorating capital and liquidity position, regulators will impose either formal or informal regulatory remedial steps, which may include raising new equity capital, prohibiting further dividend payments, increases in management remuneration, disposing of bank assets and businesses, and limiting growth and expansion. These measures can either be given to a bank informally through a Memorandum of Understanding or supervisory letter, or formally through legal cease and desist orders, and written directives as provided for in legislation. Failure to comply with formal actions should result in civil money penalties, criminal fines and/or imprisonment (Schadrack, 1994:88-89).

3.4.4 Rehabilitation options

Deciding whether to rehabilitate or liquidate an insolvent bank is probably the most difficult aspect of dealing with a financially-distressed bank. Regulatory authorities in different countries use various criteria in making a rehabilitation or liquidation decision. In the U.S.A, the Federal Deposit Insurance Corporation (FDIC) decides whether to intervene and is restricted in its choice of intervention methods to those that are cheaper than would be liquidation costs. In Belgium, the Intervention Fund Committee must ensure that the intervention decision and type of intervention is less costly than reimbursing depositors (Sheng, 1996:56). Once the relevant authorities make the decision to intervene rather than to liquidate the bank, the available options typically include a bailout, nationalisation, a merger or purchase and assumption process (Glaessner and Mas, 1995:61; Dewatripont and Triole, 1996:67-68).

1. **Bailouts:** In a bailout the regulators provide all the required finance to fully recapitalise the bank, including assuming the bank's losses and outstanding obligations (Glaessner and Mas, 1995:61). The shareholders of the bank usually retain ownership and control of the bank, or ownership and partial control. Rojas-Suárez and Weisbrod, (1995:4) state that bailouts must only occur when funds that can be committed quickly to address liquidity pressure are scarce. Bailouts are a risky option because insolvent institutions remain in the hands of those that were responsible for creating the bank's problems.

2. **Nationalisation:** In some cases the regulators may decide to assume full control and ownership of the failing bank and nationalise it. Where the expertise is available, regulators may take over the bank and attempt to manage its affairs itself in the hope of recouping taxpayers' funds through earnings generated. In doing so, the regulators bear all the losses and capital requirements of the failing bank. Rojas-Suárez and Weisbrod, (1995:3) note however, that this option is highly risky and success depends on restoring the bank to private ownership as soon as possible. Because regulators are unlikely to possess the skills required for managing a nationalised bank, this is an

increasingly unlikely option, and if it is used, it is likely to be a relatively short period. State managerial intervention may take the form of a curatorship or conservatorship for a defined period during which, shareholders retain ownership of the bank but lose control. The appointment of a curator is typically precipitated by the occurrence of technical insolvency, unsafe and unsound banking practices by management, or regulatory concerns about possible fraud or general mis-management by a bank's shareholders and directors (Glaessner and Mas, 1995:62). Once the period of curatorship is completed, it is the curator's duty to evaluate the remaining regulatory options for managing the bank and recommend the most viable option.

3. **Assisted Mergers/takeovers:** As an alternative to nationalisation, the regulators may encourage a merger or takeover of the bank having covered all outstanding losses and recapitalised it. Conducted properly, such regulatory assisted mergers can reduce the initial re-capitalisation costs incurred by the government. Occasionally, mergers/takeovers occur without regulatory assistance. Large banks may be willing to take over a bank or other long-term benefits such as easier access to a banking license in a preferential jurisdiction or the acquisition of an already existing favourably positioned banking branch network (Schadrack, 1994:90). Where the merger is assisted with regulatory resources, the government absorbs all or some of the losses, restores the bank to solvency and provides financial resources to attract other institutions or individuals to invest in it (Glaessner and Mas, 1995:61)

4. **Purchase and assumption:** In a purchase and assumption transaction, the regulators not only recapitalise the institution but also, separate the bad assets of the bank from the good assets. The good assets are then sold to/or merged with another bank, while the bad assets, usually non-performing loans, are placed in an Asset Recovery Trust (Glaessner and Mas, 1995:61).

When shareholders fail to recapitalise the institution, the regulators fail to find a willing external investor and the government is no longer willing to provide additional liquidity and capital support, the regulator closes the bank and disposes of its assets to recover public funds and to meet depositor obligations (Rojas-Suárez and Weisbrod, 1995:3; Dewatripont and Triole, 1996:67). Closures usually occur because the market for impaired institutions doe not exist or is insufficiently large to absorb the supply of institutions. The decision to close a bank is potentially very damaging to a financial system and regulators will not take such a decision lightly. Even in the presence of deposit insurance, closing a bank is very costly in terms of the time taken to process claims, the disturbance to regular banking relationships and transactions and loss incurred by uninsured depositors and creditors (Schadrack, 1994:91).

3.5.0 Explaining Regulatory Performance

The main obstacle to research work on regulation and supervision is that many aspects of the process are not directly observable. For example, it is not possible to directly observe political pressure on regulators to keep an insolvent bank open. Unfortunately, these very unobservable factors are the most critical elements of the regulatory process. There are, however, attempts to quantify the regulatory process and undertake empirical research on the subject (Dziobek and Pazarbaşioğlu, 1997; Garcia; 1997, Caprio et al, 1998, Rossi, 1999; Basel, 1999; IMF, 2000; Barth et al, 2001).

3.5.1 Dziobek and Pazarbaşioğlu (1997) intervention and closure study

Dziobek and Pazarbaşioğlu (1997) conducted a comprehensive study of intervention and closure techniques implemented in IMF member countries that had undergone systemic bank restructuring during 1980 and 1992[6]. Using eight detailed cases studies, and statistical analysis of restructuring practices in 24 countries, their paper illustrated

[6] Countries included, amongst others, Chile, Cote d'Ivoire; Mauritania; the Philippines, Poland, Latvia, Spain, Sweden, the United States, and the Baltic States, Russia, and other countries of the former Soviet Union

particular aspects of best practice[7], or the consequences of not following best practice. The paper concluded with 14 policies the authors judged to be successful and sufficiently robust to be useful in a wide range of circumstances (Dziobek and Pazarbaşioğlu, 1997:141-143), eight of which are:

1. **Diagnosis:** Countries that had been successful in restructuring their banking sectors had accurately diagnosed the causes of financial distress and designed appropriate regulatory responses to the specific and usually varied causes.

2. **Comprehensive regulatory approach**: Successful programmes addressed both financial and operating restructuring needs of banks, as well as the regulatory environment within which they were operating. Firstly, financial restructuring concentrates on reorganising the stock of non-performing loans and other bad assets on a bank's balance sheet affecting its solvency. Garcia (1997:45-60) identified financial restructuring options as including raising additional capital, reducing other liabilities, or boosting the value of existing assets. Appendix 9 details the various instruments of financial restructuring, their corresponding effect on the balance sheet, liquidity and income, and examples of their use in different countries.

   Secondly, operational restructuring concentrates on improving the profitability of a restructured bank by improving its internal governance and operations. Possible instruments include changing management, closing branches and staff downsizing, rationalising operations, re-evaluating a strategic, tactical and operational business plan, improving loan recovery procedures and increasing the level of automation in the bank. Garcia, (1997:60) identified five key elememts of operational restructuring as listed in Box 2. Although more difficult and time-consuming than financial restructuring, it is essential for improving the long-term prospects of a bank. Cote d'Ivoire, Chile Spain,

[7] "Best practices" is defined in the paper as 'those that are observed, based on experience over time and across a broad group of countries, to contribute to a successful bank restructuring outcome... A basic requirement of best practice is that they should be robust to a reasonable wide range of conditions faced by restructuring countries ... ' (Dziobek and Pazarbaşioğlu, 1997:75).

Sweden and the U.S.A successfully addressed financial distress in their banking sectors by removing management and owners, and strengthening the banks' risk management systems (Dziobek and Pazarbaşioğlu, 1997:141). Thirdly, restructuring programmes need to address the regulatory environment by improving the financial sector's regulatory, supervision, legal, accounting and monetary framework. Countries which have been more successful in restructuring their financial systems, introduced new banking legislation alongside new off-site and on-site bank monitoring programmes.

Box 2 Key Elements of Operational Restructuring

1. Formulating a business plan that focuses on core competencies.
2. Reducing operating costs by cutting staff and eliminating branches where appropriate, ceasing unprofitable activities, and disposing of unproductive assets.
3. Implementing new technology and improving systems of accounting, asset valuation, and internal controls and audit.
4. Establishing and enforcing internal procedures for risk pricing, credit assessment and approval, monitoring the condition of borrowers, ensuring payment of interest and principal, and active loan recovery.
5. Creating internal incentive structures to align the interests of directors, managers, and staff with those of the owners.

Source: Garcia (1997:62)

3. **Loan workouts and non-performing loans**: As part of the financial and operational restructuring process, successful restructuring countries made a deliberate effort to remove non-performing loans from a bank's balance sheet and, subsequently, to sell or foreclose on those assets they were unable to return to performing status. Often, used a separate loan recovery agency to facilitate the process in order to free the central bank from the day-to-day responsibility of chasing defaulting debtors. Foreclosure and asset sales helped to reduce the overall cost of the restructuring process and sent clear and appropriate incentive signals to defaulting borrowers that they would be subject to legal proceedings.

4. **Prompt corrective action rules:** The study found prompt corrective action, preferably within a few months of banking sector problems emerging, important. Countries that were successful in restructuring their banking sectors, such as the U.S.A and Sweden, took appropriate intervention measures within a year of problems emerging. Whether for economic, legal or institutional reasons, countries that were less successful in their restructuring programmes differed in taking corrective action. Principal-agent problems affect the decision to intervene in the operations of distressed banks, giving rise to regulatory forbearance, whereby regulators delay the disclosure of problems in banks, and delay or avoid intervening in the management of those banks (Brownbridge and Kirkpatrick, 1999). Regulators delay the closure of a bank for a variety of reasons: the size of the bank, the availability of deposit insurance funds, government budgetary circumstances in the absence of the above, up-coming political elections and concern about the reputation of the financial system as well as the regulator's personal reputation as an effective supervisor. Regulatory forbearance is often caused by political pressure exerted on regulators expecting them to act in a certain way, or a fear on the part of regulators that the disclosure of problem banks may have a negative effect on their own reputation or career prospects (Goodhart et al, 1998; Boot and Thakor, 1993).

Brownbridge and Kirkpatrick (1999:36) identified two major problems with regulatory forbearance. Firstly, it encourages imprudent bank behaviour. When regulators acquire a reputation of "forbearance", bank owners and managers have less reason to expect regulatory sanctions for imprudent risk-taking. Secondly, the propensity for risk-taking increases with the erosion of the bank. The longer regulators take to intervene in distressed banks, the more likely such banks are to gamble with the remaining capital by pursing highly risky investment strategies.

The debate on regulatory forbearance is akin to the "rules versus discretion" debate, which has emerged from the rational expectations literature. (Brownbridge and Kirkpatrick, 1999:37) On one hand, forberance may be costly to the tax payer, especially in terms of central bank lender of last resort resources. On the other hand, forbearance has a number of advantages. Firstly, discretion may be appropriate as each financial distress situation is different. Regulators may save a financially-distressed bank by allowing it more time to rebuild its capital base. The closure of one big bank or several small banks might lead to industry-wide systemic problems. These problems may prove to be more costly than financially supporting individual banks for limited periods. Secondly, rushing to close a bank may result in higher financial losses for the taxpayer (in the absence of a deposit insurance scheme) as forced liquidation sales may earn less than a disposal of the institution as a going concern. Certainly, some bank assets may be worth more under current management than under regulatory administration. Lastly, regulators may avoid bankruptcy costs by pursing a successful forbearance policy (Goodhart et al, 1998:53). Unfortunately, episodes of successful use of regulatory forbearance are largely unreported, hence the natural bias against it.

However, in the face of strong incentives or pressure for forbearance, a clear set of rules may be more appropriate. Clear and specific rules that specify the circumstances in which regulators should intervene, and the form of such intervention may force regulators to act promptly, thereby enhancing the incentives for bank management to act prudently. Rules-based regulation for dealing with financially-distressed banks is centred on a series of pre-determined ladders of graduated responses to deteriorating levels of financial performance by banks (Goodhart et al, 1998). However, it is recommend that although regulators establish a pre-committed graduated series of responses in the face of capital erosion in banks, they have the power to override these responses as long as such decisions are specifically justified in a report to an independent audit body, and that response is published.

The case for expanding the discretion available to regulators is at least as strong as that for subjecting them to a more mechanistic discipline, particularly in a dynamic financially intergrated world (Quinn 1996:5). A major question asked is how to stop discretion in supervision from becoming arbitrary or capricious, especially in an environment where deep-seated distrust of bureaucracy and the abuse of power exist.

The USA first introduced PCA rules USA in 1991 as part of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). They use the concept of Structured Early Intervention and Resolution (SEIR) developed in the 1980s in the aftermath of the Savings and Loans institutions (S& Ls), when regulators exercised regulatory forbearance. Because of the generous deposit insurance, the S&L failures cost US taxpayers around $150 Billion (Bn) (Benston and Kaufman, 1996; Kane, 1989). Japan introduced a weaker version of the PCA in 1998 (Brownbridge and Maimbo, 2001).

In October 1998, the International Working Group on Strengthening the Domestic Financial Systems[8] recommended adopting, implementing and enforcing a method of structured early intervention in the banking sector (Bank of International Settlements, 1998:11-16). In its report, it recommended that a method of structured early intervention in the banking sector needed the following properties:

a) A well-considered evaluation mechanism that ensures a consistent, timely and graduated response by supervisors. Depending on the nature of the banking and supervisory system, this mechanism, may rely on automatic quantified

[8] In response to the Asian Financial crisis Financial Ministers and Governors of the world's leading economies (Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, the United Kingdom and the United States) met in Washington in April 1998 to examine issues related to the stability of the international financial system. Three working groups (Enhancing Transparency and accountability, Strengthening domestic financial systems; and Managing international financial crisis) aim to contribute to the international dialogue on the key issues affecting the international

triggers for action (in which case there should be provision for over-riding the triggers by following a prescribed process with appropriate checks and balances). Such automatic triggers may not always be the preferred option, but are given overleaf as useful components of the process:

b) A set of explicit rules, procedures and options to allow owners and managers to assess in advance the consequences of alternative courses of action. In particular, these rules should allow for a range of actions depending on how serious a problem has become. In the early stages of a problem the early intervention procedures may require only some constraints being put on the troubled institution's activities, or extending new credit, while advanced problems may require the unwinding of existing positions;

c) Having effective processes in place for the supervisory authorities to collect and analyse the information necessary for the above procedures to work efficiently;

d) Legal and other arrangements which ensure that decision-makers do not incur legal liability for exercising their supervisory authority, and have the right incentives to take prompt corrective action where required.

5. **Leading agency and the role of the central bank and government:** To ensure administrative efficiency, the study concluded that it was advantageous to have one lead agency to co-ordinate the financial restructuring programme, preferably not the central bank. The agency required some measure of autonomy supported by a firm and unambiguous commitment to reform at the highest level of government. Once the agency was in place, it needed to ensure continuous monitoring of the process because restructuring programmes were typically a multi-year process, including significant public expenditure. However, even where the central bank was not the lead agency, it had to be

financial architecture. The heads of the Bank of International Settlements, IMF, OECD and the World Bank, as well as the Chair of the Interim Committee, attended as observers.

ready to provide liquidity support during the restructuring of viable banks. Although central bank liquidity support ought to be minimised, the study found that very few countries refrained from using short-term liquidity support. The successful countries were those that made a conscious decision to avoid converting short term financing arrangements into long-term sources of finance, and avoided lending to insolvent banks. Further, where the financial cost of the restructuring was beyond the available central bank resources, government financial support was unavoidable. However, where this was the case, it was important to design financial instruments that were incentive-compatible for bank managers, owners and regulators.

6. **Firm Exit Policies**: Where the central bank and/or the government were involved in providing liquidity support, an important aspect of a successful intervention programme was a firm exit policy and procedure. The study found that successful countries were those that established clear performance indicators for not providing additional liquidity (Appendix 10). Unsuccessful countries tended to succumb to the "too big to fail" syndrome by continuing to support insolvent banks because of the fear that their collapse would precipitate runs on other banks and cause excessive economic disruption to the country.

7. **Loss sharing**: During the process of providing liquidity support and when executing an exit strategy, it is paramount that there is an equitable loss-sharing arrangement between the state, the banks and the public. Until the mid-1980s, regulators considered deposit insurance schemes as a key element of a stable financial system. By promising to compensate depositors in the event of a bank failure, deposit insurance schemes minimised their potential losses and reduced the risk of panic deposit withdrawals that precede banking sector problems. Economists and politicians praised deposit insurance schemes as having a stabilising effect in the event of a financial crisis. Economists stated that deposit insurance schemes had undoubtedly achieved their primary objective, the prevention of bank panics. They claimed that the creation of the

US Deposit Insurance Corporation had contributed more to monetary stability than the establishment of the Federal Reserve System.

Based on the American experience, the IMF, the World Bank and other policy advisors widely prescribed deposit insurance schemes for reforming financial systems (Fry 1995:366). However, support for deposit insurance schemes began to wane in the mid 1980's when it became clear that financial risk was not all exogenous (Calomiris 1997:7). Amid mounting evidence that banks appeared to be taking greater financial risks because of having insured deposits, albeit at public expense, criticism of government-provided insurance began to increase.

Some critics argued that deposit insurance schemes were in fact the single most important destabilising influence in the financial system. White (1995:5), for example, argued that despite its much proclaimed benefits, deposit insurance schemes were simply "a US invention arising from the politics of the US banking system in the depression years, an invention that does not merit international imitation". In his opinion:

> "Deposit Insurance was the peculiar creation of the US banking experience generated by the worst features of the system. It is inappropriate for developing countries or transition economies. Deposit Insurance presents enormous incentive problems and requires additional regulation and close supervision to make it workable in the short run. These conditions may demand too much from regulators in developing countries, as it did the US, there are simpler less costly alternatives that may achieve the same basic objectives."

The primary problem with deposit insurance is that it is impossible to escape the moral hazard and other associated difficulties. It lowers the incentive of depositors to monitor the health of financial institutions holding their funds. Additionally, it lowers the incentives for managers to make prudent decisions regarding the level of risk that they acquire (Benston et al 1986:82, Calomiris 1997:9-12, Fry 1995:366). Garcia (1997) warned public deposit insurance schemes against unconditionally taking responsibility for underwriting banking decisions. She argued that as private institutions operating in an uncertain market for profit, banks must reap the results of taking chances, over-extending credit and acting imprudently. She cautioned against governments treading "the thin line between guaranteeing the health of the banking system and encouraging recklessness on the part of individual banks by protecting deposits".

8. **Positive economic growth**: Although the study acknowledged that positive economic growth contributes to the early recovery from banking sector problems, it did not discern strong links between underlying economic conditions and the success of restructuring programmes. It therefore concluded that what was more important was that regulatory action was taken promptly without waiting for an upturn in economic condition to undertake difficult and unpalatable measures.

Concerns about the conflicting interests between managing the macro-economic condition of the country and making regulatory and supervisory decisions has led to research into the advantages of separating the supervisory and monetary roles of regulators. In some industrialised countries, the fear of negative implications for monetary policy because of inappropriate regulatory decisions (or vice versa) has led to the separation of the monetary policy and bank supervisory responsibilities of the central bank.

It may be that conflict exists between the roles of the monetary authorities and supervisory authorities. The objective of monetary authorities is to ensure price stability in the macro environment. The objective of supervisory authorities is to ensure a safe and sound financial system, essentially to protect depositors and to avoid systematic risk. Therefore, it is quite conceivable that there will be times when monetary authorities would prefer higher interest rates to bear down on inflation whereas regulators would be more concerned with the adverse effects such higher interest rates might impose on the profitability and solvency of the banking system.

So, one might argue that the objectives are best met if separate authorities are responsible for the different roles. Further, the arguments for separation include, factors relating to government financing of bank rescues and policy credibility (Goodhart 1995b:35). Large financial rescues of bank failures will continue to call on government and political involvement. Regulatory forbearance weakens central bank credibility upon which the success of monetary policy is entirely dependent and unless there is a separation of monetary and bank supervision roles, subservience in the latter will extend to monetary policy management.

The counter arguments to separation include the contention that the two roles are in fact complimentary to, rather than contradictory to, each other (Goodhart, 1995b:35). Firstly, the central bank may implement monetary policy through the banking system by changing the amount of reserves. Therefore, the central bank has a stake in the safety and efficiency of the banking system. Secondly, the central bank acts as the LoLR and would want to have first-hand knowledge of the operations of the banking system. Thirdly, The central bank, with its mandate for price stability, is better positioned to strike a balance between allowing no risk in the banking system, and allowing too much. A supervisory authority without responsibility for monetary policy might be too cautious about risk and unconsciously stifle economic growth by preventing institutions taking calculated risks.

And lastly, in order to avoid the overlap between the areas of interest between the monetary policy and bank supervision the information required by both the two functions is best managed by one agency. In the event of a bank rescue operation, for example, the immediate provision of liquidity can only be done by the central bank considering the implications for both monetary and bank supervisory policy.

3.5.2 Garcia (1997) A framework for analysis and assessment

In conjunction with the work done by Dziobek and Pazarbaşioğlu, (1997), Garcia (1997:43-44) established a framework for analysing and assessing the success of bank restructuring programmes. She identified six criteria for evaluating restructuring instruments, namely, cost effectiveness, ease of implementation, equitable distribution of losses, minimisation of cost to the public, fostering internal governance, and consistency with sound macro-economic policy (Appendix 11).

Garcia did note, however, that the extent to which individual instruments met each of the above factors would vary according to specific circumstances and possible trade-offs. Therefore, the application of the framework she proposed needed to be done in cognisance of the specific problems affecting the banking system, the institutional structure of the economy, the critical constraints facing regulators, and the available regulatory financial and human resources. Nevertheless, the sample of case studies she used showed that there were best practices, which were consistent with the framework that appeared to be robust across countries.

3.5.3 Caprio et al (1998) indices for regulatory environment

Caprio et al (1998) adopted a model used by regulators to analyse commercial bank performance to analyse central bank regulatory and supervisory performance. He used a modified version of the CAMEL rating model to derive measurements against which to compare the regulatory and supervisory performance of 12 East Asian and Latin American Countries for which comparable data were available. Just as it is possible to rate commercial banks according to their capital, asset quality, management, earnings and liquidity, Caprio applied similar criteria to regulatory systems (Table 1). He assessed not how these measures compare for all the banks in a country, but rather how the country's requirements and environment compares with those of others.

Table 1 Caprio et al (1998) Indicators of Regulatory Performance

Capital	Definition of capital: Minimum required capital assets ratio
Asset Quality	Definition of non-performing loans (required number of days) The provisions required once loan is classified as non-performing
Management	Proportion of banking assets in foreign owned banks
Earnings	Excluded from analysis (as they relate more to the business cycle)
Liquidity	Minimum liquidity requirements
Operating Environment	Measures of property rights: Creditor's rights/Measure of enforcement of laws
Transparency	Availability of bank ratings: No of top ten banks with international ratings/An index for corruption

Source: Caprio et al (1998)

Table 2 Selected Measures of Bank Regulatory Environment

	Total Score	Capital	Asset Quality	Managers	Liquidity	Operating factors	Transparency
Singapore	16	1	6	2	5	1	1
Argentina	21	1	4	3	4	7	2
Hong Kong	21	3	9	1	2	2	4
Chile	25	5	1	4	8	5	2
Brazil	30	7	3	4	3	8	5
Peru	35	5	2	6	1	11	10
Malaysia	41	5	9	8	8	3	8
Colombia	44	3	4	11	6	10	10
Korea	45	7	9	10	11	3	5
Philippines	47	4	6	7	7	11	12
Thailand	52	7	12	12	8	6	7
Indonesia	52	7	8	9	12	8	8

Source: Caprio et al (1998)

The study found that countries with low ratings using this model experienced banking crises (Table 2). Whilst those with higher rankings were less likely to do so. Caprio viewed the model developed in the study as a useful means by which regulators could identify the areas in which to make improvements to the regulatory framework. However, as acknowledged by the author, these indices suffer from some important limitations. Each category is equally weighted, an arbitrary decision made by the author who is subject to criticism from different researchers. Most importantly, however, is the fact that the indices merely measure the regulatory environment as defined by legislation and regulations. They do not measure the supervisory effort. Nor is it possible, with the indices selected, to determine how the regulations are enforced. Effectively, the study only focused on the design of prudential regulations. It ignored the rest of the regulatory process – administration and implementation.

3.5.4 Rossi (1999) indices for prudential regulation and supervision

Rossi (1999) attempted to rectify this shortcoming by explicitly including an index for "enforcement of regulations". In an empirical study of the links between capital account liberalisation, prudential regulation and supervision, financial crises and economic development, Rossi (1999) used Basel-based internationally accepted guidelines as indices of prudential regulation and supervision. He defined a strong regulatory and supervisory framework as one that reflected:

1. Satisfactory capital adequacy requirements and definitions of capital;

2. Adequate loan classification and provisions;

3. Suitable maximum exposure limits; effective enforcement of regulations;

4. Clear responsibilities and objectives for each agency involved in bank supervision; strong powers to review and reject specific activities that do not meet the required standards;

5. Proper disclosure and accounting requirements;

6. An adequate system of market incentives to complement regulatory and supervisory requirements.

The study used a variety of sources to develop the indices; these included case studies, staff papers, available databases at the World Bank and private bank reports. Like Caprio's study, the relevant homogenous information was gathered, analysed, integrated and translated into synthetic indices, ranging from 1 to 4 for each of the 15 developing countries used in the study. The study covered the period 1990-1997.

It found lenient prudential regulations exacerbated financial fragility. Stronger prudential practices together with a less-repressed financial system seem to allow countries to achieve higher economic activity over the business cycle. The paper made a valuable contribution to the literature by acknowledging that prudential regulation and supervision is a process involving both regulatory design and enforcement. As a proxy to measure the enforcement of regulations in a country, Rossi used the duration it took regulators to enforce major regulations. The period ranged from 6-24 months. However, the use of a single index for enforcement makes light of the complexity of regulatory and supervisory monitoring and enforcement of regulation. Like previous studies, this study placed greater emphasis on the design of regulatory frameworks rather than enforcement. Additionally, by seeking to achieve homogeneity across a broad spectrum of countries, researchers only pay attention to those items of the regulatory and supervisory framework for which information is available across the entire sample. This runs the risk of excluding those factors that are essential in understanding the unique characteristics of a country that necessitate a specific form of regulation over another.

3.5.5 The Basel (1999) core principles methodology

One of the most pressing problems for the Basel Committee has been that of developing a reliable, consistent and fair methodology for evaluating the extent to which supervisory authorities implement regulatory decisions in different countries. Clearly, the local socio-economic and political characteristic of the country influences the quality of implementation. The presence of a competent and motivated professional body of regulators, a banking regulatory framework that supports a sound credit culture, adequate accounting standards, reporting and disclosure systems all have an important bearing on the quality of supervisory and regulatory principles implementation. In April 1999, the Basel Committee initiated a survey on compliance with the core principles for effective banking supervision (Basel, 1999), and distributed questionnaires to 140 countries. More than 120 participated in the self-assessment exercise, but the quality of responses was uneven. Although there was a high response rate, the quality varied greatly. The Committee observed that the principles were subject to very varied interpretations and possibly inconsistent advice on the required remedial actions for failing banks. In an effort to ensure that there was consistency in the assessment of supervisory regimes, the Basel Committee issued a document entitled the "Core Principles Methodology" in October 1999. The document included a detailed list of criteria for determining whether a regulatory and supervisory structure conformed to its core principles. For each of the 25 core principles, the document provides two criteria to be used: "essential criteria" and "additional criteria". The assessment scheme uses four grades of compliance:

1. Compliant: full compliance or only insignificant shortcomings;

2. Largely compliant: only minor shortcomings and which do not raise doubts about the authority's ability to achieve the objectives of the principle are observed;

3. Materially non-compliant: the shortcomings raise doubts about the ability to achieve compliance, but substantive progress has been made in rectifying the deficiencies; and

4. Non-compliant: in the judgement of the assessors, regulators have not achieved substantive progress toward compliance.

To achieve full compliance, regulators must meet all the essential criteria without any major deficiencies. The additional criteria are elements that further strengthen supervision. The questions are very detailed in nature and cover both the design and implementation of regulations. The Committee acknowledged in the document that regulators must effectively enforce and comply with laws and regulations; the mere existence of these does not indicate that regulators enforce them.

The core principles methodology is a qualitative assessment process, which runs the risk of subjectivity. Its use necessitates an assessment of sufficient depth to allow a judgement on whether regulators are fulfilling the criteria in practice, not just in theory. The document recommends that a suitably-qualified outside person conduct the assessment. It also recommended that at least two individuals with varied perspectives undertake the study to provide checks and balances. The assessment of bank supervision requires a judgemental weighing of numerous elements that only qualified assessors with practical relevant experience can provide.

3.5.6 The International Monetary Fund (2000) core principles assessments

The IMF in conjunction with the World Bank conduct its own Core Principles Assessments[9] (CPAs) to judge the adequacy of both the rules for banking supervision, and the supervisor's ability to monitor and limit major risks run by banks. The IMF especially, uses the CPAs to aid its work in surveillance, technical assistance, benchmarking in IMF programmes, and transparency.

The first CPAs, which took place in February 1998, used very short explanatory notes for each core principle. At the time, the IMF employed a combination of its own assessors as well as self-completion processes by member central banks. The lack of clarity in the core principles resulted in varying interpretations and difficulties in cross-country comparisons. Further, member country central banks had incentives to reflect favourable implementation assessments.

Subsequently, the IMF has worked closely with the Basel Committee to strengthen the assessment methodology and methods. As at April 2000, it had conducted 26 CPAs, of which 17 were part of larger technical assistance missions, three on a stand-alone basis, one in the context of programme design, and five were part of Financial Sector Adjustment Programme missions (Canada, Colombia, India, Lebanon, and South Africa). The assesstments required countries to decide whether they were compliant, largely compliant, materially compliant, or non-compliant with each core principle. Although there was better clarity in the instructions for completing the assessments, there remained some degree of variation in the interpretations of the reulsts and difficulties in cross-country comparisons. Again, member country central banks had incentives to reflect favourable implementation assessments. So far, 24 experts in banking supervision have taken part in the process. Ten were from central banks or financial supervisory authorities, 11 were retired supervisors and three worked on a freelance basis (IMF, 2000:5).

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[9] The CPAs are an improvement to the Core Principles methodology, an exercise in which IMF staff collaborated with the Basel Committee on Banking Supervision.

The 26-country IMF study concluded that compliance with the majority of individual core principles was far from satisfactory (Table 3). In particular, there were serious weaknesses in banking supervision in many countries, especially in risk management, the taking of corrective actions, and consolidated supervision. The study found weak implementation and enforcement of laws and regulations and deficiencies in the necessary pre-conditions for effective banking supervision, namely, effective accounting systems and loan valuation procedures, legal processes, and market discipline (IMF, 2000:3).

In terms of methodological comparisons with earlier self-assessments conducted by member central banks, the study revealed that half of the self-assessments were materially different from the IMF/World Bank CPAs; and in nearly all of those the IMF/World Bank assessments were stricter. Only 15% of the self-assessments reflected a stricter view. In some cases, where the IMF/World Bank CPA concluded that the country was non-compliant, the country had rated itself fully compliant, indicating a possible misunderstanding of the purpose behind the relevant core principle and the criteria for judging compliance. The study found that self-assessments tended to focus on the regulators compliance with legislation, regulations and other written material without an adequate and comprehensive assessment of the actual success of implementation.

Although the IMF/World Bank assessments have improved in the recent years, they still suffer fundamental weaknesses, which both the IMF and the World Bank acknowledge. Firstly, due to time and human resource constraints, the assessments are not always as in depth as warranted to identify all the underlying weaknesses within a regulatory system. It is difficult to obtain a comprehensive understanding of the 'functioning' of a country's banking system, adequacy of the regulators staff and resources and level of professional skills in the banking sector. Secondly, even where evidence of forbearance, is apparent, there is often insufficient hard evidence to prove it. Instead, the assessor relies on anecdotal information supplied by parties who may have undisclosed interests (IMF, 2000:22). Thirdly, assessors face measurement problems due to the lack of international regulatory performance standards.

Table 3 IMF/ World Bank Core principles Assessments*

Principle	Compliant	Largely Compliant	Materially compliant	Non-compliant	Not applicable
Framework for supervisory authority	19	42	38	-	-
(a) Objectives	54	35	8	4	-
(b) Independence	27	31	31	12	-
(c) Legal framework	42	42	15	-	-
(d) Enforcement powers	38	23	27	12	
(e) Legal protection	42	19	15	23	-
(f) Information sharing	38	31	15	15	-
2. Permissible activities	58	27	12	4	-
3. Licensing criteria	27	65	8	-	-
4. Ownership	54	35	-	12	-
5. Investment criteria	31	62	-	8	-
6. Capital adequacy	12	46	35	8	-
7. Credit policies	31	23	42	4	-
8. Loan evaluation	19	46	27	8	-
9. Large exposures	19	46	23	12	-
10. Connected lending	38	23	23	15	-
11. Country risk	15	4	23	46	12
12. Market risks	15	27	38	19	-
13. Other risks	15	19	46	19	-
14. Internal control	15	31	23	31	-
15. Money laundering	15	15	12	58	-
16. Off-site and on-site supervision	27	35	31	8	-
17. Bank management	27	46	19	8	-
18. Off-site supervision	19	38	38	4	-
19. Information Validation	54	15	23	8	-
20. Consolidated supervision	15	8	31	27	19
21. Accounting	27	46	15	12	-
22. Remedial measures	4	42	46	8	-
23. Global consolidation	35	4	19	15	27
24. Host country supervision	35	31	12	12	12
25. Supervision of foreign investments	62	19	15	4	-

Source: IMF/ Note *: Percentage Shares for Compliance with the Basel Core Principles (For CPAs conducted by the World Bank and the IMF)

3.5.7 The World Bank (2001) Database

More recently, the World Bank has created a Banking Regulation and Supervision database (Barth et al, 2001). As at March 2001, this included information on regulatory practices from 107 countries and covers various aspects of banking; entry requirements, ownership restrictions, capital requirements, activity restrictions, external auditing requirements, deposit insurance scheme characteristics, loan classification and provisioning requirements, accounting/disclosure requirements, troubled bank resolution actions, and uniquely the "quality" of supervisory personnel and their actions (Barth et al, 2001). Though the database is a useful first step in increasing the level of regulatory and supervision information in the public domain, the database is still far from being an effective tool for assessing the quality of regulatory and supervisory implementation in developing countries. Firstly, as the authors indicate, the business of supervision typically proceeds at such a detailed level that it escapes detection even by a detailed survey. Secondly, the data in the database is provided by regulators who describe the regulatory powers they have and the extent to which the regulations are enforced. In other words the database suffers the same weaknesses that self-assessment CPAs suffer. The risk of self-interested completion of the questionnaires remains high.

3.6.0 Conclusion

Having considered the rationale for banking regulations and the different theoretical reasons for regulatory failure in Chapter two, the study proceeded to examine specific regulatory and supervisory practices in this Chapter. The Chapter acknowledged the absence of a standard model of regulation and supervision and drew attention to the three traditional models that have dominated the academic literature, namely, the British, European and American Models. It also highlighted the growing literature on the New Zealand Model, which emphasises market discipline over government-supplied regulation. Rather than debating the merits of each model, the Chapter focused on the core features of the general banking regulatory framework that are common to all models: entry regulations, rules and techniques for monitoring for unsafe and unsound banking practices, and exit regulations and supervisory practices [3.1.0].

Firstly, the literature discussed the consensus in the literature that, when licensing banks, regulators need to ensure that those institutions are adequately capitalised; that the owner's character, financial condition, history and experience is suitable for owning and managing a bank; that the bank will satisfy the convenience and needs of the community that it intends to serve; and that the bank is capable of operating in a safe, sound and profitable manner. In a detailed review of each attribute listed above, the Chapter highlighted current thinking on what are considered to be the most appropriate regulations, policies and procedures for their evaluation. More importantly, however, it also identified the areas where there remain differences in regulatory licensing practices, namely, the determination of the most appropriate level of capital for a new bank, the certification that an individual is 'fit and proper' to own a banking licence, and the evaluation of business plans at the licensing stage [3.2.0].

Secondly, Chapter three reviewed the literature on models for monitoring unsafe and unsound banking practices. It discussed the objectives, methods, strengths and weakness of macroeconomic models, microeconomic models and integrated models of analysis. It was observed that although macroeconomic models which rely on financial indicators such as exchange rate movements, export performance, growth in domestic credit and GDP, were useful in understanding why bank failures occur, they were less practical in monitoring the performance of individual banks [3.3.1]. Microeconomic models, which utilise individual bank statistics, fared better in this regard. The ratios used for monitoring bank performance were classified into five categories, namely, capital, asset quality, management, earnings and liquidity. Three types of micro-models were discussed – problem prediction models, outlier/peer group models and failure-prediction models. The first replicated regulatory classifications for the level of financial distress in a bank. The second focused on the statistical differences between banks. Banks with the highest differences from the industry average received closer regulatory monitoring and supervision. The third group attempted to identify factors that led to the seizure or complete failure of an institution's operations. The study observed, however, that the use of financial ratios faced a number of weaknesses. In particular, the deterioration of financial ratios was actually one of the last indicators of financial distress [3.3.2]. The chapter reviewed the use of integrated models of analysis, which combined the use of both macro and micro indicators of financial performance. Due to the diverse nature of banking crises and individual bank failures, it was important to consider an inclusive combination of financial performance indicators [3.3.3].

Lastly, the Chapter also noted that while the literature acknowledged the role that bank management played in bank failures, it remained divided on the most suitable indicators to use to evaluate its performance. For this reason, the study discussed the potential benefits of applying management models such as Porter's Five Forces model and the Igor Ansoff Product-Market matrix for understanding management quality in banks [3.3.4].

Thirdly, Chapter three reviewed the literature on exit regulations and supervision practices. It focused on the remedial and rehabilitation measures available to regulators during a banking crisis [3.4.0]. After discussing the main types of bank crisis and the definitions of bank insolvency [3.4.1], and emphasising the choice, sequencing, scale and pace of implementation was dependent on the size and scale of the banking problem, regulatory environment, legal provisions available to regulators and the regulatory incentives for compliance [3.4.2], the Chapter discussed the main types of remedial actions [3.4.3] and rehabilitation options [3.3.4] found in the literature – bailouts, nationalisation, assisted mergers and takeovers, and purchase and assumption transactions. The objective of this section was to highlight the challenges facing regulators when seeking the most appropriate policy response to an emerging banking crisis.

Having considered the fundamental aspects of banking regulation and supervision, the Chapter concluded with a discussion on the difficulties of conducting empirical research into prudential regulation and supervision [3.5.0]. The objective of this section was to provide an explanation of why there remain important unanswered questions in the development of appropriate regulatory models, and also to provide a basis for a more detailed discussion of the research methodology described in Chapter four. The section noted that the main obstacle to assessing the quality of regulatory and supervisory performance was that many of the aspects of regulation, such as political interference are not directly observable. Using a selection of recent studies, the Chapter considered how researchers had attempted to circumvent these obstacles.

Each study discussed in this Chapter (Dziobek and Parzarbasioglu, 1997; Garcia, 1997; Caprio, 1998; Rossi, 1999; Basel, 1999 IMF, 2000; and World Bank, 2001), makes a valuable contribution to the literature. Together with the work by Dziobek and Parzarbasioglu, (1997)[3.5.1], Garcia (1997) established a useful framework for analysing and assessing the success of bank restructuring programmes – cost effectiveness, ease of implementation, equitable distribution of losses, minimisation of cost to the public, fostering internal governance and consistency with macroeconomic policy [3.5.2]. Caprio (1998) introduced a rating system based on the CAMEL model to derive measures against which to compare the regulatory and supervisory performance of 12 East Asian and Latin American Countries [3.5.3]. Rossi (1999) rightly argued that the enactment of legislation was not an accurate measure of regulatory enforcement of regulations and proceeded to develop an index for the 'enforcement of regulations' [3.5.4]. The Basel Committee (1999) [3.5.5] and later the IMF (2000)[3.5.6] developed a detailed core principles assessment methodology for determining whether regulators were complying with its core principles. More recently, the World Bank has created a banking regulation and supervision database which uniquely included information on the 'quality' of supervisory personnel and their actions.

However, this Chapter argued that the studies discussed above, suffer weaknesses that are best addressed by conducting detailed individual case studies. By seeking to achieve homogeneity across the entire sample, cross-country studies run the risk of excluding factors that are essential to a more accurate understanding of the regulatory and supervisory practices. Secondly, studies that rate regulatory performance using a series of indicators often do so by weighing each factor equally without establishing regulatory preferences. Thirdly, measures of regulatory performance based on legislative design ignore the fact that enacting legislation does not equate to their effective implementation. Lastly, the business of regulation and supervision proceeds at such a detailed level that it escapes detection by broad country surveys, especially when the surveys use self-assessment questionnaires. The risk of self-interested completion is high. Chapter four presents a methodological framework that seeks to address the limitations discussed above.

CHAPTER FOUR

RESEARCH METHODOLOGY AND METHODS

4.1.0 Introduction

> "To understand how political administrators behave, we must begin by seeing the world through their eyes. The world looks different depending on whether the participant is in parliament or government ... the participant is the expert on what he does, the observer's task is to make himself expert on why he does it..."
>
> - Helco and Wildavsky, 1991:ixvii.

This chapter discusses the research methodology and methods used in this study. Section 4.1 introduces the chapter by highlighting the challenges facing prudential regulation and supervision researchers. Section 4.2 considers the key aspects of critical systems thinking (CST) - methodological pluralism, critical awareness, emancipation and boundary judgements - that make it particularly appropriate for regulation and supervision research. Section 4.3 presents the specific methods for the study's three research questions. Section 4.4 explains the data collection methods employed during the field visit to Zambia. Section 4.5 details the data analysis process intended to ensure the study was representative of the practice of regulation and supervision in Zambia. Finally, Section 4.6 concludes the Chapter by registering the study's research limitations and steps taken to mitigate their potentially negative effects on the research findings, conclusions and recommendations.

There are three main obstacles to bank regulation and supervision research. Firstly, many aspects of regulation are not directly observable. Unfortunately, these unobservable factors are often the most critical elements of the regulatory process. For example, it is often not possible to directly observe political pressure on regulatory decision-makers. It is the responsibility of the researcher to find alternate, yet credible, means by which to measure/document the presence of political pressure.

Secondly, a variety of academic disciplines – economics, management, sociology and politics - influence research into banking regulation and supervision. Additional to the interdisciplinary academic influence, the practice of regulation is heavily influenced by the ideological and political history and climate of the country in question as the application of the different types and instruments of regulation varies considerably between nations, industries within nations, and between different time periods.

Thirdly, understanding regulatory and supervisory practices requires the assessment of a chain of related processes, activities and events. These include the process of enacting laws, establishing prudential regulations and supervisory guidelines, conducting on-site examinations and off-site analysis, reviewing supervisory reports and monitoring the procedures for enforcing supervisory regulations and standards. Individuals whose contribution to any regulatory research is important therefore include members of staff at the Central Bank, MoF, Ministry of Legal Affairs, commercial banks, auditors, and other financial sector institutions.

Research on prudential regulations and supervisory practices is thus a dynamic exercise. To be effective, the researcher requires the genuine and full co-operation of the regulators in the country of research. Free access to a range of individuals and interested parties is essential. The required information includes, not only published information such as the relevant legislation, regulations and policies, but also more sensitive information, relating to the operational guidelines for bank inspectors, and where possible, supervisory assessments of individual banks.

This particular research focused on Zambia's experience with the design, development and implementation of financial sector regulations. It proceeded in three principal phases, namely, descriptive, exploratory and explanatory. The descriptive stage traced how financial repression and government interference during the 1970s and early 1980s resulted in the absence of an appropriate environment for financial sector development in general and banking regulation and supervision in particular. The exploratory aspect of the research investigated and documented the BoZ regulatory and supervisory practices of the late 1980's and early 1990's, with particular regard to the licensing process and monitoring of unsafe and unsound banking practices, and the intervention and closure policies and procedures for failing banks. At the explanatory stage, the research used a critical systems approach to compare the views of those "involved in" and those "affected by" the regulatory process. Further, the study synthesised these views, compared them with the documentary evidence and documented its findings, conclusions and recommendations.

4.2.0 Critical Systems Thinking

The thesis adopted CST as the methodological framework within which to conduct the research. CST invites the researcher to interact with target respondents to obtain facts, opinions and attitudes about specific aspects of the research problem. The methodology was ideal because the thesis aimed to examine the political and regulatory process of designing, developing and implementing banking regulations, rather than the specific regulations themselves. This section of the chapter explains the principal tenets of CST, notes its advantages and explains the procedures and techniques used in the analysis of the data collected. The chapter concludes by indicating the primary weaknesses of the chosen methodology and the measures taken to strengthen the findings of the research.

The literature ascribes different definitions to CST depending on the author's chosen perspective and interpretation of the central themes found in the CST. Midgley (1996) identifies the fundamental themes of CST as:

> *Critical awareness:* examining and re-examining taken for granted assumptions along with the conditions that give rise to them.
>
> *Methodological pluralism:* using a variety of research methods in a theoretically-coherent manner, becoming aware of their strengths and weaknesses to address a corresponding variety of issues.

Emancipation: relates to the argument that all research must result in action that leads to an improvement in the quality of work and life in organisations and communities. The improvement can be of a technical nature - improving our ability to predict and control our environment; a practical nature - achieving mutual understanding; or an emancipatory nature - freeing ourselves from power relationships and the false ideologies that they give rise to.

The next section discusses the relevance of each of the above tenets to the study of banking regulation and supervision; arguing that the methodological concepts used in CST are ideal for subjects as multi-disciplinary and culturally diverse as banking regulation and supervision in developing countries.

4.2.1 Critical awareness

Critical awareness refers to the the need for the researcher to conduct the study with a clear appreciation of the research objectives, methodology and methods at three levels. Firstly, it is essential that there is a clear understanding of the strengths and weaknesses of the theoretical underpinnings of the available methods, techniques and methodologies of research. Secondly, there must be adequate understanding of both the context of application and the possible consequences of using various methods once the researcher establishes the context of application. Finally, there is a need for a close examination of the assumptions and values entering into the existing system designs and proposals for system design changes. The first two requirements support the commitment to 'thinking about' and 'using' methodological pluralism respectively as a basis for research. They emphasise the need to ensure the effective development and use of methodologies within their given context of application. While the third supports the notion of emancipation as a basis for understanding 'power relations' and defining 'improvements' (Midgley,1996:14-15).

4.2.2 Methodological pluralism

CST advocates the alignment of methodologies with the specific objectives of the research as well as the epistemological requirements of the problem at hand. Because different methodologies make different assumptions, it is important to use them in a complimentary rather than universal manner to deal with a variety of different contexts. Hard systems approach concentrate on modelling as a central aspect of their research technique. As a methodological construct, it assumes that the problem is well defined and understood by the researcher and the observed. It has, as a research objective, obtaining *control and predictive* power. Soft systems methodologies seek to manage debate between people so that learning occurs; people exchange ideas and develop plans of action. Rather than seeking to control and predict the outcome of a specific issue, soft systems methodology aims to achieve *mutual understanding* between the researcher and research constituents. CST, goes a step further by examining the underlying assumptions that define the nature of the relationship between those involved in making decisions and those affected by those decisions. It seeks to free research subjects, participants from conventional approaches to addressing problems that define current thinking. Both the researcher and the participants are required to question and evaluate whose views should enter the design, development and implementation process, and how to achieve this. Ackoff (1960) in an analysis of systems, organisations and interdisciplinary research, observed the tendency for researchers to concentrate on one methodological technique while either ignoring or mishandling the multi-disciplinary concept. In his own words:

> "Complete understanding of such systems requires an integration of perspectives. By integration, I do not mean a synthesis of results obtained from independently constructed studies, but rather results obtained from studies in the process of which disciplinary perspectives have been synthesised. *The integration must come during, not after, the performance of the research* (italics added). We must stop acting as though nature were organised into disciplines in the same way universities are" (Ackoff, 1960:342)

In the emerging field of banking regulation and supervision research, the concept of methodological pluralism is highly relevant and applicable. Part of the methodological dilemma that researchers in this field find themselves in is partly due to the "hard" systems approach adopted by researchers. Researchers with strong positivist traditions, may find it difficult to develop appropriate research methodologies because the majority of regulatory and supervisory issues are ill-defined. The cause, nature, effect and implications of regulatory capture and forbearance are difficult to define, measure and evaluate using a hard systems approach. However, CST acknowledges and accepts the difficulties inherent in the study of such vague concepts. It then proceeds to select the methodology that best suits the epistemological and ontological requirements of the concept (and not the other way around). The actual research then starts by questioning the existing norms and assumptions of the traditional thinking that defines the issue.

4.2.3 Emancipation

The concept of emancipation in CST has its roots in Marxist thinking. It is concerned with the desire to ensure that all individuals maximise their development potential by raising the quality of work and life in organisations and the societies in which they live. (Jackson, 1991). Likewise, studies of banking regulation in developing countries will only be valuable if they result in the "emancipation" of regulators in these countries. The results of such studies must facilitate a better understanding of their own regulatory and supervisory environment. That understanding must be useful in the development of regulatory requirements that are specific to their own environment. They must be free to disregard the externally-prescribed "international regulatory standards" sometimes imposed on them by international financial institutions as part of financial sector adjustment programmes if their environment renders such standards inapplicable. They must also be 'emancipated' from domestic political interference.

4.2.4 Boundary judgements

To fully appreciate the basic tenants of CST (methodological pluralism, critical awareness and emancipation) it is important to discuss the concept of *boundary judgements* (Churchman, 1968, 1971, 1979 and Ulrich, 1983). The problem of boundary judgements in CST arises from the simple questions; "what is a system?" "In reality, does the world operate as a system?" "Is the real world system composed of a number of different systems?" For example, when regulators refer to the 'financial system', what do they mean? Which institutions have they included in the definition? Are all financial transactions, regardless of their size, part of the financial system? Where do the boundaries of the 'financial system' lie? The boundary judgements on what constitutes the financial system has policy implications for regulators.

Midgley (1996) noted that before the work of Churchman, many people assumed that the boundaries of a system were "given" by the structure of reality. Churchman, however, questioned this assumption and argued that systems boundaries were "constructs that defined the limits of the knowledge that is to be taken as pertinent" (Midgley, 1996:17). When people defined something as a system, was that how it operated in reality or was the "system" simply described as one because of the limited knowledge construct of the researcher? The definition of a system had an important bearing on the level of critical awareness, methodological pluralism and emancipation that researchers could achieve. The boundary judgements of a system that people make have direct implications on the selection of research participants, observations, findings and recommendations. A narrowly-defined system leads to a solution that is invalid within the context of a broader definition of the same system.

4.2.5 Systems and Social Critique

Influenced by the work of Churchman, Ulrich (1983) formalised a methodology called Critical Systems Heuristics (CSH) in which the priority is to evolve practical guidelines that can help people steer the process of critical reflection on the ethics of drawing systems boundaries. The objective of CSH is to provide both involved planners and affected citizens with a conceptual framework for identifying and discussing the practical issues of problem definitions, systems designs and programme evaluations. This methodology has a direct appeal for this thesis in the sense that it is difficult to define, for example, what amounts to regulatory failure. Secondly, the boundary of the regulatory systems are broad and subject to different interpretations and finally, the aim of the study is to evaluate the effectiveness of the regulatory system and make practical policy recommendations for its improvement. Ulrich referred to a process of unfolding when analysing the conceptual and practical constitution of a system. The three steps in the process of unfolding are:

1. Boundary questions: whole system boundary judgements

2. Systems critique: contrasting "actual" with "ideal"

3. Social critique: contrasting "affected" and "involved"

The first step in unfolding corresponds in soft systems methodology with the process of formulating a "rich picture". The process involves gathering information from, and "brainstorming" with, various stakeholders who are involved with the system. During this process, CST requires the researcher to map out the system in terms with concepts, such as motivation, control and legitimacy. It is important to establish the main *motivation* or *purpose* or *objective* of the system and the complementary prerequisite of any objective, thereby, defining criteria for success. The main problem with the latter objective arises when the system serves many clients because a system cannot satisfy all clients. The researcher must make a trade-off in determining the appropriate measures of performance. Ulrich (1983) distinguished between measures of performance (sub-system criteria for success) and measures of improvement (wider system benefits, prerequisite to defining measures of performance). The degree of trade-off determines the extent to which the system is serving surrogate clients (capture) or the intended beneficiaries (improvements). The researcher must also determine the level, form and type of control existing within the system. He/she must determine the appropriate decision environment by distinguishing between factors which have no bearing on the system's performance, hence should be left out, and those that, although not under the decision-makers control, influence the systems performance, and thus should be included. The range of factors includes material non-human resources (capital, finance, tools) and human expertise (professional technical know-how and informal and tacit knowledge). The key problem associated with control and legitimacy is that of a possible tension in "world views" (weltanschauungen) – "visions of social reality and what human life ought to be" between those affected by systems design and those involved in the systems design. A critical system approach starts with the premise that any system has redistribute effects and therefore cannot possibly work to everyone's interests.

Once the researcher derives a working definition of the system, he/she must then subject it to a systematic process of critical evaluation. Systems critiques involve juxtaposing "actual" with "ideal" mapping. This is a discursive process in which the researcher compares what "is" the present (actual) state of circumstance against what "ought" to be (ideal) future state of circumstances. An actual/ideal dialectical debate encourages the researcher to derive the ideal model from the key problems emerging from the first stage, and to re-represent that ideal to the "actual" world of the involved. Ulrich (1983) proposed a list of 12 questions that enable researchers to define what constitutes a system and what it ought to be (Appendix 12). Ulrich's 12 questions are applicable to both quantitative modelling and qualitative analysis.

Finally, there must be a process of assisting the 'affected' to achieve emancipation from the rationality of the 'involved'. A system attains legitimacy when there is consensus between those involved in its operation and those affected by its motivation/necessity.

4.3.0 Data Collection Process

The data for this thesis was collected on a field visit to Zambia which occurred over a four month period from 19th May to 29th August 2000. The visit comprised three principal activities, namely, documentary review, interviews and two workshops with BoZ members of staff. The documents examined relate to relevant banking laws, regulatory policy statements, World Bank and BoZ reports, legal case documents, and where possible, correspondence between the BoZ and commercial banks. The researcher held interviews with politicians, civil servants, central bank officials, commercial bank senior members of staff, and officials from other regulatory bodies and non-bank financial institutions in the country. The workshops facilitated group discussions amongst the various inspectors of a number of regulatory issues. In total the study used 480 documents (letters, memo's, off-site and on-site reports, anonymous letters...) 192 financial statements for eight banks for a period of 24 months prior to each banks date of closure, 28 interviews (Past/present BoZ Governor(s), past/present Financial System Supervision Director(s), Assistant Directors, bank owners and directors of failed bank) and two workshops with 15 BoZ inspectors.

4.3.1 Activity 1: Documentary review

The first phase focused on the BoZ bank licensing policies and procedures. This involved a documentary investigation of the application forms for bank licenses submitted to the MoF and BoZ between 1980 and 1998. Twenty bank licence applications were examined, six from banks that had not failed, and 14 licences originally approved, but subsequently failing. The second part of the documentary review concentrated on the legal, political, economic and social context within which the FSSD took various regulatory and supervisory actions. Various documents relating to the department's activities were consulted. Due to the poor state of the files and the state of records, the process was frustratingly long and tiring.

The examination of the documentary evidence took place at the BoZ, which granted complete access to the confidential bank licence applications on three conditions: that the researcher would not remove any documents from the premises of the bank, make any photocopies, or identify individual banks by name in any publications. The BoZ agreed to the use of codes, an index of which would be available to third parties upon receiving written authorisation from the BoZ.

4.3.2 Activity 2: Interviews

To evaluate the factors BoZ staff took into account when faced with regulatory and supervisory decisions, the study used intensive in-depth individual interviews. This approach was preferred on the premise that the regulatory process is political. The selection of respondents took into account the interviewees' professional characteristics, patterns of behaviour, association with a particular political, economic or social interest group. Twenty eight in-depth interviews were conducted:

1. Former BoZ Governors (5),
2. Former FSSD Directors (3),
3. Assistant Directors (5),
4. Bank Inspectors (5),
5. Former owners/directors of failed banks (5), and;
6. other key contact persons (5).

The interviews were conducted by the researcher and notes were made as the interview progressed. Although the ideal method of recording the interviews was to use a tape recorder, prior experience with regulators in a pilot study revealed that such an approach yielded unsatisfactory results, because the confidential nature of the information discussed and the secrecy agreement signed by all members of the Bank's staff made few of the respondents willing to have their voices recorded. Respondents faced similar questions in all the interviews, but were deliberately encouraged to provide additional comments on issues not raised by the researcher. Although the number of interviews was relatively small, the sample embraced a sufficient heterogeneity of experiences and accounts within the constraints of money and time.

4.3.3 Activity 3: Workshop

The field visit ended with two workshops for fifteen senior bank inspectors in the FSSD[10]. The workshops provided a forum at which the researcher discussed the preliminary findings of the visit with the inspectors.

4.4.0 Research Methods

4.4.1 Hypothesis I: Entry regulations and supervision practices

For ease of reference, the first hypothesis is: "The weaknesses in the licensing procedures for new financial institutions were significant factors that led to the bank failures of 1995-1997/98. There was insufficient regard given the quality of the new banks' owners, directors and managers, the minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners".

Research method: Testing this research hypothesis involved a documentary investigation of the application forms for bank licenses submitted to the MoF and the BoZ between 1980 and 1998 (Appendix 13). The research used a standard checklist of questions to evaluate each application form submitted during that period (Appendix 14). In-depth interviews were also conducted with all senior BoZ officials involved in the licensing process to compliment the documentary review of applications. These steps facilitated a comprehensive understanding of the licensing system, a comparison of "ideal" with "actual" performance, and an analysis of views as presented by the "affected" and the "involved".

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[10] The planned three-day workshop did not take place for a number of reasons, which included, amongst others, the absence of a number of inspectors from the office due to training programmes running in the U.S.A and the death of a former Director of the FSSD. The funeral necessitated the change of the workshop dates from the preferred dates.

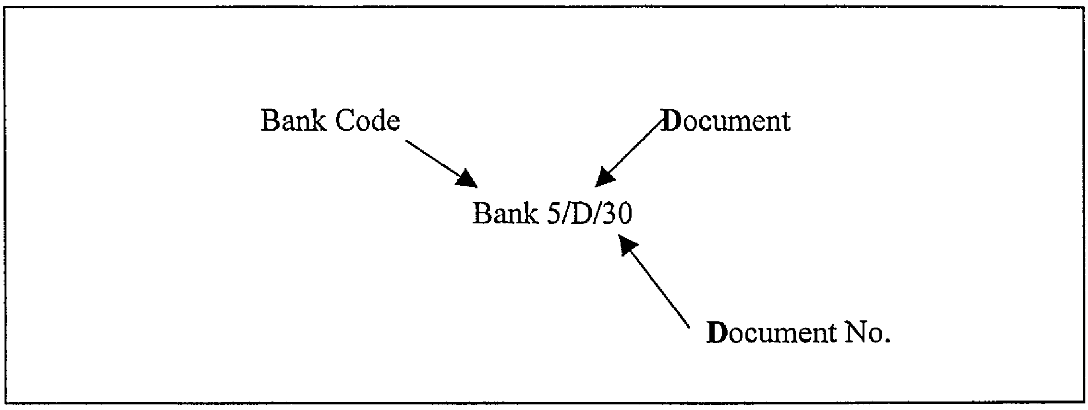
Research sample: The sample of documents used to test the first hypothesis included all bank licence applications submitted to the MoF and the BoZ between 1980 and 1999. For purposes of analysis, the research classified the applications into three groups, namely, successful applicants that have not failed, successful applicants that subsequently failed, and unsuccessful applicants (Appendix 13). The sample of interview respondents used to test the first hypothesis includes bank officials at the BoZ and the MoF who participated in the licensing process between 1980 and 1999.

Research design: The study used the Core Principles Methodology notes developed by the Basel Committee in 1999 (Appendix 15) to evaluate the bank licensing policies and procedures. The checklist was standardised in order to facilitate the identification of any discernible license review patterns. The identification of interview candidates was based on the decision-making process at the BoZ from receipt of the initial application to the issuance of a licence, placing particular emphasis on the duration of the licence review process, the steps taken during that process, and the nature of information that was both requested and not requested by the regulatory authority.

Research analysis: Firstly, the entire sample of licence application documents held by the BoZ was summarised on specially-designed working schedules. The schedules indicated the date on the document, the type of document (letter, press statement, minutes of a meeting...), details of the person initiating the document, details of the document's recipient, the subject matter and the details of the issues raised in the document (Appendix 16).

To protect the identity of individuals involved in the licensing process, and to maintain the confidentiality of the documents, the study used codes for all the banks to conceal their identity. Additionally, all the names of individuals involved in the licensing process were removed from their working schedules. Secondly, every single document was allocated a specific code to facilitate the analysis. The codification process used a total of 123 codes for banks that subsequently failed, and 70 codes for licensing documents relating to non-failed banks (Figure 3).

Figure 3 Coding System for Bank License Documents

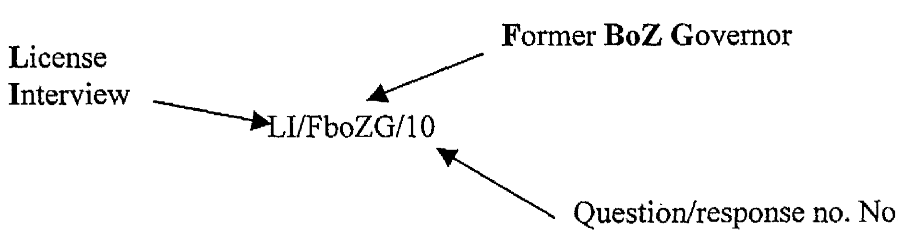


Thirdly, interview transcripts of the license process respondents received similar codes and analysis procedures. After typing the interviews in full, each interview question and response received a specific code identifying the nature of the interview, the type of respondent and the paragraph number (Figure 4/Table 4). Six individuals formed the core sample of licensing process interviewees - a former Treasury Counsel at the Ministry of Finance in the 1980s, a former BoZ Governor, a former FSSD Director, a former bank director and shareholder and two current BoZ Assistant Directors. For reasons of confidentiality, the names of officers involved in the licensing process were all coded using the names of towns in Zambia (Livingstone, Lusaka, Ndola...). Due to time constraints, for both the respondents and the researcher, it was not possible to arrange separate interviews for the licensing and closure processes. Instead, single session interviews included issues pertaining to both the licensing process and the closure process. Thereafter, the research process involved documenting and coding the transcripts of the bank licensing workshop in exactly the same manner as the individual bank license interviews. Each question, response, contribution and follow-up was as described in Figure 5. Thereafter, the analysis followed the general critical system thinking methodological framework of: boundary judgements, systems critique and social critique.

Table 4 Interview Transcripts

3.1	FORMER TREASURY COUNSEL: MR LIVINGSTONE	
LI/FTC/1	Sam	Thank you for meeting with me. As you are aware, I am currently undertaking postgraduate studies at the University of Manchester in the area of banking regulation and supervision. My primary interest, with respect to this interview is the BoZ's handling or mishandling of the financially-distressed commercial banks in the recent past. By interviewing individuals such as you, I hope to gain a better understanding of what the issues facing both the BoZ and the distressed financial institution were. May I emphasise that I will treat everything that you say to me with the strictest confidence. I will not attribute anything you say to me to you personally as an individual. Let us start at the beginning; how bad was the licensing process at the MoF when you were there?
LI/FTC/2	Livingstone	Very Bad! As simple as that! The problem started during the nationalisation period. All the insurance companies were nationalised into the ZSIC. All building societies were amalgamated into the Zambia National Building Society. With each of these new bodies, a single registrar was appointed to oversee the operations of the national financial institution. Because they were effectively government institutions, supervision was relegated to a nominal role...

Figure 4 Coding System for Bank License Interviews



Boundary Judgements: To identify the key decision-makers as well as establish the license evaluation process, Bank License Duration/Correspondence Tables (Table 5) were prepared for each bank from the individual Banking Licensing Documentation Schedules (Appendix 16). Each entry on the table denotes the unique document no. (excluding the bank code) and the issue date. The tables established the frequency and the speed of correspondence between key decision-makers in the licensing process. Further, by searching for common subjects raised in the document 'subject' and 'issues' columns in the individual bank license documents (Appendix 16), the study identified the principal issues of concern. The next step involved preparing individual schedules for each core issue.

Figure 5 Coding System for Bank License Workshop

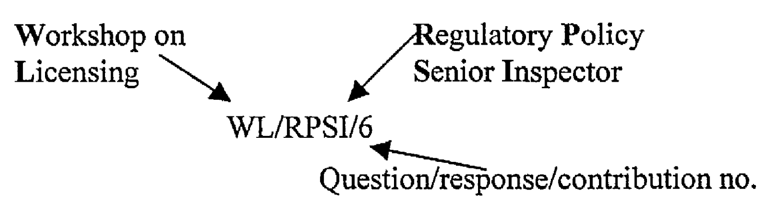


Table 5 License Duration/Correspondence Analysis

From\to	Applicants	Registrar	Hon. Min	AD	Dir. FSS	BoZ Gov
Applicants					[10-12/11/92] [24-	
Registrar			[14-12/11/92]			[1-1/07/92] [2-13/07/92] [8-27/10/92]
Hon. Min		[13-4/11/92]				
AD – FSS	[20-26/07/92] [23-25/08/95] [42-12/05/96]				[9-11/11/92] [23-25/08/95]	[6-11/09/92]
Dir – FSS	[22-22/08/95] [27-21/12/95]			[25-29/12/95] [28-09/01/96] [29-		[5-1/07/92] [12-21/07/92] [43-29/05/96]
BoZ Gov		[3-24/07/92]				

Source: Thesis Working Papers

Systems Critique - contrasting 'actual' with 'ideal'. A critical stage in the analysis process was documenting the actual manner in which the MoF and the BoZ implemented the licensing policies and procedures. The study achieved this process in two stages. Firstly, analysis schedules for each of the five core components of the licensing process as identified in the literature review in Chapter two and confirmed in the boundary judgement analysis, were prepared. Each schedule reflected the specific issues of concern found in the documents and included a provision for specific references from the original working schedules providing evidence of that specific phenomenon. Table 6 is an example of a schedule indicating how one element of the license process, minimum capital requirements assessments, was assessed.

Table 6 Minimum Capital requirements

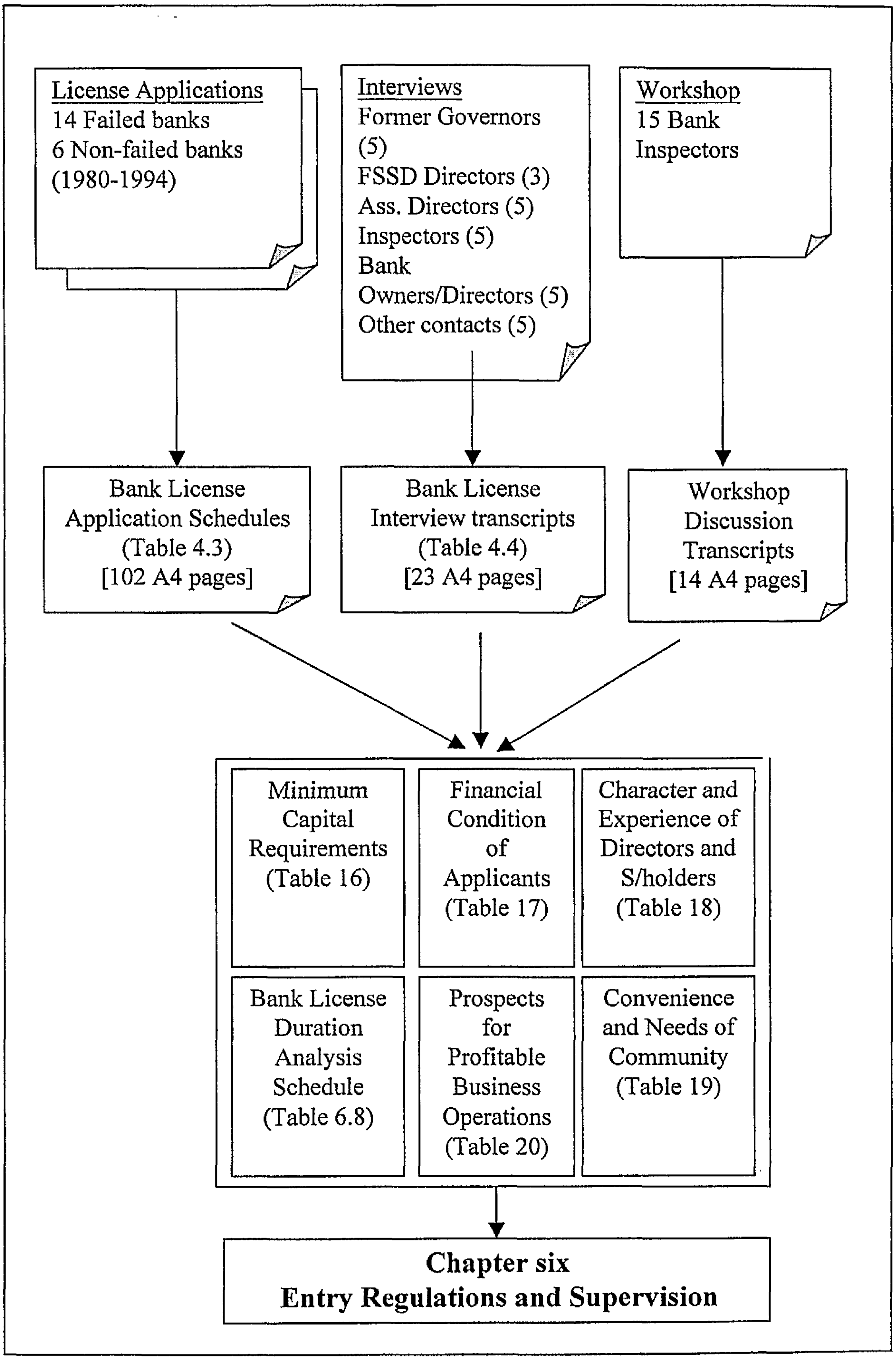
Year	Bank	Evidence of compliance with minimum capital requirements	Issuing Institution	Amount
1980	Bank 25	Statement of authorised capital **[Bank 25/D/1]**	Bank 25	K2m
1984	Bank 5	Letter of confirmation **[Bank 5/D/9]**	BoZ	K2m
1984	Bank 7	Statement of paid up capital **[Bank 7/D/1]**	Bank 7	K2m
1984	Bank 18	Confirmation of bank balance **[Bank 18/D/1]**	Citibank	K2m
1986	Bank 11	Confirmation of bank balance **[Bank 11/D/3]**	Bank 25	
1989	Bank 14	Confirmation of bank balance **[Bank 14/D/2]**	Bank 11	K20m
		Confirmation of bank balance **[Bank 14/D/21]**	Bank 7	K21m
		Confirmation of bank balance **[Bank 14/D/22]**	Bank 5	K22m

Source: Bank Licensing Working Papers

Similar schedules were prepared for evaluating licensing policies and procedures for evaluating the financial condition, resources and history of applicants; character and experience of the proposed directors and major shareholders; convenience and needs of the community; and the prospects for profitable operation of the business. Once completed, the study's findings, summarised in the schedules, were compared with the 'ideal' licensing policies and procedures as defined in banking legislation, the Basel Core Principles for effective banking supervision and most importantly, as defined by those 'involved' and 'affected' by the 'actual' banking licensing process. In comparing 'actual and ideal', the study asked; did the process allow banks without adequate capital and managerial expertise to open? Was the licensing process politicised, allowing applicants with political connections to obtain licenses without satisfying the minimum license requirements? Did regulators give insufficient regard to the quality of owners, directors and managers, the amount of capital required, the quality and reasonableness of the business plans and the financial strength of the owners for those banks that failed? Was it a deliberate policy of the MoF to encourage the creation of local banks in Zambia? Did the policy result in the proliferation of too many small banks and other deposit-taking institutions? Did the policy lead to any distinction between banks that failed and those that did not? While some of the above questions were raised in the standard checklist of questions (Appendix 14), others arose as a result of the research evidence as expected when applying the CST approach.

Social Critique: 'affected' and 'involved': The depth of social critique was severely restricted by the absence of a sizeable sample of respondents, especially bank directors/owners who had submitted bank license applications and had undergone the bank's licensing process. Instead, the study relied on the available documentary evidence to understand the licensing process. Further, during the licensing workshop, the researcher presented the participants with the study's documentary analysis findings and asked them to comment, criticise and/or explain the results. Finally, during the final research visit to Zambia, research respondents received a discussion paper on the study's findings and conclusions for them to criticise. Their views influenced the final thesis conclusions and recommendations. Figure 6 graphically summarises the key steps taken to test the first hypothesis, and to discuss and report the research findings in Chapter Six (Entry regulations and supervisory practices).

Figure 6 Bank Licensing Analysis Process



4.4.2 Hypothesis II: Monitoring of unsafe and unsound banking practices

Research objectives: For ease of reference the second hypothesis is: "The BoZ had the capacity and resources to detect financial mis-management, breaches of the law and financial deterioration in the banks that failed." The study examined the bank's performance monitoring technique employed by the FSSD in 1995 and 1997/98 to determine its capacity to detect bank mis-management and the violations of prudential regulations. It considers the resources and supervisory skills available to the FSSD before the deterioration of the banks that failed.

Research Design: Firstly, a framework was established within which to evaluate the BoZ off-site monitoring model, both in terms of its objectives and design of the model, and the results obtained from that model. Secondly, the study used the established framework to test the CAMEL model and to identify its strengths and weaknesses in the diagnosis and prediction of bank failures in Zambia.

Research Sample: The study sample included all commercial banks in operation over the period December 1995 to March 1998. Excluded from the study are banks such as the Bank of China, Inter Market Discount House, Investrust, and the United Bank of Zambia. Having started operation in the latter half of the stated period, they did not portray typical banking ratios and served no purpose other than to distort the financial ratios used in the study. Also excluded was Bank 2, which merged with Bank 9. Its activities before its merger, especially at the time of closure, were too insignificant to affect the results obtained in this study.

In studying early warning systems, it is usual to pair samples of failed banks with those that have not failed based on some common factor such as asset size or turnover. This study did not adopt the paired sample approach due to the small size of the industry as a whole. In any case, Beaver (1968) rightly pointed out that the controlled variables might be important predictors of failure yet remain undetected because the paired sample approach masked their predictive power. As in Beaver's 1968 study, the predictive power of the BoZ's system for monitoring unsafe and unsound practices based on bank sizes was not analysed in this study. However, in visually inspecting the results of the CAMEL, the study divided the commercial banks into two groups- foreign banks and local banks.

The first group, foreign banks, included all banks that were associated with an overseas headquarters or parental control. These include Barclays Bank, Citibank Bank, Stanbic Bank, and Standard Chartered Bank. The second group, local banks, consisted of those with their headquarters in Zambia. Included in the second group were two banks, Indo-Zambia Bank and Zambia National Commercial Bank that the study could have alternatively classified as Government banks. The former is a joint venture between the Indian and Zambian governments, while the latter is state-owned. The study used this classification because visual comparison of ratios of the failed banks occurred with respect to banks of similar characteristics rather than with respect to the industry as a whole.

Table 7 Types of Banks in Zambia

Foreign Banks	**Local Banks**	**Failed Local Banks**
Bank of China (1997- Barclays Bank (1918- Citibank Bank (1979- Stanbic Bank (1956- Standard Chartered Bank (1906-	Cavmont Bank (1993- Finance Bank (1988- First Alliance Bank (1995- Indo-Zambia Bank (1985- Invest Trust Bank (1995- New Capital Bank (1989- Union Bank (1979– (Formerly BCCI) United Bank of Zambia (1997 Zambia National Commercial Bank (1968 –	Chase Trust Bank (1995-1997) Credit Africa (1994-2 Dec. 1997) Firstly Merchant (1994–1998) Manifold (1987-1997) Prudence (1994-1997)

Source: BoZ

Early warning system analysis: To be truly effective and comprehensive an early warning system must meet the following criteria: -

1. It must be able to monitor socio-economic, industry-wide, and bank-specific conditions, because of the variety of banking risks. The identification of bank problems and the degree of potential failure needs to occur at these three levels. To restrict an early warning system to the financial statements of a bank is to exclude the high degree of socio-economic and political factors that may influence its financial performance.

2. It needs a mechanism for co-ordinating and analysing information from many diverse sources. The model must integrate complimentary sources of information such as the bank's strategic plans, and reliable press articles. However, because of the possibly subjective nature of such reports, careful analysis and interpretation on the part of regulators is required and must be emphasised.

3. The model must be able to account for, and incorporate emerging developments in the banking sector. Developments in the banking sector are taking place at an increasingly rapid pace. Unless the model acknowledges these emerging developments, there is a danger of constantly and consistently reacting to market developments rather than pro-actively anticipating them.

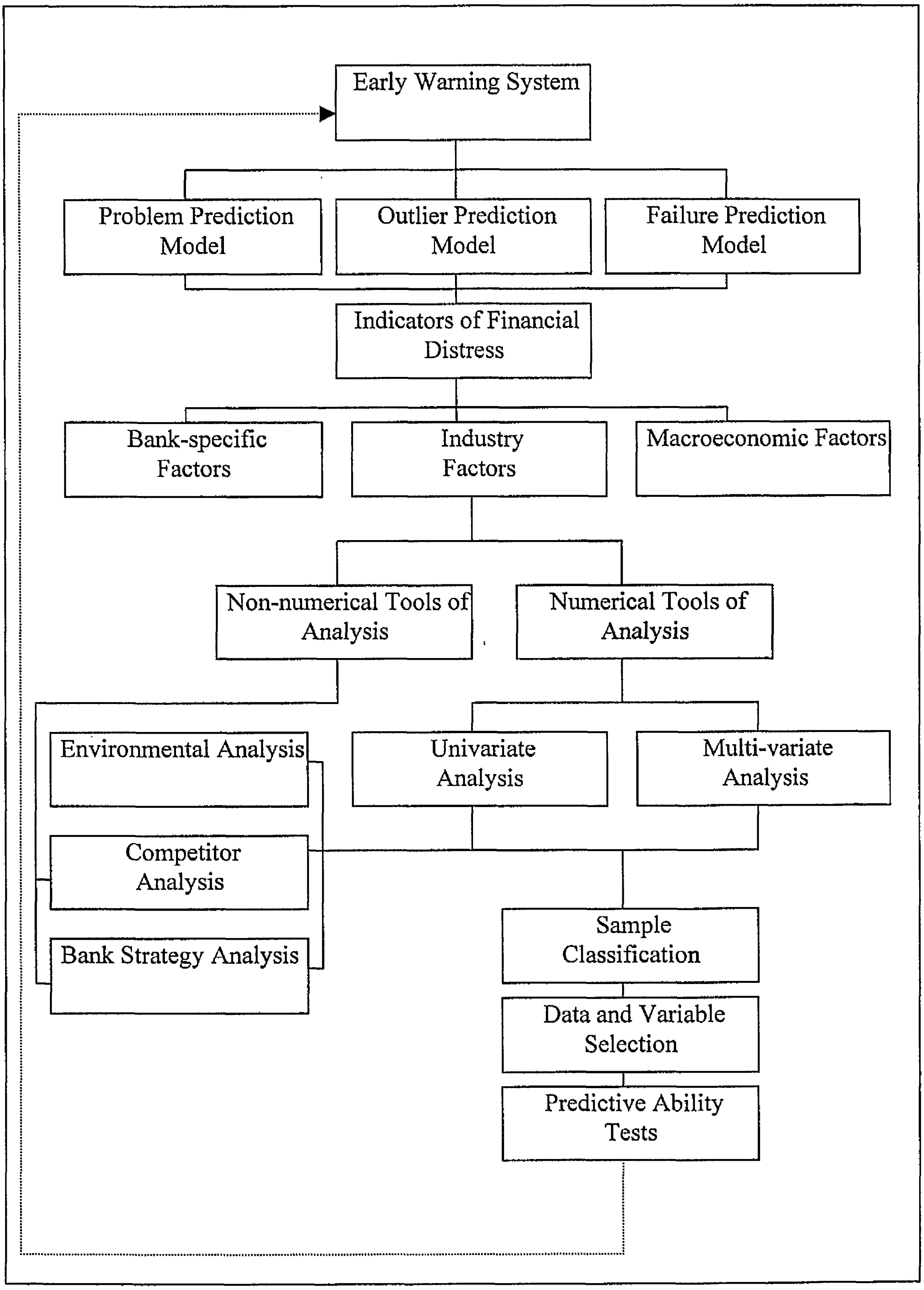
4. The system must have a feedback procedure to facilitate the revision and updating of information it receives. It must include an on-going monitoring process so that it becomes an integral part of the regulatory process (Figure 7).

Figure 7 provides a framework within which to both evaluate and design an early warning system. The first task is to establish whether the model is a failure prediction, problem prediction, or merely an outlier prediction model. Clarity of this point is of paramount importance in determining the relevance of the model to the specific needs of the BoZ. Once the framework facilitates the identification of the type of model, the next step involves determining the variables it uses. Are they solely bank-specific factors or do they include industry-wide as well as socio-economic factors too? Consequent to identifying the variables used in the model, Figure 7 indicates that the tools of analysis by which the variables are analysed in the model. Are the variables quantitative, requiring numerical tools of analysis, or are they qualitative variables needing non-numerical tools? If numerical, are the variables analysed using univariate or multivariate techniques? If non-numerical, do the qualitative techniques focus on socio-economic analysis, competitor analysis and or bank strategy analysis? It is also important to check whether the model has a mechanism to revise it and the standards that it has set for evaluating bank performance. The key objective throughout this framework of analysis is to determine if the model is capable of providing sufficient warning of a possible bank failure, whether it is able to identify symptoms of failure, and the underlying causes of that failure.

Data analysis: In evaluating the results obtained from subjecting the CAMEL off-site analysis system using the analytical framework in Figure 7, the study paid particular attention to the choice of analysis variables.

Data and Variable Selection: The rationale for selecting specific variables rather than others is very important, especially where ratio analysis is concerned. With an early warning system, the best variables are those that display the most markedly differential behaviour between failed and non-failed firms before the failure of the former. The rationale for the selection of variables in the CAMEL model received special consideration. A variety of sources provided data for the qualitative analysis, namely, the BoZ Annual Reports, Quarterly Financial and statistical reviews, Commercial Banks' Annual Reports, Monthly Prudential reports submitted by commercial banks to the BoZ, papers prepared by BoZ officials for presentation at various meetings, business and financial journals, newspapers, magazines, and various other publications.

Figure 7 Early Warning System Assessment Framework



To illustrate that the qualitative models can indeed be useful, the study searched *The Post* newspaper archives for every banking-related article between the period December 1995 and December 1997 and information obtained was used in qualitatively analysing the banks in the industry. This approach was intended to show that if the study could identify preliminary indicators of failure using publicly-available information, bank inspectors with access to confidential information could identify more substantive indicators.

4.4.4 Hypothesis III: Exit Regulations and Supervision Practices

Research objectives: For ease of reference, the third hypothesis is; "due to political and economic regulatory forbearance, the BoZ failed to enforce the required corrective action for failing banks in a timely and consistent manner".

Research method: The study used a qualitative research approach to investigate the third hypothesis. Intensive individual interviews and one workshop formed the primary process through which the research evaluated the factors BoZ staff consider when faced with regulatory and supervisory decisions. This approach was preferred on the premise that the regulatory process is a political process. In order to understand if regulatory forbearance was characteristic of the 1995 and 1997/8 failures, the study needed to evaluate regulatory practices within the political and economic context of the environment prevailing within the financial system genrally and the BoZ in particular.

The use of regulatory power is more akin to the field of political science than it is to economics, albeit that the new school of institutional economics has bridged this gap significantly. Nevertheless, the study of power is a "complex phenomenon, which entails the study of relationships. It is not a concept that is easily turned into indicators, which can be measured"(Devine, 1997:146). Although it is possible to use traditional economic methods of research to study the design of regulations, it is not easy to use the same methods for evaluating the enforcement of regulations. Any useful research on the enforcement phase of the regulatory process needs to acknowledge the environment within which regulators operate. It needs to consider the rules by which they live, the customs they observe and the incentives they perceive and act upon in their decision-making process.

Research sample: Since the objective of the study was to go beyond the formal regulatory structure and to uncover the reasons for the actual practices of people involved in the regulatory process, the interviews were lengthy and time consuming. It was thus not possible to interview a large number of respondents in a truly representative sample. Nevertheless, the selection of respondents was undertaken, considering the normal issues of sampling – possible sources of bias, and the implications of sample design on the interpretations of findings. The selection criteria took into account the interviewees' professional characteristics, patterns of behaviour, association with a particular political, economic or social interest group. Devine (1997:142) noted that qualitative study samples are defined "to include a wide range of informants with different subjective interpretations of their lives. A sample of approximately 30 to 40 interviewees is the norm. Although qualitative researchers rely on a small number of informants, they try to embrace a heterogeneity of experiences and accounts within the constraints of money and time".

Research design: The investigation of the third hypothesis proceeded in three stages. The first stage focused on the supervisory actions that the FSSD took against banks that were financially-distressed. The second stage sought to understand the legal environment for the enforcement of prudential regulation and supervision in Zambia. What legal provisions were available to the FSSD to design and enforce corrective action? Finally, the third stage sought explanations for the BoZ's failure to implement the avaliable legal provisions. If the BoZ was aware of the condition of the financially-distressed banks, what elements, if any, hindered the BoZ from effectively enforcing regulatory and supervisory actions against the offending banks? The study sought to establish whether the FSSD failed to enforce regulatory directives in a timely and effective manner because of political pressure, economic factors and/or conflicts with other policy objectives.

Research data collection method: The research used two types of data: primary and secondary. In-depth interviews formed the basis for the collection of primary data while documents held by the BoZ formed the basis for the secondary data. These included:

1. Contemporary records, including business and legal papers, and memos.

2. Confidential reports, including monthly bank reports, industry reports

3. Public reports, including bank annual reports, newspaper reports and articles

4. Government documents, including legislation and regulations

5. Opinions, including editorials and speeches

The use of secondary data had advantages for this type of research. Firstly, it provided the necessary background information and facilitated insights into the key research areas of concern - licensing, monitoring and exit regulation and supervision. Secondly, it provided documentary evidence of the form and timing of different regulatory and supervisory actions implemented by the BoZ on failing banks. Thirdly, the data provided a basis upon which to formulate appropriate interview questions for key decision makers in the regulatory process. The primary limitation, with respect to secondary data, was that of the confidential nature of the information required for this research. The confidentiality of information held by the central bank and individual commercial banks acted as an important limiting factor in the effective conduct of the research. Access to confidential documents, for example, the Monthly Bank Analysis reports and the minutes of the Supervisory Policy Committee meetings, where possible, significantly enhanced the evaluation of BoZ regulatory decisions. While the FSSD tentatively granted approval for access to such documents, it provided the documents on a case-by-case evaluation.

Intensive interviews were used to collect the data to investigate the hypothesis. Relatively unstructured interviews were held with selected individuals at the BoZ, MoF and commercial banks in Zambia to discuss various aspects of the process of developing, designing and implementing banking regulations. The interviewees' responses determined the interview direction, with the researcher thoroughly probing each answer given.

In-depth interviewing, however, produced some problems. It was necessary to ensure sufficient rapport throughout the interview to gurantee that it was neither superficial nor too narrowly focused, a problem which could have arisen by not asking the most appropriate questions. Co-operation was essential, especially when interviewees were not willing to share all the information the research required. Another critical issue involved the analysis and interpretation of the results obtained from such open-ended interviews. Comparison of results with other respondents presented unique challenges, especially the challenge of reducing the level of subjective interpretation of the results. Nevertheless, this approach was well suited because the research focused on policy-makers. Qualitative research techniques such as intensive interviewing have several advantages over quantitative approaches. The interviewee becomes the focus of attention, whose personal thoughts and feelings are important and truly wanted. The open nature of such interviews facilitates the discussion of new information, unknown to the interviewer - information that structured interviews conceal. A longer interview also leads to the revelation of new information. Lengthy respondent probing is possible in order to reveal the feelings and motivations that underlie statements made in the interview. Devine (1997:137-141) noted three key advantages that are directly applicable to this study.

Firstly, they are most appropriate where the aim of the research is to explore people's subjective experiences and the meanings they attach to them. What has taken place in the Zambian regulatory process is essentially a series of events for which there are different interpretations attached. By engaging in open-ended discussions with informal probing from time to time, it is possible to get people to talk more freely and to offer their interpretation of events. Devine (1997:138) emphasises that it is their perspective that is paramount to the research. Through the triangulation of perspectives of different participants in the regulatory process, it is possible to arrive at valid and reliable analyses of that process.

Secondly, qualitative research methods are appropriate for the study of processes. In-depth interviews provide a means of understanding the logic and associative thinking that preceded regulatory and supervisory decisions. Why, for example, why did the BoZ make the decision to close a bank in October rather than August when all parties knew that the bank was no longer a going concern?

Finally, qualitative research methods acknowledge the contextual issues surrounding all decision-making processes. It is easier to place the interviewees' attitudes and behaviour within the context of their educational background, professional training and experience and the wider social setting within which they operate. Understanding and explaining the regulatory process requires an appreciation of people in terms of their different motives for their actions, experiences and subjective interpretations of events.

Research analysis: The working paper preparation process for the intervention and closure process followed the same procedures used in preparing the licensing working papers. Firstly, all available correspondence and documentation relating to each bank failure during the 24 months before the BoZ's seizure of the bank was documented and summarised using standard schedules for ease of comparison and analysis. Secondly, each document was given a unique code identifying the name of the bank, the type of document, details of the person originating it, document recipient, subject matter and details of the issues raised in the document. Thirdly, the research used code names for all individuals involved in the intervention and closure process to protect the identity and confidential nature of the documents. Further, the documentation process included denoting codes, similar to the licensing interview and workshop codes, for each paragraph.

As is the case with quantitative research, it is essential that the research established the validity of its interpretations and demonstrated the plausibility of its conclusions. Based on the recommendations made by Devine (1997:145) the study took the following steps to enhance the validity of the interpretations generated.

1. Numerous readings of the interview transcripts were conducted until underlying themes emerged and overall arguments established.

2. Interviewees were asked for their reactions to the interpretations of the interview transcripts.

3. During and after the interviews, the researcher checked internal consistency of the interview data.

4. The study compared the findings of each interviewee's account with those of other interviewees as well as the findings of other studies.

The interpretation of interview material was discussed with different interest groups to arrive at a consensus on the interpretations. These groups included BoZ inspectors, BoZ directors and assistant directors, and researchers attached to the finance and development research programme.

Due to the complexity of events leading to the closure of individual banks, the analysis process for the intervention and closure process was much longer than the analysis process for the licensing and bank monitoring stages of the thesis. It involved significantly more rigorous steps in making boundary judgements, systems critique and social critiques to ensure the robustness of the study's findings.

Boundary judgements: Using the individual bank closure schedules (Appendix 17), the study identified the decision-makers as well as the decision-making process. Using the coding system, the next step involved using the tables to establish the different BoZ supervisory tools and techniques, the speed of implementation as well as the key decision-makers in the intervention and closure process. Next, the individual bank summaries led to a common schedule listing the key forms of actions common to all banks. Thereafter, the analysis process involved re-listing all the regulatory actions and classifying them into groups denoting their common objectives: information-based activities, financial resource mobilisation activities and direct central bank intervention activities (Table 8).

Systems Critique: Contrasting 'actual' with 'ideal': Once the consolidated schedules reflecting actual BoZ intervention and closure performance were completed, they were also used as a basis upon which to critique the regulatory system. The critique contrasted the actual with the 'ideal' intervention and closure process as defined in banking legislation, the Basel Core Principles for effective banking supervision and most importantly, as defined by those 'involved' and 'affected' by the 'actual' banking intervention and closure process.

Social Critique ('affected' and 'involved'): The most challenging aspect of the analysis at this stage was studying the explanations for the BoZ's regulatory performance as provided by those 'affected' by and those 'involved' in the intervention and closure process. Firstly, after numerous readings of the codified text collected from interviews and other intervention and closure documents, key theoretical words were identified for each group of interview respondents: Parliamentarians, Governors, Assistant Directors, Bank Inspectors, and Directors/owners of failed banks. Using the established codes, appropriate references were included in the specific word search to denote the source of supporting evidence (Figure 8, Appendix 18).

Table 8 BoZ Supervisory tools and techniques

SUPERVISORY ACTION (No. of Months to closure)	12	11	10	9	8	7	6	5	4	3	2	1	0
Information-based solutions													
Meetings	■	■		■	■		■	■	■	■	■		
Conduct on-site bank inspections/investigations	■	■	■	■	■		■	■	■	■	■		
Follow up/enquire on the external bank audit report	■	■							■	■	■		
Request a bank recovery/re-capitalisation plan	■	■		■	■		■		■			■	
Place restrictions on unsafe and unsound banking practices					■				■	■	■		
Issue a letter of caution/reprimand	■		■	■	■	■	■	■	■	■	■	■	
Issue a public denial of financial distress					■		■		■				
Financial Resources Mobilisation Activities													
Encourage/support private bank financial support						■					■		
Encourage/support a sale, merger, and/or acquisition	■			■	■					■	■	■	■
Provide legal regulatory and accounting exemptions		■								■	■		
Agree to provide BoZ guarantees of third party loans				■									
Provide central bank financial support		■	■		■			▒	■	■	■	■	
Do not object to central government financial support										■			
Suspend the payment of penalty interest rates on overdraft											■		
Direct Central Bank Intervention													
Commence the daily monitoring of bank activities						■	■	■	■	■	■		
Appoint a resident bank inspector to monitor bank activities									▒		■	■	
Remove a manager/director/shareholder									▒	▒	■	■	■
Appoint a curator									■		■		
Seize and close the bank										▒		■	■
Appoint a receiver											▒		■
Commence compulsory liquidation													
Re-open the bank													

Figure 8 Coding System for Bank Intervention and Closure Documents

Parliamentary
Document
Interview

Date: 15 March 1995

PD/150395/45

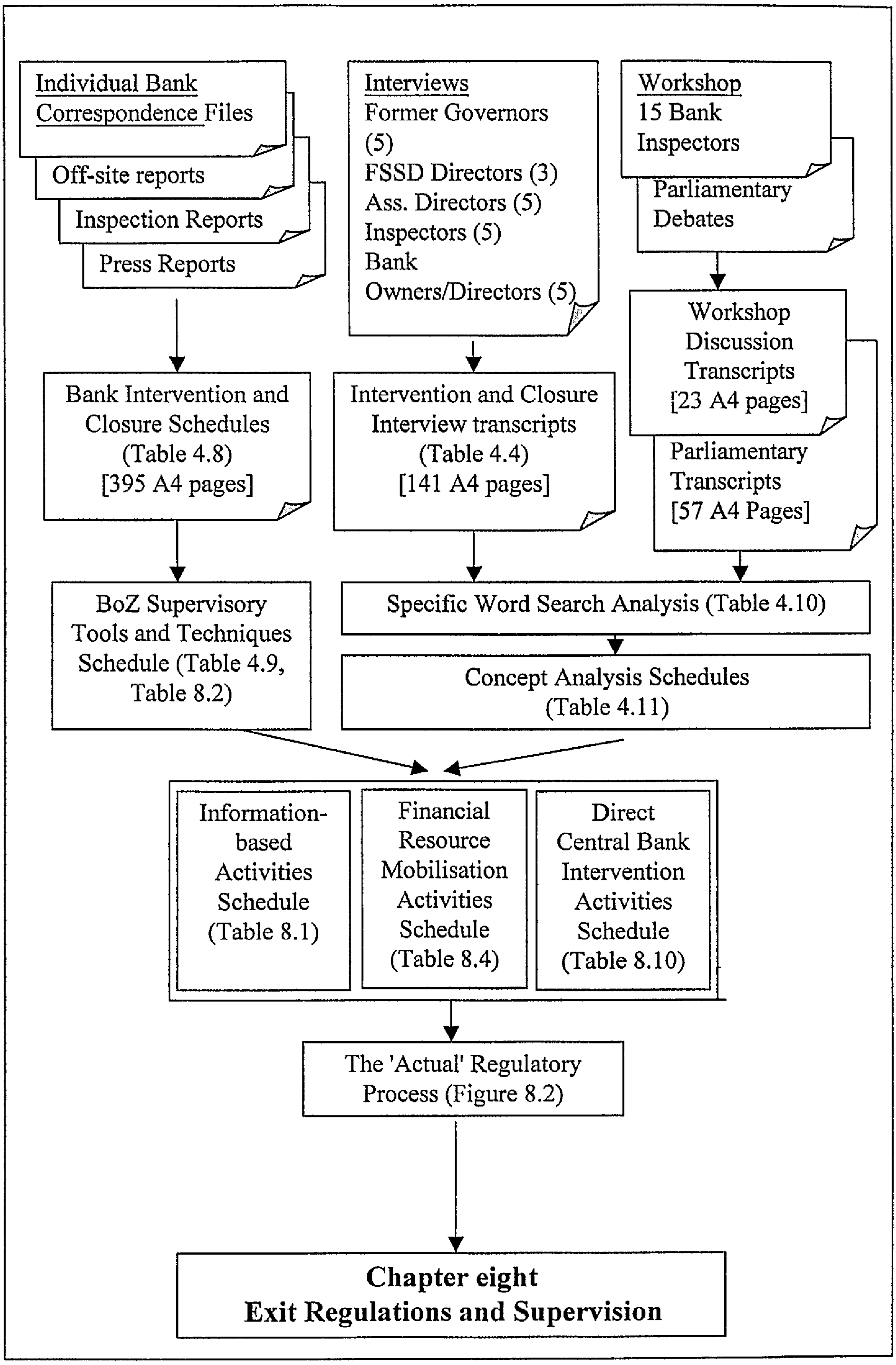
Question/response no. No.

The key concepts were derived by a systematic search and documentation of all key words recurring in the intervention and closure schedules, parliamentary debates and interview and workshop transcripts. Each time the word occurred in the text, the source was noted and referenced for subsequent analysis in broader concept schedules (Appendix 19). Thereafter, a consolidation of all the group schedules was prepared to act as a basis upon which to weigh the importance of each theoretical concept identified in the individual group assessments. Further detailed analysis did not include concepts not supported by sufficient evidence from the working papers. The consolidated version subsequently formed a point of discussion for differences between those involved in and those affected by the intervention and closure process. Further, the study presented and re-presented the research findings to interview respondents during subsequent research visits to Zambia. Figure 9 graphically summarises the key steps taken to test the first hypothesis, and to discuss and report the research findings in Chapter Eight (Exit regulations and supervisory practices).

4.5.0 Tactics for Testing and Confirming Findings

The study adopted Miles' and Huberman's (1994:263-275) guidelines for testing and confirming the findings resulting from the qualitative data collected during the field visits to Zambia. The guidelines are the culmination of a deliberate effort by Miles and Huberman to ensure that findings from qualitative research address the issues of representativeness, reactivity, reliability and replicability. The techniques minimise the risk of holistic fallacy (interpreting events as more patterned and congruent than they really are), elite bias (overweighing data from articulate, well-informed, usually high status informants and under-representing data from less articulate, lower status ones) and going native (losing your perspective and being co-opted into the perceptions and explanations of local informants). The steps move from ensuring the basic quality of the data, to checking the findings by examining exceptions to early patterns before concluding with tactics that take a sceptical, demanding approach to emerging explanations.

Figure 9 Exit regulations and Supervision Practices Analysis Process



4.5.1 Checking for representativeness

When conducting selective qualitative case studies, it is essential that 'findings' are not quickly assumed typical of the population and accepted as indicative of a more general phenomenon. The temptation to make biased inferences from samples to populations is extremely high during a qualitative PhD thesis when the researcher operates alone without any standardised or validated instruments. Miles and Huberman (1994:264) noted three typical errors that reduce representativeness in qualitative research work, namely, sampling non-representative informants, generalising from non-representative events and drawing inferences from non-representative processes. The three errors arise when the researcher places too much reliance on accessible and elite informants, overweighs dramatic events and drawing heavily from the already-faulty sample of people, events, and activities.

To ensure the findings were representative of the actual banking regulation and supervision processes in place in Zambia, the entire sample of commercial bank license applications submitted to the MoF and the BoZ and the entire set of private banks that closed between 1990 were included in the study. The increase in the breadth of the study sample matched the depth of sources of research material included. The selection of respondents took into account the interviewees' professional characteristics, patterns of behaviour, association with a particular political, economic or social interest group and embraced a sufficient heterogeneity of experiences and accounts within the constraints of money and time.

Twenty-eight in-depth interviews were conducted during the field visit. A combination of former BoZ Governors, Former Directors of the FSSD, Assistant Directors, Bank Inspectors, former owners and directors of failed banks, and other key contact persons were included in the choice of interview respondents. The intention was to include representatives from the complete hierarchy of regulatory and supervision decision-makers. Unfortunately, it was not possible to meet with the Republican President, M/Finance and MPs who played an important role in the political economy of banking regulation. However, the study used the verbatim transcripts of the Hansard published by parliament between 1994 and 1998 as a substitute that, in turn, proved to be an accurate representation of the political environment in which the bank failures were occurring.

During various stages in the analysis of individual case studies, both at the licensing and closure phases, the findings of contrasting cases were compared using a variety of different attributes, namely, size of the bank, year of licensing or closure, majority of owners – local or foreign, number of months of licensing/closure period. Additionally, although the totality of documents made available for each bank was evaluated, it was clear that some cases were better documented that others. These differences were noted and their effect on the representativeness of research findings, carefully considered.

4.5.2 Checking for researcher effects

Perhaps the most difficult aspect of the qualitative analysis for this particular study was, firstly, minimising the researcher's effects on the case studies and, secondly, minimising the effects of the case studies on the researcher as an employee of one of the failed banks, Meridien BIAO International, at the time of its failure, and a previous employee of the BoZ, the risk of the researcher being "co-opted, going native, swallowing the agreed-upon or taken-for-granted version of local events" remained high throughout the duration of the study. The potentially negative impact on the quality of the findings due to biases arising out of these past and current relationships with the "subjects" was of particular concern and a number of deliberate efforts to counter these influences were made. Firstly, when interviewing non-BoZ respondents, there was concern that the respondents, might not distinguish between Samuel Maimbo – a BoZ employee and Samuel Maimbo – the PhD candidate. As a result, they might, using Miles' and Huberman's (1994:264) terminology "switch into an on-stage role or special persona, a presentation of self to outsider". Secondly, when engaging with serving employees of the BoZ, such as the BoZ Governor, the concern was that they might "tailor their responses to be amenable to the researcher and protect their self interests".

To reduce the adverse risk of these relationship biases, the study implemented a number of different measures designed to elicit honest, objective responses from the respondents. For some of the respondents this involved conducting the interviews away from the office, either at the respondent's home or at a restaurant. One interview (a former BoZ Governor), for example, was conducted at a respondent's home between 23:00 hours and 01:00 hours because of the respondent's nocturnal habits – he slept most of the day and worked throughout the night. In another instance (former bank owner), the actual interview was preceded by an introduction through a mutually-known third party, one casual meeting at which nothing relating to the study was discussed, and a tour of the respondent's private game reserve. In all cases, a deliberate effort was made to explain the objectives of the study, the method of collecting the data, and most importantly, how the researcher intended to use the data and refer to it in the thesis production.

Avoiding biases stemming from the researcher's effects on the site were, in some respect, easier to deal with than biases stemming from the effects of the site on the researcher; primarily because, the former were easier to identify than the latter. The former largely arose from the researcher being an employee of the BoZ. The reasons for the latter, on the other hand, were subtler and more difficult to discern. Nevertheless, the study used the following techniques to minimise the potentially negative impact of biases arising from the effect of the site on the researcher. Firstly, as much time as possible was spent with respondents, lunching with them, and observing them at work or in their own environments. Most of the interview recording was done in the FSSD open office. Dressing was formal to enable the researcher to blend in with the environment. Secondly, all the respondents, both within the BoZ and without, were fully informed of the intentions of the study, the method of collecting data for it, and how the study would use the data. Thirdly, the study, co-opted informants to provide intelligence regarding the respondents' perception of the study and the researcher's presence within the bank. The selected informants (two) were individuals known to the author, for their honesty and frankness. Thirdly, some of the interviews took place off-site, either at the respondent's home or at a restaurant. As is the custom in Zambia, the cost of the meal was borne by the person requesting the lunchtime meeting, namely, the researcher. Fourthly, to avoid "elite biases" the study included a wide spectrum of individuals from former BoZ Governors, to former owners and directors of failed banks. Fifthly, the researcher interrupted the continuity of on-site research with time away from Lusaka, the financial centre in Zambia, with trips to Livingstone and the Copperbelt. In both cases, the trips took place to conduct interviews with informants who had since left Lusaka. Sixthly, the informants, mentioned above, actively provided feedback on interview transcripts, preliminary analysis, observations and findings.

4.5.3 Triangulations

However, the most important technique for reducing site bias on the researcher was the constant triangulation of the different data collection sources and methods. The study's triangulation process for generating meaning took place at three levels, namely, data sources, data collection methods and data type. Data sources included individuals (Governors), public institutions (BoZ, MoF) and public records (newspaper articles). Data collection methods included conducting interviews, conducting a group workshop, and summarising public and confidential documents. Data types were in the form of qualitative texts of documents and interviews, audio recordings of interviews, and quantitative financial statistics – balance sheets, profit and loss statements, capital adequacy computations and key financial performance ratios.

In all cases, and at all three levels, the objective was to establish and identify sources, methods and types that projected "different biases, different strengths, so that they could complement each other" (Miles and Huberman, 1994:267). Although the process of triangulation did not necessarily determine that the information was valid, it significantly enhanced the reliability of the meanings and conclusions generated in qualitative research. By consciously double-checking findings during the collection and analysis phase, triangulation was used as a process of "getting to the findings in the first instance – by seeing or hearing multiple instances of it from different sources by using different methods and by squaring the findings with others it needs to be squared with..." (Miles and Huberman, 1994:267).

4.5.4 Weighting the evidence

Miles and Huberman (1994) indicated that, for a number of reasons, certain data are stronger or weaker than others. They observed that, firstly, some informants were more articulate, knowledgeable, close to the event, action, process or setting than others. Secondly, the timing and location of the data collection could strengthen or weaken the validity of the data. In their view, the data was usually stronger when collected after repeated contact, seen or reported first-hand, collected in informal settings and the respondent was alone with the field worker. Thirdly, the data was also stronger when the researcher engaged in deliberate validation efforts such as checking for researcher effects, checking for researcher representativeness, getting feedback from respondents and triangulation.

4.5.5 Conferences and publications

An important step in the process of testing and confirming the research findings of the study, was submitting articles for conference presentations and publications in working papers and journals (Appendix 20). Both the conferences and the publications, especially the referred journals, provided a means of obtaining quality evaluation and criticism of the findings expressed in the thesis. During the three-year study period, the research included seven key papers for publications and conferences.

4.6.0 Research Limitations

4.6.1 Confidentiality

The confidentiality of information held by the central bank and individual commercial banks acted as an important limiting factor in the effective conduct of the research. Though access to, for example, the monthly bank appraisal reports and the minutes of the Supervisory Policy Committee meetings, significantly enhanced the evaluation of decisions taken with respect to the regulation and supervision, it was not always possible to quote these papers for reasons of confidentiality.

4.6.2 Conflict of interest

The researcher's position as a BoZ Senior Bank Inspector was also a limiting factor. Firstly, as a practising bank regulator, the author had to take care to avoid any researcher bias in the analysis of issues where a difference of opinion between regulators and bankers existed. Secondly, when conducting interviews with management in commercial banks there was a possibility that the position of the researcher as a central bank employee influenced the interviewee's opinions.

4.6.3 Qualitative research approach

While economic researchers generally consider quantitative research as being representative, reliable, robust, replicable and comparable, they perceive qualitative to be quite the opposite, especially in the economic literature wherein most banking research literature lies. Researchers consider findings from qualitative research as "impressionistic, piecemeal and even idiosyncratic... (It) is neither replicable nor comparable and therefore not a basis upon which generalisations can be made. Qualitative research produces 'soft' unscientific results. The major criticisms levelled against qualitative data therefore are that it is unreliable; that the interpretation of the findings are difficult to evaluate; and it is not easily generalisable" (Devine, 1997:141). Despite this criticism, it is a practical approach for studying the questions raised in this study. Further, the research procedures detailed in section 4.5 significantly strengthened the research findings and conclusions.

4.6.4 Data availability

For many countries, published comparable data for failed banks are not available. If they were, this would permit researchers to know with precision, the extent of insolvency of banks in the immediate periods before their failure. In the case of Zambia, this is especially true. Complete historical data dated back to December 1994 when the FSSD started compiling its balance sheet based on a new chart of accounts.

4.6.5 Frequency and duration of bank failures

Although it is possible to identify specific periods of bank runs, it is not so easy to establish the entire period when a country's banking system is undergoing financial distress. Such periods may persist for a long period before regulators detect them and an equally long time before the public is informed. It is not always clear when the crisis is over, and may well be that in countries with multiple episodes, they are simply a continuation of earlier distress periods. Additionally, cases where regulators successfully intervene and resolve near bank failures remain largely unreported, and whilst these cases remain confidential, research will have a bias towards negative judgements about regulatory practices.

4.7.0 Conclusion

Chapter four's objective was to set out a methodological framework and research methods suitable for the study of banking regulation and supervision in a developing country like Zambia. Given the difficulties of studying regulatory and supervisory practices discussed at the end of Chapter three, and revisited in the beginning of this Chapter, the research methodology and methods took into account three critical factors. Firstly, many aspects of banking regulation are not directly observable. Secondly, banking regulation and supervision is influenced by a variety of disciplines – economics, management, sociology and politics. Thirdly, understanding regulation requires the assessment of a chain of related processes, activities and events [4.1.0].

Because of these three factors identified above, the study adopted CST as its operational methodology. Three tenets of CST appealed to the needs of this study. Firstly, 'critical awareness' invites the researcher to interact with target respondents to obtain facts, opinions and attitudes about specific aspects of the research problem. In the process, the researcher needs to examine and re-examine taken-for-granted assumptions along with the conditions that gave rise to them. 'Methodological pluralism' allows the researcher to use a variety of research methods in a theoretically coherent manner while bearing in mind the strengths and weaknesses of each method.

Finally, the concept of 'emancipation' of 'improvement', challenges researchers to ensure that research leads to a rise in the quality of work and life in organisations and societies that they study [4.2.0]. In line with the tenets of CST, different methods were used to investigate the three research hypotheses, each being designed to cater for the limited data available and the confidential nature of the research documents and names of individuals involved in the regulatory process, and the banks involved. The data collection process comprised three activities, namely, documentary review, interviews and two workshops with BoZ members of staff. With unprecedented access to BoZ documentation, the study conducted extensive and intensive documentary analysis of Bank licensing application documents, correspondence between banks and the BoZ, monthly off-site reports and bank inspection reports. A total of 28 interviews were conducted with former BoZ Governors, former FSSD Directors, Assistant Directors, Bank Inspectors, former bank owners/directors of failed banks and other key contact persons. The data collection process ended with two workshops for 15 bank inspectors in the FSSD at which preliminary findings were discussed [4.3.0].

Evaluating the licensing process commenced by summarising 193 bank license documents on specially-designed working schedules indicating the date of the document, type of document, details of the person originating the document, details of the document recipient and the subject matter. Interviews for six individuals were transcribed and each paragraph coded for analysis purposes. Thereafter the study documented the procedures, which the MoF used to implement the license evaluation policies and procedures with respect to each of the five core components of the licensing process identified in the literature review. Separate analysis schedules were prepared which included specific references to the original working schedules providing evidence of specific phenomena. The referencing system also permitted the study to search any differences in the licensing evaluation procedures applied to banks that failed and those that did not [4.3.0].

Analysing the BoZ's method of monitoring for unsafe and unsound banking practices involved a detailed study of the BoZ's off-site and on-site analysis and inspection procedures. The study evaluated the method and quality of off-site bank monitoring tools and techniques during 1994-1995 and 1997-98. Using a selection of 19 financial ratios, the study compared the financial performance of three groups of banks – foreign banks, local non-failed banks and local failed banks - in the 24 month period prior to the bank failures of 1995 and 1997/98. The objective of this approach was twofold. Firstly, to establish if the BoZ had the capacity and resources to detect financial mis-management, breaches of the law and financial deterioration in the banks that failed and secondly, to determine the duration, in months, between the time it must have been apparent that the banks were financially-distressed and their closure [4.4.0].

Investigating the BoZ's exit regulations and supervision practices involved a considerable amount of documentary analysis in a style akin to the analysis of the licensing documents. All documents relating to each bank failure during the 24 month period before the BoZ's seizure was summarised and coded using standardised schedules for ease of comparison and analysis. Thereafter, the study documented and classified the different supervisory tools and techniques that the BoZ used during the 1995 and 1997/8 bank failures and compared those actions to the rate of financial deterioration. The BoZ actions were compared to the 'ideal' intervention and closure process as defined in banking legislation, the Basel core principles for effective banking supervision, and more importantly, as defined by those 'involved' and 'affected' by the 'actual' banking intervention and closure process [4.5.0]. Because qualitative research is often considered to be impressionistic, piecemeal and idiosyncratic – neither replicable nor comparable, the study adopted several techniques to ensure that its findings were representative, reliable and replicable. The techniques involved checking for representativeness [4.5.1] checking for researcher effects on the study [4.5.2], triangulation of information sources and methods [4.5.3], weighting the evidence against each other [4.5.4], and purposely subjecting the research findings to discussion and criticism through conferences and publications during the course of the study [4.5.5]. The results of this approach are discussed in the following four chapters: Chapter five (The Zambian Financial System), Chapter six (Entry regulations and supervision practices), Chapter seven (Monitoring for unsafe and unsound banking practices) and Chapter eight (Exit regulations and Supervision Practices).

CHAPTER FIVE

THE DESIGN AND DEVELOPMENT OF THE ZAMBIAN BANKING REGULATORY AND SUPERVISORY FRAMEWORK (1970-1998)

5.1.0 Introduction

Chapter five details the recent history of the Zambian regulatory and supervisory framework between 1970 and 1998. Firstly, Section 5.2 traces how government interference during the 1970s and early 1980s resulted in the absence of an appropriate regulatory and supervisory framework for financial sector development. It evaluates how the political and economic environment influenced the BoZ's regulatory and supervisory practices. Section 5.3 documents the 1992/93 financial sector reforms introduced as part of Zambia's Structural Adjustment Programme. Then, Section 5.4 discusses how the financial sector developed in response to those reforms. Importantly, it discusses each of the 1995 and 1997/8 bank failures. Apart from reviewing the available literature discussing the causes of the bank failures, it also reviews the available literature on the BoZ's regulatory and supervisory effectiveness before and during the bank failures. Finally, the chapter concludes in Section 5.5 with a summary of the outstanding key research questions that the study addresses in the subsequent chapters.

5.2.0 The Financial System Before the 1992/93 Reforms

5.2.1 Macro-economic environment

Since independence in 1964, Zambia has been dependent on the copper industry. High copper prices and production levels in the 1960's placed Zambia amongst the wealthiest nations in the region, being at the upper end of the scale of middle-income countries. The annual average rate of growth in terms of gross domestic product

(GDP) between 1964 and 1968 was 2.4%. The manufacturing and agricultural sectors grew at an impressive rate of 9.8% and 2% respectively (Kani, 1996:20).

However, despite the impressive economic growth rates between 1964 and 1970, there remained significant differences between people working in the formal and informal sectors, and between those living in urban and rural areas. In an attempt to address these imbalances, the government implemented the 1968 Matero reforms, which resulted in it taking control of a significant proportion of the economy (Kaunda, 1968:27). Between 1965 and 1975, the government established nearly 80 state firms that accounted for more than 50% of manufacturing and transport output, and dominated the services industry (Kaunda, 1968:39, Kani, 1996:20). However, that change in internal economic policy and the external macro-economic shocks, especially in oil prices, in the 1970's, ended the rather promising rate of economic growth.

Internally, by the mid 1970's Zambia had become a classic case of a public sector-led economy with excessive controls, state monopolies and a pro-urban, anti-agricultural bias. The introduction of price controls and the nationalisation of the domestic industry had a negative effect on the economic efficiency of Zambia's industries. The rapid expansion of state firms, coupled with a growth of government employment and public spending, particularly in government wages and consumption subsidies, created an unfavourable economic environment. Increased government spending on consumption, price controls and a protectionist trade regime resulted in strong incentives for growth of import substitution industries and a bias against exports. Externally, a fall in the price of copper on the world markets, at a time when oil prices were rising, compelled Zambia to seek external borrowings to sustain its budget deficit. Other external shocks that Zambia suffered included: a severe deterioration in the terms of trade; maize harvest failures due to drought; transport dislocations due to the Unilateral Declaration of Independence by Southern Rhodesia; and military activities related to its support for independence struggles in neighbouring countries.

Between 1970 and 1990, Zambia's current account was in deficit for all but three years, averaging $315 million, 11% of GDP. Between 1975 and 1984, the external debt grew from 46% of GDP to 94% (Kani, 1996:20). Economic growth was not export-oriented and the economy still relied on copper for its foreign exchange earnings despite the mining sector's decline in its contribution to GDP. Jones (1994a:27) identified eight structural problems affecting the Zambian economy at the time, namely:

1. An extremely high level of debt in relation to exports and GDP. By 1980 the capita per debt burden was the highest in the developing world;

2. A real effective exchange rate whose level had remained almost constant at the pre-1975 level implying no additional incentive to promote non-traditional exports;

3. An agricultural sector whose development had been neglected and was characterised by extreme dualism between large scale capital intensive commercial farming, and subsistence farming;

4. Continued dependence on the mining sector to generate foreign exchange and government revenues and consequent extreme vulnerability to world price fluctuations and to the exhaustion of mineral deposits;

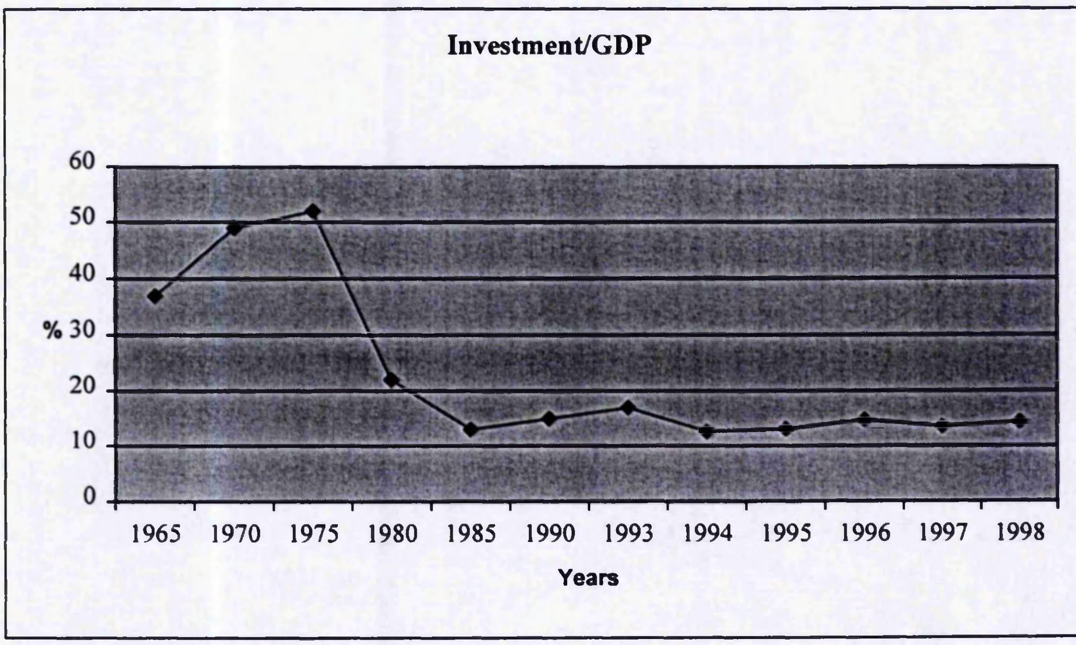
5. A relatively large manufacturing sector of doubtful economic viability enjoying high external variable rates of effective protection dependent on receiving rationed foreign exchange at a price well below its scarcity value, and intermittently crippled by foreign exchange shortages, and depending on state financial injection;

6. A highly urbanised and rapidly-growing population, with a stagnant formal sector employment and a high degree of dependence on subsidised consumer goods and welfare services;

7. An extremely skewed income distribution, with the richest 5% receiving a third of total income and the poorest 60% only a fifth, and;

8. A political system, which to a considerable degree entrenched the interests of those who had most to lose from reform.

Figure 10 Economic Trends (1965-1993)



Source:The BoZ Economics Department

By 1990, the debt burden amounted to 216% of GDP and reached US$7Bn, making Zambia one of the most indebted nations in the world, relative to GDP, especially with GDP declining from 3.7% per annum in the early 1970s to an average of only 1% during the 1974-90 (Mwinga, 1998). By the following year living standards had further declined - 70% of the population was living below the level sufficient to provide for their basic needs, GDP had significantly declined, the external debt increased to 231% of GDP and the current account deficit averaged 12.5% of GDP (Kani, 1996:21; Mwinga, 1998).

5.2.2 Financial System before the 1992/93 reforms

Before the 1992/93 financial reforms, the banking sector consisted of four distinct groups – old foreign banks, state banks, new foreign banks and the local banks. The old foreign banks - Barclays Bank (1918), Standard Chartered Bank (1906) and Grindlays Bank (1956) - primarily served the interests of foreign corporate entities and the state perceived them as not serving the interests of the local populations in need of small and medium scale financial services. In his 1968 Economic Reforms speech, President Kaunda (1968:27) charged that they "...have not been willing to assist the Zambian Businessman". National sentiments, as expressed in the national papers, at the time (see Box 3) were highly critical of the foreign banks. In lieu of public pressure, it was "...time to take more drastic steps to assist the People's business to bridge the gap that exists between it and the resident expatriate business" (Kaunda, 1968:27).

Although the state did not nationalise commercial banks, it established its own financial savings institutions, notably the Zambian National Commercial Bank in 1969 (Brownbridge, 1996:2) and the National Savings and Credit Bank (NSCB) in 1972. State intervention continued through the 1980's with the creation of Lima Bank in 1987 and the Co-operative Bank in 1989 (Brownbridge and Harvey, 1996:38-43).

Government intervention, however, was even more dominant in the non-bank financial sector (NBFI) where nationalisation resulted in a small number of monolithic government-owned NBFIs, the most notable institutions being the Zambia National Building Society (Brownbridge and Harvey, 1996:38), which, until the early 1990's was the only source of long term mortgage finance, and the Zambia National Provident Fund (ZNPF) which was the was the sole social security provider in Zambia. As a matter of policy, the former restricted its loans to the amount of its deposits and shares, and in consequence, it actively engaged in savings mobilisation. Even though its deposit rates were below market rates, it offered easy account opening procedures and was accessible with over 200 branches.

Box 3 Newspaper Reports on the Banking Sector from the early 1970's

Some commercial banks with foreign interests have been accused of sabotaging the economic reforms by refusing to grant loans and overdrafts to Zambian Businessmen. At a meeting of businessmen in Ndola, the banks were accused of mounting a systematic financial war against Zambians by restricting overdrafts on which some of the businesses were being run. Alex Shapi, backed the claim and confirmed that many Zambians had complained about the conduct of certain banks

- *Zambia Daily Mail, 18 August, 1972*

Zambian Shop Owners in Mufulira have bitterly complained about the difficulties they face in obtaining loans from commercial banks. They made their complaints to Copperbelt Minister of State, Mr Joseph Mutale, when he visited shops taken over by Zambians during the economic reforms

- *Times of Zambia, 14th August 1972*

A small committee of Zambians who should look into the whole structure of banking in this country over the next 10 to 15 years has been suggested by Mr Antony Tuke, Chairman Barclays Bank International, following his four day visit here

- *Zambia Daily Mail, 1 August, 1972*

The Development BoZ should be fully operational next year. The MoFs permanent Secretary has already invited application from Zambians to study abroad in the techniques of development banking. Applicants should have university degree or accountancy qualifications and experience in banking. He also said it was impossible to estimate how many expatriate experts would be engaged but it was certain that in the bank's early days the Government would rely on experts from all over the world.

- *Times of Zambia, 1 August, 1972*

Moves to boost personal savings - including an increase of interest rates by a half percent– have been taken by Zambia's five commercial banks. The moves, announced through Standard Bank (Zambia) Limited on behalf of all the commercial banks, are already being warmly welcomed by the man-in-the-street. The chief change is the increase, in interest rates for customers' savings accounts from three and a half percent to four percent. The announcement issued by Standard Bank on behalf of others, said; in conjunction with the BoZ, the commercial banks have revamped their interest approach to savings and this is aimed at the man in the street. This also supports the National Savings Campaign.

- *Zambia Daily Mail, 4th August 1972*

Banks in Zambia were yesterday accused of preserving the image of colonialism. The general secretary of the Zambia National Council of Commerce and Industry (ZNCCI), Mt Thomas Chomba, said banks underrated the borrowing power of Zambian Businessmen. He accused banks of taking over where colonialism had left off by regarding a Zambian Businessman as worthless and useless. He called for the formation of an all Zambian commercial Bank. He suggested that each trader should deposit K100 per year with the MoF to establish an all Zambian Bank within 10 to 15 years. "With such a bank you would be assured of a loan when you need it", he said. "The practice today is that loans are given only to expatriates and or naturalised Zambians".

th

Consequently, it managed to attract public deposits through the 1970's and 1980's. ZNPF, on the other hand, attracted compulsory contributions. Legislation required all employers to deduct a monthly contributions from employees on which the ZNPF then provided annuity benefits roughly represented by the contributions made and an annual interest rate of 6.5%. Yet, the ZNPF never provided any meaningful benefits to its contributors. The Government often used funds from the ZNPF to finance low interest loans to both the Government and the state sector.

Until the 1990's, the government also took the lead in providing finance to micro, small and medium scale enterprises in the economy. In the early 1980s, for example, the BoZ set up the Credit Guarantee Scheme as a means of encouraging financial institutions to extend more credit to small-scale industries. Other important organizations that the government created included the Small Industries Development Organisation (SIDO), Village Industries Service and the Small Enterprise Promotion Unit. Policymakers thought that banks did not extend credit to this group of entrepreneurs because of their inability to raise adequate collateral. This scheme, like many others before it, relied on government and donor funds for their operations, which precluded the need to raise funds directly from the public (Maimbo, 2001).

Overall, government involvement in the financial sector resulted in an inefficient and non-competitive market. Like other developing countries at the time, before the 1990's government placed greater emphasis on protecting the real sector, with the financial sector only playing an ancillary role. The belief then was that governments could support the real sector through direct involvement in the financial sector, partly by creating their own financial institutions, and by selective credit allocation and price control mechanisms for the entire financial sector. Mehran et al (1998) noted five debilitating effects of these trends on the development of financial systems of sub-Saharan African countries during the 1970's and 1980's that are applicable to Zambia's financial sector:

1. There was a low return on capital in the real sector due to the inefficiency of state-managed companies which were allocated cheap credit by financial institutions as directed by the government. Despite the high levels of credit the state firms received, Zambia's rate of development was not commensurate with the level of investment.

2. Credit allocation directives resulted in high levels of loan portfolio concentrations, particularly in the agricultural sector. The un-diversified loan portfolios of banks, especially state-owned banks, exposed them to increasing levels of financial vulnerability. Furthermore, the allocation of credit led to the erosion of financial discipline, which in turn left many financial institutions unprofitable, and some insolvent. The ability to borrow at low interest rates encouraged investments in projects with low rates of return. Later, when interests rate ceilings were removed, such borrowers, mostly the state-owned companies, failed to repay their loans because the low rates of return would not match the increased levels of interest.

3. As the economy deteriorated, the government resorted to increased borrowings from the central bank to finance its rising fiscal deficit. Given the small size of the commercial banking system, the central bank was the only institution capable of providing the government with the much needed liquidity. This resulted in high inflation. Volatility in economic growth and rising inflation made it difficult for banks to evaluate borrowers' credit worthiness, leading to the granting of more bad loans.

4. Negative real interest rates undermined the economic efficiency of the financial system and led to capital flight. Although capital controls were still in place in Zambia during the 1980's, it was common practice to physically smuggle out foreign currency by a variety of means. Furthermore, interest rate ceilings on loans led to an excess demand for credit, which forced banks to ration credit, a process which encouraged rent-seeking behaviour amongst economic agents.

5. Interest rate ceilings and credit allocation directives also undermined liquidity management by banks, resulting in disintermediation and the reduction of the banking systems' client base and overall profitability.

Additionally, the emphasis on credit allocation, rather than domestic savings mobilisation weakened savings mobilisation efforts. Since the government heavily subsidised its financial institutions, management had little incentive to actively encourage savings mobilisation. Neither was there much effort on ensuring that borrowers repaid their loans. Many borrowers considered government loans as the "fruits of independence". In fact, lending practices in state banks and public financial institutions ignored the basic commercial principles concerning a loan applicant's character, capital, capacity, collateral and economic conditions. For the above reasons, very few banks entered the banking sector between 1970 and 1990, and those that did occupied niche markets without a significant impact in the deposit market, dominated by the old foreign banks and the state institutions.

Except for Citibank (1979), the "new foreign banks" – Meridien Bank[11] (1984), Bank of Credit and Commerce (1979) and Indo-Zambia Bank (1985) were primarily retail banks and increased the level of private savings. Citibank concentrated on corporate finance while the Bank of Credit and Commerce expanded rapidly by offering innovative services and attracting business from other banks to capture 7.5% of total bank deposits by 1989. Union Bank purchased the bank in 1991 after the bank's parent company failed (Brownbridge, 1996:8). Unfortunately, Union Bank entered the sector when policies were not particularly conducive to private investment. Interest rate controls, which, together with high reserve requirements, deteriorating macro-economic conditions, political interference, negative interest rate policies and directed credit policies, depressed profit margins (Brownbridge 1996:9). Further, an inefficient payments system and inadequate legal and accounting standards reduced the banking system's efficiency and its ability to perform its financial intermediation

[11] Although Meridien was lauded as a local bank since its most public shareholder was a Zambian national and the bank had its headquarters in Zambia, the bank's shareholding and control structure makes it impossible to ascertain the origins of its ultimate owners. Meridien International owned the bank and like other Merdien subsidiaries, had its headquarters in an offshore centre.

function. The local banks - Bank 11 (1988), Bank 18 (1987), New Capital Bank (1989) and Manifold Investment Bank (1987) - had comparatively small deposit and asset bases. They were attracted to the financial sector by the high returns on average investments (ranging from 1.2 to 10.5% in 1990). Moreover, the un-regulated nature of banking entry by the MoF, which required low capital requirements, permitted easy access for the new banks.

5.3.0 Financial Sector Reforms

5.3.1 Structural Adjustment Programme

Attempts to restructure the economy with the aid of the IMF and the World Bank during the late 1970s and 1980s failed to yield the desired results due to the lack of adequate political will to implement the prescribed economic policies. As Table 9 shows, the first major attempt at restructuring the economy was made in 1983, when the main thrust of reforms was the removal of regulatory controls, to ease administrative restrictions on the economy. The reforms included the part liberalisation of trade and the foreign exchange markets and the decontrol of interest rates and commodity prices.

However, on several occasions, the government defaulted on its IMF/World Bank agreements (Table 10). This culminated in the government's decision to completely abandon all IMF and World Bank support programmes in 1987, following public riots over the reduction of maize meal subsidies (Jones, 1994a:31). Debt service payments were unilaterally restricted to no more than 10% of all foreign exchange receipts. However, the subsequent suspension of all external economic aid by IMF, the World Bank and the donor community forced the government to reconsider its position and resume the agreed economic programmes.

Table 9 Chronology of Zambia's Economic Policy Changes

Period	Economic Regime
Before Dec. 1982	Controlled planning and controlled regime
Dec. 1982 - Oct. 1985	Decontrol and deregulation
Oct. 1985 – Apr. 1987	Highly liberalised regime
May 1987 – Nov. 1988	Return to controlled regime
Nov. 1988 – June 1989	Relaxation of some controls
July 1989 – Apr. 1991	Return to highly flexible regime with movement towards full scale liberalisation
May 1991 – Oct. 1991	Political transition with both government and opposition supporting liberalisation
31 October 1991	New government of President Chiluba took over power from that of Kaunda during elections
Nov. 1991 - 1996	Fully fledged structural adjustment programme (SAP) and stabilisation policies

Source: Saasa (1996)

Table 10 Policy agreements between Zambia and the IMF/World Bank

Period	Policy agreement
1981-85	Attempted stabilisation and limited liberalisation, initially under an IMF extended fund facility, and then under a stand-by agreement.
1985-86	An intensive reform effort during which the foreign-exchange auction operated and the abolition of food subsidies was attempted
1986-87	A period of disintegration of the IMF and the World Bank programme, culminating in the formal break in May 1987
1987-89	An attempt to go it alone under the Interim National Development Plan from May 1987 to June 1987
1989-91	Rapprochement with the Bretton Woods institutions, a phase beginning formally in June 1989 and lasting up to September 1991 when the programme broke down as food subsidies were increased following drought and the collapse of the marketing system in the run-up to elections

Source: Stephen Jones (1994a)

The key areas of reform were External Sector Adjustment, Financial and Fiscal Reform, Agricultural Pricing and Food Subsidy Reform (Jones 1994b:32). The economic reform programme emphasised the need to reduce the government deficit, improve its balance of payments position and develop a more balanced approach to economic growth. Although the government implemented some of the reforms, it was not until after the change of government in 1991 that the State showed the necessary political will required to fully implement the economic reform programme. In October 1991, the government commenced the implementation of the Structural Adjustment Programmes (SAP) agreed with the IMF and the World Bank. This enabled the World Bank to resume disbursements in January 1992. In July 1992, the government signed the Rights Accumulation Programme with the IMF, enabling Zambia to pay back arrears to the IMF by accumulating rights to future borrowing as long as Zambia continued with the Structural Adjustment Programme and met the agreed benchmarks. The government/World Bank/IMF designed the 1992-1994 SAP to achieve a real GDP growth of 2% in 1992, 3% in 1993 and 4% in 1995. The investment was to increase from 13.5% of GDP in 1990 to 20.5% of GDP in 1994. The inflation target was 45% for 1992 from 100% in 1991, 15% in 1993 and 5% in 1994 (Adam, 1995).

Table 11 Zambia's Basic Economic Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total GDP (at current prices in Billions of kwacha)	113	218	570	1,482	2,241	2,998	3,945	5,169	6,241
Total consumption (% of GDP)	83.5	91.6	100.7	88.8	88.4	92.7	91.5	91.9	94.6
Total Investment (% of GDP)	17.3	11	11.9	15	12.7	13.1	14.8	13.6	14.4
Net Exports of Goods and Services	-0.7	-2.6	-12.6	-3.8	-1.0	-5.8	-6.2	-5.5	-9.0
Total external debt (US$'millions)	6,898	6,827	4,981	5,102	6,397	7,041	7,085	6,871	6,613
Gross National Savings	14.8	11.3	7.8	14.1	14.1	8.9	11.1	7.4	6.4
Balance on current account	-2.5	0.3	-4.1	0.9	1.4	-4.2	-3.7	-6.2	-8.0
Total external debt (% total exports)	505.7	577.1	413.4	483.1	545.2	549.6	619.8	534.2	672.5

Source: IMF Staff country report No. 99/43

The main components of the SAP were demand restraint, expenditure switching and attaining long term economic efficiency. Demand restraint involved reducing government expenditure, reducing the budget deficit, controlling money supply and credit creation and restraining wages. Expenditure switching involved shifting resources from non-tradable to tradable sectors by changing incentives through devaluation, changes in domestic prices and wage controls. Finally, the World Bank sought long-term efficiency by encouraging a more market-oriented economy by way of trade liberalisation, and financial and price regulation.

5.3.2 Financial sector reforms

Within the context of the overall adjustment programme discussed in section 5.3.1, Zambia also undertook structural reforms of the financial sector. The objectives of the financial sector reforms were, in part, to mobilise domestic savings for domestic investment and to maintain a safe and sound financial system in order to encourage economic development through the efficient allocation of resources. Generally, the reforms included granting the central bank more autonomy in conducting monetary policy; liberalising interest rates and eliminating administrative credit allocation mechanisms; instituting the transition from direct to indirect monetary policy implementation; restructuring banks to restore their solvency; developing financial markets; and improving infrastructures, including infrastructures, including banking supervision and accounting and auditing practices.

The BoZ has been implementing financial sector reforms since the early 1990s as part of the World Bank/IMF Structural Adjustment and Financial Stabilisation Programmes. The reforms started with the partial liberalisation of interest rates and the removal of sectoral credit ceilings in the late 1980's. However, the most significant reforms took place after 1992/93 with the restructuring of government owned financial institutions, the liberalisation of foreign exchnage and interest rates, liberalisation of entry into the financial system and reforms to the prudential regulatory system.

Table 12 Components of Financial Sector Reforms in Zambia: 1992-1998

Policies	Action Taken
1. Interest rates	Interest rates first raised and then decontrolled in 1992. Treasury bill auctions introduced in 1993
2. Directed lending	Sector lending directives not imposed before reforms
3. New entry	New entry by private sector banks allowed, although entry criteria not made explicit. Increase in new entry during 1991-1994 before enactment of new banking legislation indicates a de facto liberalisation of licensing. New banking legislation raised minimum capital requirements
4. Prudential reforms	New Banking Act enacted in 1994, covering banks and other financial institutions and gives central bank authority to issue prudential directives e.g. capital adequacy requirements, restrictions on large loan exposure, insider lending, etc.; bank supervision strengthened.
5 Restructuring of government-owned banks	Government has not recapitalised ZNCB, or other government banks. ZNCB implemented dome internal reforms to strengthen management and internal controls.

Source: Brownbridge and Gayi (1998:48)

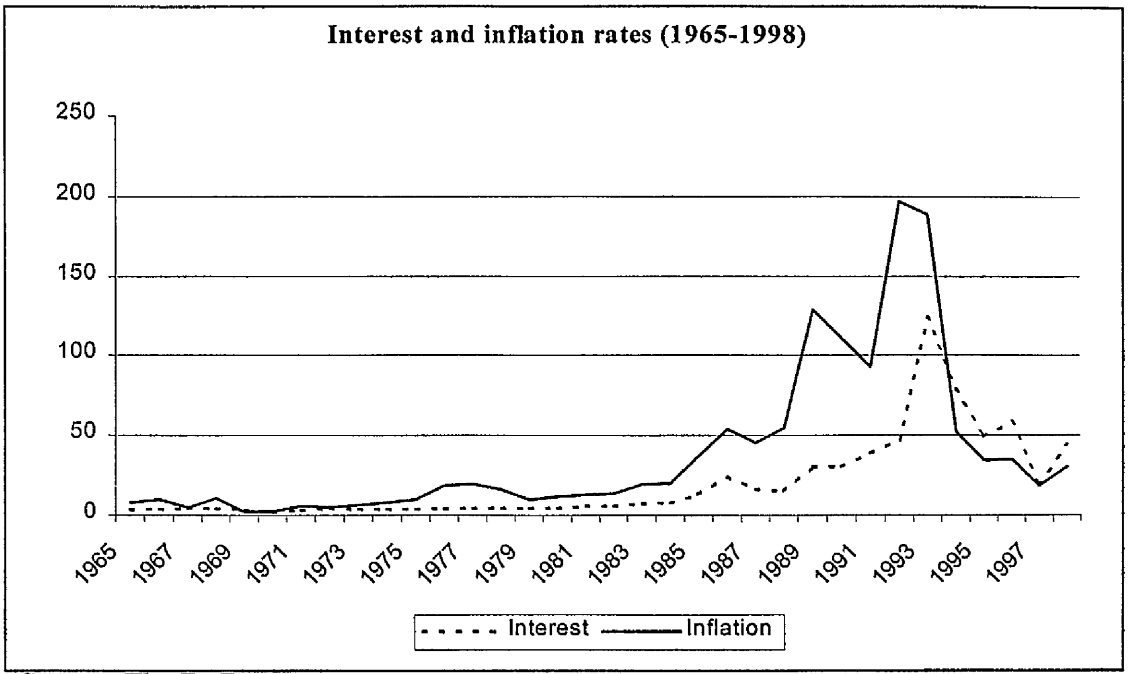
1. **Restructuring of Government-owned financial institutions:** By the late 1980's, the Zambia National Building Society, ZNPF, NSCB, Lima Bank and Co-operative Bank were either financially-distressed, illiquid or insolvent. Though initially successful in providing savings facilities, they all faced severe financial problems due to high transaction costs, mis-management and political interference. Although government subsidies had earlier helped them sustain high overheads, declining state resources resulted in financial insolvency. By 1992/93, the NSCB was insolvent and only saved from collapse by government re-organisation. As part of a K400 million investment programme, the government separated it from the national post office and restructured it to manage external financing intended for micro and small enterprises.

   Lima Bank and Co-operative Bank, however, failed to attract government resources and went into liquidation. Lima Bank, which handled agricultural loan disbursements, had had long running financial losses, a negative capital position and a large non-performing loan portfolio. Further, mis-management, severe drought, low loan recovery rates and erratic government funding accelerated its closure. Co-operative Bank too, failed primarily due to mis-management and weaknesses in the agriculture-based cooperative movement.

2. **Liberalisation of foreign exchange and interest rates:** In 1992, direct BoZ determination of interest rates ceased and the government introduced weekly auctions of treasury bills (Mulaisho, 1998). The BoZ progressively reduced the commercial bank statutory and core liquid assets ratios and started engaging in open market operations through the sale of deposits to commercial banks and by entering into repurchase agreements. By 1993, the central bank implemented the remaining money market reforms and removed all restrictions on commercial bank lending and deposit rates. The BoZ also started adjusting the foreign exchange rate in order to reflect the market value of the local currency, the Kwacha (K). Weekly auctions of foreign exchange commenced in 1993 for three different maturity rates (28, 91, and 182 days). The auction of treasury bills acted as a fiscal instrument to finance government budget deficits as well as a monetary instrument to smoothen liquidity in the banking system.

   By January 1994, the government controlled official exchange rate and the market rate had merged and all remaining foreign exchange regulations were suspended (Mulaisho, 1998). In the same year, financial reforms allowed investors to open bureaux de change in order to widen the participation in the foreign exchange market. Also suspended were the need to obtain import and export licenses and the need for exporters, including the Zambia Consolidated Copper Mines (ZCCM), to surrender a portion of their foreign exchange earnings to the central bank.

Figure 11 Interest and Inflation rates (1965-1998)



Source: The BoZ

3. **Entry into the financial system:** Foreign exchange and interest rate liberalisation had a profound effect on the profitability and competitiveness of the banking sector. The resulting increase in interest rates from 40% (1992) to as high as 192% (June 1993) led to a sharp rise in interest rates on loans and government securities. Because interest rates on deposits did not increase in a commensurate manner, the widening interest rate spread resulted in higher nominal banking profits than in previous years. New entrants were attracted to the sector and by December 1994, there were 19 registered banks in Zambia. Further, at that time, the Banking Act provided for a minimum capital requirement of only K2 million (US$3 million at 1971 exchange rates), and it remained unchanged until 1989 by which time it was only worth US$150,000 following the depreciation of the Kwacha. Although it was raised to K20 million and subsequently revised in 1994, with inflation and the depreciation of the Kwacha, it had eroded the capital requirement to a mere US$ 30,000. Additionally, to the increase in the number of banks, was a rise in the number of NBFIs.

By 1996 there were 26 NBFIs registered with the BoZ (11 of which were set up between 1993-1996), namely, leasing companies (12), building societies (3), deposit-taking NBFIs (2), and development finance institutions (DFI's). Compared to banks, their relative size remained small. Deposits and deposit-like instruments amounted to K28.5Bn in 1996, almost half of which was accounted for by the Zambia National Building Society, and only represented 4.5% of the total deposits of banks.

4. **Reforms to the prudential system:** The main reforms to the prudential framework took place between 1994 and 1997 and were composed of two main parts. Firstly, the BoZ needed restructuring to ensure that it had the necessary legal, financial and human resources to discharge its obligations. This involved recruiting professionally-qualified persons, and providing specialised training. The number of off-site Bank Inspectors increased from four in 1994 to 13 in 1995 reflecting the increased responsibilities of the BoZ. Secondly, the banking sector needed a comprehensive and effective banking legal framework to reflect the new economic environment, which involved a complete revision of the 1972 Banking Act leading to the enactment of the 1994 Banking and Financial Services Act (BFSA), the introduction of standardised reporting and accounting procedures, and the strengthening of the BoZ supervisory capacity. Banks were required to submit additional, and more frequent, financial reports. Further, the BoZ issued statutory instruments for capital adequacy, insider loans, large loans, fixed assets, interest disclosure, classification and provisioning of loans (Appendix 21).

The above set of reforms occurred as part of the BoZ's overall capacity building programme. The BoZ was established under the BoZ Act No. 43 of 1996, a successor Act of the 1985 BoZ Act, and its aims and objectives are derived from the Act. In accordance with Section 4(1) of the Act, the BoZ is empowered to formulate and implement monetary policy and supervisory policies that will ensure the maintenance of price and financial system stability to promote balanced macro-economic development. The other functions Section 4(2) of the Act) are:

1. To license, supervise and regulate the activities of banks and non-bank financial institutions so as to promote safe, sound and efficient operations and development of the financial system;

2. To promote efficient payment mechanisms;

3. To issue notes and coins to be legal tender in the Republic and regulate all matters relating to the currency of the Republic;

4. To act as banker and fiscal agent to the republic;

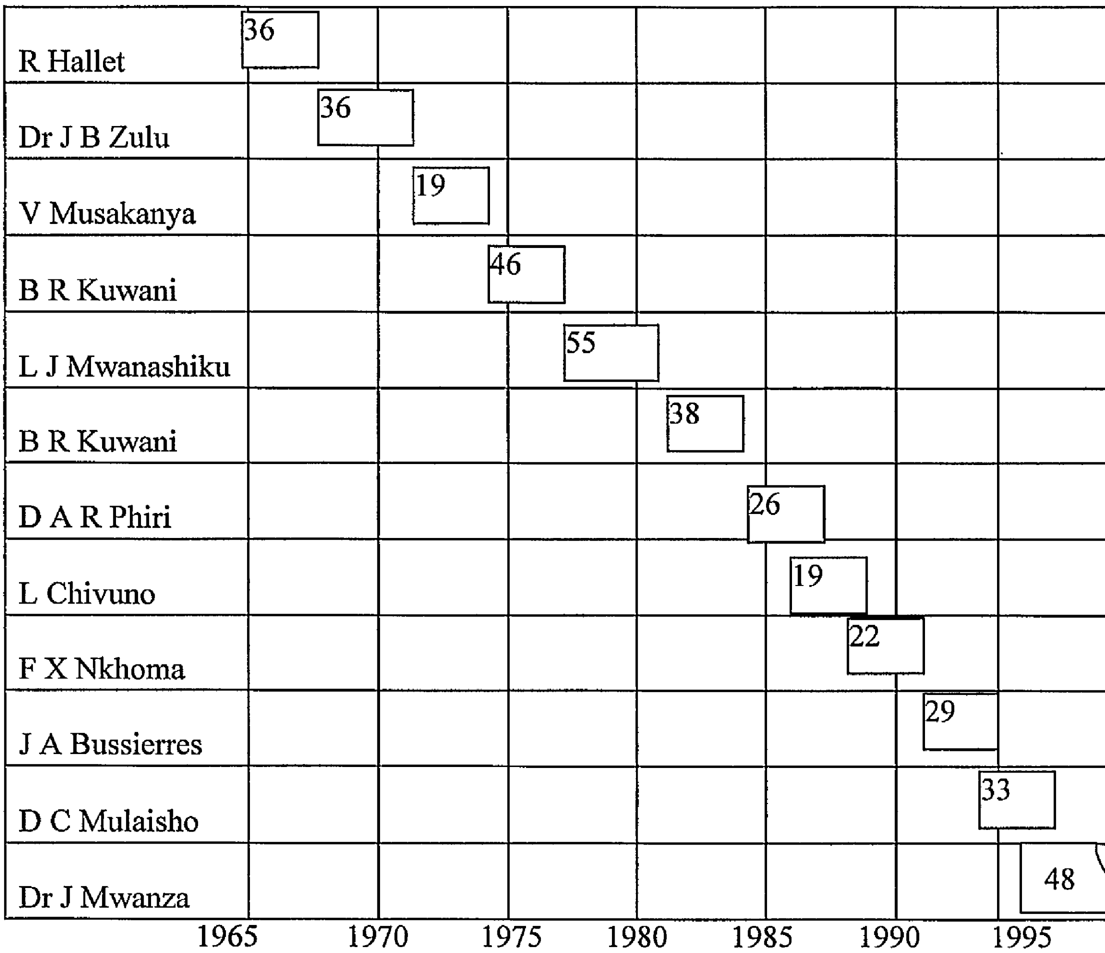
5. To support the efficient operations of the exchange system; and

6. To act as advisor to the government on matters relating to economic and monetary management.

During the 1970s and the 1980s, the ability of the BoZ to effectively execute this role was severely constrained by the political philosophy of the then socialist government. The primary responsibility of the central bank, at the time, was ensuring the compliance of financial institutions to the controls relating to foreign exchange, domestic credit and interest rates. The BoZ largely neglected the supervision of commercial banks since foreign subsidiaries dominated the banking sector. The BoZ relied on their home regulators to monitor the performance of the branches based in Zambia. Further, the high turnover of central bank governors appointed to hold office by the head of state negatively affected the BoZ's performance. Figure 12 shows the number of months which the last 12 bank governors held office. The high turnover of Governors resulted in divergent policy approaches and management styles and limitations in the BoZ's level of political independence.

Similar to most other economic institutions, by 1991 the institutional capacity of the BoZ had significantly declined. For example, the BoZ had not produced any audited accounts since 1988, as its accounting system was plagued with human and computer errors. In line with the changing structure of the financial industry and the general economy since liberalisation in 1991, the BoZ underwent a series of United Nations Development Programme financed restructuring programmes.

Figure 12 BoZ Governors 1964 to 1999 (Number of Months in Office)



Source: Profit No. 3/9 March 1995 and BoZ

5.4.0 The Financial Sector after Financial Reforms

Foreign exchange and interest rate liberalisation had a profound effect on banking sector profitability. The interest rate (Figure 11) rose from 40% (1992) to 192% (June 1993), led to a sharp rise in interest rates on loans and government securities (Muke, 1996:2). Because deposit interest rates did not increase proportionately, the interest rate spread resulted in higher nominal banking profits. By December 1994, there were 25 registered banks, 19 of which were operational with 188 branches (Muke, 1996:2).

The number of NBFIs also rose. By 1996 there were over 26 NBFIs registered with the BoZ, namely, leasing companies, building societies, deposit-taking NBFIs, and DFIs. Compared to banks, their relative size remained small. Deposits, and deposit-like instruments, amounted to K28.5Bn in 1996, almost half of which was accounted for by the Zambia National Building Society, representing 4.5% of the total deposits of banks.

As inflation and the exchange rate began to stabilise in the last quarter of 1993 and early 1994, it became more difficult to maintain earlier levels of profitability. Instead of curtailing activities in line with the declining profit margins, some banks ran greater risks in an attempt to match previous results (Mwape, 1997b:3; Mbalashi, 1999:7). In the third quarter of 1994, and early 1995, adverse developments were taking place. Reckless lending left banks with irrecoverable loans and, in the quest to attract and retain customers, banks were disregarding prudent loan procedures and security arrangements. The cost of funds, the erosion of earnings from treasury bills and foreign exchange operations, and shortages of capital and liquidity compounded the problem (Brownbridge, 1996:11; Muke, 1996:2). These developments culminated in the closure of three banks in 1995. Meridien BIAO Bank, then the fourth largest bank, with 25% of the total industry deposits, collapsed on 19 May, African Commercial Bank on 17 November, and Commerce Bank later within the same month (Appendix 22) (Maimbo, 2000:2). Between 1995 and 1998, nine commercial banks failed and several government-owned financial institutions were allowed to collapse as previously-guaranteed financial subsidies were withdrawn. The first set of bank failures occurred in 1995 and the second in 1997/98 as mentioned.

5.5.0 The 1995 Bank Failures

5.5.1 Meridien BIAO Bank Zambia Limited

The BoZ placed Meridien BIAO Bank into receivership on 19 May 1995 and subsequently into liquidation on 16 August 1995 (FSSD, 1995:10). In the months leading to its closure the bank received official support equivalent to 1.5% of GDP

(Goodhart et al; 1998:30). At the time of its closure, Meridien BIAO Bank had a BoZ overdraft of K43Bn (GRZ, 1998:273). The BoZ made K4.6Bn available to the liquidator to pay the 40,000 depositors the initial statutory payout of K500,000 per depositor during 1996. Later the liquidator declared a dividend of K10.8Bn to pay up to K50 million per depositor (FSSD, 1996:18). The major liquidation activity has been debt recovery and disposal of assets, the most important sale being that of the Meridien Centre which was sold to the Common Market for East and Southern Africa for a sum of US$5.5 million. As at 31 December 1996, close to K3Bn had been realised from the disposal of assets through public auctions and private treaty sales (FSSD, 1996:19). At 30 May 1998, only balances of 32 depositors were yet to be paid (GRZ, 1998:273). The BoZ overdraft reduced to K19Bn (US$13 million) as at December 1997 (BoZ, 1997).

The BoZ attributed MBBZ's failure to insider abuse, incompetent management coupled by an ineffective Board of Directors, and foreign exchange exposure risks. In his submissions to a Parliamentary Committee, the Governor attributed the bank's failure to non-performing bank placements with its parent foreign bank, the high level of non-performing loans, excessive connected lending to related parties and high levels of insider borrowing (GRZ, 1998:268, Appendix 23, 24). The FSSD reported that the failure occurred "despite the Government and BoZ providing financial assistance to bail out the bank from its liquidity problems. Earlier during the year, the BoZ replaced the management of Meridien BIAO Bank in order to revamp the operations of the bank. However, these measures failed to stem the run on the bank" (FSSD, 1995:10). The BoZ stated that to avert the bank's failure it took the following measures: provided immense funding from the BoZ and the Government, requesting shareholders to recapitalise the bank, dissapproved branch expansion plans, appointed a joint Managing Director to co-manage the operations of the bank, appointed the technical Director of the Zambia Privatisation Agency as Chairman of the Board, directed the bank to curtail new lending, and directed the bank to recall loans and advances (GRZ, 1998:268)

5.5.2 African Commercial Bank

The BoZ closed African Commercial Bank, placing it in receivership on Monday 13 November 1995 (FSSD, 1995:10). When it closed, African Commercial Bank had a BoZ overdraft of K10.2Bn (GRZ, 1998:271). After the 90-day statutory period of receivership, the BoZ resolved to place the bank in compulsory liquidation. The Managing Director, however, applied for and obtained, a court injunction to restrain the BoZ against liquidating the bank (FSSD, 1996:16). The injunction significantly delayed the disposal of assets (FSSD, 1996:19). On Thursday 21 August 1997, the High Court ruled in favour of the BoZ and ordered that the central bank proceed with liquidating African Commercial Bank (GRZ, 1998:272).

In 1996, BoZ availed the receivers of K867 million to pay 6,878 depositors the initial statutory payout of K500,000 per depositor (FSSD, 1996:18) In December 1997 a dividend was declared and K332 million was available to pay 250 account holders a sum of up to K5 million per account (GRZ, 1998:272). The BoZ attributed the bank's failure to abuse of insider borrowers coupled by the ineffective Board of Directors, which was easily manipulated by one major shareholder (FSSD, 1995:10). In his submissions to a Parliament Committee, the Governor attributed the bank's failure to high levels of non-performing loans leading to negative regulatory capital as defined in the Capital Adequacy Regulations, high levels of insider borrowing, and interference by shareholders and directors (GRZ, 1998:264)

In its annual report, the FSSD reported that the failure of the bank occurred because proposals to save the bank did not materialise due to "the lack of commitment from interested parties". The two proposals included: institutional investors injecting capital into the bank and revitalising its operations and, a takeover of selected assets and liabilities by New Capital bank in a deal arranged by Bank 16 (FSSD, 1995:10). The BoZ stated that it took the following measures to avert the banks failure: provided the bank an overdraft for the purpose of meeting depositors' demands and clearing shortfalls; requested the shareholders to recapitalise the bank, disapproving branch expansion plans; directed the bank to curtail lending; directed the bank to enhance its debt recovery efforts; and removed the managing Director from office (GRZ, 1998:264)

5.5.3 Commerce Bank Zambia Limited

Commerce Bank first closed and was placed in receivership on 30 November 1995 (FSSD, 1995:10). In 1996, the BoZ provided the Receivers K518 million to pay 3,700 depositors the initial statutory payout of K500,000 per depositor (FSSD, 1996:18). The BoZ attributed the bank's failure to negative effect on the bank of the earlier closure of African Commercial Bank because of its connection to it through the common shareholding of the two banks by one shareholder, Mr Siame (FSSD, 1995:10). In his submissions to a Parliament Committee, the Governor attributed the bank's failure to under-capitalisation, over-reliance on high cost of funds, poor lending practices leading to poor asset quality, excessive connected lending, high levels of insider borrowing; and the image of the bank being negatively affected by the common shareholding with Bank 18 (GRZ, 1998:265).

The FSSD reported that the failure of the bank occurred because the "management and the Board of Directors of the bank had not come up with tangible solutions to the problems affecting the operations of the bank and its future prospects" (FSSD, 1995:10). At the end of the 90-day period of receivership the receiver, together with the bank's management formulated a plan to restructure and reorganise the bank (FSSD, 1996:19). The BoZ stated that it took the following measures to avert the bank's failure: provided the bank an overdraft for the purpose of meeting depositors demands and clearing shortfalls; requested the shareholders to recapitalise the bank; directed the bank to curtail lending; directing the bank to enhance its debt recovery efforts; directed the bank to effect a reduction in its overhead expenses; directed a shareholder to relinquish his shares; and disapproved branch expansion plans (GRZ, 1998:265). Despite its negative capital position, Commerce bank was re-opened in 1997. The BoZ approved the re-opening plans on the premise that the bank would recover a significant amount of non-performing loans. As expected, this failed to materialise. The period within which loan recoveries were to have occurred elapsed without much success. Rather than admit failure, and promptly close the bank a second time, the BoZ allowed it to operate without supervisory action until April 2000. During April 2000, it placed Commerce Bank under curatorship. Following months of recommending more stern action, such as liquidation, curatorship was the least of the actions that BoZ could have effected to take control of the bank. Receivership was the legally correct option to pursue. However, the word "receivership" was not politically palatable, hence the decision to put the bank under curatorship.

5.6.0 The 1997/98 Bank Failures

The crisis affected the remaining banks in different ways. A general loss of confidence occurred in the banking system, which favoured the foreign banks at the expense of local ones. The latter experienced unprecedented deposit withdrawals and, consequently, some faced severe liquidity problems. There was a general "flight to quality" as customers moved accounts to foreign banks, perceived as being more stable and better managed. The managerial deficiencies exhibited over the following two years worsened the declining financial performance of the local banks. Despite various regulatory and supervisory actions implemented by the BoZ following the 1995 bank failures, Zambia suffered its second set of banking failures in 1997/8 when four banks collapsed (Appendix 25). The economic impact of the four bank failures on the economy was less severe than the bank failures of 1995, because these small banks accounted for less than 5% of the industry assets and their impending closures were widely expected over an extended period.

5.6.1 Credit Africa Bank

The BoZ placed Credit Africa Bank in receivership on 28 November 1997 following the discovery of fraudulent transactions discovered in the course of a bank inspection. The BoZ attributed the bank's failure to under-capitalisation, high levels of non-performing loans, over-reliance on high cost of funds, excessive connected lending, high levels of insider borrowing; malpractice by directors; and excessive lending without adequate security or none at all (GRZ, 1998:266). Forensic accountants, Ernst and Young, later revealed several offences punishable under the BFSA, Companies Act, Penal Code, Anti-Corruption Act and the Zambia Revenue Authority Act (GRZ, 1998:272). In accordance with the requirements of the BFSA, the BoZ placed the bank in compulsory liquidation on 6 March 1998 and as at December 1998 the Receiver had paid out the initial K500,000 statutory payment to depositors through an advance from BoZ of K1Bn. The overdraft currently stood at K15.5Bn (GRZ, 1998:273).

The BoZ stated that it took the following measures to avert the bank's failure: provided the bank an overdraft for the purpose of meeting depositors' demands and clearing shortfalls; requesting the shareholders to recapitalise the bank, disapproved branch expansion plans; directed the bank to curtail lending; directing the bank to enhance its debt recovery efforts; issued instructions to limit the level of withdrawals per depositors; stationed a BoZ Inspector on-site to monitor the day to day operations of the bank; removed the executive powers of the Executive Chairman, which left him as an ordinary Chairman; and appointed an audit firm, Ernst and Young to conduct an investigative audit following findings by the BoZ Inspectors (GRZ, 1998:267).

5.6.2 Prudence Bank Zambia Limited

The BoZ placed Prudence Bank in receivership on 18 October 1997 and then into compulsory liquidation on 2 February 1998 leaving an overdraft of closure of K10.8Bn (GRZ, 1998:274). In his submissions to a Parliamentary Committee, the Governor attributed the bank's failure to high interest rates on foreign deposits, hence the high cost of funding, excessive advertising cost and overheads, inexperienced management and the family-controlled and ineffective Board (GRZ, 1998:269). The BoZ stated that it took the following measures to avert the bank's failure; provided the bank an overdraft for the purpose of meeting depositors' demands and clearing shortfalls; requested the shareholders to recapitalise the bank, disapproved branch expansion plans; directed the bank to curtail lending; directed the bank to enhance its debt recovery efforts; appointed a curator for close to two years; restricted bank overhead expenses; requested the Chairman to resign; and removing the managing Director from office (GRZ, 1998:269)

5.6.3 Manifold Investment Bank

BoZ seized Manifold Investment Bank and placed it in receivership on 4 December 1997 following persistent liquidity problems and deficiency on the minimum regulatory capital requirements leading to an overdrawn account of K667 million at the BoZ. The bank went into compulsory liquidation on 6 March 1998. In his submissions to a Parliamentary Committee, the Governor attributed the bank's failure to under-capitalisation and high levels of non-performing loans (GRZ, 1998:267). BoZ stated that it took the following measures to avert the bank's failure; provided the bank an overdraft for the purpose of meeting depositors' demands and clearing shortfalls; requested the shareholders to recapitalise the bank, directed the bank to curtail lending; directed the bank to enhance its debt recovery efforts; and stationed BoZ Inspectors on-site to closely monitor the day-to-day operations. (GRZ, 1998:267)

5.6.4 Firstly Merchant Bank

Firstly Merchant Bank collapsed following negative press reports on the seizure of certain accounts at the bank by the Drug Enforcement Commission which resulted in a bank run, liquidity strains and the bank suspension from the clearing house (GRZ, 1998:273). The bank subsequently closed on Monday 2 February 1998 leaving the BoZ with an unsettled overdraft of K5.3Bn. In his submissions to a Parliament Committee, the Governor attributed the banks failure to under-capitalisation, malpractice by the Directors and negative press reports leading to a run on the bank's deposits (GRZ, 1998:265). BoZ stated that it took the following measures to avert the bank's failure; provided the bank an overdraft for the purpose of meeting depositors' demands and clearing shortfalls; requested the shareholders to recapitalise the bank, disapproved branch expansion plans; directed the bank to curtail lending; directed the bank to enhance its debt recovery efforts; and removed the managing Director from office (GRZ, 1998:264)

5.7.0 Merged Banks

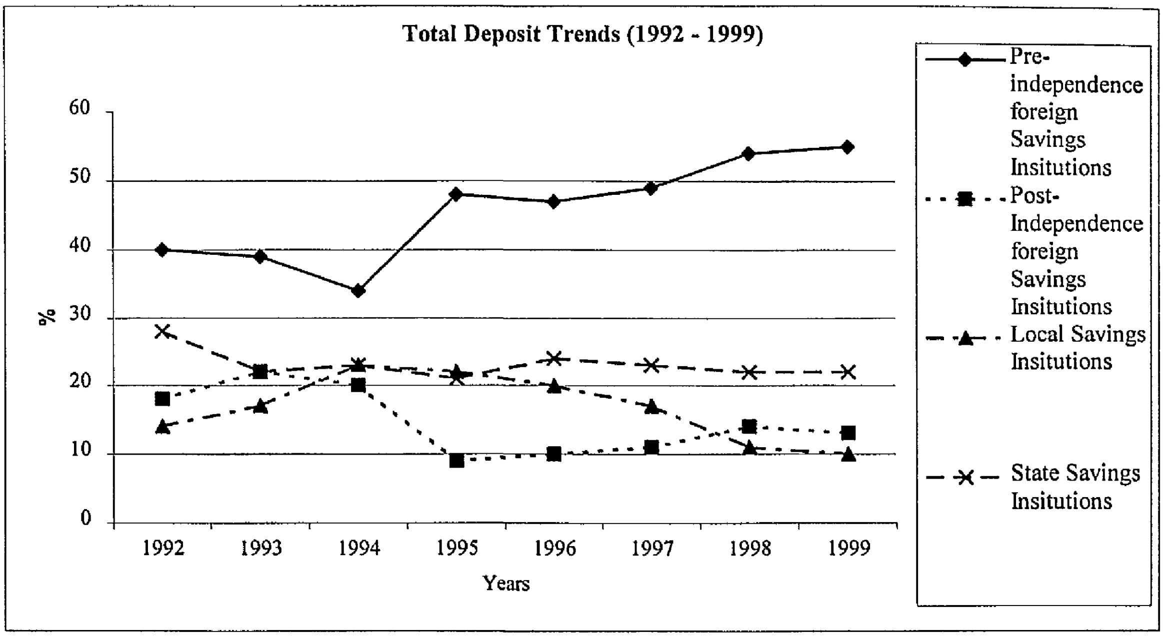
ZNCB took over Chase Trust Bank on 1 December 1997. The BoZ stated that it took the following measures to avert the bank's failure; requested the shareholders to recapitalise the bank, facilitated the takeover of the bank by Zambia National Commercial Bank, stationed BoZ inspectors on-site to closely monitor the banks daily activities; and directed the bank to effect a reduction in their overhead expenses (GRZ, 1998:265). Safe Deposit Bank merged with Firstly Merchant Bank on 31 December 1996 to become Firstly Merchant Bank (Zambia) Limited. The BoZ stated that it took the following measures to avert the bank's failure; provided the bank an overdraft for the purpose of meeting depositor's demands and clearing shortfalls; requested the shareholders to recapitalise the bank, disapproved branch expansion plans; and facilitated the merger with Firstly Merchant Bank (GRZ, 1998:264)

5.8.0 Recent Studies on Banking Sector Instability in Zambia

After the 1995 and 1997/8 bank failures, the pre-independence foreign banks continued to dominate the banking sector with respect to deposit size. Figure 13 shows that in the period 1994-1999, the total deposits market share of pre-independence foreign banks grew from 35% to well over 50%. Local banks, conversely, have lost the largest proportion of the market with a decline from 25% of total deposit market share in December 1994 to less than 10% in December 1999.

That the foreign banks dominate the banking system has not been of particular academic interest and study. Recent studies of the Zambian financial system have focused on two matters, namely, the causes of the 1995 and 1997/8 bank failures and the BoZ's effectiveness in regulating and supervising the banking system. There are different explanations for the causes of banking sector instability (Brownbridge, 1996:12-13, 1998:9-15; Pamu 1996; Chimuka, 1997; Simatele and Ndulo, 1998:12-14; Maimbo 2000:289-298, Nchite, 2000), and BoZ's regulatory performance (Brownbridge 1996:16-19, 1998:18-21; Simatele and Ndulo, 1998:16-21, Mudenda 1998, Maimbo, 1998; Chiumya; 1999).

Figure 13 Total Deposit Trends (1992-1999)



Source: BoZ

5.8.1 Causes of bank failures in Zambia

The most cited academic work on bank failures in Zambia, however, is that by Brownbridge (1996, 1998). He identified four causes of financial distress among local banks in Zambia, namely, insider lending, lending to high-risk borrowers, macro-economic instability and liquidity support and prudential regulation. He argued that many local banks established in Zambia closed because of "insolvency and illiquidity caused by non-performing loans. The severity of bad debt problems was attributable to problems of moral hazard and adverse selection" (Brownbridge and Harvey, 1998:21). He observed that, firstly; moral hazards contributed to the highly imprudent and in some cases, fraudulent lending strategies of many of the failed banks. Secondly, that a significant proportion of the non-performing loans were due to insider loans, often unsecured, in high-risk ventures such as real estate. Thirdly, that some of the failed banks also suffered from adverse selection of their clients, due to the high interest rates which the local banks charged to compensate for their higher cost of funds (Brownbridge, 1998:13-14). Further, poor loan evaluation techniques impaired the quality of the loan portfolio. Finally, severe macro-economic instability exacerbated the adverse incentives on borrowers and the difficulties banks faced in considering the viability of loan applications (Brownbridge and Harvey, 1998:21).

Using the Meridien BIAO Bank as an example, Brownbridge (1996) was also critical of the BoZs enforcement of banking regulations and supervision guidelines. He highlighted the "inordinately long delay in taking action against Meridien Bank because it continued to receive financial support long after it must have become apparent that the bank was in serious difficulties (other banks stopped lending to Meridien Bank months before it closed)" Brownbridge, 1996:18). Secondly, he observes that BoZ's authority to deal with the crisis appears to have been severely constrained by the government, which suggested that the newly enacted BFSA had done little to clarify their respective roles. Brownbridge (1998:9-16) discusses in detail the weaknesses in the licensing process, low minimum capital requirements and large loans.

Pamu (1996), in his discussion of the reasons for financial sector instability in Zambia, focused on the asymmetric information problems and the resulting moral hazards and adverse selection problems in Zambia. He argued that lack of a deposit insurance scheme, adverse macro-economic policies, high concentration of credit in large conglomerates, and weak regulatory structures exacerbated the asymmetric problem. In particular, he questions the quality of the licensing procedures in place in the years preceding the bank failures. He states that "companies are opening up banks which are used as vehicles for money laundering and when these companies begin facing financial difficulties, the banks collapse along with them" (Pamu, 1996:29). Further, he contended that the problem with the financial sector in Zambia was that a large share of the credit had been channelled to perennially loss-making firms, a problem which was worsened by a premature increase in nominal interest rates (Pamu, 1996:43). However, because his interest was primarily the effect of financial liberalisation on the credit market, he did not provide detailed evidence to show how the factors he noted contributed to financial sector instability or how prevalent they were.

Nchite (2000) conducted an econometric study to argue that macro-economic instability and poor management were responsible for the bank failures that occurred in Zambia. As a proxy for the quality of management, he used the extent to which the bank's management charges were above market rate interest rates on their loan portfolio. He did this on the assumption that higher rates than market interest rates increased the risk of adverse selection and moral hazard, which reduced the quality of prospective borrowers for the financial institution. The result was higher levels of non-performing loans, which then led to bank failures.

Nchite (2000) concluded that a 1% increase in interest rates correlated to a 0.538% increase in non-performing loans 12 months later. He also concluded that a 1% increase in the inflation rate correlated to a 1% increase in non-performing loans in the same month. He suggests that interest rates and inflation rates influenced the level of non-performing loans although the latter had a stronger impact. Therefore, he argues that macro-economic instability as measured by price (consumer price index) is: "a necessary condition for the occurrence of non-performing loans. However, the bank-specific characteristics such as the managerial decisions of the appropriate rate of lending rate to effect are the sufficient condition to raise non-performing loans to levels likely to cause bank failures" (Nchite, 2000:43).

In the face of significant informational problems, Nchite (2000) managed to conduct the first formal quantitative analysis of the scale of non-performing loans in the months preceding the 1997/98 bank failures. Before the enactment of the BFSA (1994), there was no definition of what a non-performing loan was. Thereafter, the earliest comparative records available are from 1996. Therefore, Nchite (2000) used monthly non-performing loan figures for the period January 1996 to September 1999. Herein lies one of the study's major weaknesses. Firstly, during that period, there were significant inconsistencies in the accounting treatment of non-performing loans. Secondly, most of the banks that failed in 1997/98 had applied and received exemptions from classifying some of their most problematic loans for a period of 12 months under the classification and provisioning regulations. Most seriously though, is that by January 1996 when Nchite started his regression, all the banks that failed in

1997/98 already had very high levels of non-performing loans. In fact, by then, the BoZ had instructed some of the banks to stop all lending because of their adverse financial position. It is clear that Nchite (2000) was heavily constrained in his analysis by the non-availability of data. In his analysis of non-performing loans, he did not distinguish between different forms (insider loans) or the size (large loans) of the loans. Neither did he consider the role the central bank played before and during the bank failures because the quantitative proxies do not exist. Instead, he settled on inflation and interest rate variables for which he could find a "suitable sample" for his model.

The cost of the bank failures to the BoZ has been high, both financial and in terms of its reputation and credibility as regulator and supervisor of the financial sector. The 1997 BoZ Annual report indicates that the overdrawn accounts for banks in liquidation as at 31 December were in excess of US$30 million (Table 13).

Table 13 BoZ Overdrawn Accounts of Closed Banks

Name of Bank	**1997 K'000**	**1997 US$'000**
Meridien BIAO Bank (Zambia) Limited (in liquidation)[1]	19,242,686	13,804
Bank 4 Zambia Limited (in liquidation)	10,825,252	7,766
Bank 12 Zambia Limited (in receivership)[2]	11,022,000	7,907
Manifold Investment bank Limited (in liquidation	667,257	479
Zambia Export and Import bank Limited (in liquidation)	459,439	330
	42,216,634	**30,286**

Source: BoZ Annual Report 1997 **Notes:** [1]the BoZ held security valued at K11, 000 million against this debt. [2]an amount of K4,516 million due from the Bank was secured by assets held by the receiver and mortgages on property. [3] Exchange rate as at 31 December 1997 K/US$ 1,393.97

However, an anonymous respondent placed the BoZ's and the government's overall exposure to the failed banks in excess of K100Bn. The amount included Government loans advanced to failed banks (K16.7bn), deposits of Government ministries (K12.2bn), commercial banks overdrawn positions at BoZ (K67.1Bn) and BoZ advances to pay depositors the statutory K500,000 (K7.1bn). These estimates do not include the cost of court cases emanating from both the 1995 and 1997/98 bank failures (Box 4).

Box 4 Court Cases Relating to the 1995 and 1997/8 Bank Failures

1. Simeza Sangwa Associates and Another Vs. Meridien BIAO Bank Limited and BoZ

This is a case involving funds locked up in Meridien. The funds were paid out in full but the plaintiffs have insisted that they wish to proceed with the matter.

2. R B Devalia Vs BoZ

This is a set of two new cases wherein Mr Devalia is challenging the Bank's placing of caveats on several pf his properties. The Bank placed caveats on Mr Devalia's properties to stop him from dissipating his assets. The two cases were consolidated into one and heard by the high court, however, the presiding Judge declared an interest in the matter and was unable to deliver a ruling.

3. The People Vs B C Muntanga and others

This is a private prosecution instituted by the BoZ against the directors of Credit Africa seeking to enforce breaches of the directors under the BFSA. The hearing of the case has been split into two. One case has four counts under the penal code, which is continuing in the magistrates Court. Trial commenced in November and continues. The second case involves about twenty counts, which are under the BFSA. These were transferred to the High Court and a nolle prosequi was entered during the last Criminal sessions as no certificate to prosecute has been issued by the Director of Public Prosecutions (DPP). The charges have since been redone with the assistance of the DPP and his consent to the prosecution obtained. The hearing of the case has commenced.

4. BoZ Vs Muntanga, Banda, Z and P Nizam

This is a case wherein the Bank sued the former directors of Credit Africa Bank seeking to enforce personal guarantees given to the Bank by the said directors. The Bundles of documents have been filed into the Court and the parties await allocation of a date of hearing. The bank was given leave to serve documents out of jurisdiction on Mr Nizam and have since done so.

5. P Mangungu and Others Vs. Meridien Bank

This is a claim by former employees of Meridien Bank Limited for benefits from the bank.

6. BoZ Vs. Chibote Meat Corporation

This is a case in which the Bank was seeking to enforce a debenture and floating charge over the assets of Chibote Meat Corporation Limited given to the Bank as security over Chibote Meat Corporation abattoir. Judgement was delivered against the Bank in 1998. The Bank appealed in this case to try to obtain a retrial and present fresh evidence. The appeal was heard in Kabwe on 22 April 1999. Judgement was delivered on 14 July 1999 in favour of the Bank. The High Court judgement was set aside and the Bank was given possession of the Chibote Meat Corporation abattoir. The Bank has since taken possession of the abattoir and is carrying out an inventory of the assets of the corporation in readiness for sale of the same.

7. Chibote Limited and Others Vs Meridien BIAO Bank Zambia Limited

This is a matter in which several of the Chibote Group Companies sued Meridien Bank Limited for certain properties, which they allege the BoZ caused to be fraudulently transferred from them to the closed bank without the group companies' consent or authority. Judgement was pronounced in favour of the plaintiffs. The bank appealed against the High Court Judgement to the Supreme Court requesting a retrial. The hearing took place at Kabwe on Wednesday, 21 April 1999 where the Supreme Court ordered a retrial of the case by the High Court. This means the Bank will now be able to present new evidence before the court. The parties are in the process of preparing their documents for filing in the Supreme Court. Trial has been set for 18th October. The other party has made fresh overtures for settlement out of court, which is being studied.

8. R K Mushota Vs. Receiver/Liquidator of Bank 12 Limited, the BoZ and the Attorney General

This is a claim by Dr Mushota for monies stuck in Bank 12 Limited. The ruling of the Supreme Court on the hearing of the Defendant's application against an injunction obtained by Dr Mushota against the liquidation proceedings of Bank 12 Limited is still awaited.

Source: BoZ

Although the liquidator would pay towards reducing the bank's indebtedness both to Government and to BoZ, the liquidation process has been slow due to: a depressed property market; a tight monetary economy; a slow judicial process; protracted legal battles between the liquidators and depositors; high cost of the liquidation process. The prospects for full recovery of these funds are therefore pessimistic in most cases. In other cases such as in the case of Meridien and Bank 12, partial recovery may be anticipated but this will not be in the near future as the liquidation process in Zambia has been extremely slow. And because the government and the BoZ rank as priority creditors respectively under Section 107 of the BFSA, it was initially unlikely that depositors would be compensated beyond the statutory payout of K500,000 per depositor.

An immediate consequence of the bank failures was a BoZ-commissioned study to establish a deposit insurance scheme in Zambia. The 1997 study made recommendations (Box 5), which were included in the initial Banking and Financial Services Bill 1999. However, due to differences in opinion over funding and the level of operational independence from the BoZ for the scheme, the Zambia Deposit Insurance Bill is yet to receive parliamentary and presidential approval.

Box 5 Key Proposals for a Zambian Deposit Insurance Scheme

1. **Membership**: Compulsory for all commercial banks

2. **Organisation**: An independent corporate body. However, in the initial period the scheme had to be a part of the BoZ, which would provide financial and logistical support until the deposit, fund became self-sustaining.

3. **Fund Capital**: The initial capital contribution of to be funded by a capital injection from the government and a long term loan from the BoZ.

4. **Premiums**: All commercial banks to pay a premium to the fund of bi-annually plus an annual assessment based on the level of deposits.

Source: FSSD

5.8.2 The effectiveness of BoZ regulation and supervision

Although the deposit insurance scheme will improve the compensation process for banks that fail, and may contribute to maintaining financial sector stability, there are significant questions that remain unanswered regarding the BoZ's handing of the bank failures.

Firstly, in what ways did regulatory failure contribute to the collapse of the banks? To What extent did the BoZ fail in its responsibilities when it came to licensing, monitoring, supervising and closing financially-distressed commercial banks? Were the weaknesses in the licensing procedures for new commercial banks significant contributing factors to the bank failures of 1995 and 1996/97? Was there insufficient regard given to the quality of owners, directors and managers of new commercial banks, the minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners?

Secondly, the bank failures of 1995 and 1997/8 did not occur suddenly. The failures were a culmination of a long process of mis-management, breaches of the law and financial deterioration. To what extent was the BoZ aware of the financial problems and violations of the law of the failed banks? Did the BoZ have the necessary legal authority to force offending banks to address the problems that it identified? Were the banks able to ignore the BoZ because of their political connections? To what extent did the political and economic environment prevent the BoZ from resolving the emerging banking problems early? How long did it take the BoZ to close under-capitalised and insolvent banks? What were the reasons for the delay? Did it lack the legal authority to intervene and close the banks? Was there political interference to prevent banks the BoZ from carrying out its duties? Did the BoZ delay the regulatory process delayed simply because of administrative factors such as the availability of inspectors to conduct the required off-site and on-site examinations; the lack of adequate skill in detecting falsified bank returns and financial statements; and the inadequacy of the accounting standards at the time?

The BoZ has not prepared any formal reports on the recent bank failures, outlining their history, causes of failure, and policy lessons. Only at a meeting 20 June 2000 was the Regulatory Policy and Financial Analysis Division requested to prepare reports on banks in liquidation, outlining their history and issues that leading to their closure. The only reports that have been prepared are Receivership Reports, Liquidation Reports, specially-commissioned Forensic Accounting Reports, Ministerial reports, Parliamentary Reports and media reports.

Except for media reports, the other types are not usually in the public domain. Additionally, because the BoZ has commissioned them all, none of them has critically evaluated the role the BoZ played in detecting and handling the bank failures. The Receivership and Liquidation reports tend to focus on the disposal of assets and payment of depositors and other creditors. The Forensic Accounting reports commissioned by BoZwere prepared with the aim of securing the prosecution of bank owners and managers suspected of conducting the affairs of their banks in a fraudulently. These are highly confidential documents to which the BoZ did not grant access for the purposes of this study. The Ministerial and Parliamentary documents are informative reports intended to keep the M/Finance and Parliament abreast with banking sector developments. Although they detail the BoZ's response to the emerging bank failures and the actions that the BoZ took with respect to each bank, the reports do not chronicle the timing of the BoZ's actions nor do they evaluate the efficacy of its choice of regulatory and supervisory instruments. The BoZ, in its public statements to the press and to parliament has always listed the various actions it took to avert bank failures. However, it has never added a time dimension to the occurrence of financial distress in the banks that failed and the timing of the regulatory and supervisory actions that it imposed on the banks. Therefore it has not been possible to effectively evaluate the efficacy of the BoZ's actions.

Recent academic studies on the 1995 and 1997/8 banking failures cite weaknesses in the prudential regulations and banking supervision practices as important considerations in discussing causes of financial distress in the failed banks

(Brownbridge, 1996:16-19; 1998:15-16; Simatele and Ndulo, 1998:16-21, Mudenda 1998, Maimbo, 1998; Chiumya; 1999,). However, the evidence they provide is largely anecdotal and has not been subject to a comprehensive and systematic evaluation.

Mudenda (1998) conducted an evaluation of the effectiveness of prudential regulations and banking supervision in Zambia using her experiences as an Assistant Director in the FSSD, plus the available literature on prudential regulation and supervision in Zambia. Citing the work of Brownbridge (1996, 1998), she attributed management failure as the main reason for the 1995 and 1997/98 failures, suggesting that some banks management had been "pursuing imprudent banking policies and strategies and could not find a niche to position their banks in the competitive financial market" (Mudenda, 1998:55). She also indicated that all the new banks opened their branches in Lusaka, which may have created fierce competition with the established banks. Further, she argued that the closure of three banks in 1995 led to a loss of confidence in the small local banks. Mudenda (1998), however, did not scrutinise the weaknesses exhibited by the Central Bank in its handling of the failures. Instead, she merely refers to the BoZ's failure to restructure and/or to merge under-capitalised banks before financial sector reforms stating that: -

> "The large number of bank failures suggest that these banks should have been restructured before financial sector reforms were implemented. Out of the three banks that were closed in 1995, one bank has been restructured and two banks, have been liquidated. This seems to suggest that the Central Bank delayed in closing down the liquidated banks until their net worth fell below zero and hence could not be restructured or sold." (Mudenda, 1998:56)

Although she alludes to the problem of regulatory failure in terms of regulatory forbearance, she does not examine why regulatory forbearance occurred. She recommends the introduction of a deposit insurance scheme and streamlining the activities of the FSSDs then four division. However, she does not state in her analysis, whether the absence of a deposit insurance scheme or the administrative structure of the FSSD contributed to the regulatory forbearance of 1995 and 1997/98. Earlier, Chimuka (1997) was more assertive in drawing a direct relationship between the bank failures of 1995 and the quality of the BoZs supervision of commercial banks. Using questionnaires and face-to-face interviews with officials from the BoZ Supervision Department, the Economics Association of Zambia and the Zambia Institute of Certified Accountants, he tried to determine whether a relationship existed between the bank failures and the BoZ's supervision of commercial banks, concluding:

> "Though an adequate regulatory framework was put in place, its enforcement through BoZ supervision was poor. Several factors seem to have contributed to this, namely: - the supervision department at BoZ is seriously understaffed, the institutional and supervisory capacity of the Central Bank is weak, the bank supervision department seems to lack the risk management expertise which is vital for inspection and surveillance, there is a lack of political independence of the BoZ, many of the problems that led to the failures had already taken root when the BASE, 1994 came into effect" Chimuka (1997:48)

There are two similarities in work of Mudenda (1998) and Chimuka (1997). Firstly, Chimuka (1997:47) argues that financial liberalisation in Zambia was premature and should have been delayed until the macro-economic stability had been achieved. In this way, lower nominal interest rates would have reduced the rates of loan defaults by borrowers, and thus helped to protect the bank's loan portfolio's. Secondly, like Mudenda, he refers to the long delay in taking action against Meridien BIAO Bank (Chimuka, 1997:40). Unlike Mudenda (1998), however, he then suggested, that there were "serious questions about the political independence of the BoZ to take decisive action when it is required". While Chimuka's (1997) work attempts a formal assessment of the BoZs role in the 1995 failures, its findings are weakened by the lack of access to primary data held by the BoZ on the banks that failed (Chimuka, 1997:10). Consequently, although he raises the issue of political independence of BoZ, he is unable to substantiate his claims and relies, instead, on a substantial amount of anecdotal evidence from respondents.

Unlike Chimuka (1997), Chiumya (1999) had access to more BoZ documents and used the Basel (1997) Core Principles of Effective Banking Supervision guidelines to evaluate the effectiveness of the BoZ's regulation and supervision of the banking system. Chiumya's study, which was largely based on an earlier BoZ self-assessment exercise to determine the extent to which the central bank had implemented the Core Principles, had three objectives: Firstly, to establish whether the BFSA, and its accompanying regulations, were sufficiently comprehensive for regulating the banking sector. Secondly, to determine whether the BoZ had adequate financial and human resources to discharge its obligations and; lastly, to determine the degree of political will and government support for BoZ decisions (Chiumya, 1999:4).

Chiumya (1999:42) discovered that although the legislation governing the banking sector was relatively comprehensive, experience in its application had highlighted a number of weaknesses in its enforcement. She noted that there were "instances where directives have been issued but these have been ignored by the respective bank and the supervisor has not taken further action (other than repeating the directive)" (Chiumya, 1999:36). She also acknowledges the existence of external pressure on the BoZ's actions without giving details on the source and form of the external pressure when she states "External forces have also hampered enforcement. There have been cases where the BoZ has had to reserve decisions made undermining its credibility even further" (Chiumya, 1999:36). She also found that despite the capacity building programme that started in 1994, the conditions of service and working environment were not conducive. Salary increases had not been commensurate with inflation resulting in a significant fall in real income, and the general worsening of the terms and conditions of service for central bank employees, which resulted in low morale and apathy. Employees devoted much time and energy to finding alternative sources of income, diverting their attention from the job at hand. It also makes inspectors more susceptible to kickbacks for over-looking breaches. Chiumya also draws attention to poor working conditions in which inspectors had to share computers terminals and the furniture was old and dilapidated. Further, cutbacks on training had a knock-on effect on the calibre of inspectors, especially new recruits. Administratively, Chiumya (1999:38) found that communication within the FSSD was very poor. Frequently, a division in the department requested information from a bank that another division already held. The lack of communication resulted in wasteful duplication of effort, and decision-making without the full information available to the central bank or in isolation, without other divisions knowing. Further, in her assessment of the level of political will and government support, Chiumya (1999:40) concludes that:

> "...the central bank is by no means independent ... the department [FSSD] does not enjoy much operational independence and has been subject to a number of external pressures, especially with regard to bank closures, the most notable being the Meridien BIAO Bank Closure ..."

She suggests that politicians are particularly sensitive to bank closures as their tenure of office is often dependent on the votes of the small depositors. Overall, Chiumya's (1999) work is revealing in its discussion of the internal operations of the FSSD. Because of its extensive use of an FSSD self-assessment document it is useful in presenting the department's own view of its strengths and weaknesses. However, like Mudenda (1998) and Chimuka (1997) there is little in the way of primary evidence in the study to support of her many assertions, findings and conclusions. Undoubtedly she refers to incidents she witnessed during her working experience with the BoZ, but, she does not document these within the study itself. For example, while she notes "external forces hampering enforcement" she fails to indicate the prevalence, form or frequency of these forces , and how they affected the bank's independence.

Although Chilembo (1999) referred to the degree of the BoZ's monetary independence, its discussion on the BoZ's operational and political independence highlights some of the issues that may have influenced the work by Chiumya (1999). As a proxy for central bank independence, he used the governor's turnover rate alongside the official exchange rate, treasury bill rate, broad money supply as measured by M2 and the gross domestic product in an ordinary least squares regression, on data from 1964-1968.

The regression results showed that all the variables regressed against inflation had strong t-probability values, including that of Governor's turnover. However, as Chilembo (1999:46) himself acknowledges, although the turnover rate seemed significant, it may have been because the regression included the liberalisation period

1992-1994 when the government was anti-inflation and the central bank had a "conservative" governor. Before that, the governor's term of office had no bearing on inflation. He further acknowledges that it is very difficult to quantify the governor's term of office and the degree to which that term contributed to the lowering of inflation, concluding that the debate is more theoretical than it is practical.

Nevertheless, in his qualitative discussion, Chilembo (1999:48) observes that the central bank lacked the required infrastructure to support its independence. In particular, he expressed concern that the governor's political insulation was not sufficient. He recommended that a broader constituency of organisations must appoint the governor and that the governor's term of office should be longer than the presidential election cycle. He also recommended that the public subject the Governor's actions to a higher level of public scrutiny than was the case. Unfortunately, the qualitative discussions of Chimuka (1997), Mudenda (1998) and Chiumya (1999) are largely anecdotal and not based on systematically-documented primary data.

5.9.0 Conclusion

Chapter five discussed the recent history of the Zambian financial system and its effect on the government's approach to banking regulation and supervision; the nature of the 1992/93 financial sector reforms and the development of the financial sector after those reforms, and; the 1995 and 1997/98 bank failures and the literature that the bank failures have generated.

The Chapter discussed how persistent government interference in the economy in general and the financial sector in particular, led to an inefficient and non-competitive market, interest rate controls, high reserve requirements, deteriorating macroeconomic conditions, political interference, negative interest rate policies and credit allocation directives, an inefficient payments system, and inadequate legal and accounting standards which reduced the banking system's efficiency and its ability to perform its financial intermediation function [5.2.0]. During this period, banking regulation and supervision was one of benign neglect. Since foreign bank subsidiaries dominated the banking sector, the BoZ relied on its home regulators to monitor the performance of branches based in Zambia.

The 1992/93 financial sector reforms, however, promised a more profitable and viable financial sector. Financial sector liberalisation which included the restructuring of government-owned financial institutions and the liberalisation of foreign exchange and interest rates resulted in higher nominal banking profits and attracted new banking sector entrants. However, as inflation and exchange rates began to stabilise in the last quarter of 1993 and 1994, the local banks found it difficult to maintain earlier levels of profitability. In an attempt to maintain previous performance levels, the banks are said to have begun to disregard prudent banking loan procedures and security arrangements. These developments culminated in the closure of three banks in 1995 [5.5.0], and a further five banks in 1997/98 [5.6.0]. The bank failures were attributed to similar problems, particularly, high levels of non-performing loans, excessive connected lending to related parties and insider borrowing, incompetent management coupled with ineffective boards of directors, and foreign exchange exposure risks, and critically, a weak and ineffective regulatory and supervisory framework. In its defence the BoZ, in its report to a Parliamentary Committee, stated that it had instituted a wide range of remedial and rehabilitation measures, which included providing financial assistance, replacing management, requesting shareholders to recapitalise capital-deficient banks, disapproving branch expansion plans, prohibiting new loans, directing banks to reduce their overheads, limiting the level of depositor withdrawals, appointing curators and directing banks to enhance their debt recovery efforts.

There are different interpretations about the causes of the bank failures [5.8.1] and the appropriateness of the BoZ response to them [5.8.2]. Despite differences in their methodological approach, the limited literature shares four similarities.

1. Except for Nchite (2000), there is a dearth of quantitative research and analysis on the two subjects. This is understandable given the general quality of financial records before the 1992/93 financial reforms and the BoZ capacity building exercise that started in 1994. Subsequent to these two events/processes, access to quantitative data remains constrained due to existing confidentiality concerns.

2. Despite the extensive use of qualitative data in all the studies, it is largely anecdotal, and in cases where it is not, the studies often do not explicitly indicate how prevalent the examples used were. Discussions with the various authors of the studies reviewed, revealed that this was largely due to the confidential nature of the information, most of the qualitative data, like quantitative data, not being in the public domain.

3. Despite the above data concerns, general agreement exists on the principal causes of both the 1995 and 1997/8 bank failures, namely, macro-economic instability, poor management, insider loans, large loans and weak enforcement of banking legislation, regulations and guidelines.

4. All the studies are similar in that none of them makes a deliberate attempt to establish the factors that the BoZ considered in its interpretation and enforcement (or non-enforcement) of the banking legislation and regulations at its disposal. The recent studies still leave a number of unanswered questions that are at the core of establishing the fundamental weaknesses in the design, development and implementation of banking regulation and supervision practices in Zambia. Which aspects of the methods previously used by the BoZ to assess the quality of owners, directors and managers of new commercial banks, the minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners were flawed? Did the BoZ have the capacity and resources to detect financial mis-management, breaches of the law and financial deterioration in the banks that failed? How

prevalent was political interference in the BoZ's regulation and supervision of the banking sector? In what form, and how frequent, was this pressure?

The next three chapters will seek to address some of these outstanding research questions through a formal, detailed evaluation of the BoZ's actions. Despite the recent failure of local banks it is important that the BoZ does not discourage their registration. Local banks can provide services that foreign and Government banks are either unwilling or unable to supply, and can inject the much-needed financial competition in the financial sector. They extend access to individuals and small businesses that have trouble relating to the formal banking sector. Private sector deposit growth in the early 1990's occurred mostly amongst local banks, especially Merdien BIAO Bank, which provided longer opening hours, shorter queues, higher deposit rates and/or lower minimum balances, shorter and quicker bank account opening procedures, and quicker and more personalised services (Brownbridge, 1996:11). Further, unlike foreign banks, they invested in the rural sectors where the latter were either divesting from that market altogether or maintaining, but concentrating on corporate clients. The key to minimising bank failure risk is not in discouraging their registration, but rather in ensuring their compliance to prudential regulations relating to licensing (Chapter Six), unsafe and unsound banking practices (Chapter Seven), and intervention and closure (Chapter Eight).

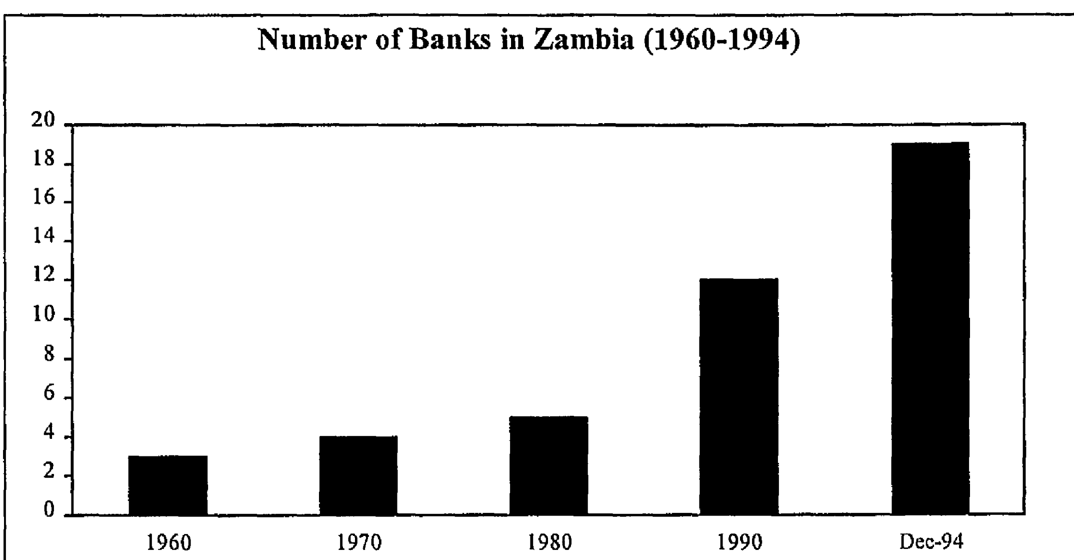
CHAPTER SIX

EXPLAINING REGULATORY PERFORMANCE: ENTRY REGULATION AND SUPERVISION PRACTICES

6.1.0 Introduction

Chapter Six presents the thesis findings on the design, development and implementation of bank licensing policies and procedures in Zambia between 1984 and 1994. This chapter is particularly important because all the banks that failed in 1995 and 1997/8 obtained banking licences during this period. Figure 14 and Table 14 show that between 1980 and 1994, the BoZ registered no less than 19 new banks. Of the 19 banks, three never commenced operations and 11 have since failed.

Figure 14 Zambian Banking Industry Growth



Source: Bank licensing Working Papers

Table 14 Banks Licensed in Zambia (1906-1994)

No.	Name of Bank	Year of Incorporation	No. of Branches
1	Standard Chartered Bank	1906	23
2	Barclays Bank	1918	39
3	Stanbic Bank	1956	5
4	Zambia National Commercial Bank	1970	40
5	Citibank	1979	1
6	Meridien BIAO Bank	1984	13
7	Indo-Zambia Bank	1984	6
8	African Commercial Bank	1984	5
9	Finance Bank	1984	28
10	Manifold Investment Bank	1987	1
11	Zambia Export and Import Bank	1987	1
12	Co operative Bank	1989	2
13	Commerce Bank	1989	1
14	Union Bank	1991	13
15	Cavmont Merchant Bank	1992	1
16	Firstly Alliance Bank	1992	1
17	New Capital Bank	1992	4
18	Firstly Merchant Bank	1992	0
19	Mercantile Bank	1993	1
20	ITAL Bank	1993	0
21	Continental Bank	1993	0
22	Safe Deposit Bank	1993	0
23	Prudence Bank	1994	1
24	Credit Africa Bank	1994	1
	TOTAL BRANCHES		**188**

Source: Bank Licensing Working Papers

The Chapter provides evidence of insufficient regard to the required minimum bank capital, the financial condition, resources and history of the applicants, the character and experience of major shareholders and directors and the convenience and needs of the economy. Section 6.2 examines the methods used to establish whether the applicants met the minimum capital requirements. Section 6.3 considers the procedures for evaluating the financial condition, resources and history of the applicants. Section 6.4 discusses the criteria used to determine the character and experience of major shareholders and directors. Section 6.5 focuses on the regulatory attempts to ascertain the convenience and needs of the community served by each banking licence and Section 6.6 reviews the guidelines used to analyse the prospects of the profitable business operations of the proposed bank. Finally, Section 6.7 documents the 1994 banking licence reforms while the chapter's conclusions are contained in Section 6.8.

6.2.0 Minimum Capital Requirements

The study identified five banking practices, which indicate that between 1984 and 1994, there was insufficient regard given to the level and quality of capital of the new banks entering the sector. Firstly, throughout that period, the MoF, and later the BoZ, focused on the applicant's satisfaction of the minimum legal capital requirement without consideration of the economic and business capital required to achieve stated business objectives. This is particularly important because, although the minimum capital requirement increased to K20 million from K2 million, inflation had reduced the real value of the minimum requirements to around US$300,000 in 1991, and a little more than US$50,000 by 1994 (Brownbridge, 1996:9, 1998:5)

Table 15 Minimum Capital Requirements (1985-1994)

Year	K'm	US$'m
1985	2	0.6
1988	2	0.2
1991	20	0.3
1994	1250	1.9

Source: Brownbridge (1998;5)

Secondly, when required to do so, the majority of banks merely evidenced the availability of the required minimum capital by way of a letter from an existing bank confirming that it held an account on behalf of the promoters to the sum of the required capital at the time (Table 16:[Bank 18/D/1][Bank 11/D/3][Bank 14/D/2] [Bank 13/D/16][Bank 9/D/1][Bank 4/D/1][Bank 2/D/2][Bank 3/D/1]). In none of these cases did the Registrar obtain an independent confirmation of the bank balance from a third party such as the applicant's external auditors.

Thirdly, with the exception of one bank (Table 16: [Bank 18/D/1]), none of the applicants, who used this form of confirmation, obtained a letter of confirmation from one of the larger and more established banks. In fact, five of the nine banks that provided issues letters of confirmation later failed themselves.

Fourthly, Special Investigations Team for Economy and Trade[12] once arrested one of the directors who had obtained and used one such letter on charges of "false representation" on the amount of capital he had for opening his bank (Table 18:[Bank 14/D/3]). Despite the same bank submitting three different letters from three different banks during the licensing process (Table 16: [Bank 14/D/2][Bank 14/D/21][Bank 14/D/22] the MoF favourably considered the application.

Lastly, in at least five cases (Table 16:[Bank 25/D/1][Bank 7/D/1][Bank 22/D/1][Bank 10/D/1][Bank 16/D/1]), the applicants only evidenced the existence and availability of capital with a statement of authorised or paid-up capital signed by their directors. The registrar did not request any third party confirmation from the bank's auditors. In one case (Table 16:[Bank 12/D/1]), one bank used a photocopy of a debenture receipt issued by a leasing company owned by the bank licence applicants. In another, the Registrar granted a licence to a bank on the promise that its shareholders would remit funds to Zambia once the owners received the licence (Table 16:[Bank 5/D/1]). Although records indicate that the BoZ had "evidence to the effect that funds to the amount of K2m were held in the pipeline awaiting remittance abroad", there is no subsequent evidence to confirm that the applicants ever remitted the funds to Zambia.

Individually, none of the above matters necessarily confirms weaknesses in the licensing process. However, viewed collectively, they provide sufficient reason to question the sufficiency of the MoF policies and procedures for evaluating minimum capital requirements as an adequate criterion for confirming the level, sufficiency and quality of capital for each bank application.

[12] The Special Investigations Team for Economy and Trade was an organ of the state security system that specialised in detecting and prosecuting cirminal violations of an economic nature such as foreign exchnage controls, fraud, and tax evasion. The team was disbanded when economic liberalisation programs started in the country.

Table 16 Minimum Capital requirements

Year	Bank (BOLD: failed bank/revoked license)	Evidence of compliance with minimum capital requirements	Issuing Institution	Amount
1980	**Bank 25**	Statement of authorised capital [Bank 25/D/1]	Bank 25	K2m
1984	**Bank 5**	Letter of confirmation [Bank 5/D/9]	BoZ	K2m
1984	Bank 7	Statement of paid up capital [Bank 7/D/1]	Bank 7	K2m
1984	**Bank 18**	Confirmation of bank balance [Bank 18/D/1]	Bank 26	K2m
1986	Bank 11	Confirmation of bank balance [Bank 11/D/3]	Bank 25	
1989	**Bank 14**	Confirmation of bank balance [Bank 14/D/2]	Bank 11	K20m
		Confirmation of bank balance [Bank 14/D/21]	Bank 7	K21m
		Confirmation of bank balance [Bank 14/D/22]	Bank 5	K22m
1989	**Bank 13**	Statement of paid up capital [Bank 13/D/1]	Bank 13	K2m
		Confirmation of bank balance (1993) [Bank 13/D/16]	Bank 27	K20m
1992	**Bank 9**	Confirmation of bank balance [Bank 9/D/1]	Bank 18	K20m
1992	Bank 10	Statement of paid up capital [Bank 10/D/1]	Bank 14	K138m
1992	Bank 16	Confirmation of bank balance [Bank 16/D/1]	Bank 16	
1992	**Bank 6**	Certificate of paid-up capital [MBT/D/4]	Bank 6	K200m
1993	**Bank 12**	Copy of a debenture receipt [Bank 12/D/1]	Bank 12 subsidiary	K20m
1993	**Bank 21**	Statement of proposed capital [Bank 21/D/1]	Bank 21	K750m
1993	**Bank 4**	Confirmation of bank balance [Bank 4/D/1]	Bank 7	K20m
1993	**Bank 2**	Confirmation of bank balance [Bank 2/D/2]	Bank 14	K30m
1994	Bank 22	Statement of paid up capital [Bank 22/D/1]	Bank 22	K300m
1994	**Bank 3**	Confirmation of bank balance [Bank 3/D/1]	Bank 18	K20m
1994	**Bank 15**	No records available	N/A	N/A
1995	**Bank 23**	No records available	N/A	N/A

Source: Bank Licensing Working Papers

6.3.0 Financial Condition, Resources and History of Applicants

Before 1992, the MoF did not query or investigate the applicant's source of funds for opening a bank. Because the MoF placed greater emphasis on the minimum capital requirement, there was insufficient importance attached to investigating the source of funds. Partially, that is because, before 1992, a top-down approach to licensing banks appears to have prevailed. Politicians made the decision to approve the application before the documentation reached the Registrar's office and what followed thereafter was a mere formality (Appendix 26:[LI/FBoZG/2][Bank 18/D/5][Bank 25/D/2]). The Registrar's responsibility merely involved ensuring that the applicants submitted the minimum legal documentation and did not include investigating the credibility or authenticity of those documents.

As the number of bank licence applications increased, however, there was a slight change in that approach. At the request of the then M/Finance, the Registrar started asking applicants to indicate the source of the finances used to meet the minimum capital requirement (Table 17:[Bank 12/D/10]). Although the MoF made the decision to formally query the source of applicant's finance in 1993 and the BoZ included it in its 1993 Inspection Handbook (BoZ, 1993),[13] there was no uniformity in the policy's implementation. At best the enquiries were superficial and did not go further than the verbal or written explanations provided by the applicants themselves (Table 17:[Bank 4/D/1][Bank 3/D/1][Bank 2/D/2][Bank 10/D/1][Bank 22/D/3]); there was no independent third party verification of the information the Registrar received.

On the two occasions that the MoF requested information on the tax status of the group of companies owning two different applicants (Table 17:[Bank 4/D/1][Bank 12/D/10]), the applicants informed the Registrar that all the companies in the group had only been registered within that tax year and were yet to pay any taxes.

[13] The handbook requires Bank inspectors to assess "the nature and sufficiency of the financial resources of the applicant or applicants as a source of continuing financial support for the institution".

Table 17 Financial Condition, Resources and History of applicants

Bank	Request for Information	Response from Bank applicants
Bank 10	Application stage	Source of funds: Applicants are part of a Group holding company of 12 Companies ranging from Manufacturing, Pharmaceuticals, Construction, Motor Vehicles, General Trading and Banking with K3Bn in assets. (2) Previously were the single largest shareholders of Bank 24 (Z) Limited – 24% **Bank 10/D/1**
Bank 12	"...I believe banking is very serious business. I need to know the source of funds and indeed if adequate taxes have been paid to the state in respect of the income in the hands of the promoters." – *M/Finance* **[Bank 12/D/10]**	(1) Source of funds from the settlement by Mr ... for Mr ...'s share in Bank 11 (K175,000,000) **[Bank 12/D/12]** (2) Most of the companies registered in 1993 and yet to pay any taxes. Certificates for 1993 companies provided (ALease, Afinance bureau, Amex, Travel Care, A and company, Abuild, Aproperties, A Business Bureau, Afinance Consultants, A Newspapers.) **[Bank 12/D/12]**
Bank 2	Application stage	Sources of financial support – Bank owner's investment holding company **[Bank 2/D/2]**
Bank 4	Application stage "...except for one issue referred to below we were satisfied with all the information and findings (1) the issue concerns the ability of the companies within the group to raise a loan of K180 million to Bank 4 limited ...(2) request for audited financial statements of those companies that will syndicate the K180m. *Director FSSD* **[Bank 4/D/5]**	(1) Sources of funds – Group Companies (1) A Travel and Tours Limited, A Bureau de change limited, A Shop Limited, A Insurance Agency, A Advertising and promotions Ltd, A Agro Industries Limited - **[Bank 4/D/1]** (2) List of subscribers to the bank: (1) A Travel and Tours Limited – K100m, A Bureau de Change Limited – K30m, A Shop Limited–K5m, A Insurance Company- K25m, A Advertising and Promotions Ltd –K15m, A Agro Industries Limited –K10m, A – K50m, A Fashions – K10m, Mr ... – K20m, Mrs ..., K1m Total K266m – **[Bank 4/D/4]**

Table 17 Financial condition, resources and history of applicants cont...

Bank	Request for Information	Response from Bank applicants
		"...I was surprised to note that you require audited financial records of all our companies when I submitted the audited accounts of A Travel and Tours Ltd. As you can see from the figures of turnover and profits and even the net worth it far surpasses the K180 million K you are referring to. Anyway the legal requirement of K20 million is confirmed by our deposit of that amount by a letter from our bankers...You will also note that the usual 120 days after the application has long expired...we shall be grateful if now our application can be approved quickly as it fulfils all the necessary requirements." **[Bank 4/D/6]**
Bank 3	Application stage	Source of funds: (1) Mr...: (Savings + terminal benefits and grinding mill income), (2) Mr ...: (Business Woman/Property rentals) (3) Mr...: (Economist/Banker/Farm produce) **[Bank 3/D/1]**
Bank 22	Application stage	Source of fund : 1991 Financial Statements of Transnational Holdings Limited (Holding company), 1992 Annual Report for Bank 22 **Bank 22/D/3**

Source: Bank License Working Papers

A few applicants (Table 17:[Bank 22/D/3][Bank 10/D/1]) chose to submit financial statements of their group companies. However, no reference in either case was made to the cash flow statements and bank statements to assess the financial liquidity of any of the group companies or the availability of on-going financial support, nor were the applicants required to submit previous bank statements to assess the personal, collective availability of on-going liquidity of the applicants.

6.4.0 Character and Experience of Major Shareholders and Directors

Until August 1989, the MoF had no set criteria for assessing the character and experience of major shareholders and directors. Regulators did not evaluate any of the major shareholders and directors licensed between 1984-1989 (Bank 18, Bank 25, Bank 7, and Bank 5) for their fitness and probity.

In 1989 the MoF determined that the only fair and effective method of assessing the credibility of bank licence applicants was to subject them to vetting by Zambia's security institutions - Ministry of Home Affairs, Anti-Corruption Commission (ACC), SITET, and later the Drug Enforcement Commission (DEC). Although this approach significantly reduced the possibility of known criminals entering the financial system, it gave the impression that anyone cleared by the state security departments was qualified to own and operate a bank, which was not true. It also precluded any formal analysis of owners' and directors' banking experience, educational qualifications and probity. The study found no documentary evidence of the Registrar conducting or causing to be conducted an analysis to determine the professional suitability of applicants based on the curriculum vitae that they submitted to the MoF. Instead, the Registrar filed the curriculum vitae and gave them little attention. Often, the Registrar's requests for applicants security clearance from the state security departments went unanswered (Table 18:[Bank 13/D/20][Bank 3/D/4][Bank 3/D/5][Bank 16/D/4][Bank 10/D/9][Bank 11/D/10]). In the majority of responses, the state agencies did not have any adverse information about the applicants (Table 18:[Bank 13/D/21][Bank 3/D/8][Bank 16/D/5][Bank 10/D/12]). In a few cases, the Registrar's requests resulted in adverse information about the applicant's suitability for a banking licence (Table 18:[Bank 14/D/33][Bank 13/D/22][Bank 9/D/4]). However, in all three cases, the security departments subsequently cleared the applicants and the M/Finance approved their application. Largely, this was due to the lack of evidence upon which the security departments could obtain a conviction in court (Appendix 26:[LI/BoZAD/51][LI/BoZAD/53]). The Registrar could only act on actual prior convictions. Mere suspicions, criminal investigation, or insufficient evidence were inadequate to declare an individual unfit to own or manage a bank.

Table 18 Character and Experience of Directors and Major Shareholders

Bank	Regulatory agency conducting evaluation	Issues raised by regulatory agency
Bank 14	SITET **[Bank 14/D/4]**	"... I am pleased to inform you that after due inquiries, we have found nothing against the subjects except for Mr ... who had earlier given false representation to the effect that the intended bank had already 20 million as nominal capital when in fact this was not true. You may therefore go ahead in preparing your report to the Honourable Minister" **[Bank 14/D/33]**
Bank 13	ACC **[Bank 13/D/19]**	"...we have no adverse reports on this company and those named in the application" **[Bank 13/D/21]**
	SITET **[Bank 13/D/20]**	No documentary evidence available
	Ministry of Home Affairs (11 Nov 1992)	"...we have no adverse report against Directors, however, Mr ... is the subject of inquiries going at the Drug Enforcement Commission, Immigration and the Ministry of Home Affairs and we would advise that you get in touch with those institutions before clearing ...." **[Bank 13/D/22]**
	DEC (26 July 1993) **[Bank 13/D/24]**	"...the DEC does not have any traces of illicit drug activity or adverse reports in respect of the above named company." **[Bank 13/D/26]**
Bank 9	ACC **[Bank 9/D/4]**	"...Although we have no adverse reports on the names submitted the attention of the commission was recently drawn to a Mr ... in connection with a stolen Euro cheque and who may be one and the same person named as a director of this company. I need to double-check this with the senior officer who handled the matter but is on leave at present. **[Bank 9/D/9]** "...I can now confirm that this commission is satisfied about the applicant in question and we therefore have no objection to a licence being issued" **[Bank 9/D/9]**
	SITET **[Bank 9/D/5]**	"...we have no adverse reports on this company and those named in the application" **[Bank 9/D/10]**

Table 18 Character and experience of directors and major shareholders Cont…

Bank 6	ACCA **[Bank 6/D/31]**	Confirmation that the director in question was admitted to the membership of the ACCA in 19.. and became a member in 19... He is currently a fellow in good standing. **[Bank 6/D/36]**
	INTERPOL **[Bank 6/D/32]**	No documentary evidence available
	GOVERNOR – UAE **[Bank 6/D/33]**	Acknowledgement of receipt of request. Undertaking to investigate the matter and revert to BoZ **[Bank 6/D/37]**
	GOVERNOR – KENYA	No adverse findings noticed on the conduct of the affairs of one of the directors. The Bank of Kenya advised the third Director to consolidate local institution before expansion abroad **[Bank 6/D/35]**
CAV	ACC **[Bank 16/D/3]**	"…we have no adverse reports on this company and those named in the application" **[Bank 3/D/5]**
	SITET **[Bank 16/D/4]**	No documentary evidence available
Bank 11	ACC **[Bank 11/D/9]**	No documentary evidence available
	SITET **[Bank 11/D/10]**	No documentary evidence available
	Ministry of Home Affairs **[Bank 11/D/11]**	"…we have no adverse reports on this company and those named in the application" **[Bank 11/D/12]**
Bank 3	SITET **[Bank 3/D/3]**	"…we have no adverse reports on this company and those named in the application" **[Bank 3/D/8]**
	ACC **[Bank 3/D/4]**	No documentary evidence available
	DEC **[Bank 3/D/5]**	No documentary evidence available

Source: Bank Licensing Working Papers

Notwithstanding, the legal argument that an individual is "innocent until proven guilty", the seriousness of the issues for which the security departments were investigating some of the applicants required a measured approach to the approval of their bank licence application. Drug Trafficking and Money Laundering (Table 18:[Bank 13/D/22]), False Representation, (Table 18:[Bank 14/D/4 – 6]), and Fraud (Table 18:[Bank 9/D/4]) should have affected the respective applicants' claims to fitness and probity.

Another matter of concern is the high number of senior Bank of Credit and Commerce (BCCI) officials that entered the banking system between 1991 and 1994. The MoF made no formal effort to check whether the former BCCI individuals applying for bank licences had played a role in the closure of the former international bank. The BoE warned the BoZ of at least one individual who was previously involved in money laundering. Although the government arrested the individual and had him deported, he later returned to Zambia and continued in business for a long time (Appendix 26:[LI/FBoZG/4]). One of the biggest problems for the Registrar was that the applicants were well connected (Appendix 26:[LI/FFSSD/2]) and had substantial political influence. One of these applicants let it be known that he was instrumental in raising $200 million for Zambia at a time when Zambia was economically isolated from the IMF and the World Bank.

It was also noted in the study that the Registrar never returned a bank application to its promoters because of concerns about the integrity of the shareholders or director, not even when the shareholders and/or directors were involved in, or accused of, grievous criminal activities *during* the licensing process. Instead, the Registrar merely requested the applicants to replace the individual concerned and the processing of the licence continued. There was no limit on the duration of the licensing process or the number of times the shareholding structure or list of directors changed. In one instance, after submitting the licence application, the promoter's Chairman resigned after the police arrested him on charges of murder. The Chairman who succeeded him also resigned because the majority shareholder fled Zambia on hearing that the government was about to deport him for undisclosed reasons. The ownership and management structure changed on each occasion. Despite these events, the Registrar approved the licence after a number of replacements and changes to the list of shareholders and directors.

6.5.0 Convenience and Needs of the Community

None of the banks licensed between 1984 and 1994 underwent formal assessment to determine their individual contribution to the convenience and needs of the community. Although the MoF repeatedly expressed overall concern about the number of banks entering the financial system during that period, the emphasis remained on the applicant's satisfaction of the minimum legal requirements and not on whether the bank would make a unique contribution to the financial sector. The reason for the absence of evidence of any formal assessment of a bank's contribution to the convenience and needs of the community was due to two key factors. Firstly, there were no agreed criteria for assessing a bank's contribution to the convenience and needs of the community. Secondly, there were no agreed criteria for assessing the level of market saturation of the banking system.

The MoF's licensing of the first local banks in 1984, in line with its economic programmes of economic liberalisation (Table 19:[Bank 18/D/3][Bank 18/D/4][Bank 5/D/5]). However, concern existed in the Ministry that the financial system did not have the capacity to sustain additional financial institutions at the time, given the size of the economy. Despite these concerns, the first wave of local banks entered the market on sentiments of nationalist pride in local entrepreneurial initiatives, entering a sector hitherto dominated by foreign banks. Whilst the MoF succumbed to these nationalistic, rather than economic sentiments, it resolved to adopt a more cautious approach to any subsequent applications into the banking sector.

Table 19 Convenience and needs of the community

Bank	Assessment of convenience and needs of the community
Bank 18	"...I have examined the requests carefully relative to the present economic climate and it is my view that the bank could be of economic assistance to our programmes..." **[Bank 18/D/3]** "...I still share your sentiments on the capacity of our system to sustain the number of institutions we now have, However, the present case is unique in that it represents a debut effort by indigenous entrepreneurs into a field that has traditionally been dominated by foreign enterprise or state ventures. Having allowed the setting up of a few foreign owned facilities it would be clearly unfair to close the door to this venture. I would recommend that you approve the registration. The BoZ needs to keep a close eye on the operations of this and the other facilities to ensure that the interests of the clients are protected. For the future we need to adopt a very cautious approach to any new applications into the banking field." **[Bank 18/D/4]**
Bank 5	"...In light of both the economic and financial benefits to be derived from establishment of the bank, I wish to recommend that the Minister be requested to authorise registration of the bank..." **[Bank 5/D/5]**
Bank 11	"...I have held the view that this ministry must not be seen to be standing in the way of any bank promoter who fulfils the legal requirements. To reject the registration of a bank on the grounds that the banking sector is already saturated without adducing adequate and reasonable evidence would simply place this ministry in the position of advocate for the existing banks only to the total exclusion of any other promoters wishing to enter this vital sector." **[Bank 11/D/4]**
Bank 13	"...I am not sure whether or not in this case we should still consult BoZ after that report on a study on banking and the discussion that followed on the 3rd May, 1989 on the same which revealed that the banking market is still wide." **[Bank 13/D/1]**
Bank 3	"...I have no objection, in principle, to the establishment of Bank 3 Limited. However, from now on, I would like us to be very careful in the future registration of commercial banks in view of the rapid increase in the number of new banks in the market." **[Bank 3/D/10]**

Source: Bank Licensing Working Papers

In 1986, when another bank was registered, individuals with the MoF again expressed concern about the number of commercial banks in the financial system. Still, in the absence of documented government policy on the required/acceptable number of banks and a standardised formula for measuring the level of market saturation of the banking sector, the M/Finance instructed his ministry "not to be seen to be standing in the way of any bank promoter who fulfilled the legal requirements" (Table 19:[Bank 11/D/4]). However, dissenting views continued to prevail until the MoF decided to commission a study to formally assess the level of market saturation. The 1989 BoZ report, discussed with the MoF on May 3, 1989, concluded that the banking sector was still open to further competition, (Table 19:[Bank 13/D/1]), and thereafter, the MoF adopted a more open door policy towards registration in Zambia. By the time of the 1992/1993 financial sector reforms, the prevailing view within the MoF was that as long as an applicant met the minimum legal requirements for registration there was no need to consider the convenience and needs of the Zambian financial system or economy. Between 1992 and 1994, the MoF registered a comparatively large number of banks. Using the same expressions documented ten years earlier, senior officials within the MoF called for "care in the future registration of commercial banks in view of the rapid increase in the number of banks in the market" (Table 19:[Bank 3/D/11]). The study also noted that for the first time, senior officials within the MoF referred to the possible failure of some banks. Increasingly, officials at the MoF became concerned about the number of banks the Ministry was registering. Officials made comparisons with Kenya where a mushrooming of banks preceded the failure of several of them. The officials in the Ministry were concerned that, with no action, the same would happen in Zambia.

6.6.0 Prospects for Profitable Business Operations

The Registrar did not conduct any independent financial analysis of the applicant's prospects for profitability. The office of the Registrar did not have the technical know-how to assess the business plans submitted by the applicants (Appendix 26:[LI/FTC/4]).

Table 20 Prospects for Profitable Business Operations

Bank	**Documentary evidence of evaluation/Issues raised in business plan evaluation**
Bank 9	No documentary evidence available **[Bank 9/D/1]**
Bank 21	Yes/"Factors noted (1) nature of the business to be conducted (2) background and group structure (3) Capital resources – far beyond minimum capital of K20 million (4) forecast results for three years - reasonable - BoZ" **[Bank 21/D/4] [Bank 21/D/1]**
Bank 6	Yes/"The Business Plan was not sufficient in that it did not include a detailed prospective three-year plan indicating the bank's operating projections and how that would affect the bank's viability. The underlying assumptions were not indicated either. The turnover is based on the bank raising US$10million from ... Bank, but no options shown in case this fails. A revised business plan requested." – BoZ **[Bank 6/D/1] [Bank 6/D/9]**
Bank 16	Yes/"...After examining the application, I am pleased to advise that the BoZ has no objection to Bank 16 Limited being given the licence." – BoZ **[Bank 16/D/1] [Bank 16/D/9]**
Bank 13	No documentary evidence available **[Bank 13/D/16]**
Bank 12	No documentary evidence available **[Bank 12/D/1]**
Bank 4	Yes/Issues noted (1) employment of three expatriates (2) Total staff complement of twenty five **[Bank 4/D/1] [Bank 4/D/4]**
Bank 2	No documentary evidence available **[Bank 2/D/2]**
Bank 11	No documentary evidence available **[Bank 11/D/7]**
Bank 15	No documentary evidence available **[Bank 15/D/1]**
Bank 3	Yes/"...After examining the application we find the technical aspect of the proposal acceptable. We wish to point out that even though the proposed level of share capital at K20m meets the stipulations of the current Act, the present financial environment may require a much higher level of capitalisation." – BoZ **[Bank 3/D/1] [Bank 3/D/6]**
Bank 22	Yes/"...The project proposal has been studied and accepted by this office and the BoZ and I am recommending that the company be registered as a financial institution." – BoZ **[Bank 22/D/7] [Bank 22/D/7]**

Source: Bank Licensing Working Papers

Instead, the Registrar deferred the business plan to the BoZ for its evaluation and comment a he practice which started in 1992. Before then, there is no evidence to suggest that applicants were even required to submit their business plan when applying for a banking licence. The BoZs evaluation of the business plan was at best cursory (Table 20:[Bank 21/D/4][Bank 6/D/9][Bank 4/D/4][Bank 3/D/6]). Although the January 1993 BoZ Inspection Handbook for Financial Institutions required Bank inspectors to assess details of a prospective business plan for the institution for the period of three years, there is no evidence of any detailed or critical evaluation of the business plans it received. A BoZ business plan evaluation primarily consisted of ensuring that the business plan was complete with respect to content rather than quality (Table 20:[Bank 6/D/9]). Because of this approach, the Registrar, on behalf of the BoZ, requested the applicants to submit more information (Table 20:[Bank 4/D/4]). The BoZ accepted the rest of the business plans as reasonable and did not raise any specific issues regarding their quality; none were returned and no applicants were requested to revise their business plans.

6.7.0 The 1994 Bank Licensing Reforms

In line with the banking sector reforms introduced after the liberalisation of the financial sector, the MoF introduced important changes to the licensing process. The BFSA formed the basis for the newest approach to evaluating bank licence applications. Although the licensing provisions introduced in the Act improved the BoZs legal position with regard to evaluating bank licence applications, they took effect long after the MoF had granted a significant number of bank licences. The government was, quite literally, "closing the stable doors long after the horse had bolted".

Apart from the reforms to the technical process of evaluating a banking licence, two administrative problems were also addressed in the licensing process. Firstly, although the perception was that political pressure was exerted on the Registrar to licence banks, this study found that political interference (Appendix 26:[LI/FBoZG/2][Bank 25/D/2][Bank 11/D/3]), where evidenced, was primarily for increasing the efficiency of the licensing process and not because of a desire to circumvent the law. The political pressure on the Registrar focused on the length of time it took to process licence applications (Appendix 26:[LI/FTC/8]), and not on circumventing the legal requirements, which were basic and simple anyway. The delay in the licensing process was partly due to the institutional design of the office of the Registrar. The Registrar's office was not a full time civil service position. It's duties were discharged by a junior civil servant alongside his/her other day-to-day responsibilities, which often took preference of those of licensing banks (Appendix 26:[LI/FTC/4]). Further, the Registrar was dependent on the response from the state security departments, and only after he receiving their clearance, could he proceed to process the application

Table 21 Duration of Bank Licence Evaluation Process

Bank	**No. of Months from Submission to Final Approval/Rejection**
Bank 13	53
Bank 14	21
Bank 23	12
Bank 10	11
Bank 11	9
Bank 5	9
Bank 4	9
Bank 3	9
Bank 9	7
Bank 12	6
Bank 2	6
Bank 16	5
Bank 6	5
Bank 18	4
Bank 21	4
Bank 1	4
Bank 25	3
Bank 7	1
Average	**10**

Source: Bank License Working Papers

Secondly, between 1984 and 1994, there was a significant regulatory gap in between the MoF and the BoZ in terms of responsibility for evaluating and approving bank licence applications. Each agency placed reliance on the other for the regulatory evaluation and admission of new financial institutions in the banking sector. In his correspondence to either the Permanent Secretary or the Minister, the Registrar repeatedly referred to the BoZ not raising any objections to the bank licence application (Appendix 26:[Bank 14/D/34][Bank 13/D/18][Bank 13/D/29]Bank

4/D/8][Bank 16/D/9]). Even though the Registrar received no response from the state security departments, as long as there was a "no objection" response from the BoZ, the Registrar recommended the approval of the application to the Permanent Secretary. Yet, the BoZ never acknowledged the level of responsibility which the Registrar seemed to confer on it. The view at the BoZ was that the ultimate authority at the time was with the Registrar at the MoF. Consultation with the BoZ was at the discretion of the Registrar and not legally mandatory (Appendix 26:[LI/BoZAD/4][LI/BoZAD/10][LI/BoZAD/29]). On one occasion, the BoZ actually reminded the Registrar that it was *his* responsibility to satisfy himself as to the personal financial probity of the applicants. In reality, both institutions placed reliance on each other's work without assessing the adequacy of their respective evaluation policies and procedures. The objectives of the 1994 bank licensing reforms therefore included moving the role of the Registrar from the MoF to the BoZ. Besides increasing the level of operation independence, that decision removed the ambiguity regarding responsibility for licensing banks (Appendix 26:[LI/FTC/10]).

Chapter II of the BFSA contained provisions for the licensing of banks and other financial institutions. It also provided for the revocation of licences, the prohibition of unlicensed business, the appointment of a Registrar of Banks and Financial Institutions and required the BoZ to keep a register of all licences issued. The chapter provided for the BoZ to make administrative decisions regarding the granting, setting of conditions and revocation of licences. It also included provisions for appeal by applicants to the Minister, sections 10(3), 13(5) and 16(2). The rationale was to remove the Minister from the burden of having to be involved in every application but reserve him the right to review any decision - if the applicants were dissatisfied with the BoZ's judgement.

The information required for a licence included the memorandum and articles of association of the company, the address of its head office, names and addresses of directors, senior officers and major shareholders and the amount of capital. This basic information was deemed sufficient for the BoZ to make further enquiries, and if required to satisfy itself regarding the character and general suitability of persons who were in a position to influence the affairs of the bank.

A time limit of 120 days for the BoZ to decide on the merits of an application was included in the Act. If the BoZ was satisfied that an applicant met the criteria for a licence, it was to authorise the organiser to apply for incorporation under the Companies Act. The objective of including the time limit was to ensure that the BoZ handled all applications promptly. The Act also required the BoZ to assess, the financial and managerial capacity of the applicant(s), satisfy itself that the applicants provided sufficient evidence that there was a need for the proposed financial services, and that the new institution was financially viable. The new licensing procedures aimed to protect the BoZ from improper public pressure when deciding on new applications to licence financial institutions. It also sought to ensure that the applicants had the necessary financial resources, the necessary business record and experience, and the character and competence to manage the bank successfully. The BoZ incorporated these requirements into its Bank Inspection Handbook revised at the same time as the new Act (Box 6 and 7). The Act permitted banks to open and close branches freely within Zambia, but had to keep the BoZ informed of their intentions. With respect to opening a branch or office outside Zambia, a bank required prior consent from the BoZ. The latter provision was included to enable the BoZ to determine at the outset whether the bank had the managerial and financial resources to undertake foreign operations and whether the operation would be of benefit to Zambia. The provision was included to ensure that the BoZ was able to obtain adequate prudential information on the bank's foreign operations. The Registrar also was empowered to revoke a licence for various reasons stated in the Act, which included failure of the institution to comply with conditions of the licence or with requirements of the Act. The Act included a procedure of appeal to the Minister from a decision of the BoZ to grant, or revoke a licence, or to impose particular conditions on the licence.

Box 6 Revised Bank Licence Application Documents for Zambian banks

An application shall be accompanied by a written statement stating:

1. Whether the person applying is doing so in his own capacity, as promoter of the financial institution to be established or as an agent on behalf of a principal.

2. In the case of an agent on behalf of a principal, the written consent of such principal to the submission of the application on behalf of his client.

3. The proposed name of the institution.

4. The proposed place in Zambia where the Head Office of the bank is to be situated.

5. The nature of the particular type of business to be conducted by the bank.

6. The amount of issued share capital with which the institution is to commence business.

7. Full details of the anticipated shareholding in the institution.

8. The nature and sufficiency of the financial resources of the applicant or applicants as a source of continuing financial support for the institutions.

9. Details of the prospective business plan for the institution for the period of three years commencing on the date on which the institution is for the first time provisionally registered as a financial institution.

10. The proposed memorandum of association and articles of association.

11. The proposed organisational structure and full details of how the affairs of the institution will be managed when it is registered as a financial institution.

12. The name of the proposed auditor of the financial institution.

13. The names and curriculum vitae of the persons who will be chief executive officer and other executive offices of the institution when it is registered as a financial institution.

14. The curriculum vitae and the principal business of the directors of the bank.

15. With regard to any individual named in 13 and 14 above, details of any criminal records, and

16. The proposed opening date of the institution.

Source: BoZ Inspection Handbook for Financial Institutions (1993)

Box 7 Revised Bank Licence Application Documents for Foreign Banks

Additionally to all the requirements listed in Box 6, the following are required:

1. A letter from the regulators in the home jurisdiction that the authorities are aware of the application
2. Information on the type and scope of supervision that apply in its home jurisdiction;
3. Information on the parent company; name, name of jurisdiction of incorporation, date of incorporation and address of principal office;
4. A list of names and addresses of all companies in which the parent or a company associated with it holds more than 10% of the voting stock, including an outline of the main business undertaken by each of them;
5. An organisation chart of the parent bank and it affiliates, with a list of names and titles of the senior officer;
6. A copy of the latest annual report;
7. A copy of the audited financial statements of the parent bank and of the consolidated organisation i.e. balance sheet, statement of income and expenses, statement of changes in shareholders equity – for the most recent year – i.e., for a period ended not more than 12 months before the date of submitting the material.

Source: BoZ Inspection Handbook for Financial Institutions (1993)

An important change introduced by the new Act, was the transfer of the position of Registrar of Banks from the MoF to the BoZ. The new Act empowered the M/Finance, on the recommendation of the BoZ, to appoint a BoZ employee as Registrar of Banks and Financial Institutions to administer the Act. The change provided for a more effective and efficient operation of the Act.

The Act introduced new restrictions on bank ownership, control and the qualifications of directors and managers of banks and financial institutions. Under it, the shares issued by a bank had to be of such classes or series as approved by the BoZ. The section also limited the number of shares that any one person could hold to 25% of total voting shares, unless expressly permitted by the BoZ. The BoZ had noted that in some countries, problems had arisen because of dominant shareholders exerted influence on the board and management to obtain loans from the bank on concessionary terms, and sometimes in excess of ability to repay. As a result, institutions had become illiquid and insolvent and depositors had suffered losses. The Committee, which had drafted the Banking and Financial Services, wanted to minimise the possibility of such occurrences, but its provision was not retrospective. On the date of the Act enforcement, a person owning shares in contravention of the Act, could retain any such shares or control as long as they did not sell or dispose of them to any person, if doing so caused the successor to contravene that section of the Act. The Act prohibited individuals from controlling more than one bank, except in the case of implementing an amalgamation of two or more banks. Regulators were concerned about the problems of conflicts of interest where a person controlled more than one bank. Additionally, there were concerns about concentration of financial power and influence. Further, the transfer of shares equivalent to a significant percentage of a financial institution's voting shares required the BoZ's approval to ensure that shareholders who might be in a position of substantial influence were qualified for such a role.

The Act reiterated the importance of the members of the Board of Directors as the highest policy-making body of a bank. It added affirmative qualifications to the existing list of disqualifications. On significant provision was the prohibition of any person being a director of more than one bank or financial institutions, necessary in order to obviate conflicts of interest and to maintain confidentiality of information on a bank's depositors and borrowers. In requiring a majority of outside directors, Section 32 implemented a desirable objective that boards become more independent of management. Section 33 contained provisions on directors' and officers' duties. It enhanced the common law duty of directors and officers to reflect the development in corporate law standards and the needs of a modern financial system. To ensure that the interests of the financial institution were primary in directors' and officers' actions, there was a provision for disclosure of conflicts and procedures for deliberations about matters in which such persons have material interests.

On March 23 1994, the BoZ Committee established to review the Banking and Financial Services Bill, 1994 met to discuss, among other issues, the necessary changes to the licensing regulations and procedures required to effect the new legislation about to be passed by parliament. Among the tasks assigned to different committee members at that meeting was that of determining and proposing a minimum capital amount for new banks. The Committee proposed that one of its members establish the minimum capital levels obtaining in other countries and compare them to the initial capital of K750 million, which the BoZ had proposed for Zambia. In August 1994, the FSSD completed a study aimed at upwardly revising, the minimum capital requirements for opening a bank, realising that the then minimum capital of K20 million required by the Banking Act was inadequate. The level of K20 million was set in 1988 when the value of the domestic currency was approximately K11 to US$1 (US$2 million). However, because of the devaluation of the Kwacha, the minimum capital requirement in US dollars had declined to approximately US$30,000, an amount far from sufficient for start-up expenses and capital expenditures associated with opening a new bank. In the absence of a local precedence, the department compared the minimum capital requirements in seven neighbouring countries – Botswana, Kenya, Malawi, Namibia, South Africa, Swaziland, and Zimbabwe - and recommended an amount of K1Bn.

Table 22 Minimum Capital Requirements in Selected Countries in 1994

Country	Minimum Capital requirement	Equivalent K'm
Botswana	P1 million or 6% of total assets	248
Kenya	Kshs 75 million	848
Malawi	MK 2 million	185
Namibia	NAD 2 million or 12% of the bank's public liability	400
South Africa	SAR 10 million	1900
Swaziland	E1 million	190
Zimbabwe	Equivalent of US$ 1 million	680

Source: BoZ

The study arrived at the sum of K1Bn by taking a simple average of the Kwacha equivalent of the capital requirement in the seven countries (K4451/7 = K636). This simplified approach ignored the differences in size of the financial sectors and economy found in the sample countries. Nevertheless, the amount of K1Bn was proposed in an effort to keep the amount as close as possible to the 1988 original amount of US$2 million or K1.36Bn at 1994 Kwacha equivalent value. The amount was also selected in the hope that it would act as a means of maintaining a high minimum capital level and high standards for applicants seeking banking licences in order to ensure that Zambia retained a high quality banking and financial sector.

Table 23 shows the capital levels prevailing in the Zambian banking sector as at 30 June 1994. Five banks had capital levels below the proposed amount of K1Bn, namely, Bank 18 (K565 million), Bank 14 (K255 million), Bank 7 (K266 million), Bank 4 (K328 million) and Bank 18 (K565 million). Of these five banks, four would subsequently fail.

Table 23 Capital Levels of Commercial banks (30 June 1994)

Bank	Capital K'000	Reserves K'000	Total K'000	Less K1 billion Proposed
Barclays	1,723,200	11,316,267	13,039,467	12,039,467
ZNCB	2,625,000	6,174,814	8799,814	7,799,814
Standard Chartered	1,950,000	6,845,690	8,795,690	7,795,690
Bank 5	**462,915**	**3,504,866**	**3,967,781**	**2,967,781**
CITI	521,230	3,013,429	3,534,659	2,534,659
Indo-Zambia	300,000	3,147,931	3,447,931	2,447,931
Finance	2,000,000	886,889	2,886,889	1,886,889
Stanbic	300,000	2,147,171	2,447,171	1,447,171
Capital	250,000	1,075,673	1325,673	325,673
Cavmont	500,000	710,123	1,210,123	210,123
Union	449,637	226,587	676,224	(323,776)
Bank 18	**200,978**	**364,319**	**565,297**	**(434,703)**
Bank 4	**330,000**	**(1,123)**	**328,877**	**(671,123)**
Bank 7	**6,483**	**259,937**	**266,420**	**(733,580)**
Bank 14	**225,000**	**0**	**225,000**	**(775,000)**
Total	**11,884,443**	**39,672,573**	**51,517,016**	**36,517,016**

Source: BoZ/Note: All banks in bold failed in 1995 or 1997/98

The FSSD recommended that it meet the management of all banks failing to fulfil the new capital requirements, to discuss re-capitalisation plans. It also recommended that the BoZ give the affected banks a grace period of two years within which to bring their capital levels to at least the new minimum level. Although initially intending to rely on moral suasion to achieve this, the FSSD acknowledged then, that it would have to rely on other directives provided in the Act. The directives it could rely on for this purpose included imposing restrictions on the purchase of new equipment, the opening of additional branches, the bank's ability to lend, and the payment of dividends to its shareholders; all of which it intended imposing on a case-by-case basis.

The new capital adequacy requirements also affected those licensed banks that failed to commence operations. One bank in particular, Royalty Bank brought the issue before the courts for judicial review (See Box 8)

Box 8 Royalty Bank (Z) Limited Vs. The BoZ Court Case

In November 1994, the BoZ licensed Royalty Bank as a Bank under the Banking Act (CAP 700), which required banks to commence operations with a minimum regulatory capital of K20 million. The BFSA became law a month later. The new requirement was that banks maintain a minimum regulatory capital of K2Bn. Royalty bank took out an interim injunction (ex parte) to restrain the BoZ from effecting the requirements of the BFSA. The court discharged the interim injunction granted ex parte and there were no further steps to persecute the action. In 1996, the BoZ revoked its banking license.

Source: FSSD (1996)

6.8.0 The Post 1997/98 Bank Licensing Reforms

In 1998, the BoZ started revising the bank licensing procedures and introduced additional criteria for assessing the suitability of applicants for a banking licence. In 1999, the FSSD issued a document setting out a pre-approved licensing procedure, to guide all members of staff involved in licence evaluation. It hoped that the document would standardise the evaluation process in all major aspects, regardless of the staff involved. The new licensing handbook requires bank inspectors to ensure that the initial capital of a bank is sufficient to finance: start-up expenses, to act as a buffer against losses, for initial funding of loans and investments, to generate an initial source of income; and to serve as an indication of the viability and market presence of the bank. The new policy also restricts the admission of non-cash items as capital to 10% of the required level of start-up capital. Additionally, the non-cash contributions must be of a kind that would be of sufficient use in the ordinary course of business in a bank. Further, the initial capital should be financed from the shareholders' own funds, not from borrowed money. Additionally, the Capital Adequacy Regulations issued in 1995 increased the minimum capital requirement to K2Bn.

The vetting process for shareholders now includes consultations with the tax authorities (to determine the promoters' tax obligations in their business dealings), home country regulators (for foreign banks), and other commercial banks in Zambia (enquiring about whether the major promoters have any non-performing loans with any of the banks.) Before the Registrar issues a banking license applicants are required to submit:

1. A written statement from a foreign supervisory authority (foreign banks) that the shareholder is in good standing;
2. An auditor's statement on the net-worth of the shareholder;
3. copies of tax returns, indicating the income of the shareholder;
4. extracts from the Register of Companies, showing the other business interests of the shareholder and financial statements regarding those interests;
5. Police statements that the shareholder has not been investigated/convicted by the police with regard to any criminal activity on the part of the shareholder;
6. Court or police affidavits that the shareholder has not been convicted of any substantial crime, and;
7. A completed and signed questionnaire by all shareholders.

The bank licence applicants must also show that management is "fit and proper" for the offices they have been appointed to. The burden of proof is on the part of the applicant. Suitability, or "fitness and propriety" or "sufficient experience and good repute", are criteria the BoZ evaluates by:

1. Requesting a completed director's form and curriculum vitae of managers;
2. Using any legitimate means of its own in collecting information about bank managers, for instance if a prospective manager has worked for a bank before;
3. Conducting an informal discussion with the prospective managers; and establishing if the prospective manager has exercised banking business in another country,
4. Obtaining a clearance letter from the supervisory authorities in that country.

The new guideline does not specify how to assess the convenience and needs of the community. It merely states, "The applicant must convince the Registrar that the proposed bank or financial institution meets a need and will, therefore, have the support of the community". The applicant must demonstrate that it has a strategy for attracting and maintaining community support for the new bank. The applicant must also demonstrate that the services to be offered will be responsive to those needs, will be convenient to customers, can be provided by the bank or financial institution profitably and will be consistent with the safe and sound operation of the bank or financial institution - the burden of proof lies with the applicants and not the BoZ.

Assessing the prospects for the profitable operation of that business now requires inspectors to "Verify whether the relevant externalities have considered the business plan: the appropriateness of interest rates, exchange rates, development of certain economic sectors, availability of staff and management, etc. Apart from checking that the business plan is also internally consistent and plausible, the BoZ will also verify, by means of interviews and discussions, whether the management of the bank, who will be responsible for the implementation of the plan, fully understand the plan, can discuss it and defend it convincingly. They should be able to explain it to the supervisory authorities in their own words, and without reference to the text. Previously, interviews of this nature were not required. In assessing the application of a banking or financial institution licence, the BoZ will utilise the profit and loss projections submitted as part of the business plan. Drawing on the experience of existing banks or financial institutions and knowledge of the financial market, the review should then reach a judgement as to whether the profit forecast is reasonable and achievable from the forecast balance sheet. This will give the new management an opportunity to demonstrate their professionalism and prudence, or lack of it. Subsequent profit results may then be compared to management's initial forecast as part of the exercise to assess how well-managed the bank or financial institution is.

In terms of its specificity of the minimum criteria for a banking licence, the post-1995 and 1997/98 banking license reforms reflect internationally-accepted minimum standards for granting bank licenses as determined by the Basel Core Principles for

Effective Banking Supervision. The new guidelines are comparatively exhaustive with respect to the information that applicants must submit to the BoZ. However, what the guidelines do not establish are guidelines for inspectors to use in *interpreting* the information that applicants provide, especially, with respect to the financial condition, resources and history of the applicants and the prospective management. To date, there are no rules or regulations or guidelines to follow in determining the knowledge, experience, judgement, reputation, character and diligence of bank applicants, especially those that apply for banking licenses in jurisdictions outside their previous residence. Neither are there guidelines for determining "fitness and propriety".

6.9.0 Conclusion

This chapter reviewed the bank licensing process in Zambia. It considered the design, development and implementation of the commercial bank licensing regulations and procedures between 1984 and 1994. The study hypothesised that the weaknesses in the licensing procedures for new commercial banks were significant contributory factors to the bank failures of 1995 and 1996/97. It set out to provide evidence that there was insufficient regard given to: (1) the minimum capital requirements; (2) the financial condition, resources and history of applicants; (3) the character and experience of directors and major shareholders; (4) the convenience and needs of the community and finally; (5) the prospects for profitable operation of that business. The evidence discussed in this Chapter confirms that there was insufficient attention placed on the quality of owners, directors and managers of new commercial banks, the minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners.

Efforts to ensure that banks met the minimum capital requirements were undermined by five critical factors. Firstly, by focusing on the minimum legal capital requirement, which inflation had reduced in real terms anyway, the regulatory authorities neglected the need for banks to raise additional business capital to make their operations viable. Secondly, there was no independent confirmation provided to the registrar that the capital stated in the application form existed. Applicants evidenced the existence of capital with a letter from a recently-opened local bank stating that it held an account with the required amount of funds. The letters were provided by the applicants and were not verified by a third party. Thirdly, the study found evidence that one director was arrested on charges of false representation over the amount of capital which he declared his proposed bank to have. Fourthly, applicants sometimes evidenced the existence of capital with merely a statement of authorised, or paid up capital signed by the directors. Although none of these factors independently confirm an inherent weakness in the licensing process, their collective effect raises concern about the level, sufficiency and quality of capital with which banks were allowed to start operations [6.2.0].

Importantly, the study found evidence that the MoF's methods for evaluating the financial condition, resources and history of applicants, and the character and experience of major shareholders and directors was weak. Investigations in the financial condition, resources and history of applicants were superficial and did not go beyond requests for verbal or written explanations from the applicants. Requests for information on their tax compliance either went unanswered or were met with summary information. Applicants were not required to provide their bank account statements nor information on their sources of wealth [6.3.0] nor did the MoF establish criteria for assessing the character and experience of major shareholders and directors. Although the process adopted in 1989 of submitting applicants' names to security departments, reduced the threat of known criminals entering the financial sector, it precluded the formal analysis of owners' and directors' banking experience, educational qualifications and probity. In the four instances where the security institutions warned the MoF of the applicant's possible involvement in drug trafficking, money laundering, false representation and fraud, the MoF did not stop processing the applications because the allegations had not been proved in a court of law. Often the applicants withdrew an applicant's name and replaced it with another. The Registrar never returned an application even when the shareholders and/or directors were accused of criminal activities such as murder, during the licensing process [6.4.0].

Lastly, the study found no evidence of the MoF formally evaluating the bank license applications for their convenience and needs of the community or the expectation of financial profitability. Although the MoF was concerned that the rising numbers of local banks might precede widespread bank failures, it did not have a standardised formula for measuring banking sector market saturation. None of the banks licensed between 1984 and 1994 were assessed to determine their individual contribution to the convenience and needs of the community. The regulatory emphasis was on the applicants' satisfaction of the minimum legal requirements [6.5.0]. In fact, the M/Finance instructed the MoF 'should not be seen to be standing in the way of any bank promoter who fulfilled the legal requirements.' Further, there was no evidence of any financial analysis to determine the applicants' prospects for profitability. The MoF lacked the technical skills to for business plan evaluation and instead deferred this function to the BoZ whose evaluation was at best cursory. No evidence was found indicating any detailed or critical evaluation of the business plans it received [6.6.0].

The study concluded that a strict adherence to the established minimum capital requirements precluded a detailed evaluation of the required business and economic capital which the banks required. Further, the emphasis on the minimum capital requirements, which were extremely low in real terms, diverted regulatory attention from a more pertinent matter - the quality of bank ownership and management. The study found found insufficient evidence of adequate management evaluation. Although the security checks intorduced in the late 1980s reduced the risks of known criminals obtaining banking licenses, they were not an assurance of good ownership and management either. Under a more stringent regime, the MoF would not have approved some of the bank licence applications, and thus it can be asserted that weaknesses in the bank licensing policies and procedures contributed to the bank failures of 1995 and 1997/8. However, because, the weaknesses in the design, development and implementation of licensing policies and procedures applied both to banks that failed and those that did not, the study failed to confirm its hypothesis that weaknesses in the bank licensing policies and procedures were *significant* contributory factors to the bank failures of 1995 and 1997/8. There were no discernable differences in the MoF's evaluation of applications between banks that failed and those that did not.

CHAPTER SEVEN

EXPLAINING REGULATORY PERFORMANCE: MONITORING UNSAFE AND UNSOUND PRACTICES

7.1.0 Introduction

Following the 1995 and 1997/8 bank failures, the BoZ came under severe criticism for its handling of the banking failures. Because the bank failures of 1995 and 1997/8 did not occur suddenly, the BoZ was criticised for not acting promptly in dealing with the affected banks. Critics argued that the failures were a culmination of a long process of mis-management, breaches of the law and financial deterioration. The public felt that the BoZ was aware of the financial problems and violations of the law of the failed banks yet it failed to take any action. This chapter evaluates the method of financial analysis the BoZ employed during that period. It shows that despite the weaknesses in its regulatory and supervisory polices and procedures, the BoZ had the capacity and resources to detect financial mis-management, breaches of the law and financial deterioration in the banks that failed.

Section 7.2 describes the structure of the FSSD and details the functions of each of its four divisions in operation at the time of the bank failures. Then, section 7.3 evaluates the method and quality of off-site bank monitoring tools and techniques during 1994-1995 and 1996-1998. Thereafter section 7.4 compliments the quantitative analysis with an analysis of the non-quantitative indicators of impending financial distress in the banking sector. Section 7.5 presents an analysis of the legal provisions available to the BoZ for dealing with failing banks. The issues examined in this section include unsafe and unsound banking practices, the suspension and dismissal of directors and managers, the appointment of Curators, the suspension and revocation of bank licenses, bank insolvency, fraudulent trading, wrongful trading, the seizure of financially-distressed banks and the appointment of receivers

7.2.0 The Financial System Supervision Department

The FSSD, created in 1974, is one of the BoZ's core functions, and is responsible for licensing, regulating and supervising banks and NBFIs registered under the BFSA and ensuring a safe and sound financial system (Musokotwane, 1997:9). Before 1992, it did not undertake any off-site analysis, on-site inspections[14] being the only supervisory tool employed (Mwape, 1997a:5). Additionally, banks were not required to submit any prudential returns other than those required for monetary policy. The focus of the FSSD was on checking compliance with foreign exchange controls and other economic directives. There was heavy reliance on direct controls, such as ceilings on interest rates and lending of banks for monetary policy purposes. This approach was acceptable at the time because the majority of commercial banks operating in Zambia were subsidiaries of reputable international commercial banks, which were subject to consolidated supervision by home country regulators. Thus, through liaison with these supervisory authorities, it was relatively easy for the BoZ to monitor the banks' financial conditions and performance (Mwape, 1997b:6).

In 1994, a year before the first bank failures, the FSSD comprised four members of staff who conducted quarterly analyses of all banks in the industry. Banks only provided four financial returns: the profit and loss statement, balance sheet, liquidity return and statement of capital. These quarterly returns had no legal backing. The department only inspected institutions once a year and, consequently, it did not notice any problems until the next round of inspections, often too late for any corrective action. Such inspections only provided an appreciation of the condition of a bank as at a given date without the necessary support of continuous monitoring of potential risks arising at the bank.

[14] "On site examinations are ameans by which supervisors obtain information in situ on the financial condition of an institution, and its compliance with the law" (Lastra, 1996;115)

However, with the increasing number of financial institutions entering the sector, this approach was clearly inadequate. The need to re-examine the regulatory framework to suit the changing environment was unavoidable. Following the enactment of the BFSA, the FSSD embarked on a capacity building programme of its core divisions, namely, Bank Inspection Division, Non-Bank Financial Institutions Division and, Regulatory Policy and Financial Analysis Division (GRZ, 1998:279). The BoZ significantly improved its terms and conditions of service in order to attract the right calibre of professional staff. In 1995, the number of professional staff increased to 26 from 22 in 1994. By December 1996, that number of had increased to 33. The 1996 FSSD Annual Report attributed the increase in staffing levels to the need "to meet the expectations related to the management of bank crisis, increase the frequency of on-site inspections as well as develop an appropriate regulatory framework for NBFIs."

Since the 1994/95 capacity building programme started, the department has conducted a wide range of training activities in the form of attachments, seminars and short courses, both within and outside Zambia. In the aftermath of the Meridien crisis the department undertook a number of courses, locally and abroad, and in many cases, the central bank invited resource persons from outside Zambia to lecture on various subjects.

In its 1995 FSSD Annual report, the BoZ acknowledged the need for continuous training of its professional members of staff in order to keep abreast with developments in the financial sector. Training during that year focused on: bank restructuring of troubled banks and financial institutions; credit risk analysis; financial institution analysis and secondment to reputable supervisory authorities and central banks around the world. During 1996, members of staff attended various seminars, courses, workshops and conferences conducted by the Federal Reserve Bank, the Federal Deposit Insurance Corporation, East and Southern African Banking Supervisors Association and the INTRADOS Group. One member of staff went to the United Kingdom for a Masters Degree in Business Administration.

7.2.1 Bank Inspection Division

The Bank Inspection Division is responsible for conducting on-site examinations involving the verification of books and prudential returns through regular or ad hoc visits to all commercial banks. Although some branch inspections do occur, the Division typically focuses on the Head office because that is the location of key directors and management staff (Mudenda, 2000:2). Additionally, it takes an active role in the enforcement of prompt corrective measures that financially-troubled banks are required to undertake. In the months leading to the 1995 and the 1997/8 bank failures, the department also assumed the responsibility of closely monitoring the daily core liquidity ratio; deposit movement and the net clearing of financially-distressed banks. This function later included monitoring the foreign exchange exposures, treasury management and the level of non-performing loans. The Director receives a weekly monitoring every Tuesday but in case of problem banks, the Director receives a report on a daily basis (FSSD, 1995:12).

7.2.2 Non-Bank Financial Institutions

The Non-Bank Financial Institutions (NBFIs) Division conducts on-site examination of such financial institutions (FSSD, 1995:12). As is the case with the Bank Inspections division, it plays an active role in the enforcement of prompt corrective measures that financially-troubled institutions are required to undertake. Before the BFSA, 2000, the activities of this division were restricted because the BFSA, 1994 did not provide for adequate supervision of the NBFIs, focusing instead primarily on the supervision and regulation of commercial banks. The provisions in the BFSA relating to providers of financial services are, overall, inadequate, at times misleading and inconsistent. For a long time, NBFIs managed to evade prudential regulation with negative implications on the supervisory system. For example, the Building Societies Act, which solely regulated Building societies, had far less stringent licensing and on-going supervisory requirements than the BFSA (Musokotwane, 1997:10). With the increasing number and variety of providers of financial services, it became imperative that there be an appropriate legislative framework that would address the operations of all providers of financial services. To this end, revisions regarding the regulation of the NBFIs sector were included in the BFSA, 2000, which sought to enhance the powers of the BoZ as the supervisory authority with responsibility for licensing, supervision and regulation of this sector. This was deemed important because of the fast rate of growth in the numbers and range of services, the marked inadequacy of capitalisation, and the lack of proper management resulting in some institutions being insolvent, hence, posing a significant threat to the stability of the financial system. (GRZ, 1998:277)

7.2.3 Management Information Division

The FSSD originally created this division as a banking intelligence unit, investigating specific tasks, whilst allowing the other divisions to continue their normal functions. The intention was that the division would act as a rapid response wing of the FSSD that would verify information through follow-ups to events, reports and rumours. If necessary, the division would then request the Banking Inspection Division to conduct a "snap" inspection of a bank or financial institution, thus guaranteeying a proactive approach to emerging financial difficulties. Although, the division did initially uncover malpractices in several banks relating to, for example, excessive insider borrowing that were not reported to the BoZ, its role in the department was received with mixed feelings, especially, when it was felt that the division was encroaching on the key functions of other departmental divisions.

In the aftermath of the 1995 and 1997/8 bank failures, the Division now focuses on dealing with all matters regarding commercial banks in receivership, liquidation and other forms of bank restructuring. It is also responsible for compiling management information reports for the department; attending to public queries concerning banks; co-ordinating tripartite meetings between external auditors, bank management and the FSSD and co-ordinating the FSSDs training programme (FSSD, 1995:12).

7.2.4 Regulatory Policy and Financial Analysis Division

The Regulatory Policy and Financial Analysis (RP and FA) Division's responsibilities include: licensing banks, non-banks and foreign exchange bureaux; conducting off-site analysis of banks and NBFIs; handling administrative matters in the BFSA; and monitoring compliance with prudential returns (Muke, 1996:4). The Division drafts licensing policies, procedures and makes recommendations to the director on licensing matters. It evaluates license applications and initiates reports on approved and rejected licenses to the Director. The Division also maintains the register for bank licenses and ensures that the register reflects changes in management, shareholders and directors.

Its other more ad hoc responsibilities include the review of existing regulations and the drafting of new regulations and amendments to the BFSA. During 1995, the Division concentrated on issuing statutory instruments for capital adequacy, insider loans, large loans, fixed assets, interest disclosure, classification and provisioning of loans (See Appendix 21). It prepares monthly off-site analysis reports, which, in conjunction with the Bank Inspection Division should ensure that the FSSD enforces the provisions of the BFSA and that banks implement supervisory directives from the BoZ. The monthly reports should show the status of supervisory actions under enforcement. Bank inspectors then review the identified breaches and facilitate enforcement actions, recommending appropriate supervisory actions in case of non-compliance.

The Division is also responsible for carrying out off-site examination of banks and NBFIs and checking their compliance with prudential regulations. It evaluates bank performance using monthly financial statistics and prudential returns data, which include balance sheets, and profit and loss statements (Mudenda, 2000:3). The Division played a key role in the provision of information about the quality of banks during the 1995 and 1997/98 banking sector instability that occurred immediately after the financial reforms.

7.3.0 The BoZ CAMEL Model

7.3.1 The 1994-1995 off-site model of analysis

Before the introduction of uniform monthly off-site reports for each bank, the FSSD produced ad hoc 'Financial Highlights Reports' and 'Market Share Analysis' Reports. The Financial Highlights Reports focused on total risk capital, asset growth, deposit growth, earnings performance, particularly the return on assets and return on average equity. The Market Share Reports focused on total assets, deposits and loans distribution. Due to the lack of resources, the FSSD did not prepare individual bank off-site analysis reports, but instead, relied on annual on-site inspections as the chief source of information about the condition and behaviour of a particular bank and its management. The inspections, however, typically focused on verifying compliance with applicable laws and regulations and a comprehensive review of assets, particularly loan portfolios. In a market share analysis report Mulendele (1995:9) identified several discernable trends that were indicative of impending financial difficulties in the banking sector, especially for the small local banks, namely that:

1. The more established banks had lost deposit market share slightly to the new market entrants. The loss in deposits was a possible indication of an increase in the level of innovation among the local banks used to attract more depositors. The paper recommended developing appropriate monitoring techniques so that commercial banks did not engage in unethical ways of attracting depositors.

2. The increase in loans and advances among the new and small banks suggested the prevalence of poor credit policies. Therefore, the report concluded there was a need to closely monitor the new credit exposures to ensure that banks used sound business principles. The report believed that the small banks might not even have the capacity to evaluate the creditworthiness of borrowers. It recommended additional monitoring of large credit exposures and non-performing loans to ensure that wrong calculations of interest and under-provisioning of bad debts did not inflate reported profits.

3. The banking sector had become more competitive. The report expected that in the coming years, only banks that were able to offer quality services would withstand the competition and maintain their market niches. The increased competition in the banking sector required FSSD to increase its supervisory activities in order to detect malpractice in the industry.

4. Finally, the report expressed concern that at the time, there were no regulations stipulating the nature of capital required to open a bank. It was therefore possible for individuals to open banks with overvalued fixed assets as capital, mobilise cash deposits and subsequently let the bank collapse without suffering any financial loss or undue risk.

Along with increased competition reported in the Market Share Analysis reports, the Financial Highlights Reports (FSSD, 1995) also reported declining banking sector profitability. Compared to 1993, the banking industry's return on average equity reduced from 75% to 30%, and the return on average assets reduced to 3% from 7% the previous year, after tax profits declined by 33%.

While both the Market Share Analysis and Financial Highlights Reports provided valuable off-site monitoring information, they suffered a critical weakness in the delay in their preparation. For example, the FSSD only produced the 31 December 1994 Market Share Analysis Report in February 1995, the Financial Highlights Report in May 1995 (long after the Meridien banking crisis had escalated) and the 31 March 1995 Market Share Report in June 1995. During the banking crisis, decision-makers used data that was often six months (or even more) out of date [Bank 5/D/57]. In the midst of the banking crisis, the FSSD found itself trying to understand transactions, which had their genesis many months before the crisis [Bank 5/D/59].

7.3.2 The 1996-1998 off-site model of analysis

During 1995 and 1996, the FSSD continued to recruit professional staff with financial analysis skills to enhance the Financial Analysis Division (FSSD, 1996:4). In January 1996, the FSSD also improved the off-site monitoring system by adopting the CAMEL method of financial analysis, developed in the U.S.A, which employed traditional ratio analysis in its approach (Muke, 1996:5). CAMEL is an acronym for the Federal Bank regulatory agency Uniform Interagency Bank Rating System signifying five areas of analysis used to evaluate bank performance, namely; C-Capital; A-Asset quality; M-Management; E-Earnings; L-Liquidity. The model used selected ratios for the different categories of bank performance - capital, asset quality, management, earnings and liquidity. It then consolidates the individual category ratings into one composite rating, for comparison with other banks in the financial system. The ratings are used to classify banks as a "Strong", "Satisfactory", Potential Problem" or "Problem" in order to assist regulators determine the required supervisory action.

The CAMEL approach, as designed, developed and implemented by the BoZ between 1996 and 1998 followed the same basic principles as the US model, being primarily a ratio-based financial model that incorporated bank-specific performance indicators. The 19 ratios focused exclusively on bank performance with respect to capital, asset quality, earnings and liquidity. When the FSSD first designed and developed it in 1996, it was intended to act as an early warning system and improve the quality of information requirements for decision-making (FSSD, 1996:18). This section considers the model's success in monitoring and detecting unsafe and unsound banking practices. Before an inspector formed an opinion on the overall condition of a bank, each of the 19 ratios was analysed and interpreted individually, in accordance with the definitions provided in Appendix 27. No explicit mechanism existed to consolidate the ratios into a single measure of performance, against which to compare the performance of other banks in the industry. The model did not classify banks into different "peer groupings" for analytical purposes. At the time, Inspectors felt that such a ranking was not particularly useful in Zambia, given the small size of the industry. Despite plans and attempts to develop software, to record, store, and analyse the data submitted by banks monthly, quarterly and annually (FSSD, 1996:18), throughout the 1995 and 1997/98 banking crises, the model was a manual system utilising basic spreadsheet packages for analysis.

The choice of ratios, discussed in Appendix 27, was a culmination of the initiatives of individual inspectors of the FSSD and reflected recently-introduced statutory ratio limits. Non-financial variables were included in the monthly and industry reports largely at the discretion of inspectors responsible for preparing them. In the absence of a rating system, the model provided no predictive testing criteria, but analysis of its usefulness proceeded by graphing the ratios in each category: capital, asset quality, earnings and liquidity. However, implementation of the BoZ model faced a number of problems, namely:

1. **Lack of information:** At the time of implementing the model, the information submitted by commercial banks was inadequate for substantial financial analysis. Commercial banks submitted a limited number of prudential returns. Additionally, some banks displayed a tendency to delay the submission of some of the prudential returns.

2. **Absence of standard accounting practices:** The absence of a standard approach in the treatment of a number of accounting practices reduced the comparative value of the ratios computed. The most common and serious deficiency was the non-existence of guidelines for the valuation of assets and criteria for the inclusion in the profit and loss statement of unearned interest. Further, before the Classification and Provisioning Regulations, and for many months after their introduction, there were no guidelines for determining the classification of loans, and the level of provisions required for each classification. Similarly, the lack of policies and procedures for accruing interest on non-performing loans led to highly overstated earnings (Muke, 1998a:7).

3. **Choice of ratios**: The FSSD could only compute a limited number of ratios because of inadequate financial information, and a standard approach in the preparation of financial statements.

4. **Absence of industry performance benchmarks**: No industry benchmarks were set and agreed upon for all the selected ratios as indicators of bank performance. The model offered only a convenient classification of different ratios under suitably-designated titles, leaving room for subjective analysis and interpretation. Where a number of Bank analysts were responsible for different institutions, such subjectivity did not facilitate a fair and objective assessment of the industry as a whole.

5. **The absence of a standard rating mechanism** increased the level of analysis subjectivity. Such a mechanism, ideally, would consider, amongst other factors, the nature of business of the bank, its relative size and the types of customers, each of which can influence the inter-industry comparison of performance results by means of ratios. Yet, the current method of analysis ignored the different attributes and nature of business of the commercial banks in the industry.

6. **Lack of resources**: The off-site department was seriously under-staffed at the time, with very limited operational resources. Each inspector was responsible for an average of five commercial banks, and manually collected and analysed a substantial part of the banks' data. Given these constraints, there was a negative effect on the both the quality and timeliness of the financial analysis.

Despite weaknesses in its design, the BoZ CAMEL model highlighted the key aspects of a bank in which an analyst should be interested: capital, asset quality, earnings and liquidity. For off-site analysis purposes, it also offered the flexibility of selecting what felt were the most appropriate ratios for its own financial environment. The model offered a framework for selecting the appropriate ratios and specifying the standards against which to evaluate the performance of an individual bank, as well as the performance of an industry. Most importantly for the BoZ, it provided sufficient indicators of financial distress amongst local banks in 1997/8 in terms of their capital, asset quality, earnings and liquidity ratios. Firstly, there was a significant difference between the capital ratios of the failed and non-failed local banks (Figure 15). The failed banks show a greater weakness in their capital adequacy levels compared to the two other categories, sometimes as early as nine months before failure. The tier one and total risk-based capital ratio differences for the three groups indicated that at least 21 months before closure, the financial ratios of the failed and non-failed banks appear to have been markedly different.

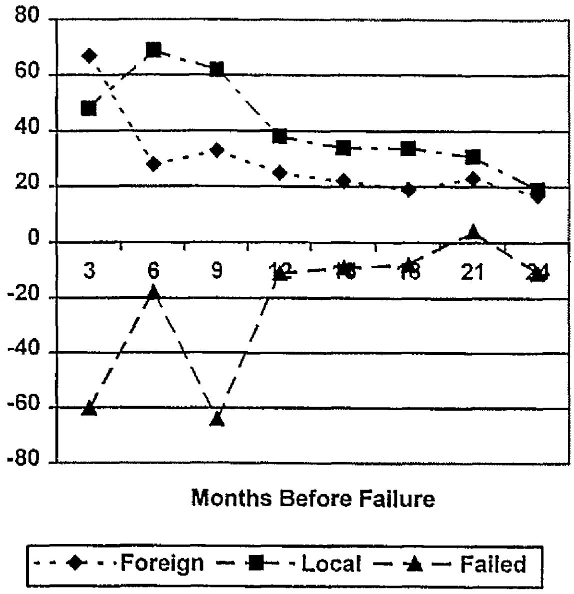
Figure 16 indicates that the non-performing loans to total assets ratio and non-performing loans to total loans ratio reflected differences between failed and non-failed banks nine and six months before failure, respectively. There was, however, a marked difference in the level of provisions made for non-performing loans relative to the total loans portfolios of the two groups. However, we have to treat the ratios obtained under the asset quality category with caution. Following the introduction of the Classification and Provisioning Regulations in 1996, there was a lot of agitation about the levels of provisions required for past due loans. Some banks implemented them fully; others received exemptions from certain requirements, while others simply ignored them altogether. The uniformity of the ratios obtained for the different banks therefore could not be ascertained. One of the most discussed issues during the year 1994, one year before the Bank 5 failure, was the steadily rising level of non-performing loans[15] in the banking sector. Table 24 below shows that reported non-performing loan portfolio grew from 25% of the total loans portfolio in March 1994 to 36% by December 1994. Likewise, the proportion of non-performing loans as a percentage of total capital and reserves grew to 86.5% from 60.33% over the same period.

[15] In the years leading up to 31 December 1994, the BoZ defined non-performing loans as those loans on which interest was not being accrued due to the existence of reasonable doubt as to the ultimate collectability of the principal and/or interest. Commercial banks were required to classify loans and advances as non-performing when principal and /or interest payments were past due for 90 days or more. By that time, the BoZ presumed that reasonable doubt existed.

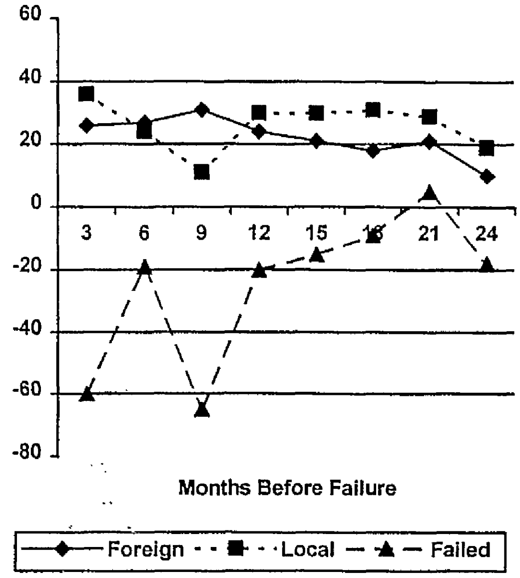
Figure 15 BoZ Camel Capital Ratios

0

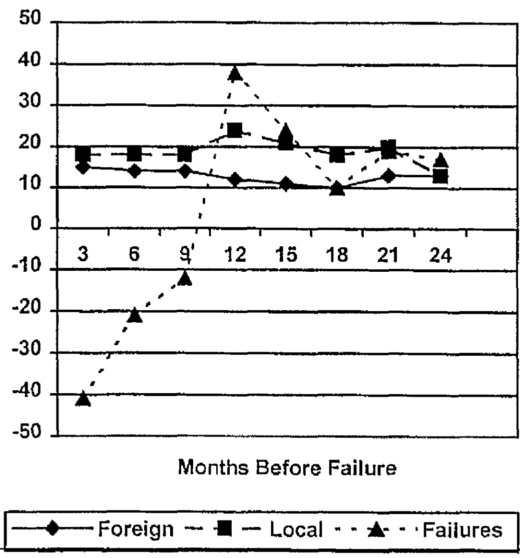
Total Capital to Risk Based Assets



Tier 1 to Risk Based Assets



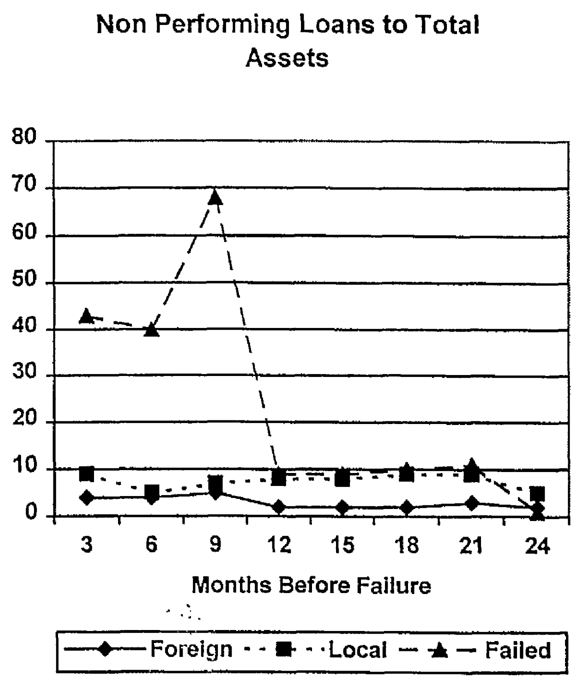
Equity to Total Assets

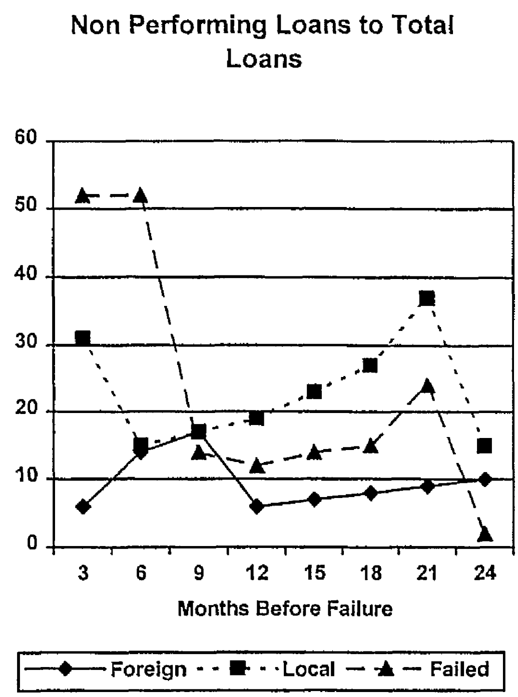


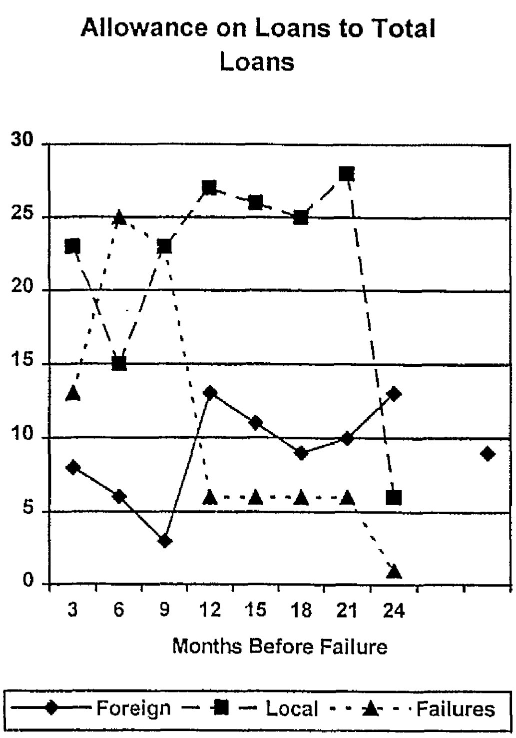
Equity to total assets
A crude measure of the extent to which a banks total assets are financed by the shareholders equity

Tier 1 to risk weighted assets
Total capital to total weighted assets
Express the primary and regulatory capital as a percentage of the total risk weighted assets of a bank. The ratios indicate the margin of protection available to depositors and creditors against unanticipated losses that may be experienced by the bank. Thus they include banks resilience to economic difficulties.

Figure 16 BoZ Camel Asset Quality Ratios





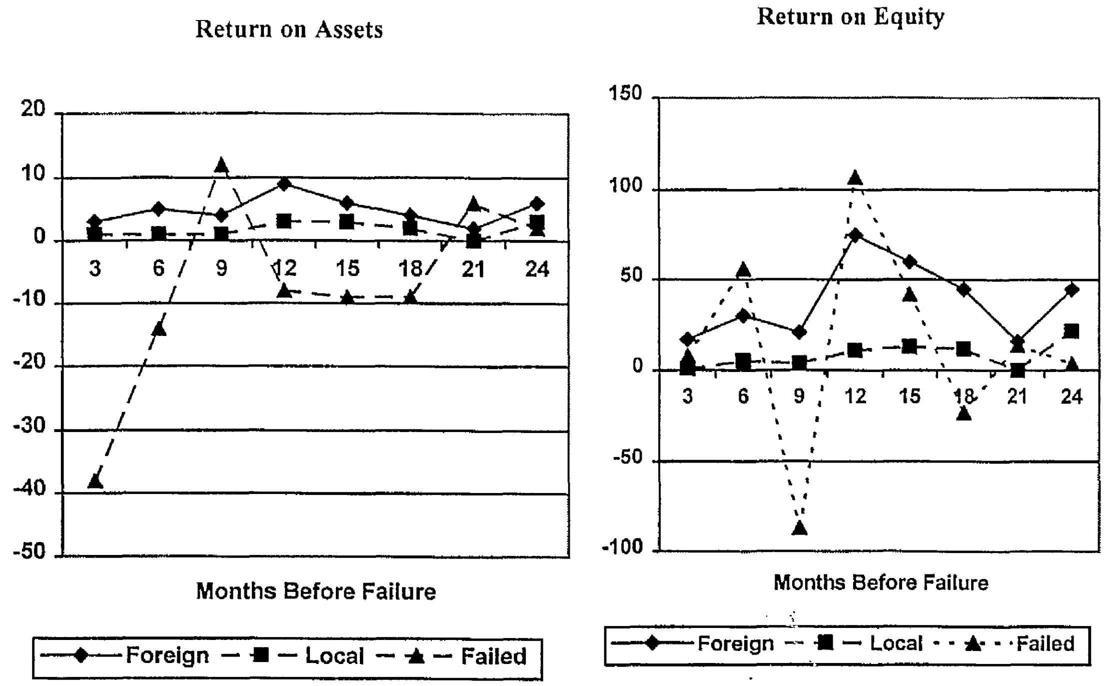


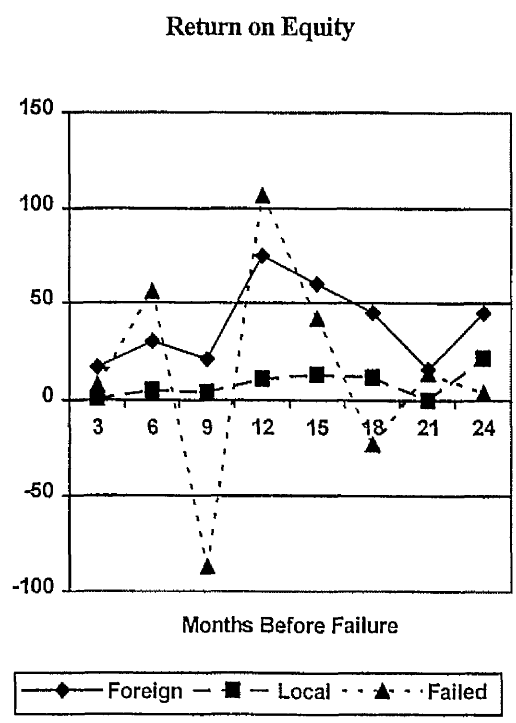
Non Performing Loans to Total Loans
Loans and advances usually represent the single largest asset of most banks. Thus monitoring the quality of the banks loan portfolio is of the utmost importance. The greater the ratio the higher the credit risk the bank is exposed to.

Non Performing Loans to Total Loans
Provides useful insight into the quality of a banks loan portfolio and bad debts coverage, and the adequacy of loan loss provisions. However, this ratio may not be as useful as it ought to be due to reluctance on the part of the banks to write off unrecoverable loans, which inflates the ratio.

Allowance on Loans to total Loans
A test of the adequacy of the allowance for loan losses. It reflects the extent to which the bank recognises how badly its total loan portfolio has been impaired.

Figure 17 Camel Earnings Ratios





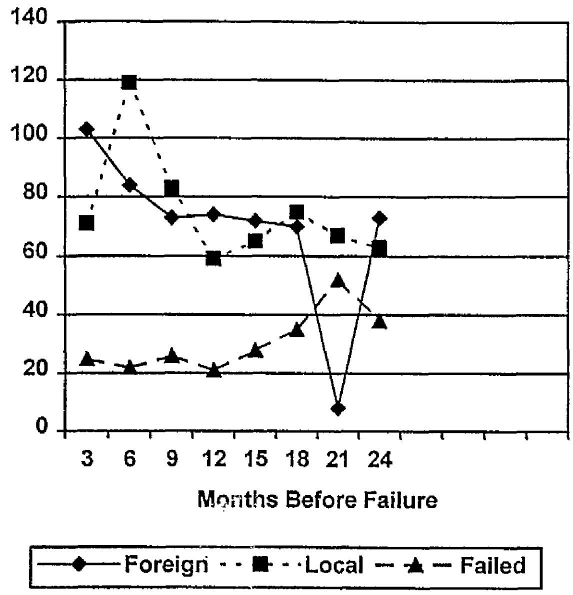
Return on Assets
Measures the net income generated from the employment of the total assets of the bank. If reasonable accounting principles are consistently applied to banks with similar asset structures, a bank with a higher return on assets is inherently sounder than one with a lower ratio.

Return on Equity
Measures the rate of return on the shareholders equity investment. In an inflationary environment likely Zambia the rate should ideally be at least that of the ruling inflation rate so as to enable the bank to maintain its equity base in real terms, assuming no dividends are paid out

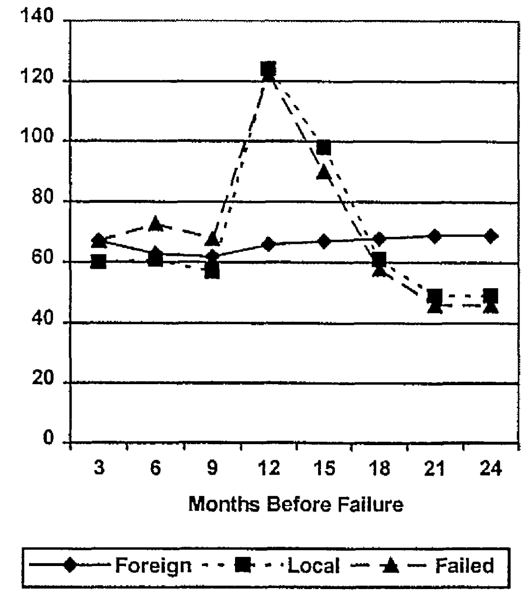
Interest Margin
Identifies and evaluates the core earring capacity of the bank. A negative or declining ratio is an important indicator of treasury management problems that require attention.

Figure 18 Camel Liquidity Ratios

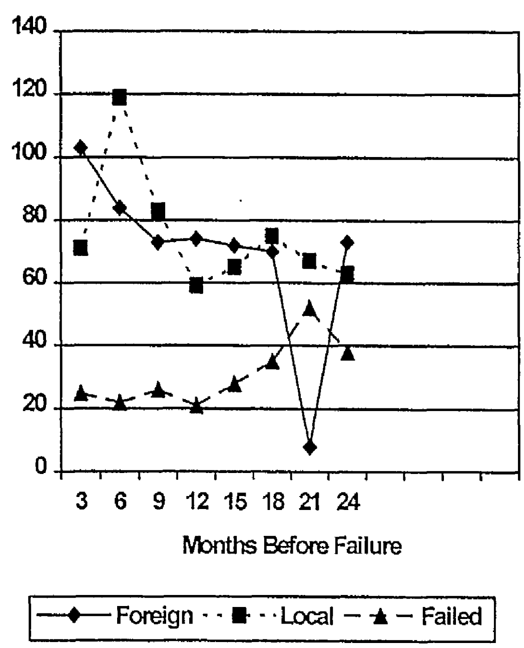
Liquid Assets Ratio



Total Deposits To Total Assets



Liquid Assets Ratio



Liquid Assets Ratio
A rather crude yet useful measure of a banks liquidity. It reflects the banks' ability to meet its short-term liabilities with its short-term assets. A bank that does not have to rely on the repayment of its loans in order to meet its obligations is "insulated" against its non-performing portfolio.

Total Deposits to Total Assets
Measures the extent to which the bank assets are financed by the deposits of its customers. The greater the ratio the greater its vulnerability to liquidity problems in the event of a run on the bank.

Gross Loans to Total Deposits
Measures the extent to which a bank is able to mobilise deposits from the public to support its operations and the extent to which it is able to lend these deposits. A higher ratio is traditionally associated with a greater element of risk since this indicates lower liquidity vulnerability to institutional lenders, adverse economic conditions, and or, the consequences of a deposit run.

Table 24 **Growth in Industry Non-Performing Loans during 1994**

Quarter	Total Non-Performing Loans K'm	Total Loans K'm	Total Capital and reserves K'm	Non-Performing Loans as a % of Total loans	Non-Performing Loans as a % of Capital and reserves
March 1994	25,6363	99,419	42,491	25.78	60.33
June 1994	32,496	119,006	52,893	27.30	61.43
Sept 1994	44,191	142,694	55,450	30.96	79.69
Dec 1994	49,364	136,576	57,051	36.14	86.5

Source: BoZ non-performing loans returns

Table 25 **Industry Non-Performing Loans as at 31 December 1994**

Loans Category	Gross Balance K'm	As a % of total Non-performing loans	Provision K'm	Net balance K'm	Interest Taken to income K'm
180 days past due	41,989	85.07	9,428	32,562	74
90-179 days past due	6,210	12.57	168	6,041	2,124
Renegotiated loans	2,165	02.36	546	620	55
Total	**49,365**	**100**	**10,142**	**39,223**	**2,253**

Source: BoZ non-performing loans returns

Both Tables 24 and 25 are an understatement of the actual level of non-performing loans for the quarter ending December 31, 1994, because only 11 banks out of 18 submitted their returns for non-performing loans. Since there was no penalty for the non-submission of returns, the remaining seven banks faced little or no consequences. Nevertheless, the loan portfolio of the 11 banks (K136, 577 million) represented 94.26% of the total industry loan portfolio (K144, 885 million). The capital base of these 11 banks (K57, 057 million) was 97.32% of the industry total capital and reserves (K58, 623 million). The reported non-performing loans for the 11 banks were K49, 365 million representing 86.5% of total capital and reserves. As Table 25 shows, at least 85% of the reported non-performing loans were in excess of 180 days past due and 12% between 90-179 days. ZNCB had the largest proportion of non-performing loans, which stood at K33, 873 million or 68.61% of the total non-performing loans in the industry. Bank 14 and Bank 5 were second and third respectively with 5.26% and 5.36% of the industry total respectively.

The FSSD was aware of the increasing level of non-performing loans: A year-end banking industry non-performing loans report for the quarter ending 31 December 1994, concluded that "banks should be advised to be prudent in their lending activities. They should be told to try and reduce the level of non-performing loans in general within a given time-frame."

As indicators of potential failure, the return on assets and the interest margins perform better over the 24 months period than the return on equity ratio. The latter's variability, shown in Figure 17, is possibly a result of a combination of deteriorating capital levels and variations in the reported profits relative to that capital. As with the asset quality ratios, the study did not ascertain the degree to which the agitation, caused by the levels of provisions required by the introduction of the Classification and Provisioning Regulations affected the reported profits. The probability of banking using creative accounting to report artificial profits is an important factor.

However, the most significant visual mean difference between the non-failed local banks and the failing banks is the liquid assets ratio shown in Figure 18. As early as 24 months before closure, the failed banks had liquid assets ratios of less than 50%. From 52%, the ratio consistently declined over the 24 month period to 25% at the time of closure, having averaged 30% over the entire period. This is in sharp contrast to the 75% average maintained by the non-failed local banks. The gross loans to total deposits ratio also reflects a significant difference in means (Figure 18). There is, however, no observable difference in the total deposits to total assets ratio between the two groups, perhaps, suggesting that even though the liquid assets ratio was markedly different, the non-failed banks were equally vulnerable to liquidity problems in the event of a run on the banks.

7.3.3 The Post 1997/98 off-site model of analysis

An important FSSD priority in the post-1997/8 period was the creation of comprehensive off-site monitoring procedures that would eventually result in an effective early warning system. The FSSD decided, that the development of an early warning system needed to be done in conjunction with a financial database, which was lacking in the department at the time. It was also decided that the database would cover all banks and financial institutions without exception, in the hope that it would generate analyses, ratios and trends that would facilitate timely indications of potential problems. The FSSD developed an on-site inspection manual with the assistance of several supervisory offices and technical advisors. The manual provides background information and details procedures for specific bank inspections. Overall, it covers the key areas of a bank's inspection, consistent with worldwide bank inspection practice.

The FSSD also revised its approach to financial analysis in 1997, by producing a financial analysis guide stipulating the benchmarks for the ratios used in the analysis of commercial banks. Additionally, it also extended the number of ratios used in the model to reflect the extra information being collected, such as the level of insider loans and large loans made at the bank. In 1998, the BoZ developed an early warning system with the assistance of an expert from the IMF (FSSD, 1998:14). The revised early warning system is a rating system that consolidates the financial condition of bank into a composite rating (Appendix 37).

Additionally, the FSSD prescribed new reporting requirements for all banks intended to capture information for both supervisory and monetary analysis purposes. The FSSD also developed Microsoft Access '97 based templates for the revised reporting formats to facilitate electronic submission of returns with the view of enabling speedier and more efficient means for updating financial data at the BoZ (FSSD, 1998:15). The FSSD has also made significant strides in improving the data collection and provision of information. As late as 1995, it was very difficult to establish the financial condition of a commercial bank in Zambia using data held by the central bank. Prudential returns were submitted on a quarterly basis and financial reports were prepared over a period of two to three months. Thus, the most current information was often six months old. The situation today has dramatically changed. The format and frequency of filing prudential returns by commercial banks with the BoZ was significantly enhanced during the year 1998. Commercial Bank circular No. 1/98 of January 21, 1998 requires all banks to submit 12 financial statements monthly and an additional two statements biannually. The statements were designed to provide off-site inspectors with the requisite data for substantive financial analysis.

To enhance the effectiveness of supervising banks, a risk-based approach to bank inspections has been introduced, the intention being to develop a very focused approach to bank inspections by identifying the risks inherent in banks and assessing management's ability to identify themselves identify, measure, monitor and control risk. The new approach will require constant contact between on-site officers, bank management and both internal and external auditors. This approach, which is in response to the new technologies, product innovations, size and speed of financial transactions, will require the analysis of both financial and non-financial information.

The BoZ implemented the system in 1999, and it is yet to assess its effectiveness. It is intended that information from the early warning system reports, along with an understanding of the risk profile of the institution prepared by Bank Inspection will enable FSSD to be proactive with respect to dealing with a deteriorating situation or to initiate prompt measures to address a potential problem at a financial institution.

7.4.0 Strategic Business Indicators of Financial Distress

A review of the local banks corporate strategies in the years 1996 and 1997 further revealed that the banks that failed in 1997/8 lacked the requisite business strategies for their operational environment. The failed banks' competitive and business strategies were inappropriate for the competitive and economic environment prevalent during those years.

7.4.1 Competitive strategies

Following the liberalisation of the banking sector, significant rivalry existed between the local banks as they competed for market share. The decontrol of foreign exchange, the liberalisation of interest rate controls and the introduction of the tender system in the sale of treasury bills on the open market had attracted new entrants to the banking system. However, following the bank failures of 1995, the reduction in the number of banks increased the level of market concentration. In the following months a significant shift of deposits occurred from the smaller local banks to the larger, and presumably safer banks. The five largest banks increased their share of total deposits in the market from 64% in December 1994 to 80% in December 1995, a level they maintained throughout 1996 and 1997. The 14 remaining banks, largely local ones, had to compete for the remaining one fifth of the total deposit market. Table 26 and Figure 13 show the Kwacha deposit trends between 1994 and 1997 and between 1994 and 1999 respectively.

Table 26 Banking Industry Deposit Trends (1994-1997)

	Dec. 1994	Dec. 1995	Dec. 1996	Sept. 1997
Five largest Banks	K186Bn (65%)	K338Bn (80%)	K463Bn (80%)	K561Bn (77%)
Rest of the Banks	K102Bn (35%)	K85Bn (20%)	K118 Bn (20%)	K169Bn (33%)
TOTAL DEPOSITS	K288Bn (100%)	K423Bn (100%)	K581Bn (100%)	K732Bn (100%)
Total No. of banks	18	17	19	19

Source: BoZ

Figure 13 shows that in the period 1994-1999, the total deposits market share of pre-independence foreign banks grew from 35% to well over 50%. Local banks, on the other hand, lost the largest proportion for the market with a decline from 25% of total deposit market share in December 1994, to fewer than 10% in December 1999. The 1995 and 1997/98 bank failures dissipated public confidence in the banking system. In the absence of a deposit insurance scheme and a working social security system, people were understandably wary of the risk of losing their money in failing banks. In the event of a bank failure, the BFSA only provided for a fixed compensation amount of K500,000 ($150).

The intense competition for deposits resulted in some unethical banking practices. The FSSD received anonymous letters attesting to these unethical practices and investigated them. Rumour-mongering was also rife in the banking community, with bank's spreading false stories of imminent closures by the BoZ of certain banks. This caused significant instability in the market, especially among the local banks hit the hardest by 'flight to quality' phenomenon, as banks attracted unstable and volatile deposits;. The more established banks like, Barclays, Standard Chartered, Citibank and Stanbic benefited from these rumours.

Additionally, the FSSD received intelligence reports that banks were bribing public officials controlling huge accounts to transfer from competing banks. At a meeting with Chief Executives of all banks in August 1995, the Governor expressed his concern over these unethical practices and asked banks to refrain from using unorthodox methods to woo depositors.

The lack of service differentiation[16] between the local banks also made them even more vulnerable to a price-based competitive environment. The rational economic response to such competitive pressure was for smaller banks to merge in order to present the larger banks with more credible competition. Speaking at the merger of Bank 9, and Bank 2, on 10th January 1997, Bank 9 managing director acknowledged "the Zambian banking sector had to accept that, in the prevailing financial quagmire, weaker banks had to merge with stronger ones in order to survive". Unfortunately, many of the failed banks resisted this option right up until their closure. The Bank 12 chairman and owner dismissed talks of a merger with Bank 4 on 23 April 1998, eight months before both banks collapsed, saying there was no benefit in bringing together two troubled banks. In the absence of clear viable strategic alternatives, failure was almost inevitable.

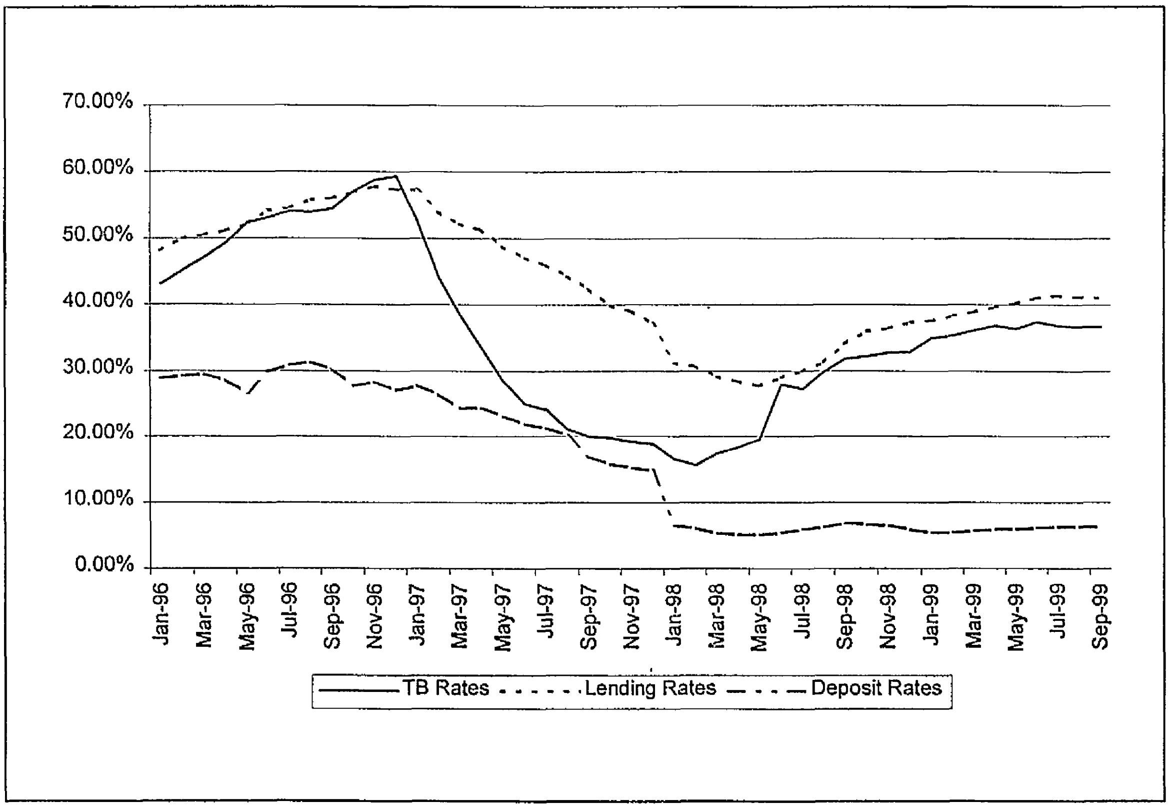
[16] The banks offered the same banking services, namely; savings, current and time deposit accounts.

The threat of new entrants and suitable products was also a notable indicator of potential banking distress. During that same period, the banking sector faced an increase in the number of non-bank financial institutions. By 1996 there were over 26 NBFIs registered with the BoZ, namely, leasing companies, building societies, deposit-taking NBFIs, and DFIs. Compared to banks, their relative size remained small. Deposits, and deposit-like instruments, amounted to K28.5Bn in 1996, almost half of which was accounted for by the Zambia National Building Society, which represented 4.5% of the total deposits of banks. These credit organisations were more willing and able to provide enterprise finance at lower interest rates than the banks. Finally, due to the shortage of a profitable variety of financial instruments, the local banks, especially those that failed, invested heavily in treasury bills during the same period 1995-1997, giving the government immense bargaining power to determine the level of industry profitability. The government could reduce the cost of its borrowing by reducing the Treasury bill rates without undue fear of losing its largest source of domestic funding. The reduction in Treasury bill rates squeezed the profits out of an industry heavily invested in treasury bills (Figure 19).

7.4.2 Business Strategies

An examination of the business strategies of local banks revealed inapprpriate reliance on cost based competitive strategies. With only a few exceptions, the banks in the industry pursued a cost leadership generic strategy. Yet, unable to muster the resources required to sustain operations at the least possible prices, the smaller banks found the advantages of such a path were short lived, as rivals easily imitated each other. The failed banks would have been well advised at the time to reconsider their competitive positions in favour of either differentiation or focus strategies, leaving the larger banks to pursue the least cost option. Only a bank of the size of the Zambia National Commercial Bank (ZNCB) could have sustained a loss of K9Bn for the financial year-ended March 31, 1996 and continued to operate. The bank's Managing Director attributed the loss to the bank's cost restructuring exercise which intended to entrench the bank's low cost leadership position, on 15 January 1997.

Figure 19 Nominal Interest Rate Trends: January 1996 to September 1999



Source: BoZ Financial Statistics

Further, during the two years before closure, increasingly unbalanced and unprofitable portfolios of services inhibited the profitability of the failing banks. Government securities, which had been a very profitable investment in the past, ceased to be as profitable as in the early 1990's. Some of the banks tried to realign their portfolios by increasingly engaging in foreign exchange transactions, but exchange rate volatility meant that this was not always a favourable option. The local banks' heavy reliance on capturing savings accounts from the public also worked to their disadvantage. These accounts were highly unprofitable. At the opening of Investrust Merchant Bank, the bank's finance director acknowledged this fact. Explaining why his bank would only concentrate on corporate and merchant banking he said, "...the volume of transactions on savings accounts was high, yet the returns were low".

Little expansion into new banking markets during the years 1996 and 1997. Most of the local banks were struggling to maintain their existing market shares and continued to penetrate the market with the same profile of products and services. The few publicly-reported exceptions were ZNCB, Stanbic and PBZs. On July 9, 1997, ZNCB announced its intention to open a branch in the Democratic Republic of Congo, soon after the fall of Mobuto Se Se Seko's government. The fact that a government minister announced the planned market expansion underscores the point that political rather than economical factors took precedence. In any case, the civil war that erupted soon after rendered such plans void. Stanbic announced plans to open branches on the Copperbelt on February 2, 1997 expecting to benefit from the anticipated boom in the regional economy once the government privatised the ZCCM. Except for the above growth actions, the rest of the banks appeared to be content with penetrating an otherwise saturated market, a recipe for disaster in an economy that was not growing. The ideal strategy would have been for them to seek new markets or new products that would not have placed them in direct competition with the larger banks.

7.5.0 Legal Provisions for Dealing with Failing Banks

Given the declining financial condition of the local banks discussed in Section 7.3.2 the next question that needs to be addressed before evaluating the BoZ's response to the emerging banking crisis is: *Did the BoZ have the necessary legal authority to force offending banks to address their financial problems*?

This section considers whether the legal framework conferred on the BoZ the legal authority to take legal action against the directors of banks when it detected financial mis-management, breaches of the law and financial deterioration in the banks that failed. It considers the position of the shareholders and directors in relation to their role in the mis-management of the failed banks, and details the directors' respective legal obligations to their banks and identifies the principal legal provisions available to the BoZ with respect to enforcing corrective measures and actions. It is based on a review of the failed bank's Memorandum and Articles of Association and the Zambian Companies Acts 1921 and 1994, Banking and BFSAs 1972 and 1994, respectively, Securities Act 1993 and relevant BoZ guidelines and regulations (Large loans, Insider loans, Capital adequacy, and Non-performing loans, overdrafts and investments). It also summarises the basis for the regulatory actions against the banks that failed in 1995 and 1997/8 by referring to the key documents, interviews and workshop contained in the Intervention and Closure Working Papers collected during the thesis fieldwork. The section concludes by identifying the potential claims against the directors of the failed banks from their involvement in unsafe and unsound banking practices. The documents available to the researcher in this respect were incomplete. There is ample reason to believe that substantial numbers of potentially incriminating documents relating to the activities of the various directors of the failed banks were removed or destroyed, before the BoZ closed the banks and appointed receivers and/or liquidators.

7.5.1 Unsafe and unsound banking practices

Various provisions in the BFSA restricted banks from conducting unsafe and unsound banking practices. For example, the Act required banks to comply with regulations relating to reserves for bad/doubtful debts[17], prohibited banks from declaring dividends or other transfers from surplus if such transfers would impair capital adequacy[18], set the loan limit at 25% of regulatory capital[19], prohibited loans secured by bank own stock[20], and prohibited any amount, whether secured or not, to directors of the lending bank. Where, a bank or its director(s) were committing, pursuing, or about to commit an act or course of conduct that was considered as unsafe or unsound practice, it could enter into one or more written agreements with the bank or its board of directors to establish a programme of action to counteract the unsafe and unsound practice[21]. Where the BoZ was unable to obtain an agreement within a time and in a form and content satisfactory to the BoZ, or where the BoZ considered that the need for prompt action made the negotiation of such an agreement impractical, the BoZ was to direct the bank or director, manager or other person concerned in its management to do either or both of the following:[22]

[17] Section 58
[18] Section 69 (3)
[19] Section 73 (1)
[20] Section 73(2)
[21] Section 77 (1)
[22] Section 77 (2)

1. Cease or refrain from doing the act or pursing the course of conduct;
2. Perform such acts as, in the opinion of the BoZ, are necessary to rectify the situation;
3. Direct the bank to refrain from adopting or pursuing a particular course of action or to restrict the scope of its business in a particular way;
4. Impose any limitation on the bank's acceptance of deposits, the granting of credit, the making of investments or the paying of dividends;
5. Prohibit the bank from soliciting deposits either generally or from specific persons or classes of persons;
6. Prohibit the bank from entering into any other transaction or classes of transactions, or from commencing or continuing any activity which it is permitted under this Act to carry on; or
7. Require the suspension or removal from office of any director, officer or other person.

Any person in contravention of the provisions of an agreement made or direction given under this section was guilty of an offence and liable on conviction to a penalty not exceeding ten million Kwacha or to imprisonment for a term not exceeding five years, or to both[23]. Under Chapter VII, banks could appeal against a decision of the BoZ[24].

7.5.2 Suspension and dismissal of directors and managers

The M/Finance, on the recommendation of the BoZ, was entitled to suspend from office for any period not exceeding six months, any director or officer of a bank that failed to take all reasonable steps to secure compliance by the bank with the requirements of the Act[25]. At any time before the expiry of the period of six months, the BoZ could apply to the Court for an order extending the suspension. The court might then suspend the director or officer concerned for such period as it thinks fit or,

[23] Section 77 (6)
[24] Section 77 (7)
[25] Section 37 (1)

if the court is satisfied with the reasons, remove the director from office permanently[26]. The BFSA determined that a director or officer who performed any power or duty pertaining to his office during any period of suspension imposed or after removal from office, would be guilty of an offence and be liable on conviction to a fine not exceeding ten million Kwacha or imprisonment for a term not exceeding five years, or both[27].

7.5.3 Appointment of Curators, Suspension and revocation of bank licenses

Where a bank refused to: comply with an order of the BoZ under this Act; permit an examination to be made as provided by this Act, or otherwise obstructed such an examination; or an authorised examination showed that the bank concerned conducted its business in an unlawful manner or engaged in a course of conduct that was unsafe or unsound; or that for any reason (other than insolvency) the bank was unable or was likely to become unable to continue its operations in the ordinary course, the BoZ could take disciplinary measures against the bank[28].

The disciplinary measures included appointing a person (in this section called a curator) who in its opinion had proper training and experience, to advise the bank on the implementation of such measures as may be specified by the BoZ to rectify the matter (and whose remuneration, as fixed by the BoZ, was paid by the bank concerned) suspending the bank's licence for a period not exceeding six months; or revoking or restricting the bank's licence[29]. Alternatively, the BoZ could vary the conditions of its licence as to impose any restriction[30].

When a curator was appointed, the bank and every director, officer, agent and employee of the bank had to act in accordance with every instruction given by the curator concerning the bank or any part of its property, administration, operations or business regulated by under this Act[31]. If a bank failed to comply with an instruction of

[26] Section 37 (2)
[27] Section 37 (3)
[28] Section 81 (1)
[29] Section 81 (2)
[30] Section 81 (3)
[31] Section 81 (4)

a curator appointed, the bank could implement disciplinary measures against the bank[32]. The curator had to comply with any written instruction of the BoZ, and in all other matters act honestly and in good faith in what the curator reasonably believed to be the best way to restore the bank to a sound financial and operating condition[33]. Acts or omissions of the bank in accordance with a direction of the curator were binding upon the bank, but no person had any right or claim against the curator or the BoZ because of any direction given by the curator in good faith in accordance with this Act[34]. The curator would advise the BoZ within six months following the curators appointment whether in his opinion, the bank could be restored to a safe operating condition within a reasonable time, or should be wound up[35].

7.5.4 Bank insolvency

The BFSA defined a bank as insolvent when it ceased to be able to meet its obligations as they fall due or when its assets were insufficient to meet its liabilities[36]. An insolvent bank was not allowed to receive any deposit; or enter into any new, or continue to conduct any existing, banking or financial service business[37]. A director, officer or employee of a bank who knew or, in the proper performance of his duties, could reasonably be expected to have known of the insolvency of the bank and who caused or permitted any act in contravention of this section shall be guilty of an offence and liable on conviction to a fine not exceeding ten million Kwacha or to imprisonment for a term not exceeding five years, or both[38].

[32] Section 81 (5)
[33] Section 81 (6)
[34] Section 81 (7)
[35] Section 81 (8)
[36] Section 86
[37] Section 87 (1)
[38] Section 87 (2)

7.5.5 Fraudulent trading

The Companies Act CAP 26 of 1994 defines fraudulent trading as the intentional or reckless incurring of debts while knowing that the company has no hope of being able to repay. It was introduced into English law by the Companies Act 1929 and is preserved by the Insolvency Act 1986 Section 213 and 215. In Zambia, the legislation relating to fraudulent trading is maintained in s. 383 (1) of the Companies Act, CAP 26 of 1994, which provides that:

> "In the course of the winding up of a company or any proceedings against a company, the court may, on the application of the liquidator or any creditor or member of the company, if it is satisfied that a person was knowingly a party to the carrying on of any business of the company of a fraudulent purpose, make an order that the person shall be personally responsible, without any limitation of liability, for the debts or other liabilities of the company or for such of those debts or other liabilities as the court directs"

Section 383 imposes no restriction in terms of any time period before the company's winding up during which the event must have taken place in order for the liability to be imposed. To succeed with such a claim, the BoZ must prove, on the balance of probabilities, the conducting of business with an intent to defraud, and that the respondent was knowingly party to this. Conducting business with the intent to defraud requires a person take positive steps to incur the debts while knowing that the bank is insolvent. The spirit of the provision is to catch those who have actively participated. The element of intent to defraud requires actual dishonesty on the part of those conducting the business, which may consist of a course of conduct or a single act.

In Zambia, no individual in the financial sector has ever been convicted of the offence of fraudulent trading. English-based case law, from which Zambia draws precedence, on fraudulent trading is sparse since the "silver lining" or "sunshine test" or the "light at the end of the tunnel" test protects directors. Very few cases have been successful (Wood, 1995:142). The "sunshine test" is evident in the 1960 case of Re White vs. Osmond (Parkstone) Ltd, in which Buckley J said;

> "There is nothing wrong in the fact that directors incur credit at a time when, to their knowledge, the company is not able to meet its liabilities as they fall due. What is manifestly wrong is directors allowing a company to incur credit in such circumstance that it is clear the company will never be able to satisfy the creditor. However, there is nothing to say that directors who genuinely believe that the cloud will roll away and the sunshine of prosperity will shine upon them again and disperse the fog of their depression are not entitled to incur credit to help them get over bad times."

7.5.6 Wrongful trading

The liability for wrongful trading contained in Section 357 of the Zambian Companies Act 1994 provides that wrongful trading occurs if an officer of a company who is knowingly a party to the contracting of a debt by the company has, at the time the debt is contracted, no reasonable or probable ground of expectation (after taking into consideration the other liabilities, if any, of the company at the time) of the company's being able to pay the debt.

The burden of proof in a wrongful trading claim is much lower than in a fraudulent trading claim because there is no need to show dishonesty. Instead, the director's actions after he realised or ought to have realised, that the bank could not reasonably avoid insolvent liquidation determines his level of guilt or innocence. The main difference between fraudulent trading and wrongful trading is that there is no regard to moral blame or intention to defraud creditors. Instead, the law deems the director to have the competence of a "reasonably diligent person" having (a) the general knowledge, skill and experience reasonably expected of his function and the general knowledge, skill and experience he actually has. The only defence a director has from wrongful trading is if he took "every reasonable step with a view to minimise the potential loss to the company's creditors he ought to have taken." Wood (1995:144) lists the practical steps as including; calling a board meeting, commissioning auditors to report, seeking advice of insolvency experts and taking other steps to improve the company's position e.g. reducing overheads or disposing of loss-making businesses. In a hopeless situation, the director must stop the company from trading.

7.5.7 Seizure of financially-distressed banks and receivership

An officer of the BoZ, or any person acceptable to the BoZ and willing to act, may be a receiver for the purposes of this part[39]. The BoZ may by resolution, appoint and direct a receiver to take possession of any bank that, in its opinion is insolvent[40]. When taking possession of a bank, the receiver shall post in each branch a notice announcing its action and specifying the date and the time at which such possession shall take effect, and shall transmit a copy of the notice to the court[41]. Within a period of 21 days after the date on which the receiver has taken possession of a bank, the bank or any interested person acting on its behalf may institute proceedings in the court to require the BoZ to show cause why the seizure should not be terminated[42]. A receiver who takes possession of a bank has full and exclusive powers of management and control of the bank including, without limiting the generality of the foregoing, the power: –

(a) To continue or discontinue any operations;
(b) To borrow money, whether on the security of the assets of the banks or otherwise;
(c) To stop or limit the payment of any obligation;
(d) To employ any necessary officer, employee or professional advisor;
(e) To execute any instrument in the name of the bank and to initiate or defend and conduct in its name any action or legal proceeding; and
(f) To terminate possession by restoring the bank to the control of its board of directors or owners, as the case may be[43].

7.6.0 Conclusion

Chapter seven sought to establish whether the BoZ had the capacity and resources to detect declining corporate governance, financial deterioration and violations of the banking regulations and laws in the banks that failed in 1995 and 1997/98.

[39] Section 94 (1)
[40] Section 94 (2)
[41] Section 95
[42] Section 96

The Chapter commenced with an evaluation of the methods and quality of off-site bank monitoring tools and techniques during 1994-95 and 1996-98. It found that the BoZ off-site monitoring system was initially weakened by the lack of information due to the limited number of prudential returns which banks were required to submit to the BoZ, the absence of standard accounting practices, the absence of a standard approach to the selection and use of financial ratios, the absence of industry performance benchmarks, the absence of a standard rating mechanism and the lack of departmental resources. However, despite these weaknesses, the study found that the BoZ CAMEL model highlighted key aspects of bank performance that should have alerted the BoZ to deteriorating capital levels, asset quality, and earnings performance and liquidity positions. The application of 19 financial ratios used by the BoZ in its own analysis revealed that there were sufficient differences between the ratios for failed and non-failed banks. The failed banks showed lower capital adequacy levels than non-failed banks as early as 12 months before their closure. There were marked differences in the level of provision made for non-performing loans relative to total loan portfolios, and the ratios for return on assets and interest rate margins. Significantly, as early as 24 months before closure, the failed banks had asset ratios of less than 50%, which was in sharp contrast to the 75% average for non-failed banks [7.3.0]

In addition, a review of several qualitative indicators of bank performance suggests that indicators of financial distress were present long before the financial ratios started to decline. Firstly, with the five largest banks holding 80% of the deposit market in 1995, the 14 remaining banks had to compete for the remaining one fifth of the total deposit market. The competition for depositors soon resulted in some unethical banking practices such as, it was alleged, bribing public officials in charge of large public sector accounts. Secondly, the lack of product differentiation between the local banks made them vulnerable to a price-based competitive environment. Thirdly, the shortage of a profitable variety of financial instruments led to an unbalanced investment portfolio in government treasury bills. The reduction in treasury bills rates affected the banking sector's profitability [7.4.1]. Given the financial and qualitative indicators of financial distress, most of which were apparent as much as 24 months before the banks were

[43] Section 97 (1)

closed, the Chapter then considered the legal provisions available to the BoZ to determine whether the BoZ had the necessary legal authority to force the failing banks to address their financial problems [7.5.0]

Despite its weaknesses, the BFSA, 1994 provided the BoZ with a wide range of options for dealing with financially-distressed banks. The BFSA, 1994 confered upon the BoZ, legal authority to implement a broad range of supervisory actions aimed at ensuring that banks operate in a safe and sound manner. These included disciplinary measures for failing or refusing to comply with supervisors' orders or conducting business in a manner considered to be unsafe and unsound, such as appointment of a curator, suspension of a bank's licence, and revocation of the licence. Others included entering into written agreements with banks or programmes of action to counteract any unsafe practices, or in the event that written agreements were deemed impractical, directing banks to cease or refrain from pursuing the current course of action[44]. The regulatory and supervisory framework gave the BoZ authority to institute examinations of banks to determine whether they were in a sound financial condition and operating safely[45]. There were provisions for penalising any person, including management and members of the boards of directors, who contravened any provisions of the BFSA[46]. These included fines and prison terms of various amounts and lengths.

[44] Section 77
[45] Section 78
[46] Section 77(6), 83(6)

CHAPTER EIGHT

EXPLAINING REGULATORY PERFORMANCE: EXIT REGULATION AND SUPERVISION PRACTICES

8.1.0 Introduction

Despite the indicators of financial distress discussed in Section 7.3 and Section 7.4 and the available legal provisions discussed in Section 7.5, there were long delays in closing banks that were breaching prudential regulations and requirements. Were the banks able to ignore the BoZ because of their political connections? What were the reasons for the delays? Was there political interference to prevent the closure of the banks? To answer these questions, the study examined the BoZ's response to the Banking crisis (Chapter eight, Section 8.2, 8.3 and 8.4) and synthesised the results of the interviews held with key stakeholders (Chapter eight, Section 8.6 and 8.7). Chapter eight presents the study's findings on the design, development and implementation of the BoZ's intervention and closure policies and procedures during the 1995 and 1997/98 bank failures.

In the 12-24 months leading to each of the bank closures, the BoZ implemented a variety of supervisory actions as provided for under the BFSA. A consolidation of the supervisory actions applied to each bank revealed interesting patterns in the choice and timing of the different supervisory tools and techniques, a pattern that has significant implications for the design, development and implementation of effective exit regulations and supervision practices. The study classified, and documented the different supervisory tools and techniques employed by the BoZ during the 1995 and 1997/98 bank failures into three main activities – information-based activities (Section 8.2), financial resources mobilisation activities (Section 8.3) and direct central bank intervention activities (Section 8.4). Further, chapter 8 proceeds to detail explanations for the BoZ's regulatory response to the 1995 and 1997/8 bank failures by those involved and affected by the intervention and closure process (Section 8.6). Finally, the chapter synthesises the varying views and presents the study's position on the hypothesis that due to politically and economically-motivated regulatory forbearance, the BoZ failed to enforce the required corrective action in a timely and consistent manner (Section 8.7)

8.2.0 Information-Based Activities

The study found that during the first phase[47] of the 12-24 months preceding each bank failure, the emphasis was on obtaining additional information about the financial condition of the financially-distressed bank. The different forms of supervisory activities included (Frequency in Table 27): holding meetings with the bank's owners and management; caution/reprimand letters for non-compliance with regulations and directives; requesting banks to prepare re-capitalisation and re-organisation plans; Conducting bank inspections and investigations, and ; demanding the completion of delayed external audit reports.

Table 27 Frequency of References to Information-based Activities

	Meetings	Caution Letters	New capital Plans	Inspections	Audit Reports
Bank 18	5	1	2		
Bank 12	4	1	1		
Bank 14	3		1		
Bank 15		1	4		
Bank 9	1	1		2	
Bank 5	8	9	4	3	6
Bank 7	1	9	3	2	3
Bank 4	7	5	5	4	2
Bank 2	3	4	6		
Frequency	**32**	**31**	**27**	**11**	**11**

Source: Intervention and Closure Working Papers

[47] The different phases were determined by comparing the dates of all regulatory actions for a period of 24 months prior to a banks failure and comparing the stages at which there was a general shift in regulatory interest from one form of actions to another.

8.2.1 Meetings[48]

Throughout the intervention and closure process the BoZ held meetings with the management of financially-distressed banks. The meetings involved different levels of staff and management, typically starting with individual meetings between the FSSD desk officer for the bank and the bank's chief financial officer, and progressing to higher levels of management in both organisations as the bank's financial condition deteriorated. The final meetings always involved the Governor and the principal shareholder of the bank.

The meetings served five primary objectives. Firstly, they facilitated the clarification or provision of additional information about a bank's financial condition [Bank 5/D/83][49] [Bank 4/D/31] [Bank 5/D/63]. Secondly, the FSSD used the meetings to express its concerns about growing liquidity problems in a bank, identify reasons for the liquidity problems, and to discuss possible solutions with the bank's management [Bank 2/D/5] [Bank 2/D/9] [Bank 12/D/8] [Bank 18/D/10] [Bank 18/D/38] [Bank 5/D/35] [Bank 5/D/40] [Bank 5/D/46]. Thirdly, several meetings were held to request, discuss and evaluate re-capitalisation plans with management [Bank 4/D/63] [Bank 9/D/10] [Bank 5/D/57]. Fourthly, the FSSD used the meetings to review ongoing debt collection and cost reduction efforts by bank management [Bank 4/D/31] [Bank 4/D/49] [Bank 18/D/26] [Bank 18/D/33] [Bank 5/D/63]. Finally, at the meetings, the BoZ and the bank's management discussed the provision of central bank liquidity support. As the imminent closure of a bank became more apparent, meetings to establish limits and deadlines for the continued provision of additional central bank liquidity to ease a bank's liquidity pressures occurred [Bank 12/D/16] [Bank 18/D/29] [Bank 4/D/40].

[48] Although the meetings involved discussions and decisions aimed at financial resource mobilisation and direct central bank intervention activities, the study classified the meetings as information-based activities because a substantial amount of regulatory resources were devoted to exchanging, discussing, and comparing information about the financial condition of the banks and not implementing financial resource mobilisation and direct central bank intervention activities which occurred at a later stage.

[49] All exit regulation and supervision practices references are included in Appendix 28

Internally, the FSSD held several meetings to address the problem of insolvent and financially-troubled banks. During the month of March 1996, in particular, the FSSD held a series of strategy planning meetings[50] to develop specific recommendations for dealing with insolvent and imminently-insolvent banks, and banks failing to meet required capital levels (KI.25Bn by 30 June 1996 and K2.OBn by 31 December 1996). The meetings resulted in the development of a 10 step process for identifying and addressing problem/insolvent banks (Box 9) including a summary of the regulatory options and their respective consequences (Table 28)

There are two cardinal issues relating to the meetings, which were particularly important for this study. Firstly, despite the above corrective strategies designed by the BoZ, the study found a substantial time lag between the identification of problem banks and their eventual closure. A long delay existed in implementing the actions discussed during both internal and external FSSD/bank meetings. The meetings usually resulted in: requests for new/revised re-capitalisation/re-organisation plans [Bank 2/D/3] [Bank 4/D/41] [Bank 4/D/51] [Bank 18/D/10] [Bank 5/D/35]; agreements to hold additional meetings, especially with the banks' directors or shareholders [Bank 4/D/31] [Bank 4/D/40] [Bank 4/D/41] [Bank 18/D/10], or; repeat instructions to stop unsafe and unsound banking practices. In some cases, the delay in taking action was in excess of 12 months. Banks continued to receive liquidity support from the BoZ long after it must have been apparent that the banks were in serious difficulties. By the time the BoZ closed each financially-distressed bank, the banks had accumulated significant liabilities with the BoZ and other government institutions.

Secondly, although the meetings generally started on a cordial note with each party seemingly interested in seeking the quickest way to financial recovery for the institutions, in some instances, the relationship soon deteriorated, sometimes with each party accusing the other of not doing enough to resolve the liquidity/capital problems [Bank 4/D/41]. On one occasion, a major shareholder of a failing bank refused to attend the meeting at the BoZ because he felt the BoZ was harassing him and his bank [Bank 7/D/21].

[50] The author participated and was involved in the preparation of financial schedules used in the meetings.

Box 9 Ten-step Process for Identifying and Addressing Problem/Insolvent Banks

1. Obtain detailed financial data (preferably not more than 30 days old) *Purpose*: to establish basis for discussions, decisions, and actions.

2. Spread financial data into common format. *Purpose*: to enable valid comparison and analysis of data.

3. Analyse data after adjusting per regulatory capital guidelines. *Purpose*: to determine amount of tangible equity and to assess severity of problems.

4. Close any bank, which is, by its own submitted data and beyond any reasonable doubt, insolvent <u>and</u> is unable/unwilling to restore capital to adequate level within five business days. *Purpose*: to minimise further erosion of assets and to maximise recovery for depositors and creditors.

5. Conduct immediate, on-site inspections of any bank which has less than 5.0% equity capital. Start with banks having lowest equity capital ratio; focus exam procedures on asset quality, adequacy of loan loss reserves, and capital deficiency/impairment. *Purpose*: to determine amount of solvency/insolvency more accurately.

6. Make "capital call" on any bank having less that 3.0% post-inspection equity. Allow up to five days to recapitalise to adequate level if equity is 0.0% or less; up to 30 days if equity is more than 0.0%. Concurrent with capital call, place bank under curator to preserve assets. *Purpose*: to minimise erosion/maximise recovery and, as much as possible, recapitalise banks which are realistically salvageable.

7. Close any insolvent bank, which fails to recapitalise by end of grace period *Purpose*: to comply with the law, prevent further risk to depositors' funds and to the BoZ.

8. Actively seek merger partner for 'solvent but failing' banks. *Purpose*: to recapitalise bank before franchise value is totally lost and to maximise salvage value of assets and deposit base before failure event further impairs value.

9. Place stringent operating restrictions on any bank, which are still viable but have inadequate capital. Restrictions should focus on quality and integrity of management/ownership. *Purpose*: to conserve earnings and capital and to deter unwarranted capital diminution.

10. Tightly control (or eliminate) authority/activities of directors, principal shareholders, managing directors/executive officers. *Purpose*: to avoid further 'pre-failure looting and conversion of assets.

Source: BoZ

Table 28 Summary of BoZ Regulatory Options and Consequences

Bank Condition	Options	Realistic?	Consequences	Cost
A. Insolvent [Liabilities exceed assets after establishing an adequate loan loss reserve and adjusting for assets of negligible value: CAMEL rating -5]	1. Close ASAP	Yes	Imposes market discipline of failure; limits further losses to depositors and creditors; depresses asset values; makes loans more difficult to collect; runs on other banks; domino effect on weak banks; political opposition	Dependent on realised sale values and priority of claims statute (Section 107) possible more failures; political pressure/fallout.
	2. Inject new capital, convert deposits and/or debt to equity, or both	Doubtful	Recapitalise wholly or in part with investor funds; If convert debt to equity, control likely to change; imposes investor/ depositor/creditor discipline; buys time to resolve longer-term problems; keeps solution in private sector.	Nothing for time being unless amount insufficient to assure viability or if re-capitalisation plan includes forgiveness of debt owed to BoZ or conversion to stock.
	3. Continue BoZ funding	Maybe	Puts more government (public) money at risk; increases loss potential via fraudulent managers; removes market discipline or opportunity to fail; transfers failure risk to public at large; forestalls inevitable solution.	Same as for closure (A) but increased by amount of additional funding
	2. Do Nothing	No	Exposes BoZ to litigation liability; continues potential for insider abuse and fraud; weakens overall financial system; undermines credibility and integrity of BoZ	Same as for closure (A) but increased by unknown amount of potential legal liability for inaction when BoZ knew/should have known of insolvency.

Bank Condition	Options	Realistic?	Consequences	Cost
B. Failing; imminently insolvent [Critically under-capitalised (less than 3% ratio of tangible equity to assets) and operationally unprofitable (losing money before loan loss provisions: CAMEL rating 4 or 5]	1. Close ASAP	Maybe	Imposes market discipline of failure; limits further losses to depositors and creditors; Allows seizure of assets and fixing of liabilities; depresses asset values; makes loans more difficult to collect; runs on other banks; domino effect on weak banks; political opposition	Dependent on realised sale values and priority of claims statute (Section 107) possible more failures; political pressure/fallout.
	2. Inject new capital, convert deposits and/or debt to equity or both. Put enforcement order in place, instal Curator, remove management.	Maybe, but unlikely	Recapitalise wholly or in part with investor funds; If convert debt to equity, control likely to change; Imposes investor/ depositor/creditor discipline; buys time to resolve longer tem problems; keeps solution in private sector; possible deposit run, political pressure, bad press	Nothing for time being unless amount insufficient to assure viability or if re-capitalisation plan includes forgiveness of debt owed to the BoZ or conversion to stock.
	3. Identify/arrange merger with healthy bank	Doubtful	Keeps solution in private sector if BoZ not needed to fund merger or cover potential losses	Dependent on structure of merger
	4. Continue BoZ funding; put enforcement order in place, instal curator, remove management	Maybe	Puts more government (public) money at risk; Increases loss potential via fraudulent managers; removes market discipline or opportunity to fail; transfers failure risk to public at large; forestalls inevitable solution; possible deposit run, political pressure, bad press.	Same as for closure (A) but increased by unknown amount of additional funding.

Bank Condition	Options	Realistic?	Consequences	Cost
	5. Do nothing	No	Exposes BoZ to litigation liability; continues potential for insider abuse and fraud; weakens overall financial system; undermines credibility and integrity of BoZ	Same as for closure (A) but increased by unknown amount of potential legal liability for inaction when BoZ knew/should have known of insolvency.
C. Troubled; problem [Under-capitalised but viable (bank is operationally profitable but tangible equity capital generally 3.0% or more of total assets): CAMEL rating - 4]	1. Put under defined corrective programme or enforcement order requiring, at a minimum: a) Raised capital b) Improved asset quality c) Correct violations d) Reduce/control expenses e) Restrict insider activity f) Restrict growth	Yes	Stabilises operations so rehabilitation can occur; controls excessive/ discretionary capital outflows; Builds public confidence in financial system; strengthens credibility of the central bank	Nothing
	2. Install Curator and/or remove management	Yes	Same as above plus controls insider abuse; possible political backlash; deposit run-offs; loss of public confidence in bank and system	Minimal to zero
	3. Identify/arrange merger with healthy bank	Yes	Keeps all or majority of solution in private sector; imposes market discipline; preserves depositors funds.	Minimal to zero

Bank Condition	Options	Realistic?	Consequences	Cost
	4. Provide BoZ funding as needed short term liquidity	Yes	Provides stability while rehabilitation occurs	Minimal to Zero
	5. Do Nothing	No	Continues potential for insider abuse and fraud; Undermines credibility and integrity of BoZ; Potential for deterioration to 'Failing' status.	Unknown
D. Potential Problem [Capital deficient relative to minimum required levels of K1.25bn by June 30 and K2bn by December 31 1996: CAMEL rating - 3]	1. Put under defined corrective programme; closely monitor progress; require adherence	Yes	Prevents slippage to problem or failing status; strengthens overall system	Minimal to Zero
	2. Identify possible merger partner	Yes	Provide private sector alternative in case needed	Zero
E. Sound [Adequately to well-capitalised; no material problems; deficiencies are correctable in normal course of business: Camel Rating 1-2]	Monitor as needed	Yes	Encourage sound operations; Provide early warning of potential or developing problems	Zero

Source: BoZ

8.2.2 On-site inspections and special investigations

Alongside the pre-scheduled annual inspection of banks, the FSSD conducted special investigations to address specific concerns at a problem bank. Occasionally, it requested an audit firm to conduct the investigations on its behalf to determine the level of solvency/liquidity pressure at a bank, to investigate specific breaches of the BFSA and to check compliance with other prudential regulations [Bank 5/D/84] [Bank 4/D/22] [Bank 4/D/67] [Bank 5/D/26]. The concerns included suspected creative accounting, unusual foreign exchange activities, suspected money laundering activities and other similar unsafe and unsound banking activities. Due to the specific, detailed and confidential nature of the special investigations this study was unable to discuss either the findings or recommendations. However, an important observation for the purposes of this study was the length of time it took to conduct the investigation and prepare a report for regulatory action. Some inspections took as long as six months to proceed from commencement to the preparation of the preliminary inspection report.

8.2.3 Audit reports

The study found a lower than expected use of external audit reports in evaluating the financial condition of failing banks. There was evidence of only three cases where the BoZ engaged the services of auditors in providing and verifying evidence of financial deterioration in a bank. The FSSD, having had difficulties confirming the extent of financial deterioration, placed great emphasis and reliance on the expected audit report before recommending additional supervisory action [Bank 5/D/104]. In two of those three cases, BoZ actively pursued the auditors because of an excessive delay in the completion of the banks' external audit report [Bank 7/D/21] [Bank 5/D/63]. In response to delays in the completion of audit reports, the FSSD followed three steps. Firstly, it requested reasons for the delay from management [Bank 7/D/23]. Secondly, it requested similar information from the auditors themselves, and thirdly, requested a tripartite meeting between the BoZ, the bank and the auditors [Bank 7/D/21] [Bank 5/D/81]. The use of external audit reports also reflected the use of regulatory forbearance to minimise the risk of a bank run. When bank management expected the final audit report to contain highly critical findings, they usually requested the BoZ to either permit them to delay the publication of the accounts [Bank 5/D/111] or to allow unconventional accounting adjustments to the accounts [Bank 4/D/41]. The BoZ considered the former more favourably than the latter.

8.2.4 Letters of caution/reprimand/sanction

As a result of the Department's off-site monitoring activities, routine and special investigations, external audit reports and meetings held between FSSD staff and bank management, shareholders and directors, the FSSD issued a number of letters of caution/reprimand. The letters of caution were for various breaches of regulation and incidents of unsafe and unsound banking practices, in particular:

1. Excessively-overdrawn BoZ current accounts [Bank 5/D/12] [Bank 12/D/24]
2. Consistently-low core liquidity ratios [Bank 5/D/12] [Bank 5/D/18] [Bank 5/D/33] [Bank 2/D/7] [Bank 7/D/49] [Bank 7/D/68]
3. Illegal investment schemes and/or foreign exchange activities [Bank 5/D/19] [Bank 18/D/4] [Bank 5/D/23]
4. Misleading/inaccurate statements [Bank 5/D/39] [Bank 4/D/23] [Bank 7/D/32]
5. Excessive overhead expenses [Bank 4/D/84] [Bank 7/D/66] [Bank 7/D/76]
6. Breach of prudential returns relating to fixed assets investments, insider loans and large loans [Bank 15/D/3] [Bank 2/D/13] [Bank 4/D/55] [Bank 4/D/72]
7. Failure to honour re-capitalisation agreements [Bank 5/D/52] [Bank 2/D/13], and;
8. Failure to publish accounts [Bank 7/D/63]

In each of the above cases, the FSSD instructed the bank to cease the offending activity (ies) [Bank 5/D/19] [Bank 5/D/23] [Bank 15/D/23] [Bank 2/D/7] [Bank 4/D/23] [Bank 7/D/35] and sometimes gave the bank a period of seven days in which to show cause why penalties should not be evoked as provided for in the BFSA, 1994 [Bank 18/D/4] [Bank 7/D/32]. Additionally, the FSSD either entered into a memorandum of understanding[51] or issued restrictions on the bank's activities[52], especially lending activities[53] and/or letters of reprimand for their breach[54]. These restrictions included:

1. No new lending unless prior approval of the BoZ was obtained;
2. Suspension of all new branch expansion plans and capital expenditure;
3. No declaration or payment of dividends, directly or indirectly, without the BoZ's approval;
4. No increment of salaries or any other form of compensation of senior management without the written approval of the BoZ.

8.2.5 Recapitalisation/re-organisation plans

A fundamental part of the regulatory process involved the FSSD requesting/instructing/demanding that a failing bank prepare a plan to address its liquidity/capital deficiency problems. Initially the plans were intended to redress growing liquidity pressures on the failing bank [Bank 5/D/37] [Bank 14/D/22] [Bank 2/D/9]. Subsequently, as the bank insolvency problems became more apparent, the focus of attention turned on recapitalising the insolvent or near insolvent bank [Bank 5/D/108] [Bank 2/D/14] [Bank 7/D/49]. Managing the transition between a capital deficiency and liquidity crisis took a substantial amount of regulatory time and resources. Often there was disagreement on whether the bank faced a temporary liquidity problem (the usual management perspective) or a more permanent capital deficiency problem (the more common BoZ perspective). Because of these divergent views, when the FSSD requested re-capitalisation plans, they often received liquidity restoration plans which focused on improving the bank's deposit mobilisation rate, realising some of the bank's fixed assets, especially property and land, and increasing the bank's debt collection efforts [Bank 5/D/108] [Bank 18/D/38] [Bank 2/D/9].

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[51] BFSA, 1994, Section 77 (1)
[52] BFSA, 1994, Section 77 (2)
[53] BFSA, 1994, Section 77 (3)
[54] BFSA, 1994, Section 77 (4)

Table 29 Recapitalisation Plans Analysis as at 31 August 1997

Bank	Regulatory Capital	Shortfall	Recapitalisation plans	FSSD comments
Bank 22	1501	499	Recapitalisation plans submitted (Further capital contribution of K1.3Bn plus retained earnings	Plan realistic
...	1845	155	Measures to raise the capital are in place	Current trends in earnings indicate that the bank will meet the capital requirements. A rights issue of K62m was made recently
Bank 7	95	1905	Plans not yet submitted	1. Highly unlikely to attract new capital 2. Bank has not been audited for the past two years 3. No commitment on the part of management and shareholders
Bank 24	1555	523	Plan for capital calls lodged with the BoZ	Bank likely to meet capital requirement from shareholders' contribution rather than from earnings
Bank 12	557	1499	Bank purchased real estate for shares in the bank worth K1.3Bn	Recapitalisation to K2.056Bn remote
Bank 15	-104	2104	No recent plans submitted to the BoZ. Earlier plans involving foreign equity participation were discussed with management	Losses are likely to deplete capital. However, the bank is hopeful foreign equity participation will materialise
Bank 9	1112	888	Plan Submitted	Bank to meet capital requirement from capital injection not earnings. Merger negotiations with Bank 2 underway
Bank 10	1658	342	Capitalisation plan submitted	Bank likely to meet the requirement by earnings as well as shareholders contributions
Bank 4	-15831	-7831	Capitalisation plan submitted	Bank is insolvent and plans are unrealistic
Bank 2	987	1013	Plan in place involving merger negotiations with Bank 9	If merger goes through, bank will meet capital requirement

Source: FSSD

However, the bank's liquidity problems were normally the result of its more important problems, namely, a poor loan portfolio, insufficient or negative capital, and internal management problems.

When there was agreement on the level of insolvency and the amount of capital required, there was often ambiguity over the source of capital and the date by which management would invest additional capital in the capital deficient bank. The most common response was that the bank shareholders had identified some undisclosed foreign equity partners interested in injecting capital into the bank [Bank 15/D/3] [Bank 2/D/10]. The plans focused on attracting more deposits and recovering outstanding debts but both options ignored the current state of the bank and the difficulties of enforcing legal contracts in Zambia. Neither option was likely to materialise within a matter of days, or weeks, let alone months.

8.3.0 Financial Resource Mobilisation Activities

Unable to provide the FSSD with immediate solutions to their capital needs, some banks ignored requests for re-capitalisation plans [Bank 7/D/15], requested extensions on the BoZ's submission deadlines [Bank 14/D/22] [Bank 4/D/65] or submitted highly unrealistic plans with overly-optimistic deposit growth and non-performing loans recovery rates [Bank 4/D/74]. Despite expressing scepticism about the success of the plans submitted [Bank 15/D/4] [Bank 4/D/64] (Table 29), the BoZ continued to provide the banks with additional time to revise and resubmit their plans. Meanwhile, the owners had to find alternative sources of finance which often meant central bank LoLR facilities. The variety of options explored included:

1. Providing different forms of regulatory, accounting and statutory exemptions. The most common exemptions included: suspending the payment of interest on overdrafts with the central bank, exemptions for implementing loan provision requirements, and complying with the minimum capital requirements.
2. Encouraging a sale, merger and/or acquisition of the distressed bank; and

3. Providing LoLR resources from the central bank in the form of an overdraft facility, and deposits from government ministries, parastatals, pension funds and departments.

Table 30 Frequency of References to Financial Resources Mobilisation Activities

	BoZ LoLR facility	Merger	Legal/Accounting Exemptions
Bank 18	6	6	1
Bank 12	4	2	1
Bank 14	2	1	1
Bank 15		2	1
Bank 9		1	1
Bank 5	4		
Bank 7	2	3	3
Bank 4	1	1	
Bank 2		2	
Incidence tally	**19**	**17**	**8**

Source: Intervention and closure working papers

8.3.1 Legal and accounting exemptions

The FSSD granted banks (as provided for in legislation), exemptions from compliance to some sections of the BFSA such as: the need to publish accounts in a national newspaper [Bank 7/D/74] [Bank 18/D/21], the minimum core liquidity requirements [Bank 7/D/62] [Bank 14/D/36], and importantly, compliance to the loan classification and provisioning regulations. As provided for under Section 18 (4) of the BFSA, banks applied and received exemptions from compliance to the provisioning regulations for periods of up to 12 months [Bank 9/D/4]. The BoZ, through the Bankers' Association of Zambia advised banks expecting adverse consequences of the newly-introduced provisioning regulations to apply for exemptions. Accounting and regulatory exemptions had the effect of temporarily reducing the financial pressure exerted on banks. Although the legal and accounting exemptions eased the immediate liquidity and capital concerns on the failing banks, they did not address the fundamental problems leading to the penalty interest rates on the overdrawn accounts and the breaches of the minimum liquidity ratios. Further, the exemptions from the publication of accounts, though legal and well-intended, weakened market discipline and may have encouraged the moral hazard problem, especially for management of insolvent banks.

8.3.2 Mergers and takeovers

While mergers and takeovers were widely-discussed as a desirable regulatory outcome, there were only two successful takeovers between 1995 and 1998, firstly, the takeover of Safe Deposit Bank by First Merchant Bank, and secondly, ZNCB's takeover of Chase Trust Bank. In both cases, the assets of the target bank were minimal and did not pose any systemic risks to the banking sector. There were two attempts made at an industry-wide merger of all under-capitalised/insolvent banks. FSSD staff made the first proposal in September 1995 [Bank 2/D/12] [Bank 18/D/40] [Bank 12/D/9] and the second in March 1997 [Bank 4/D/77] [Bank 12/D/26] [Bank 7/D/38]. In both cases, the FSSD felt that pursuing mergers, rather than dealing with individual problem banks would:

1. Save failing banks from closure,
2. Prevent systemic runs of healthy banks,
3. Protect public deposits,
4. Improve the level of confidence in the financial sector as a whole
5. Get rid of bad management, and
6. Provide a more politically-palatable solution than more bank closures.

However, the process faced a number of difficulties, particularly in arriving at acceptable asset valuations and management structures for the new bank. The study found three cases where merger attempts failed to surmount these difficulties. In the first case, the attempt to merge the Meridien BIAO and the ZNCB in order to create ZAMBANK resulted in a run on ZNCB prompting the MoF to put an immediate stop to the amalgamation process. The public was concerned that Bank 5's unknown liabilities in West Africa would have a negative effect on the then, relatively healthy ZNCB. In the second case, a foreign bank expressed interest in investing in one of the smaller local banks experiencing financial difficulties. However, uncertainties regarding the bank's asset valuation stalled merger negotiations [Bank 15/D/5].

In the third case, [Bank 18/D/47-59], the takeover of one bank was actively pursued by another more financially-stable bank. The bidding bank proposed creating a new bank from some purposely selected assets of the existing bank and establishing a management contract of up to three years for the realisation of the excluded assets. Further, the bidding bank wanted the central bank to convert the outstanding BoZ overdraft into favourable capital bonds and to provide additional liquidity amounting to 25% of the outstanding current account balance. After numerous counter-proposals and two months of negotiations, the merger talks collapsed.

The failure of the talks was mainly due to conflicts of interest, expectations and desired outcomes. Shareholders/management in the target bank were reluctant to relinquish control in the belief that with slightly more time they would raise the required capital. The BoZ, on the other hand was reluctant to provide the bidding bank with additional liquidity using taxpayers' money and the bidding bank did not want to assume too high a risk by acquiring assets whose market value was uncertain. Frustrated by the delays in concluding the merger discussions, as well as the difficulties it experienced in obtaining adequate and accurate financial information about the target bank, the bidding bank withdrew its offer.

8.3.3 Lender of last resort facility

In view of the failure to attract private investors to purchase shares in the failing banks, the most common approach was the use of the BoZ overdraft facility as a source of long-term financing. The BoZ's authority to act as LoLR is contained in Section 42 of the BoZ Act of 1996 that authorises the BoZ to operate accounts for banks on such terms and conditions as the Board may determine. The Act provides for the Bank to lend to such account holders where it feels it is necessary to meet liquidity requirements or "forestall insolvency to safeguard the financial system". The Act further provides for the granting of secured advances for a period not exceeding six months. Section 42(2)(b)(i) to (iii) specifies the acceptable forms of security obtainable for such advances. The provisions of the Act gave the BoZ a great deal of discretion and flexibility in terms of granting advances to financial institutions.

Despite utilising the provisions to grant advances to a number of financially-distressed banks the BoZ, until very recently, did not have clear policies or procedures indicating whether, when and under what conditions, support would be given to financial institutions in distress. Neither was there an attempt to determine whether a systemic threat would materialise if the BoZ did not provide liquidity support. The lax clearing rules on the need for banks to have sufficient collateral exacerbated the situation. Moreover, as all banks had current accounts at the BoZ, the BoZ permitted clearing to go through even if it resulted in overdrawn bank accounts. This was the case with all the banks that failed in 1995 and 1997/98.

Only when a bank experienced adverse clearing over an extended period did the BoZ refer the matter to the Board. The Board would then ratify decisions that essentially the FSSD and the Banking Departments, through the Governor, had already facilitated [Bank 4/D/21] [Bank 4/D/69] [Bank 4/D/82] [Bank 12/D/12] [Bank 12/D/16] [Bank 5/D/82] [Bank 18/D/43] [Bank 7/D/41]. The fact that the BoZ had no written procedures or guidelines regarding the granting of credit resulted in instances where banks were provided with liquidity support even though insolvent.

Even where banks initially may have been solvent but illiquid, the BoZ continued to lend to them even after it became apparent that they were insolvent. Surprisingly, the MoF went so far as to declare that all banks requiring financial assistance would receive full support from the MoF and BoZ. Though aimed at instilling public confidence, the moral hazard effects of such a statement were obvious (Appendix 29, 30, 31) Because the BoZ had no clear exit strategy, it continued to provide support although it was unlikely that it would be able to recover such monies. Thus, in its role as LoLR, the BoZ has experienced huge losses.

8.3.4 Transfer of government deposits to failing banks

A common practice used to aid financially-distressed banks was the transfer of government deposits held at the central bank to the accounts of such banks to improve their liquidity positions. In the Meridien BIAO Bank case, on 13 February 1995 a sum of K4,791,542,754 was transferred, on 22 February 1995, it was a sum of K3,428,673,860, on the 23 February, it was sum of K3,477,140,683 and on 28 February 1995, a sum of K1,522,859,317 was extended. The total sum extended to Bank 5 using this option was K8,428,673,860 [PD/150395/65] (Appendix 32). An anonymous source informed the study that this practice was even more prevalent during the second set of bank failures. Determined to do its utmost to preserve both financial and macro-economic stability, the FSSD recommended that the BoZ and the MoF resolve the liquidity crisis by transferring several statutory deposits held at the BoZ to the liquidity-strained banks. The most adversely-affected banks were Bank 18, Bank 14, and Bank 4. Bank 18 needed at least K6.2Bn, while Bank 14 and Bank 4 each need K2Bn. It was estimated that approximately K12Bn was used for this purpose. Table 31 shows that as at 31 March 1997 government and statutory deposits in Bank 12, Bank 15 and Bank 4 were 5%, 41% and 73% respectively. At 31 August 1997, the proportion of government and statutory deposits was 23%, 37% and 68%.

Table 31 Deposit Exposure Analysis as at 31 March 1997

SECTOR	Bank 12	%	Bank 15	%	Bank 7	%	Bank 4	%	TOTAL	%
Public	10,239	67%	973	42%	633	100%	683	27%	12,530	60%
Government	0	0%	0	0%	0	0%	738	29%	738	4%
Statutory bodies	772	5%	945	41%	0	0%	1,123	44%	2,840	14%
Non-residents	0	0%	0	0%	0	0%	0	0%	0	
Parastatal	1,893	12%	364	16%	0	0%	0	0%	2,257	11%
Financial institutions	102	1%	0	0%	0	0%	0	0%	102	
Foreign currency	2,268	15%	14	1%	0	0%	5	0%	2,287	11%
TOTAL	**15,274**		**2,296**		**633**		**2,549**		**20,755**	

Source: BoZ

Proponents of this option argued that the Government was merely moving the accounts from central bank custody to commercial bank custody. Since bank inspectors were monitoring the affected banks on an hourly basis, the government hoped that the banks would not flout FSSD directives and misuse the funds. Such reporting included the following on a daily basis: (i) consolidated balance sheet (ii) loan portfolio and (iii) deposit growth and mobilisation. Additional to these safeguards, the FSSD proposed attaching the following conditions:

1. All lending activities in the affected banks were frozen
2. BoZ approval was required for all major financial transactions.
3. No Bank could conduct foreign exchange transactions without BoZ express approval .
4. All banks had to submit comprehensive recovery programmes.
5. The affected banks had to refrain from unnecessary/extravagant overheads.
6. No bank was permitted to open new branches.

Because of the MoF's active policy of transferring government deposits to failing banks to assist with their liquidity/capital problems, the date of closure of each bank was substantially indebted to the government. Table 32 shows government's high exposure to the failed banks as at December 1999.

Table 32 Government and BoZ loans to Banks at Date of Closure

Name	GRZ loans as at Closure (K'Bn)	Security**	GRZ loans as at December 1999 (K'Billion)	Percentage of loans recovered (%)*
African Comm.	9.6	Nil	9.6	0
Prudence Bank	11	Partial	10.6	0.04
First Merchant	6	Nil	4.1	31.6
Credit Africa	17	Partial	17	0
Meridien BIAO	60	Partial	25.1	58.1
Manifold	1	Nil	1	0

Source: GRZ (2000:11) /Note: *Author's calculations **GRZ (2000:15)

Despite ranking higher legally than public depositors in the BFSA list of preferred creditors, the government often waived its rights in the interests of facilitating early liquidation dividends to the public (Table 33). The rate of deposit repayments varied from 9% (Bank 9) to 56% (Bank 5).

Table 33 Public deposits as at Date of Closure

Name	Depositors at close of bank	Funds recovered	Deposits recovered (%)
African Commercial	3,469	1,960	56.5
Prudence	1,643	222	13.5
First Merchant	13,352	1,287	9.6
Credit Africa	10,001	1,143	11.4
Meridien BIAO	30,517	17,285	56.6
Manifold Investment	667	180	30
Total	**59,649**	**22,077**	**37**

Source: GRZ (2000:20)

8.4.0 Direct Central Bank Intervention

The third and last phase of the intervention and closure process involved direct central bank intervention in the management of the failing bank. The BoZ typically started by appointing a member of department to monitor the bank on a daily basis. Thereafter, it appointed a resident inspector to monitor, as well as authorise, all payments and money transfers at the bank. Other actions at this stage included the suspension/removal of the Chairman, Managing Director or other senior manager[55], and/or the appointment of a curator[56]. Once these measures were exhausted, the central bank closed the bank[57] and appointed a receiver[58] until the bank went into liquidation or reopened in the case of one bank (Table 34).

Table 34 Frequency of reference to Direct Central Bank Intervention

	Closure/ Receivership	Management Removal	Curator	Resident Inspector
Bank 2		1		
Bank 4	8	2	2	
Bank 7	3		1	3
Bank 5	12	6		2
Bank 9	1	1		
Bank 15	2			
Bank 14	1	5		
Bank 12	1		4	1
Bank 18	2	3	2	1
Tally	**28**	**18**	**9**	**7**

Source: Intervention and closure working papers

[55] BFSA, 1994, Section 37 (1)
[56] BFSA, 1994, Section 81 (2)
[57] BFSA, 1994, Section 94 (2)
[58] BFSA, 1994, Section 96

8.4.1 Removal of management

Despite numerous breaches of banking regulations and supervisory directives, the FSSD only removed management from office in a few extreme cases of management abuse [Bank 18/D/39] [Bank 14/D/45] [Bank 4/D/88] [Bank 5/D/102] [Bank 9/D/15] (Appendix 33). On the occasions that it did, a delay occurred between the time the proposal to remove management was made, and the actual execution of that decision: in some cases, the delay was in excess of three months. Even though the FSSD was dissatisfied with a particular Managing Director or Chief Financial officer, the department only effected their removal when there was clear undisputable evidence that the individual had personally been involved in an illegal activity such as fraud [Bank 4/D/34] [Bank 9/D/15] or the personal reputation and suitability of an individual had publicly been questioned [Bank 14/D/41].

In the initial stages of enforcing the BFSA, the removal of management appears to have been a negotiated exercise. For example, when the BoZ decided to remove the chairman and major shareholder of one bank, he placed conditions on his resignation. (The study found no evidence to confirm whether the BoZ considered or met his conditions.)In another case, the BoZ consulted the Chairman of the Board on the appointment of a new Managing Director and the composition of the bank [Bank 5/D/102]. Further, the dismissed managers of the bank were allowed access to the bank while some directors attended board meetings as alternates for the new directors appointed by the outgoing bank chairman [Bank 5/D/117]. However, in other banks, the FSSD was more successful in removing the entire Board of Directors and the Managing Director for failing to comply with the BFSA, 1994 [Bank 4/D/88].

8.4.2 Appointment of curators/receivers and liquidation managers

As indicated in Chapter seven, section 7.5.3, of the BFSA provides an option of appointing a curator to a bank when a bank refuses to comply with BoZ directives, refuses examinations or in the opinion of the BoZ, an inspection of the bank showed that the bank was conducting its business in an unlawful or unsafe and unsound manner or the bank was unable or unlikely to become unable to continue its operations in the ordinary course of business. In the study's nine case studies, all these circumstances were applicable at one stage or another. However, the BoZ only appointed curators on three occasions, partly because, as at 31 December 1999, it had no policies, procedures or guidelines on the appointment and remuneration of curators, receivers and liquidation managers (Mwenda, 2000:2). When they were appointed, however, curators were useful in unearthing further evidence of management abuse and other unsafe and unsound banking practices such as not charging related companies any interest on loans [Bank 4/D/23], fictitious accounting and fraud [Bank 4/D/29], and incurring additional overhead expenses contrary to BoZ directives [Bank 4/D/32]. However, they were less successful in turning the institution around and returning it to financial stability. All three banks in which the BoZ appointed curators, eventually failed. Partially, this was because their appointments often occurred very late in the banks' route to failure, typically in the last three months to closure when their financial condition had deteriorated far beyond mere capital insolvency. Additionally, curators' duties primarily involved monitoring performance and reporting to the BoZ; raising capital was not part of their remit. Controlling expenses (which curators did very well), without the ability to organise and inject additional capital into the bank merely forestalled the inevitable closure of the institution.

8.4.3 Seizure/Receivership of banks

The last regulatory action examined in the study was the simultaneous seizure of a bank by the BoZ and the commencement of its receivership process [Bank 18/D/61] [Bank 7/D/83]. In most cases the decision to effect a BoZ seizure and receivership action occurred after a sustained run on the bank resulting in a successively higher negative daily clearing and central bank overdrawn current account balance [Bank 5/D/52][Bank 18/D/22][Bank 12/D/22][Bank 7/D/81]. The bank runs were themselves triggered by adverse press reports about a key aspect of the bank's operations. The critical press reports included: the removal of a bank's Chairman by the BoZ [Bank 14/D/44], a suspicious fire at a bank's head office started in the accounts department [Bank 4/D/88], or the closure of the bank's foreign branches [Bank 5/D/13]. In all cases, the press reports precipitated a significant decline in public confidence leading to a run on the bank. The duration of the receiverships, which varied between 16 months and four months (Table 35), was determined by the size of the bank, the complexity of the issues leading up to the bank's closures, the level of government commitment to restructure the bank and management's response to the receivership.

Table 35 Duration of Receiverships for Failed Banks

Name of Bank	Receivership Month	Month placed in liquidation	No. of months in receivership*
Bank 5	May 1995	August 1996	16
Bank 18	November 1995	February 1997	16
Bank 4	October 1997	February 1998	5
Bank 12	November 1997	March 1998	5
Bank 7	December 1997	March 1998	4
Bank 9	February 1998	March 1999	14

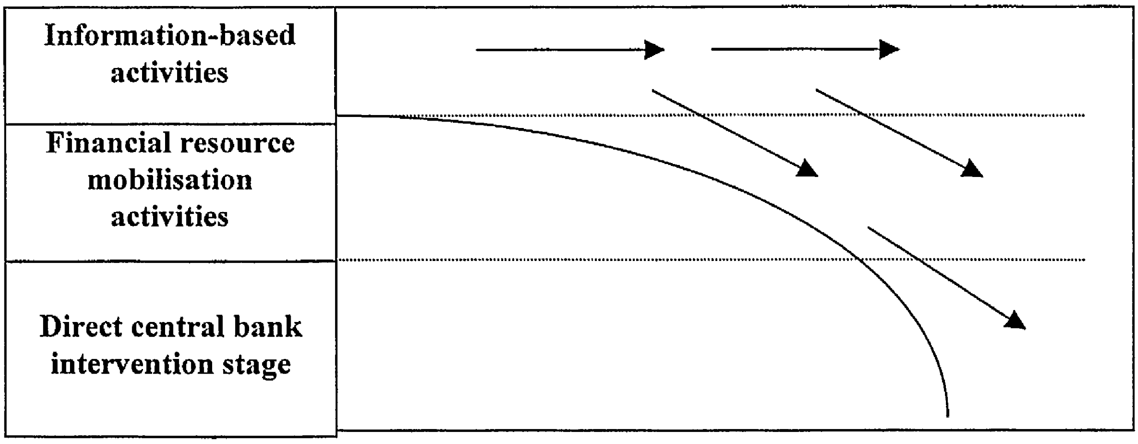
Source: GRZ 2001:4 /Note: *Authors calculations

8.5.0 Conclusion on the BoZ's Implemantation of its Exit Regulations

Although the timing of the implementation of each of these phases during the 24 months leading to a bank's closure was different for each bank, three general patterns emerged from the study as detailed in Table 36 and summarised in Figure 20. Firstly, the information-based activities continued throughout the period. There was a constant stream of meetings, exchange of correspondence and bank inspections/special investigations, all of which increased in measure as the rate of financial deterioration progressed. Secondly, the financial resource mobilisation phase was heavily dependent on the use of the central bank's LoLR facility, which the BoZ made available to all of the banks that failed in 1995 and 1997/8. There was a very limited amount of private sector support provided to the failing banks. Finally, in almost all the bank failures, there was a concentration of direct central bank intervention in the last three to four months leading to the closure of the bank. With very few exceptions, the appointment of a resident bank inspector, changes in the management, and the appointment of a curator took place towards the end of a bank's economic life cycle.

Figure 20 Current Approach to Implementing Supervisory Actions

Supervisory activity	Phase One	Phase Two	Phase Three



The most important finding, for the study was the time lag of at least 12 months between the identification of a problem at a bank and its eventual closure. The time lag between the first time a financial analysis indicated potential problems at a financial institution, and the time of eventual closure, confirms that BoZ officials exercised forbearance when faced with a choice of either extending financial support or closing a bank down. The question that remained at this stage of the study was why regulatory forbearance was so prevalent. The following section synthesises the explanations for the BoZ's failure to enforce the BFSA provisions for corrective actions. It presents the differences in respondent views as to the causes of regulatory forbearance in Zambia.

Table 36 Consolidated Summary of Regulatory Actions for Failing Banks

SUPERVISORY ACTION (Nunmber. of months to closure)	12	11	10	9	8	7	6	5	4	3	2	1	0
Information-based solutions													
Meetings													
Conduct bank on-site bank inspections/investigations													
Follow up/enquire on the external bank audit report													
Request a bank recovery/re-capitalisation plan													
Place restrictions on unsafe and unsound banking practices													
Issue a letter of caution/reprimand													
Issue a public denial of financial distress													
Financial Resources Mobilisation Activities													
Encourage/support private commercial bank financial support													
Encourage/support a sale, merger, and/or acquisition													
Provide legal regulatory and accounting exemptions													
Agree to provide BoZ guarantees of third party loans													
Provide central bank financial support													
Do not object to central government financial support													
Suspend the payment of penalty interest rates on overdraft													
Direct Central Bank Intervention													
Commence the daily monitoring of bank activities													
Appoint a resident bank inspector to monitor bank activities													
Remove a manager/director/shareholder													
Appoint a curator													
Seize and close the bank													
Appoint a receiver													
Commence compulsory liquidation													
Re-open the bank													

8.6.0 Explaining the Bank of Zambia's Regulatory Response to the 1995 and 1997/98 Bank Failures

8.6.1 Members of Parliament

During parliamentary debates, MPs accused the BoZ of failing to execute its regulatory responsibilities [PD/150395/45]. One MP charged that the BoZ appeared to be "badly managed" with an unprofessional Board of Directors in place [PD/220395/24]. Others were critical of the BoZ's failure to comply with the provisions of the BFSA, noting that the BoZ even failed to publish quarterly reports in the Government Gazette as stipulated in legislation [PD/150395/45]. MPs also questioned the failure of the MoF to "adequately supervise" the BoZ, urging the M/Finance to supervise the BoZ in the same way that it supervised commercial banks [PD/050395/158] [PD/220295/31][PD/150395/45]. They argued that the MoF urgently needed to review the BoZ's supervisory capacity and improve its management [PD/150395/46] and raised specific concerns regarding the BoZ's political independence, quality of regulatory information available to decision-makers, and policy inconsistencies and non-implementation, especially the Governments' failure to prosecute former bank owners and managers suspected of fraudulent activities.

MPs questioned the M/Finance about the level of **political independence** that the BoZ enjoyed. They accused him of interfering with the BoZ's activities and 'running it by remote control' [PD/150395/45]. In particular, the MPs queried the M/Finance over the reasons for the dismissal of the BoZ Governor after the Governor had recommended the closure of Meridien BIAO Bank [PD/150395/55].

MPs expressed much frustration with the **availability, timeliness, adequacy and even reliability of information** provided by the MoF to parliament. They claimed that they relied on inaccurate press reports and refused to accept that the information given to them by the M/Finance was entirely accurate. They concluded that the MoF and the BoZ were deliberately hiding some information about the bank. Despite repeated requests for information on the level of BoZ and MoF Meridien BIAO Bank support, [PD/170295/17] [PD/150395/38] [PD/150395/49a] [PD/150395/49b] [PD/150395/53] [PD/150395/62], the MoF only discussed the full extent of public financial support for the bank four weeks after the initial query.

MPs also raised questions about the **lack of consistency in public policy over financially-distressed companies.** On one hand, the MoF had refused to provide liquidity support to two public-owned national transport companies (Zambia Airways and the United Bus Company of Zambia). On the other hand, the MoF had approved the use of public funds to bail out a privately-owned financial institution [PD/220395/26]. MPs also asked why, despite the failure of a number of banks and the loss of significant amounts of public funds, none of the former bank owners and mangers had been prosecuted [PD/061295/115] (Appendix 34).

8.6.2 Minister of Finance

The M/Finance vigorously defended his involvement in the 1995 bank failures through several Ministerial Statements. While denying that he interfered in the affairs of the BoZ, he argued that **central bank independence** was a myth. As far as he was concerned, as long as there was a government, a central bank could never be independent. In his opinion, independence was a terrible misconception that did not exist. In a Parliamentary session, he declared:

> "...there is a terrible misconception about something called the independence of the Central Bank. I know you have read about banks being independent – there is no such thing! As long as there is a government, a bank can never be independent. What you hear of the Bundesbank in Germany, the Federal Reserve, the Bank of England, there is no such thing... What is an independent bank? One of the ways you can make the Bank of Zambia independent, if you wanted, is to make it a private company. That is one of the ways you can make it. Even then, the only private company I know of is the South African Reserve Bank. However, the Governor of the bank is appointed by the President, even though it is a private bank. There is no such thing as independent." [PD/061295/126]

The Minister blamed the BoZ for the **quality and dearth of information** regarding the bank failures. In the case of Meridien BIAO Bank, he charged that despite his personal enquiries about the financial condition of Meridien BIAO Bank, the BoZ repeatedly assured him that the bank's condition was stable [PD/220295/28a]. Instead, the BoZ waited until the matter had become 'heavy and hot'. In his opinion, it was unfair to expect him to approve the closure of the bank without due consideration to the effect the closure would have on the smaller banks in Zambia. Additionally, during the early stages of the crisis, the BoZ had been unable to determine whether the bank was illiquid or insolvent, and it took the special effort of external auditors to determine the quality of the bank's assets

He considered the case of Zambia Airways and Meridien BIAO Bank as different and totally unrelated to the financial crisis in the banking sector and did not reflect any **inconsistency or non-implementation of regulatory policy**. In the case of the national transport companies, he stated that the government was 'pouring money in a bottomless pit'. In the case of Meridien BIAO Bank, he was 'putting money to circulate so that it came back to the central bank subsequently'. The MoF, he claimed, had learnt valuable lessons from earlier failures of State enterprises and had carefully dictated how the money given to Meridien BIAO Bank was to be used [PD/220295/28b]. Further, he argued that the MoF had acted in the interest of avoiding the negative impact on the economy that Meridien failure would have had; MoFs reaction to the situation was 'in good faith and deterred panic that would have thrown the financial market into turmoil, which was consequently going to destroy the financial base that Zambia had been struggling to establish for thirty years' [PD/150395/46] (Appendix 35). In respect of the prosecution of former bank owners and managers, the Minister stated that the prosecution of the people responsible for bank failures was not his job; his job was 'not that of policeman'. Nevertheless, the BoZ appointed forensic accountants, KPMG, to make the necessary investigations leading up to the arrest of the appropriate individuals if necessary.

8.6.3 BoZ Governors

All the former BoZ Governors presented a consistent set of views, mainly; rejecting the existence of central banking independence and accepting the existence of external pressure in the decision-making process, and scepticism about the sufficiency of the FSSD's organisational and professional resources available for dealing with bank failures.

The former BoZ Governors acknowledged the existence of 'insurmountable' **political pressure** [CI/GOV/4], especially in the management of government financial resources. Central bank independence in the words of one former governor was a 'fallacy that only existed in the heads of a few academics' [CI/GOV/18a]. The Governors were of the view that the execution of the duties of the Office of Governor of the BoZ, a fundamental position in the regulatory process was as much, if not more, a matter of personal style and characteristics as it was by legislative design [CI/GOV/48] [CI/GOV/37a] [CI/GOV/42] [CI/GOV/44]. Despite legislation intended to guarantee the Governor's independence, the true level of independence was a negotiated arrangement determined by the personalities of the M/Finance and the incumbent BoZ Governor and the nature of their personal relationship. Additionally, the Governor's personal political connections were important in ensuring administrative and operational enforcement of regulations. They further expressed scepticism about legislative efforts to increase the level of central bank independence, arguing that government would resist such moves [CI/GOV/18b] [CI/GOV/37b], as it had done in the past [CI/GOV/27], and, in any case, compliance to regulations was often discretionary [CI/GOV/18c].

The Governors sympathised with the efforts of the FSSD to improve the **quality of regulatory and supervisory information**, being under-staffed and ill-equipped, especially before and during the 1995 bank failures [CI/GOV/23a] [CI/GOV/104]. One Governor was, however, unsympathetic with the superficial and elementary nature of the supervision work at the time. For example, he criticised the FSSD's emphasis on collateral rather than cash flow in its evaluation of a bank's loan portfolio; arguing that the realisable value during a 'forced sale' was substantially less than the initial valuation. Nevertheless, in fairness to the FSSD, he pointed out that during the 1980s it was hard to find suitably-qualified bank supervisors. Requests for technical assistance from the BoE were not successful due to the limited amount of resources the BoE had [CI/GOV/48]. With reference to the 1995 and 1997/8 bank failures, the overall view emanating from discussion with the Governors was that 'it was the political process of regulation, rather than the professional process than was a problem for the banking sector' [CI/GOV/23b].

The Governors appeared to transfer the responsibility for **policy inconsistencies** up to the political level or down to the FSSD level. The public attributed the failure of the Governor to take action when required to do so, as in the case of one bank, to political pressures [CI/GOV/20]. The press referred to the Governor's recommendations to the M/Finance regarding the health of Meridien BIAO Bank. Despite a strong case for closing the bank, the Minister rejected the advice and there was nothing the BoZ could do but implement Government policy to provide whatever liquidity support was required; after all, the BoZ was a "mere wing of government" [CI/GOV/27] [CI/GOV/115] [CI/GOV/33]. Administratively, the governors pointed out that their decisions were dependent of the advice they received from the FSSD. However, sometimes the advice was not feasible within the realities of the economic environment. For example, recommendations to close the largest state bank because it was unprofitable, though professionally sound, were unrealistic given the potentially-negative macro-economic effects.

The study noted differences in the reported style and approach of the two BoZ Governors in place during the 1995 and 1997/8 bank failures. The first Governor was described as very much a hands-on person who participated in the policy formulation process as well as policy implementation stages. That he recommended the closure of a bank, and was subsequently fired for it, came as little surprise to his predecessors.

The second Governor[59], on the other hand, maintains a different regime in which much of the policy formulation process occurs in the FSSD. In his view, 'when you recruit professional people to responsible positions, then you must allow them the freedom to take charge of the functions that they are entrusted' [CI/GOV/87]. In a profile which appeared in a national newspaper following his appointment, his delegative style of management at the UNZA where he was Vice Chancellor between 1976-1985, was interpreted as an inability to work by a Lusaka businessman who said of Mwanza, "To understand Jacob's performance one needs to look at what he actually did at UNZA and everywhere he has been. Jacob does not work. At UNZA, he totally relied on Father Kelly and later deputy vice chancellor Prof. Ben Mweene. He gets away with doing nothing through attending meetings" (Phri, 1995).

The study found that his approach was one of consultative consensus building in which bank owners are given the opportunity to present options for rescuing the bank [CI/GOV/79]; an acceptable compromise is reached when implementing sanctions [CI/GOV/85]; the M/Finance is consulted and kept informed since 'politicians should not be taken by surprise' [CI/GOV/72]; where, if the issue is more sensitive, the president is consulted [CI/GOV/186]; and the effect on the financial system is considered when a bank closure is being contemplated, and the interests of not only the depositors, but also the shareholders and managers of the failing bank are considered. Consulting with such a wide range of people, however well-intended, lengthened the regulatory process. The resultant delay in implementing regulatory decisions is interpreted, by outsiders, as politically-motivated regulatory forbearance, at worst, as an inability to work. But to the incumbent, it is a necessary part of sound macro-economic evaluation of the problems facing the banking sector and in particular, the interests of the small depositors.

[59] Before appointment to the BoZ, Dr Jacob Mwanza's positions included: Managing Director at the National Energy Corporation until 1975, Managing Director INDECO 1975-1976, Vice Chancellor UNZA May 1976-87, Deputy Secretary for Finance at the Cabinet Office 1987-1990, Chairman, National Economic Monitoring and implementation Committee, MoF 1990-1991, Senior advisor working with the IMF and the World Bank 1991-February 1995 (Phiri, 1995).

8.6.4 Financial System Supervision Directors

Discussions with former FSSD Directors highlighted the importance of personal relationships in the supervisory process. Having served under three Ministers of Finance, three BoZ Boards, and two Governors, one former FSSD Director concluded that the pressures and concerns were highly dependent on the nature of the relationship he had had with the three groups just mentioned [CI/FSSD/23].

The Directors repeatedly stressed the importance of **operational independence** in the supervisory process. They felt that the government was not doing enough to guarantee the officers of the BoZ adequate operational independence [CI/FSSD/15]. The lack of operational independence resulted in rising levels of professional frustration amongst FSSD staff, a trend which was said to be prevalent in other Government Departments and Ministries where highly-qualified personnel with good ideas were frustrated by high levels of political interference [CI/FSSD/21]. In particular, they noted that the political connections of bank owners and the political interference that bank owners instigated sometimes rendered the supervisory process important [CI/FSSD/5a]. They observed that although the level of legal independence had improved with the enactment of the 1996 BoZ Act, which strengthened Parliament's hand in the appointment of the Governor, a few organisational weaknesses remained. Firstly, the Board of the BoZ was not sufficiently independent of the Governor. Though the President made appointments to the Board, they were on the recommendation of the Governor. Further, the Governor was also Chairman of the Board, giving him considerable power in setting the Board's agenda and directing deliberations. Secondly, as long as the FSSD remained within the BoZ, the directors faced considerable administrative bureaucracies that were difficult to surmount in an expedient and efficient manner, especially in the midst of a crisis.

The Directors made two observations regarding the **quality of information** used in dealing with failing banks, firstly, that during the 1995 banking crisis, nobody understood the figures coming out of the distressed banks; that many mistakes were made as the BoZ continued to lend in the absence of management accounts. As a result, the department used unreliable financial accounts, which were sometimes at least six months old to make decisions [CI/FSSD/25] [CI/FSSD/35]. Subsequently, although the department receives monthly financial data from banks, it is yet to develop its forecasting abilities, skills and resources. Secondly, despite weakness in the supervisory process, the FSSD was capable of identifying the financially-distressed banks and understood the consequences of delaying regulatory actions [CI/FSSD/7a].

In the Directors' opinion, the **implementation process** was weak because of the absence of reliable information about the banks, appropriate legislative powers in the BFSA, and the slow-moving consultation and decision-making process within the BoZ and at the MoF. Firstly, as one Director complained, it was difficult to make appropriate recommendations to the Governor when the information was not reliable. When he joined the FSSD, for example, he requested information on all the banks. He received one balance sheet, which was three months old, one, which was six months old and another which was 12 months old. It was impossible to form a consolidated view on the financial condition of the entire financial system [CI/FSSD/35]. Secondly, effecting the provisions of the BFSA, 1994 was an "administrative and bureaucratic nightmare" [CI/FSSD/5b][CI/FSSD/7b]. The need to consult the Deputy Governor and the Governor delayed the decision-making process, which was highly centralised in the BoZ. The consultation process with external stakeholders was even longer, especially when the BoZ recommended a bank closure. Occasionally, the directors had to take action without consulting the Minister to accelerate the process. Directors expressed frustration with the administrative process of implementing regulatory decisions on distressed banks. The FSSD went through the same process repeatedly. It gave distressed banks regulatory deadlines in which to take action, the deadline came and went, yet, the BoZ did nothing. The BoZ summoned Bank owners to the BoZ, held discussions and set new deadlines [CI/FSSD/29]. The banks, in the opinion of one Director, were being treated with 'kid gloves'.

8.6.5 Financial System Supervision Assistant Directors

The Assistant Directors discussed the dynamics of political interference in the regulatory process in detail. Perhaps because they felt that it was not their duty, at their level "to fight the politics - that was for the Director and the Governor to do" [CI/BoZAD/86]. One Assistant Director referred to two forms of **political interference.** The first kind was direct and often linked to banks using politicians affiliated with their institutions to try to influence regulatory decisions. The Assistant Director said the practice was inevitable because, frequently, bank owners and directors had better connections with politicians than BoZ officials. They interacted with each other more closely and more frequently than regulators and politicians did [CI/BoZAD/58]. There was also a more willing acceptance of the reality that the BoZ was an arm of government. One Assistant Director said, 'whether we like it or not, we have always, we still do and will continue to act on behalf of government into the foreseeable future. The second kind of political interference, which was subtler, involved BoZ officials self-censoring regulatory decisions in order to make them more palatable to political interests [CI/BoZAD/42a]. In the words of one Assistant Director, 'Whether perceived or real, the level of fear of political repercussions arising out of regulatory decisions could not be denied' [CI/BoZAD/42b].

Assistant Directors distinguished between the **quality of information** available during the 1995 bank failures and that available during the 1997/98 bank failures. Some were of the view that the BoZ was caught by surprise because '... the BoZ had been deceived by the flamboyant activities of the bank - the Meridien Card, Meridien Baby Bonds, Investment Funds, Meridien Centre and so on. It took a long time to even begin to think that the bank would actually collapse' [CI/BoZAD/26], especially since the level of sophistication was such that, the department was not in position to capture any adverse information about the bank. Further, they also conceded that at the time, the Department did not have the expertise or technical capacity to fully understand things at the bank. Even when they received rumours, they lacked the evidence upon which they could act [CI/BoZAD/70a].

However, during the 1997/98 bank failures, the Assistant Directors indicated that the quality of information had significantly improved and the FSSD was in a better position to know exactly what was happening in the failing banks. The Department 'knew who was breaching which regulations, which bank was insolvent and which one was not [CI/BoZAD/70b]. The department had acquired capable staff that understood the banking problems well. Although there still is room for improvement, the Department had the capacity to conduct basic assessments of the bank's financial condition, and determine which banks were financially-distressed and which ones were not [CI/BoZAD/4].

The Assistant Directors identified several issues affecting the **type and rate of regulatory intervention** in financially-distressed banks, namely, the availability of sufficient evidence of financial deterioration and breach of banking regulations; the legal procedures prescribed in the BFSA in light of that evidence; the quality of re-capitalisation/re-organisation plans submitted by management; the actions and attitudes of management and owners to regulatory advice and directives; and finally the level of political appreciation, interest and urgency in resolving a specific bank's financial problems.

1. Even though regulators became aware of financial distress, they could not act in the **absence of hard evidence** indicating financial distress and/or breach of banking regulations [CI/BoZAD/70]. Sometimes, the financial evidence was outdated and did not adequately reflect the current position of the bank; it could be worse (as was often the case) or it may have improved (as often claimed by the bank's management). In Bank 5's case, the financial data was at least six months old and at the best of times three months old [CI/BoZAD/14].

2. When a problem was detected, the BoZ entered into **correspondence** with the failing bank and **several meetings** were held with it [CI/BoZAD/6]. It was only after the BoZ discussed and considered all the options that it applied sanctions and other actions. The BoZ was duty bound to follow certain

procedures when dealing with problem banks. It responded to the bank failures within the confines of the law and the administrative procedures that it had set for itself. One Assistant Director argued that 'we cannot move into an institution the day we hear that something is wrong. We cannot manage every financial institution in Zambia. Even if we wanted to, we do not have the capacity to do so.' [CI/BoZAD/56]. Sometimes, however, it was simply 'too cumbersome to institute some of the more stern action that was required to improve the situation such as removing management. Such action required the approval of the Governor and the M/Finance. Getting that consent was not easy because of concerns that doing so would precipitate a run on the bank.' [CI/BoZAD/78]

3. In the **absence of prompt corrective action rules**, it was not easy to be consistent. On one hand the FSSD was keen to resolve the problems facing the failing banks, but simultaneously, it was important that the BoZ gave 'management a chance to resolve their difficulties', even at the cost of appearing to be too lenient. Sadly, in the desire to pursue all options [CI/BoZAD/16], the regulatory and supervisory process was slow, inundated with correspondence, meetings and non-affirmative action [CI/BoZAD/28]. The one outstanding criticism of this approach, even amongst the Assistant Directors, was that the FSSD pursued the options late in the bank's life cycle. The 'effort was too late and ... too late to make a difference' [CI/BoZAD/38].

4. A significant amount of time and effort went into **evaluating the quality of the re-capitalisation/re-organisation plans** owners/management submitted to the FSSD. Often the assumptions and targets were too ambitious [CI/BoZAD/12], for example, recovery deposit rates in some plans were higher/lower than the industry average and even the best-managed banks in Zambia. One Assistant Director was particularly disappointed with the nature of the planning meetings. He reported that 'There was a lot of mistrust from both parties. A lot of disrespect as well, on both the part of the BoZ and the banks. The meetings

focused on trivial issues on the definition of capital, how to provision bad debts and so on, when the real issue was simply liquidity and bad management. It was difficult to address the problem in banks with the very people that were causing the problem. Even if the BoZ had decided to recapitalise all the banks in the banking system, they would still have crumbled under the weight of bad management' [CI/BoZAD/32]. Despite initial hopes that the management would recapitalise the banks, the hopes often came to nought, usually because of management's negative actions and attitude.

5. **Management's attitude and actions** were important factors in the nature of the FSSD's choice of supervisory actions and techniques. Often, there was initial optimism that the shareholders would secure the required capital. In the early stages, the relationship between the FSSD and management was cordial and mature, but, it was not long before that view changed. As the financial deterioration in the bank continued, the relationship became more desperate, and in the end, it was usually acrimonious [CI/BoZAD/76a]. The difference, which arose between the two parties mainly centred on the appropriate level and type of corrective action to implement, whether the bank's should take on more risk (as bank owners wanted) or to reduce the banks current activities (the usual regulatory preference) [CI/BoZAD/76b]. In a few cases, the bank realised that the directors were acting fraudulently and moved in to replace the management team. Some of the managers, the FSSD determined, did not intend saving the bank in the first place. The level of financial deterioration was such that they could not, even if they wanted to [CI/BoZAD/78]. Unfortunately, that realisation often came too late [CI/BoZAD/62]. Other times, the owners/management were in denial of the extent of the bank's financial problems [CI/BoZAD/10a] and refused to implement regulatory directives or reluctantly implemented them [CI/BoZAD/30a]. The worst kinds of management actions were when they appeared to co-operate but in effect were doing the exact opposite [CI/BoZAD/10b]. Once management realised that they could get away with not implementing regulatory decisions, it became

easier to defy subsequent directives. As the FSSD continued to ignore breaches, it became more difficult to enforce the next and so on - 'it became a meaningless exercise of exchanging correspondence for no apparent purpose other than that of going through the motions' [CI/BoZAD/30b].

6. However, despite the negative effects of the above factors, the Assistant Directors noted that it was the "**lack of political will to enforce regulatory decisions**" that was a fundamental weakness in the regulatory process. Referring to the 1997/98 bank failures, one Assistant Director said, 'the issue was no longer that of financial certainty about the bank's financial condition, but rather, whether the political will was present to stomach more bank closures'. [CI/BoZAD/14]. Although collectively the total assets of all the banks that failed in 1997/98 were less than 5% of the total assets in the industry, it was feared that the closure of the banks might lead to the failure of larger banks in the banking system.

Because of the above reasons, it was inevitable that regulatory forbearance would occur leading to policy inconsistency and even non-implementation of regulatory directives. Examples given by the Assistant Directors included;

1. Negotiating with management that had a huge overdraft with the BoZ [CI/BoZAD/40];
2. Looking for a merger for a bank with little or no value left in it [CI/BoZAD/38];
3. Telling a bank to stop lending when it had nothing left to lend, and;
4. Imposing administrative restrictions when the management that had caused the bank problems was still in place [CI/BoZAD/36].

8.6.6 Financial System Supervision Bank Inspectors

While they acknowledged the lack of BoZ **operational independence**, FSSD inspectors felt it was important to 'apportion perceived responsibility, and deal with BoZ at the departmental and institutional level and how it interacts with the MoF' [WIC/RPSI/35]. Firstly, personal contacts of the Inspectors at the MoF had complained to them about the delay in delivering information to the MoF. Information, they said, was delayed significantly until the situation in a bank was so bad that the natural reaction of the MoF was to perceive the BoZ's actions as radical since they had not been privy to early BoZ interventions [WIC/FAI/37]. Secondly, inspectors discussed incidents of 'political self-regulation' within the department itself, notably being asked to tone down the firmness of their proposals for corrective action [WIC/NBFI/12]. The Department, the inspectors claimed, had missed opportunities to inform the BoZ Board of Directors of the seriousness of the situation in banks by revising reports to make them more politically-palatable [WIC/NBFI/14a] [WIC/NBFI/34]. The major part of the problem of independence lay within BoZ when ... 'the politicians were not even involved' [WIC/RPI/13] [WIC/NBFI/14b].

When asked to evaluate the **quality of regulatory information** they generated for decision-making, the inspectors acknowledged that their reports had been historical and they had failed to conduct the necessary sensitivity analysis to support their recommendations [WIC/RPI/35] [WIC/FAI/43]. Had the FSSD been more forward-looking in its reports and indicated the likely financial consequences of delaying regulatory actions, perhaps the Governor might have been more pressed into taking action [WIC/RPI/35]. There was 'a need to move away from being historians to inventors of the future' [WIC/FAI/43]. Another major problem was the substandard communication and documentation of regulatory concerns and actions. There is a poor culture of documenting regulatory decisions and actions leaving Inspectors unsure of what was going on in the FSSD [WIC/RPI/21]. The Inspectors attributed the failure to do so to a culture of preferring to hide the facts from the public [WIC/RPSI/95].

Inspectors noted several occasions when the FSSD exercised **undue regulatory forbearance** [WIC/FAI/40]. It was common for directors to search for clauses in the law that would exempt a bank from complying with a regulatory requirement [WIC/RPI/97] [WIC/RPI/98]. Inspectors identified three principal factors that contributed to the BoZ's failure to implement regulatory recommendations in a timely and consistent manner, namely: lack of accountability, lack of regulatory responsibility and lack of knowledge and respect for the law:

1. **Lack of regulatory accountability**: There was a notion in the BoZ that there was no relationship between financial remuneration and an individual's day-to-day decisions, nor were there any consequences for their actions [WIC/RPSI/26]. There was no link between performance and reward [WIC/RPSI/35]. There was no accountability as no adverse action had been imposed on the people who had been given the responsibility of running the BoZ when things had gone wrong [WIC/FAI/10]. Inspectors expressed concern about the ambiguity in the accountability process [WIC/FAI/59], and recommended that the BoZ needed to strengthen this. There were divergent views, however, regarding who should ultimately be responsible for ensuring that the BoZ executed its regulatory responsibilities [WIC/RPI/25a]. Some Inspectors felt the **Government** should take keener interest in the BoZ's affairs since public funds were being abused in the failing banks [WIC/RPI/24]. Some thought that the **public**, should be asking more questions since they put in place the government [WIC/RPI/25b]. Others suggested that the **Internal Audit Department** should periodically evaluate FSSD's work [WIC/RPI/16][WIC/RPI/19][WIC/RPI/22], However, inspectors expressed reservations about the effectiveness of an internal body since it would report to the Governor, who was also the chief regulator [WIC/FAI/17] [WIC/FAI/18]. Instead, they felt that an **External Body,** such as the Auditor General's office should conduct periodic investigations into the affairs of the bank. In the end, however, one Inspector strongly argued that the FSSD Director, had to bear the onus for ensuring that the Department executed its assigned responsibilities.

2. **Lack of regulatory responsibility:** Closely related to the lack of regulatory accountability, was the observed absence of regulatory responsibility for decision-making. Inspectors noted a reluctance to make decisions because of an over-riding fear of making mistakes. By not making decisions, they avoided making mistakes [WIC/RPSI/32] [WIC/RPSI/48]. This was sometimes surprising because BoZ staff, including Inspectors were so well-protected by the law [WIC/RPSI/50]. There was a lack of clarity as to who was responsible for certain decisions between the Governor, the BoZ Board of Directors, MoF and politicians. One Inspector said that a BoZ Board Director known to him had once said to them "Basically, we really did not make decisions, because they were already made" [WIC/RPSI/92]. Another suggested that rather than pretend to be responsible for managing the financial system, it was better for the BoZ to be forthright and tell "the world that we do not make the decisions at BoZ, if you want to identify the real decision-makers, then go to MoF, go to the politicians. Let them take responsibility for the mess they create in the financial sector. Right now they are not in the picture, let us make them responsible for the mess they create" [WIC/FAI/53].

3. **Lack or knowledge and respect for the law:** Inspectors observed a lack of knowledge and respect for the law at various levels in the regulatory process. Some inspectors considered the much-criticised BFSA, 1994, very strong, especially for the small size of the financial sector [WIC/RPI/29]. Over the years, the BoZ had been importing legislative advancements from different parts of the world, but was failing to enforce it [WIC/RPSI/32] [WIC/RPI/59]. Failure to enforce the legislation was partially due to a lack of knowledge of the actual laws that were supposed to be enforced. Too many people in the department, some argued, did not know what was contained in the Act [WIC/RPSI/99].

Because of these factors, amongst others, there was a significant amount of professional and personal frustration amongst the Inspectors. All inspectors had personal experiences of disappointment and frustration in the FSSD. One Inspector commented, "After a while, you ask yourself, what is there for me to suffer for? I can avoid all these problems and still earn my salary at the end of the month. So you tend to shy away from doing what you are supposed to be doing" [WIC/FAI/24]. One Inspector said, although it was easy to give up and say, anyway, at the end of the day I will still earn my money, he was angry that his professional image had been dented by the BoZ's failure to manage the financial system. He said, 'people ask what you are doing about the rot in the financial system and they simply conclude that you are jokers!" Yet another Inspector bluntly stated that '... the maximum time I now spend on BoZ work is three and half hours in a day ... the truth is that I found it was no use. People even started making fun of me saying, "hard working, hard working!" You become a laughing stock. [So] you come in at 08:30, read your newspapers, have your coffee, leave at 10:00 hours and come back at 12:00; see what has been dropped on your desk; go to lunch, come back at 14:30; go down to the gate then go home. Even if supervisors come round to see you at your desk, they say, "ok", go away, and at 16:20 he says see you tomorrow. Meanwhile, it's been two weeks since he gave you a job to do." [WIC/RPSI/77]

8.6.7 Former Bank Owners/Directors

That the former bank owners of failed banks would disagree with the views expressed by BoZ staff was not surprising. However, what was surprising was the extent to which, they claimed the BoZ had not only failed to manage the banking crisis, but had actually precipitated it by allowing the large banks and the IMF to manipulate its independence and judgement. Two former bank owners/directors claimed that the BoZ was not **independent** because the big banks connived with the IMF and used the BoZ to implement their devious plans; that the big banks were envious and uncomfortable with the growth of the small banks and used the BoZ and the Governor to close them [CI/FBD/2]. The BoZ was a mere pawn in the process [CI/FBD/12], and wanting to be in good books with the IMF, the BoZ implemented regulatory measures without regard to the local banks and their specific situation [CI/FBD/4]. What made the BoZ so vulnerable to manipulation was the lack of independence from central government, caused in part, by the failure of the current and previous governors to make decisions [CI/FBD/88]. The previous governor was criticised for not being a firm decision-maker, at least "not the kind required to solve a problem of Meridien's magnitude". The current governor was seen as a man who was not able to assert himself. One former owner said of the current governor, "In a way, he knows how to achieve things in his own way. When he is directed to do certain things, he simply does nothing. But hey, he is an old man, nearing the end of his career, why rock the boat?' Interestingly, the same bank owners discussed resorting to politicians for help in dealing with the BoZ, and admitting that 1996 being an election year worked to their benefit. "... Remember that all these things were taking place within an election year. Fortunately, the Government came to our assistance. We did a lot of running around, meeting that politician there and this politician here. That is how we survived ..." [CI/FBD/21].

The former owners also insisted that the BoZ relied on **poor quality regulatory information** and did not know or appreciate what was going on [CI/FBD/2]. This opinion arose from the former owners' low perception of BoZ inspectors. They held the view that international banks were more fearful of Inspectors from their headquarters than they were of BoZ Inspectors who were neither as knowledgeable, nor asked pertinent questions [CI/FBD/106a]. They also noted that being secretly indebted to the banks they were inspecting had undermined the credibility of some inspectors [CI/FBD/106b]. The negative opinion of BoZ inspectors also stemmed from the BoZ's culture of treating bankers as 'gentlemen'. One former owner observed that "the banking sector had been infiltrated by very sophisticated financial criminals ... what the BoZ needed was a forensic accounting department to periodically investigate the affairs of the banks ... the current off-site and on-site regime of conducting standardised procedures is not useful in a criminal environment' [CI/FBD/158].

The manner in which the BoZ and the Government **implemented its policy of assisting failing banks** was viewed as a total disaster [CI/FBD/74]. The former director charged that the process was rife with rumour mongering, ill-timed decisions, and among other things, pre-mature cancellation of financial assistance.

1. **Rumours**: The former bank owners felt betrayed by the central bank's failure to keep information about the banks confidential. In the words of one owner, the BoZ "was leaking like a sieve" of information about failing banks [CI/FBD/76]. Others were more critical of the FSSD in particular, which they accused of "going around telling people to withdraw money from the bank". The FSSDs misinformation is said to have included giving the MoF "a lot of falsehoods" [CI/FBD/24] (Appendix 36, 4).

2. **Ill-judged timing**: Repeatedly, the former owners expressed dismay with the timing of the BoZ's decision to close a bank; "how do you close an institution after you have pumped in K12Bn? Let me ask you Mr Maimbo, what logic is there in such action? Tell me, eh?" [CI/FBD/4]. One owner complained that the BoZ measures came too late; "In a general sense the measures came too late and did not, in my opinion deal with the root cause of the problems" [CI/FBD/108].

3. **Premature cancellation of financial assistance:** Interestingly, the owners claimed that the BoZ ceased providing financial assistance prematurely. "An additional K2Bn to K3Bn would have resolved the problems of the bank", said one owner [CI/FBD/10]. "I mean how much was involved in saving all the banks. "Only about US$ 4 million. It was peanuts. It could have been done if the will was there." he added [CI/FBD/14]. Another owner said, "with liquidity support of approximately US$5 million, I could have turned around the bank." [CI/FBD/74].

8.7.0 Conclusion

Based on the evidence examined in the study, it is clear that in the months preceding the 1995 and 1997/8 bank failures, the BoZ implemented a variety of regulatory and supervisory instruments intended to forestall the closure of the banks. It is also clear, and indeed there was a consensus amongst all involved and affected interview respondents, that the BoZ did not implement the required corrective action in the desired timely and effective manner. Instead, the BoZ exercised an excessive amount of regulatory forbearance that resulted in high intervention and closure costs evidenced by the high BoZ overdrawn accounts. The study found that there were three primary reasons for regulatory forbearance in Zambia.

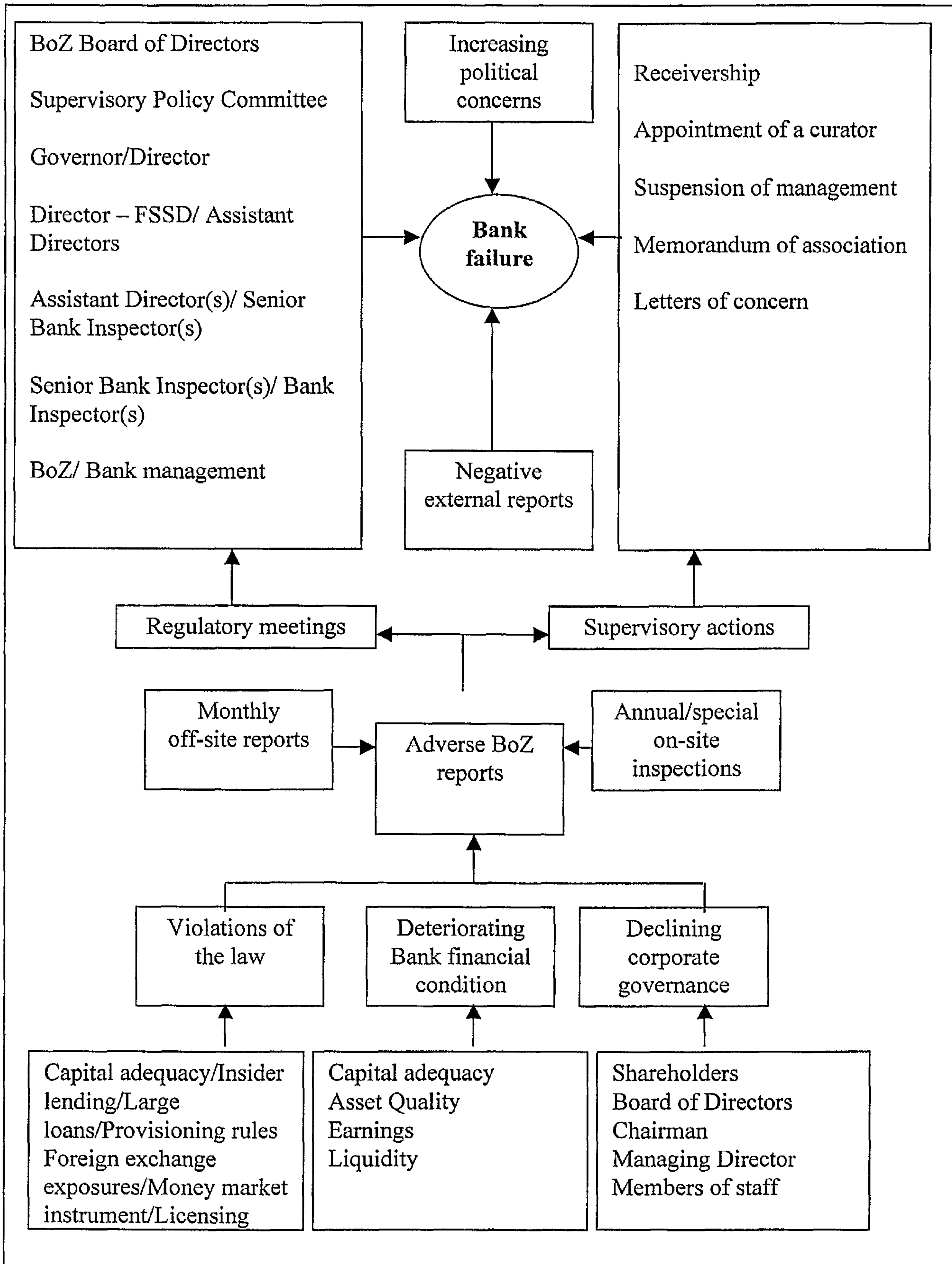
Firstly, based on the collective shared experience of the interview respondents it is clear, that politically-induced regulatory forbearance occurred in one form or another in both the 1995 and 1997/8 bank failures. In 1995, the evidence of political interference in the handling of the Meridien crisis was particularly evident in the three months leading to the bank's failure. Various statements by the M/Finance to MPs and to the Press confirm his personal involvement in delaying the closure of the bank due to his concerns about the potentially widespread negative effect on the economy and the reputation of his government. As for the 1997/98 bank failures, the study failed to identify evidence of direct political interference in the regulatory process. However, the evidence obtained from interview respondents and a detailed analysis of the regulatory response to the bank failures indicated that it was highly unlikely that any bank would have been closed during the election year of 1996. There was insufficient political appetite to stomach any more bank failures, hence the continued futile efforts to find alternative remedies to the problems afflicting the small banks in the banking sector.

Secondly, in both the 1995 and 1997/98 bank failures, the study found that the BoZ considered the economic effects, which influenced the timing of the bank closures. In 1995, the MoF refused to allow the BoZ to close Meridien Bank because it feared that the bank's closure would have destroy the financial base that following a reduction in public confidence. In 1997/98, although the total assets of all the banks that failed in 1997 was less than 5% of all the assets in the industry, it was feared that their closure might lead to runs on larger banks in the financial system. These fears were true were never tested empirically.

Thirdly, in addition to economic and political forbearance, the thesis found that a third form of forbearance was more prevalent, one which this study referred to as bureaucratically-institutionalised regulatory forbearance. This form of forbearance was not only embedded in the formal and informal administrative policies and procedures for effecting legislative and supervisory sanctions, but appears to have been part of the organisational culture of decision-making within the BoZ. The process of implementing the corrective action took an excessively long period, not only because of political and economic concerns but also because of the exhausting administrative policies and procedures, which had evolved in the department out of tradition and precedent, rather than deliberate administrative design (Figure 21).

Bureaucratically-institutionalised regulatory forbearance was most evident in the early stages of the regulatory process when the FSSD had to deal with bank violations of the law, deteriorating financial conditions through regulatory meetings and remedial supervisory actions. Significant amounts of time and resources were expended complying with bureaucratic policies and procedures that had evolved with the BoZ out of precedent and tradition rather than well-conceived out organisation design. These regulatory processes were further complicated by the decentralised responsibility structure in existence at the BoZ operating within a highly-centralised decision-making environment.

Figure 21 The 'Actual' Regulatory and Supervisory Systems Model



8.7.1 Violations of the law

The study found numerous incidents of banks violating existing banking laws and regulations particularly those relating to capital adequacy, insider loans, large loans, foreign exchange exposures and the classification and provisioning of loans. Each violation involved the BoZ:

1. Seeking and obtaining evidence that the violation had occurred;
2. Advising management that the violation had come to the attention of the FSSD;
3. Requesting management to cease the violations;
4. Waiting for confirmation that the violation had ceased before instituting - this usually meant waiting for the next off-site report produced every six weeks; and
5. If the violation did not cease, giving the bank a period of seven days to show cause why the FSSD should not effect punitive actions as provided for under the BFSA.

At a minimum, the five-step bureaucratic process of identifying violations, verifying them and effecting regulatory action took an average of at least six weeks. As the number of violations increased, that period reduced through the involvement of special investigation teams, on-site inspections and the appointment of curators. However, by then, the extent of financial deterioration required more than arms length regulatory intervention.

8.7.2 Deterioration of bank financial condition

In the absence of standard trigger ratios stipulating the required regulatory action, the FSSD allowed the financial condition of problem banks to deteriorate for longer periods than should have been the case. The very nature of financial analysis required that the interpretation of a bank's financial condition be based on sustained trends. Typically, a 'sustained' trend was one in which the ratios continued to decline or rise over three or more reporting dates. Given that the off-site reports were produced on a monthly basis, it was at least 12 weeks before the tone in off-site reports started to change to denote a worrying trend in the financial condition of a bank. Since the off-site reports did not include predictive sensitivity analysis of future trends, the concerns the reports raised were not taken seriously until much later than desired. Further, in the absence of a formal process of consolidating the individual assessments of a bank's capital, asset quality, earnings and liquidity, there was a temptation to delay the declaration of a bank's possible insolvency until all the indicators had sufficiently deteriorated so as to reflect similar individual conclusions delaying the process of regulatory intervention even further. Additionally, the fact that financial ratios tended to reflect a deterioration long after the events that caused the deterioration, especially in an environment of weak accounting rules and regulations, meant that there was an in-built delay between the occurrence of unsafe and unsound banking practices and the report of them in regulatory reports.

8.7.3 Deteriorating corporate governance

The primary mechanism for monitoring corporate governance was through FSSD on-site inspections, which, unless otherwise dictated by intervening events, were conducted annually. The number of weeks from the date of commencing an inspection to the date of the production of the final report was particularly worrying. The actual inspection lasted anything from three to six weeks and producing the inspection report took an average of a further two to three weeks. The lapse of time was in part due to the practice of sending the report to the bank's management for them to comment on before its finalisation. The length of time that it took inspectors to complete their working papers, prepare their individual findings, consolidate their first draft inspection report, obtain management comments, incorporate management comments into the report, present the report to Assistant Directors for comment and discussion, incorporate the Assistant Directors review points into the report, and then finally to prepare the final report, was usually in excess of eight weeks. Identifying and resolving declining governance standards was further hindered by the channels of communication used by the BoZ when dealing with problem banks. In the initial stages, the primary BoZ/Bank contacts occurred between a bank inspector and the chief financial officer. Later as the bank's financial condition deteriorated, the levels of contact raised to include FSSD Director and the bank's Managing Director. Despite the FSSD focus on management on whom were expended much regulatory time and resources, management had a higher incentive to present a better position, even fraudulently, than was actually the case. The FSSD only targeted shareholders and the Board of Directors, who were primarily responsible for the quality of corporate governance, in the very late stages of the regulatory process. By that time, the focus of attention was on securing additional capital and not the underlying poor quality of corporate governance that had initially caused the problem.

8.7.4 Regulatory meetings and effecting supervisory actions

The study found that on average it took at least six months from the initial reports of financial deterioration, to the commencement of formal regulatory actions, designed to effect remedial action in the form of restrictions and prohibitions of unsafe and unsound banking practices. By the time the FSSD and banks signed memorandums of understanding or the BoZ issued directives to the same effect, the bank had entered the crisis phase. A notable feature of the 'crisis' period was the amount of time spent discussing the problems affecting the bank by holding an increasing frequency of regulatory meetings. Arranging and preparing for meetings with the supervisory policy committee, the BoZ Governor, the BoZ Board of Directors and sometimes, the M/Finance and in acute circumstances, the Republican President, was a time-consuming process that perpetuated regulatory forbearance even before economic and political considerations became an issue. The meetings were held alongside the enforcement of regulatory and supervisory actions. Administratively, the resolutions reached at the meetings required the BoZ to grant management time to implement them. Management resolve to collect outstanding non-performing loans, attract fresh deposits and find new investors to replenish the bank's depleted capital and reserves, led to the inevitable request for the BoZ to grant the banks time to execute their resolutions, plans and intentions. Based on precedent rather than urgency specific to that bank, the period given to such requests averaged four weeks.

The bureaucratic structures and processes did not match the pace and rate of financial deterioration. For example, providing liquidity support using a BoZ current account overdraft required the BoZ Board approval, yet, although the increase in the BoZ overdraft occurred on a daily basis, the BoZ Board met far less frequently and convening an emergency BoZ Board meeting was not always possible given the busy schedules of its members. Further, while the rate of financial deterioration continued with every cheque drawn on the bank, the monitoring process continued to operate on a four-week cycle until the crisis advanced significantly.

8.7.5 Decentralised responsibility with centralised decision-making

The study detected an interesting combination of a decentralised responsibility structure operating within a highly-centralised decision-making organisational system. Key members of the regulatory process had the responsibility of effecting appropriate regulatory remedial measures without the required authority or power to do so. This unique organisational structure operated through continuous consultations irrespective of the seriousness or urgency of the matter at hand. Below are three areas where this phenomenon was most evident.

1. All correspondence to banks initiated by any member of the FSSD, regardless of importance or significance had to be reviewed by an Assistant Director and signed by the FSSD Director. Thus, while Bank Inspectors had the responsibility of monitoring individual bank performance, they did not have direct authority or power to influence bank behaviour or performance. On average, it took at least three to four days to process a letter out of the department. As Chiumya (1999:38) rightly noted in a study of the FSSD, that communication between the different divisions was poor. The lack of communication resulted in the wasteful duplication of regulatory and supervisory effort. More significantly, she rightly expressed concern that decisions in the department were being made "without full knowledge of the information available to the central bank or in isolation without other divisions knowing about them".

2. While the FSSD Director, who was also Registrar of Banks, was responsible for regulating and supervising banks, he did not have the direct authority or power to unilaterally suspend management, close a bank or suspend further BoZ liquidity support. Although the BFSA gave the BoZ power to effect various actions, it did not, and still does not stipulate which official within the BoZ structure should implement the action. Inadvertently, the FSSD deferred authority and power upwards to the BoZ Governor. Further, by requiring the BoZ to act in consultation with the M/Finance, the BFSA also diluted the Governor's unilateral authority to decide on the fate of problem banks. Consequently, in the wake of the 1995 and 1997/98 bank failures the regulatory structure did not provide/facilitate a single individual who had the *responsibility, authority and power* to effect regulatory and supervisory decisions promptly and effectively.

3. Likewise, while the Director - Banking Department is responsible for managing the current accounts of all banks in the financial system, the authority and power to return cheques drawn on overdrawn accounts (effectively closing the bank) has been deferred to the Governor and through him, the BoZ Board of Directors. Officially, any extension of credit though a current account overdraft required prior BoZ Board approval. In practice, the credit was extended to the banks before BoZ Board approval and the Board subsequently ratified the decision retrospectively.

The study concluded that bureaucratically-institutionalised regulatory forbearance was, in part, the product of aymmetric regulatory models, information asymmetries, a regulatory desire to act in an equitable manner for all banks in the industry and, in the opinion of some of the respondents, cultural and social norms and practices in BoZ.

1. **Asymmetric regulatory models**[60]: As the study progressed, it increasingly became clear that regulation and supervision in Zambia comprised four distinct

[60] This categorisation is adapted from the work of Hamel, G. (2000), and the researcher's thoughts on regulation documented in his research diary.

models. At the bottom is the *operating model* which encompasses what bank inspectors, assistant directors and directors actually do on a day-to-day basis: how they are organised, what activities they perform and how they interact with commercial banks. Next comes the *official model* that represents all the choices, conscious and unconscious, the central bank has made regarding the various components of entry, monitoring and exit regulation and supervision. The public sees this model. On top of the official model, is the *mental model*, which encompasses all the beliefs, which staff within the regulatory and supervisory system hold about what drives regulation and supervision in Zambia. It is the prevailing set of dogmas, perceptions and orthodoxies about regulation that drives compliments and criticism of both the operating and official model. Finally, on top of everything else, is the *political model*. The political model refers to the distribution of power throughout the regulatory system. Who has the power to close a bank?

2. **Informational asymmetries**: Throughout the regulatory process, there clearly were divergent views amongst key stakeholders on the extent of financial deterioration, the required corrective action and the timing of that action. Even where agreements were reached on some of the required corrective action, subsequent action by both regulators and managers indicates continued difference in the levels of commitment in faith in the selected regulatory and supervisory action.

3. **Equity**: When the FSSD decided to pursue industry-wide solutions to problem banks, it effectively granted banks requiring immediate regulatory intervention, temporary reprieve from expected supervisory sanctions. Likewise, the BoZ committed less financially-distressed banks to a more stringent regulatory schedule than they otherwise deserved thus precipitating further distress than should have otherwise been the case. Although exhibiting similar characteristics, all the banks had unique features and experiences that required individual evaluation and regulatory response.

4. **Social and cultural norms and practices**: Several interview respondents made reference to social and cultural norms and practices, which, they claimed, influenced the quality of regulatory process. Implementing economic reforms was not easy because it required overcoming bad business habits, counter-productive attitudes and institutional weaknesses which take a long tine and a large amount of effort to change [PD/061295/87]. Some argued that regulatory failure was a cultural problem a pervasive problem in the population [WIC/FAI/59] [WIC/RPI/45], one that may have its origins in the educational system and societal norms in which teachers teach students to listen to and not question authority [WIC/RPSI/52]. Further, because the regulatory environment was one in which people frowned upon taking responsibility for regulatory decision, they withheld expressing their honest opinions about the usefulness of regulatory actions [WIC/RPSI/78]. This, in an environment where the level of politicisation in the regulatory process, whether real or perceived, was high and hindered the professional application of regulations [CI/GOV/119].

One respondent was particularly critical of how cultural and societal norms and practices perpetuated the bureaucratic approach to regulation and supervision in Zambia. His views are an apt conclusion for this Chapter:

> " ... The provisions of the law are clear and they have been for a long time. When a bank is insolvent, it should be closed. However, look at what is happening. How many insolvent banks do we have in the economy at this moment? Look at what happened in the case of Meridien bank ... a very bureaucratic process is followed before a bank is eventually closed. There is no viciousness in the central banks' approach to dealing with bank problems. The Bank managers are first given as much as six months to tell the BoZ how they are going to restructure ... I think is has to do with the culture existing in the organisation, the political climate and to a large degree a high level of ignorance about what to do on everybody's part. People simply do not respect the rule of law. Unfortunately, it's not just politicians who are not sensitised to these issues, regulators at the BoZ are just as much to blame."
>
> \- Interview respondent [CI/BoZI/28]

CHAPTER NINE

CONCLUSIONS AND RECOMMENDATIONS

> "The level of public health [bank safety][61] corresponds to the degree to which the means and responsibility for coping with illness [bank failures] is distributed among the total population. This ability to cope can be enhanced but never replaced by medical [regulatory] intervention or by the hygienic [legal] characteristics of the environment. That society [financial system] which can reduce professional [regulatory] intervention to the minimum will provide the best conditions for health [bank safety]"
> *Ulrich, 1983:380*

9.1.0 Introduction

Over the last decade, banking regulation and supervision research has focused on analysing the linkages between financial sector fragility and regulatory and supervisory weaknesses. Such research resulted in the almost inevitable conclusion that stronger regulations should be introduced in countries that suffered banking crises. The countries were deemed to have had weak accounting and legal frameworks, acute shortages of skilled personnel and pervasive political interference in public administration. The recommended options for reform therefore included higher capital adequacy standards, explicit rules covering intervention in financially-distressed banks, restraints on competition in banking markets and greater use of the market for monitoring banks.

There is little doubt that strong regulatory and supervisory frameworks are an important factor in minimising the risk of bank failures. However, what is of even greater importance is the effective implementation of banking regulatory and supervisory policies and procedures. Yet, there remains a limited amount of literature on how best to evaluate the effectiveness of banking regulators in implementing the

[61] Parentheses include substitute words that convert the quotation into an ideal approach to banking regulation and supervision.

regulations provided for in their jurisdiction. There are a number of reasons for the limited literature. Firstly, information on the type and timing of regulatory decisions during a banking crisis is rarely held within the public domain. Most of the information is considered to be confidential and thus not available for public research. Secondly, regulatory practices and obstacles are usually not directly observable. Political pressure on regulators and moral suasion on bankers are not directly observable forces. Thirdly, cross country studies that attempt to achieve homogeneity for purposes of statistical analysis exclude unique regulatory characteristics that might be essential to understanding the quality of regulatory performance. The business of regulation and supervision often occurs at such a detailed level that it escapes detection by broad country surveys [4.1.0].

The methodology and methods employed in this study were designed to address the concerns noted above. This involved developing a theoretical framework and qualitative tools and techniques from which to evaluate regulatory and supervisory events, processes and decisions before and during the Zambian banking crises of 1995 and 1997/98. Using 480 documents (letters, memoranda, off-site and on-site reports, anonymous letters) 192 financial statements for eight banks for a period of 24 months prior to each bank's date of closure, 28 interviews (Past/present BoZ Governor(s), past/present Financial System Supervision Director(s), Assistant Directors, bank owners and directors of failed bank and two workshops with 15 BoZ inspectors, this study contributes to our understanding of how regulatory and supervisory policies and procedures are designed, developed and implemented, particularly in developing country settings such as Zambia's [4.2.0]. The empirical research in this thesis draws on the BoZ's experience to evaluate and explain regulatory performance at three stages in the regulatory and supervisory process: bank licensing, bank monitoring and on-going supervision, and bank intervention and closure procedures. This Chapter summarises the main findings of the study, discusses their theoretical and policy implications and suggests areas in which further research might be usefully directed.

9.2.0 Summary of Main Findings

9.2.1 Entry Regulations and Supervision Practices

Firstly, the thesis sought to establish whether the weaknesses in the licensing procedures for new commercial banks were significant contributory factors to the bank failures of 1995 and 1997/98. It suggested that there was insufficient regulatory regard given to the quality of the new banks' prospective owners, directors and managers, the minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners [1.3.0]. The study concluded that there was insufficient regard to the quality of the new banks' owners, directors and managers, the minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners [6.9.0]. The study found that:

1. By focusing on the minimum legally-required capital requirements, the MoF neglected the need for banks to raise sufficient business capital. There were no efforts made to ensure that the new banks were in a position to maintain ongoing capital adequacy requirements [6.2.0].

2. The source and existence of capital was not thoroughly investigated as the MoF relied on the minimal information provided by the applicants. In a number of instances, the applicants merely provided a statement of authorised or paid up capital signed by the directors. The lack of third party confirmation raised questions about the sufficiency and quality of capital [Table 16][6.2.0].

3. Between 1984 and 1989, the MoF had no criteria for assessing the character and experience of major shareholders and directors. Investigations into the financial condition, resources and history of applicants rarely proceeded beyond evaluating information provided by the applicants. Requests to applicants for information on their compliance status were either ignored or met with summary information [6.3.0].

4. Later, when applicants' details were referred to the state security departments (Zambia Police, Anti-Corruption Commission, Special Investigations Team for Economy and Trade, and the Drug Enforcement Agency) requests for information often went unanswered or were returned to the MoF late. Bank license applications whose applicants faced allegations of involvement in criminal activities such as drug trafficking, money laundering, false representation, fraud and even murder continued to be processed until the application was approved. The MoF permitted applicants to replace the 'suspect' concerned without tarnishing the credibility of the entire application [6.3.0].

5. The study found no evidence indicating that any of the banks licensed between 1984 and 1994 were assessed for their potential individual contribution to the convenience and needs of the banking sector or their prospects for financial viability. Regulatory emphasis was on the applicant's satisfaction of the minimum legal licensing requirements and not their subsequent on-going profitability [6.4.0][6.5.0].

6. There was high a number of former senior BCCI officials that entered the Zambian Banking sector through the newly-licensed banks, either as owners or managers. The MoF made no formal effort to check whether the former BCCI officials had played a role in the closure of the former international bank. All the major banks that were dominated by the former senior BCCI officials have since failed [6.3.0].

However, the study failed to confirm its hypothesis that weaknesses in the bank licensing policies and procedures were *significant* contributing factors to the bank failures of 1995 and 1997/98. The weaknesses in the design, development and implementation of licensing policies and procedures applied to both banks that failed and those that did not. The study found no discernable differences in the regulatory evaluation of bank licence applications submitted by banks that subsequently failed and those that did not [Table 16-20]. Nevertheless, to the extent that under a more stringent licensing regime, the MoF might not have approved some of the bank license applications, the weaknesses in the bank licensing policies and procedures may have contributed to the bank failures of 1995 and 1997/98.

9.2.2 Monitoring for Unsafe and Unsound Banking Practices

Secondly, the study aimed to confirm whether the BoZ had the capacity and resources to detect financial mis-management, breaches of the law and financial deterioration in the banks that failed [1.3.0]. It concluded that as early as 12 months before the closure of the banks, it must have been apparent to the BoZ that several local banks were insolvent and should have been closed. Further, the BoZ had the legal authority to close the bank but did not [7.6.0]. Specifically, the study found that:

1. The BoZ methods for monitoring for unsafe and unsound banking practices were initially weakened by a lack of information due to the limited number of prudential reports submitted to the BoZ, standard accounting practices, a standard approach to the selection and use of financial ratios, industry performance benchmarks, standard rating mechanisms, and the lack of departmental resources [7.3.2].

2. The bank failures of 1995 and 1997/98 did not occur suddenly, but rather, were a culmination of a long process of financial deterioration and breaches of the law. The BoZ CAMEL model was able to identify differences in the capital levels, asset quality, earnings performance and liquidity positions between banks that failed and those that did not as early as 24 months before the banks were closed when the failed banks had liquidity ratios of less than 50%, which was in sharp contrast to the 75% average of the non-failed banks [7.3.2] [Figure 15-18].

3. In an environment where the five largest banks held 80% of the deposit market in 1995, there was little or no product/service differentiation between the local banks and there were limited investment options available to bank managers,

Furthermore, the incidence of unsafe and unsound banking practices, price-based competitive strategies and an unbalanced investment portfolio in government treasury bills was indicative of impending financial distress many months before the financial ratios started to decline [7.4.0].

4. Despite its weaknesses, the legal framework provided the BoZ with sufficient authority to deal with financial distress and violations of the law. The BFSA conferred upon the BoZ legal authority to implement a broad range of supervisory actions aimed at ensuring that banks operated in a safe and sound manner. These included disciplinary measures for failing or refusing to comply with a supervisor's orders or conducting business in a manner considered to be unsafe and unsound, such as appointment of a curator, suspension of a bank's licence, and revocation of a banking licence. Others included requiring failing banks to enter into written agreements or to commence programmes of action to counteract any unsafe practices, or in the event that written agreements were deemed impractical, directing banks to cease or refrain from pursuing the current course of action. The regulatory and supervisory framework gave the BoZ authority to institute examinations of banks to determine whether they were in a sound financial condition and operating safely. There were provisions for penalising any person, including management and members of the boards of directors, who contravened any provisions of the BFSA. They included fines and prison terms of various amounts and lengths. A number of provisions in the BFSA protect the interests of depositors such as those that prohibit insolvent banks from accepting deposits [7.5.0].

9.2.3 Exit regulations and supervision practices

Thirdly, this thesis considered whether the BoZ failed to enforce the required corrective action in a timely and consistent manner, because of politically and economically-motivated regulatory forbearance. The study sought to establish the timeliness and effectiveness of the corrective measures, if any, that the BoZ recommended and implemented in response to the emerging financial distress of 1995 and 1997/8. It sought to examine the extent to which the political and economic environment prevented the early resolution of banking problems, lengthened the BoZ intervention and closure process, and weakened the sufficiency of the existing legal provisions for closing failing banks [1.3.0]. Based on the documents, interviews and discussions examined in the study, the thesis concluded that in the months preceding the 1995 and 1997/8 bank failures, the BoZ failed to implement the required remedial and rehabilitation actions in a consistent, timely and effective manner because of political, economic and bureaucratically-institutionalised regulatory forbearance [8.7.0].

1. In one form or another, politically-induced regulatory forbearance occurred in both the 1995 and 1997/8 bank failures. Firstly, various statements by the Minister of Finance to MPs and to the Press, especially in 1995, confirmed his personal involvement in delaying the closure of the then fourth largest bank due to his concerns about the potentially-widespread negative effect on the economy and the reputation of his government. In his defence of the MoF's involvement of the 1995 bank failures he declared to parliament, "...there is a terrible misconception about something called the independence of the Central Bank. I know you have read books about banks being independent – there is no such thing!" [8.6.2] Secondly, in 1995, the BoZ Governor was removed from his position following his recommendations to close one of the then fourth largest banks which was financially-distressed [8.6.3]. Subsequent efforts to reorganise the bank through a merger with the Zambia National Commercial Bank were announced by the MoF [8.3.2]. Thirdly, the MoF approved the use of public funds to bail out privately-owned financial institutions, particularly Meridien BIAO Bank. In 1995, the total sum extended to Meridien was K8bn. In 1997, the BoZ and the MoF attempted to resolve the liquidity crisis by transferring several statutory deposits held at the BoZ to liquidity-strained banks. It is estimated that K2bn was used for this purpose. Fourthly, all the former BoZ governors interviewed, acknowledged the existence of insurmountable political pressure in the execution of their duties [8.3.4]. It was felt that despite the legislation guaranteeing central bank independence, the true

level of independence was a negotiated arrangement determined by the personalities of the MoF and the BoZ and the nature of that relationship. In addition, the governor's personal political connections were important in ensuring the administrative and operational enforcement of regulation [8.6.3].

2. Delays in closing insolvent banks were partly motivated by regulatory concerns about the potential economic effects of the bank failures. In 1995, the MoF instructed the BoZ not to close Meridien Bank because the bank's closure would have 'thrown the financial market into turmoil, which was consequently going to destroy the financial base that Zambia had been struggling to establish for thirty years'[8.6.2]. In 1997, although the total assets of all the banks that failed in 1997 was less than 5% of all the assets in the industry, it was feared that their closure might lead to the failure of larger banks with negative economic consequences [8.6.5]. Whether or not these fears were true was never tested empirically.

In addition to economic and political forbearance, the thesis found that a third form of forbearance, referred to as *bureaucratically-institutionalised regulatory forbearance,* was prevalent. This form of forbearance was not only embedded in the formal and informal administrative policies and procedures for effecting legislative and supervisory sanctions, but appears to have been part of the organisational culture of decision-making within the BoZ. The process of implementing corrective action took a long time, not only because of political and economic concerns but also because of the exhausting administrative policies and procedures, which had evolved in the department out of tradition and precedent, rather than deliberate pre-planned administrative design. Bureaucratically-institutionalised regulatory forbearance was most evident in the early stages of the regulatory process when the FSSD had to deal with a bank's violation of the law, and deteriorating financial condition [8.7.0]. The study found that:

1. Each violation of the law by a bank (insufficient capital, unauthorised large loan, illegal insider loan, inaccurate classification and provisioning of loans) involved the BoZ: seeking and obtaining evidence that the violation had occurred; advising management that the BoZ was aware of the violation; instructing the bank to correct or cease the violation; waiting for confirmation that the violation had been rectified, and; if the violation was still occurring, giving the bank seven days to show cause why the FSSD should not effect legal action against the bank. At a minimum, these five steps took an average of six weeks to complete [8.7.1].

2. Financial analysts in the FSSD relied on monthly reports to evaluate the performance of banks. In the absence of standard industry ratios, analysts used 'trends' in ratio statistics to raise concern about a bank's condition. Given that a 'sustained trend' was one in which the ratios continued to move in one direction for at least three reporting dates, it was at least 12 weeks before the tone in the off-site reports indicated that there was cause for concern [8.7.2].

3. The amount of time that it took inspectors to conduct an on-site inspection and complete the final report was sometimes in excess of eight weeks. The process included completing their working papers, preparing summaries of their individual findings, obtaining and incorporating management comments in their reports and presenting their reports to Assistant Directors for their comments and discussion before completing the final report and presenting it to the FSSD Director, who would then present it to the Supervisory Policy Committee for action [8.7.3].

4. FSSD staff spent a considerable amount of time in meetings with both internal and external participants to the regulatory process. Arranging and preparing for meetings with bank owners and directors, potential investors, major depositors, the FSSD Management Committee, the Supervisory Policy Committee, BoZ Governors, BoZ Board of Directors, the Minister of Finance, and in acute circumstances the Republican President, was a time-consuming process [8.7.4].

5. Further, the decentralised responsibility structure in existence at the BoZ which operated within a highly-centralised decision-making environment further complicated the regulatory processes. Key players - The Governor, the Registrar of Banks, The FSSD Director, the Banking Department Director - in the regulatory decision-making process had the responsibility, but not the authority and power to implement important regulatory decisions. The effect of this structure was a voluminous amount of correspondence between key decision-makers. There were constant memoranda between and within departments consulting on every aspect of the regulatory process. It took at least three days to process a letter out of the department. Further, it resulted in inappropriate decision-making procedures. For example, although the law required the BoZ Banking Director to obtain the Board of Directors' authority to grant lender of last resort facilities, he typically could not refuse credit without the Governor's approval. Consequently, credit was granted to the banks and the Board of Directors later ratified the decision retrospectively [8.7.5].

The result of political, economic and bureaucratically-institutionalised regulatory forbearance was policy inconsistency and the non-implementation of regulatory directives designed to rehabilitate failing banks. Instead the BoZ found itself, amongst other things, negotiating with bank management that had huge overdrafts with the BoZ, looking for mergers for banks with little or no economic value left in them, telling the banks to stop lending when there was nothing left to lend, and imposing administrative restrictions on banks when the management that had caused the banking problems were still in office [8.6.5].

9.3.0 Implications for Theory and Policy

From a historical perspective, the study confirmed the existence of weaknesses in both prudential and supervisory capacities that were to be expected of a developing country in the late 1980s and 1990s. Zambia's minimum capital licensing requirements had not been raised in line with inflation resulting in under-capitalised banks being licensed.

The BoZ lacked the authority to intervene in distressed banks or sanction the closure of insolvent banks without consent from the MoF. It lacked adequate resources initially to conduct adequate off-site monitoring and supervision. The available resources were focused on ensuring compliance with both allocative controls on interest rates, sectoral credit directives and foreign exchange controls.

The study also confirmed that the nature of reforms to regulatory and supervisory frameworks that were prescribed to developing countries in the 1990s were also introduced in Zambia. Zambia revised its banking legislation in 1994. Capital adequacy requirements based on the 1988 Basel Accord were adopted in that year. Minimum capital amounts were raised and restrictions imposed on large loans, insider lending, investments into fixed assets and the classification and provisioning of loans and the BoZ's supervisory capacity and methodologies were also strengthened in terms of staffing levels, technical assistance and training for FSSD members of staff. More importantly, the research also confirmed many of the lessons for regulation that have been learnt from recent banking crises (Llewellyn, 1999).

1. *Official agencies need to have sufficient powers and independence to conduct effective monitoring and supervision.* The study's findings indicate that the BoZ was not sufficiently independent from the MoF in executing its duties, it lacked the operational independence required to licence, refuse to license and to withdraw licenses from banks. Although the BoZ gained more authority to act independently following the 1992/93 reforms, the MoF retained much formal control and informal influence. Certain provisions of the BFSA required specific prior consultation with the Minister of Finance.

2. *There is a need for a well-defined strategy for responding to the possible insolvency of banks.* The BoZ did not implement remedial and rehabilitation options in a timely and effective manner because it did not execute its own strategy for dealing with financially-distressed banks. Instead, it allowed financial problems to escalate before implementing corrective actions. While it progressively increased the level of monitoring of weak banks, it did not close

insolvent banks promptly, nor did it conduct a full assessment to determine the full scale of financial insolvency in the banking system and the total cost of resolving the problem.

3. *The use of public finds should be kept to a minimum and where used, be subject to strict conditionality.* The BoZ failed to restrain the use of public funds in attempting to resolve the liquidity pressures facing banks in 1995 and 1997/8. The government deposits which were transferred from the BoZ and placed in failing banks were in excess of the net realisable value of the banks. At one stage the Minister of Finance issued a public guarantee that any bank facing liquidity pressure would be given *all* the financial support that it required. Although conditions were sometimes imposed on the use of the funds, they were applied at a time when the banks were no longer going concerns.

4. *Governments are very reluctant to close down banks, even when they are insolvent for various reasons; the bank owners might be politically influential, fear of political fallout from the loss of jobs, lost deposits and reduced access to credit.* Political and economic considerations played an important role in advancing regulatory forbearance in the months leading to the 1995 and 1997/8 bank failures. In 1995 Ministerial Statements in Parliament documented the government's reluctance to allow the BoZ to close insolvent banks. In 1997/98, similar concerns delayed the closure of five banks, which accounted for less than 5% of the total banking assets of the industry.

However, besides confirming some of the now taken-for-granted assumptions, lessons and recommendations for better regulatory practice discussed above, this study raised other issues that have not yet received the same amount of regulatory research attention. The study has managed to raise these issues because of the methodological approach that it adopted. Firstly, although direct observation of regulatory phenomena is not always possible, the study has used numerous documents and interviews to reconstruct the BoZ regulatory process during the 1995 and 1997/98 bank failure. Secondly, by using a coding system, it has demonstrated that it is possible to place more regulatory information in the public domain without breaching acceptable standards of confidentiality. Thirdly, and perhaps most importantly, by not seeking to achieve homogeneity across countries, the study was able to investigate the process of regulation at a level that would have otherwise have escaped a broad country survey. These issues include:

1. *The different forms of political interference that exist in banking regulatory and supervisory practice.* The first kind is discussed in most of the existing literature and involves direct interference by politicians through public statements to the press or parliament, legal requirements compelling regulators to consult politicians before making certain decisions or the removal of heads of regulatory institutions from office. The second is a more benign form and is referred to in this study as 'political self regulation'. In environments where regulators believe that their recommendations will not be implemented for political reasons, they may feel, as was the case in Zambia, that little purpose is served in investing their time and resources to develop the regulations in the first place. In an effort to ensure that their recommendations are 'politically palatable', regulators may engage in self-censorship of their work long before politicians are given the opportunity to comment on their work.

2. *The role which personalities and personal relationships between regulators, and politicians, play in the regulatory process.* Although the recent literature on the incentive structure for financial regulation does consider the interaction of several economic agents involved in the process of financial regulation, and how their actions affect the incidence of systemic risk, it mainly concentrates on the incentive structures for depositors, bank managers and financial regulators. Such has been the success of this branch of literature, that in more industrialised countries there has been a declining interest in externally-imposed regulatory models in favour of internal managerial control and risk-management techniques. It is now recommended that less emphasis should be placed on detailed and prescriptive rules and more on internal risk analysis, management and control systems.

This study suggests that similar logic should be applied to the relationship between politicians and regulators, particularly in developing countries. To achieve better levels of operational independence, less emphasis should be placed on detailed and prescriptive legislation on central bank independence and more on central bank assertiveness, management and control, personalities and personal relationships. This study found that the nature of the relationship between the Minster of Finance and the Bank Governor was particularly important in the implementation of regulatory sanctions such as bank closures.

3. *The prevalence of bureaucratically-institutionalised regulatory forbearance within regulatory authorities.* Currently regulatory reform programmes have been targeted primarily at the legal framework and the skills of personnel within banking departments. For that reason, Zambia and possibly other countries like it implemented reforms to their banking legislation and invested heavily in staff training programmes. The neglect of reforms to administrative procedures may emanate from the 'black box' syndrome found in the economic literature – that if a given set of resources (strong regulations and skilled staff) are treated as input into a regulatory organisation, the output will be generated in the most efficient and effective manner. When the results are less than desirable, the resulting explanations are that regulators are either 'incompetent', 'corrupt' or 'captured' by the industry.

The possibility that hard-working and highly-qualified personnel fail to implement legislative sanctions because of cumbersome administrative procedures, does not appear in the literature. For example, the literature does not discuss the difficulties of collecting adequate evidence of unsafe and unsound banking practices before instituting remedial measures. The regulators can only impose sanctions when there is sufficient and adequate evidence that a violation of the law has occurred. However, obtaining that evidence is not easy, especially since bank managers have an incentive not to disclose the required information to regulators.

These three issues have important policy implications for the Bank of Zambia and other developing countries facing similar regulatory constraints. Firstly, there are a number of administrative problems associated with the functioning of the licensing process in Zambia, which have contributed to the relatively poor performance of the regulators in recent years. The absence of credit rating agencies makes it difficult to ascertain the credit worthiness of bank applicants. The slow judicial process makes it difficult to obtain swift judicial review of an individual's innocence or guilt with respect to possible investigations into their activities. The generally inefficient nature of the civil service means that it is difficult to obtain information that may augment the licensing process such as an individual's compliance to domestic tax and business laws. Unless the BoZ addresses these institutional weaknesses, there is a danger that the BoZ may adopt an overly-cautious approach to licensing banks, which may result in a strong bias against the registration of local banks. Despite the fact that all the banks that failed in both the 1995 and 1997/98 period were local indigenous banks, it is important that the BoZ does not discourage their registration. Brownbridge (1998:21) rightly pointed out that local banks provide services that foreign and Government banks are either unwilling or unable to supply, and can inject the much-needed competition in the financial sector. They extend access to individuals and small businesses that have trouble in relating with the formal banking sector. Private sector deposit growth in the early 1990s occurred most amongst local banks, especially Meridien Bank. They provided longer opening hours, shorter queues, higher deposit rates and/or lower minimum balances shorter and quicker bank account opening procedures, and provided quicker and more personalised services. Further, unlike foreign banks, they invested in the rural sectors where the latter were either divesting from that market altogether or maintaining, but concentrating on, corporate clients. The key to ensuring that local bank failures are avoided, however, is not in discouraging their registration, but rather in establishing effective regulatory and supervisory systems for monitoring unsafe and unsound banking practices prudently, and honestly managing them.

Secondly, although the reforms to both the off-site surveillance and on-site inspection systems have addressed most of their initial weaknesses - lack of information, absence of standard accounting practices amongst reporting banks, limited choice of ratios, absence of industry reporting benchmarks, absence of standard rating mechanisms and insufficient human and technical resources, regulators must still be encouraged to report their findings without subjecting themselves to the practice of 'political self-censorship'. The improvements to the BoZ's supervisory monitoring system makes it well-placed to effectively detect violations of the law, deteriorating levels of corporate governance and sustained levels of financial deterioration. The remaining issue of concern is whether the BoZ will be in a position to improve its ability to convey its findings to key decision-makers in a timely and effective manner, to enable remedial actions when financial distress occurs in future.

Thirdly, the successful implementation of exit regulations in Zambia depends on three factors, namely, the level of operational independence and legal authority to intervene, the personal determination and strength of the character of the BoZ Governor and FSSD Staff, and the development of a more efficient administrative structure within the Bank of Zambia.

1. Exit regulations and supervisory practices will not be effective unless the banking legislation clearly grants the regulator **operational independence** from Government and provides it with the necessary legal authority to conduct all of the discretionary and mandatory interventions specified in legislation. The banking law, or other legislation covering the operations of the regulator, should clearly state that the regulator shall act independently and not take instructions from any other person or institution in discharging all of its regulatory functions. No other person or institution should be able to block or delay regulatory interventions. The banking law should give regulators the explicit legal authority to impose regulatory orders, such as cease and desist orders, and provide for strong penalties when banks fail to comply with them. The banking law must also give the regulator explicit authority to take over a bank, to remove its management, to suspend shareholders' rights, to close it and

to put it into liquidation, based on the regulator's assessment of that bank's net worth. The regulator must have the legal authority to close and resolve an under-capitalised bank even if its regulatory capital is still positive, if this is in the best interests of its depositors. When a bank goes into liquidation, the banking laws should clearly state that shareholders' interests rank after depositors and all other creditors.

The Banking and Financial Services (Amendment) Act No. 18 of 2000 (Amendment Act) which came into effect on 25 August 2000 grants the BoZ sufficient legal authority to effect the above actions. Section 81 of the BFSA, 1994 was repealed and replaced by more streamlined but broader supervisory powers to effect remedial measures (Box 10). The BoZ no longer needs to appoint a curator to manage the affairs of the bank while it determines which regulatory option to pursue. Instead, it is empowered to take possession of the bank in any way that it deems fit, suspend the bank's licence for a period not exceeding six months, restrict the bank's licence or revoke the licence. Additionally, Section 29 the Amendment Act, grants the BoZ direct power to suspend from office for any period not exceeding six months, any director or officer concerned in the banks management who fails to take all reasonable steps to secure compliance by the bank with the requirements of the Act.

However, unless the BoZ translates these broad discretionary legal powers into specific bank intervention and closure procedures in the form of PCA rules, bureaucratically-institutionalised regulatory forbearance will continue to inhibit the implementation of prompt remedial measures. The BoZ intervention and closure policies and procedures complimenting Section 68 of the Amendment Act require specific and agreed deadlines for compliance, with specified penalties and sanctions for non-compliance. The BoZ should enforce penalties for non-compliance with regulatory directives on individual mangers and directors, such as suspension or removal from office, because unless sanctions personally affect the managers responsible for non-compliance, the incentives for non-compliance remain high. Financial penalties imposed on the bank itself are usually ineffective because they worsen the financial condition of an already financially-fragile bank, and only increase the bank's central bank overdraft facility, so that the central bank bears the cost of managerial non-compliance.

Box 10 S. 68 of the Banking and Financial Services Act No. 18 of 2000

68. The principal Act is amended by the repeal of Section 81 and the substitution thereof of the following section:
(81) (1) Where -
(a) a bank or financial refuses to comply with an order or directive of the Bank of Zambia under this Act;
(b) a bank or financial institution refuses to permit an inspection to be made as provided for by this Act or obstructs an inspection;
(c) in the opinion of the Bank of Zambia, an inspection instituted under this Act Shows-
(i) that the bank or financial institution concerned conducts its business in breach of any written law or engages in a course of conduct that is unsafe or unsound;
(ii) that for any reason the bank or financial institution is unable, or is likely to become unable, to continue its operations in the ordinary course of its business;
(iii) the bank's or financial institution's capital is less than the prescribed minimum; or
(iv) the bank or financial institution is insolvent;
the Bank of Zambia shall take supervisory action against the bank or financial institution.
(2) The supervisory action the Bank of Zambia may take includes -
(a) taking possession of the bank or financial institution
(b) suspending the bank's or financial institution's licence for a period not exceeding six months;
(c) restricting the bank's or financial institution's licence; and
(d) revoking the bank's or financial institution's licence.
(3) For the purposes of paragraph (c) of subsection (2), the Bank of Zambia may, by notice in writing served on a bank or financial institution, vary the conditions of its license so as to impose restriction.
(4) The Bank of Zambia shall, in writing, inform the Minister, regarding the state of affairs of a bank or financial institution in respect of which it intends to take action under this section.

Source: Banking and Financial Services Act No. 18 of 2000

2. The **remuneration of regulators must be competitive** with remuneration in the industry that they regulate. Legislative changes do not by themselves make public bureaucracies function better. Even where regulators are legally independent, they may be reluctant to act against the wishes of powerful figures in the Government or in society. Informal pressure from Government may be equally as effective as formal constraints, such as the requirement to seek the consent of the Finance Minister before a bank is intervened, in preventing the regulators from taking prompt corrective actions. There must be a clear political will to support regulators in their work. In countries where the

appointment of public officials is politicised and where their job security is weak, it is unrealistic to expect that the regulators can be totally insulated from political pressure, whatever their legal independence. Poorly-paid regulators will also be vulnerable to corruption from the banks they regulate.

3. Exit regulations and supervision practices require **clear and observable trigger indicators for regulatory intervention.** The triggers for regulatory interventions in legislation rules are typically a bank's capital ratios; hence, the BoZ needs accurate and timely financial information from banks. A bank's capital ratios depend crucially on the quality of financial records and the accuracy of the bank's provisioning for impaired assets. This has been a fundamental problem in Zambia, either because before the Classification and Provisioning regulations, the banking regulations themselves did not stipulate strict enough asset classification and provisioning rules, or because the banks failed to comply with the rules. In some cases, banks grossly mis-represented their true capital position. Although Zambia has recently strengthened its asset classification rules, enforcement of these rules will remain problematic if the BoZ does not implement measures to guarantee the accuracy of bank financial data.

   The BoZ should take four steps to improve the quality of financial data available for supervisory decisions. Firstly, the BoZ should work with the Zambia Institute for Chartered Accountants to make compliance with international accounting standards in general and asset classification, provisioning and income recognition standards in particular, mandatory for banks. Secondly, the BoZ should be selective in allowing only reputable and competent accounting firms to audit banks. Thirdly, the BoZ should impose meaningful penalties on banks which fail to comply with asset classification rules, and on their auditors. Lastly, the BoZ must build the capacity to conduct regular forensic examinations of all potential problem banks, because distressed banks have strong incentives to conceal losses, using creative accounting techniques, from their auditors and the regulators. Although banks can conceal losses from bank examiners, on-site examinations by competent examiners will add value to off-site reports and audited financial statements because they provide the regulator with an independent source of information on the banks they regulate. Additionally, on-site examinations give the regulators the opportunity to verify the accuracy of the monthly or quarterly financial returns submitted to them by the banks, and so encourage the banks to submit returns that are more accurate.

Improving the provision of quality information also needs to be extended to other parties who, though not directly involved in the decision-making process, have a direct influence on regulatory outcomes - MPs, the Minister of Finance and the respective banks' shareholders. Early in the supervisory process, the BoZ must provide each of these parties with timely, adequate and reliable information about a bank's financial condition and the intended regulatory response, and reasons for that response. In order to minimise the possibility of unwarranted and premature disclosure of otherwise confidential bank information, a select standing committee of Members of Parliament should liaise with the BoZ on supervisory issues. To minimise the risk of political interference, the committee should be composed of members of the major political parties who are well-versed in the workings of the banking and financial system. In order to maintain BoZ regulatory independence, the BoZ should not require authority from the committee to implement regulatory decisions. However, the BoZ must be prepared to explain its decisions to the committee as and when it is required to do so. While the Governor and the Minister of Finance must be privy to all the reports sent to the committee, and the committee meetings, the FSSD Director should be directly accountable to the Committee for providing it, with financial information on the industry and the reasons for the BoZ's regulatory decisions. Such a direct reporting structure will give the FSSD Director the required incentive to exercise direct responsibility, authority and power to effectively regulate and supervise the financial system.

9.4.0 Directions for Further Research

Conducting country-specific banking regulation and supervision research will remain challenging due to the confidential nature of the documents and decisions associated with individual bank failures. However, as demonstrated by this thesis, it is possible to conduct substantial detailed research generated for the public domain while respecting the traditional norms of confidentiality. Regulators need to be encouraged to participate in this type of research because of the insights it provides on the practical design, development and implementation of banking regulations and supervision practices, especially in developing countries. Further, researchers need to embrace the multidisciplinary nature of banking regulations and supervision practices. A variety of academic disciplines - economics, management, sociology and politics - influence this area of study and the research methods employed by researchers need to reflect this diversity. By employing qualitative research techniques, this study has shown that much stands to be gained in understanding how regulators behave.

The research on prudential licensing requirements needs to proceed beyond identifying desirable minimum requirements to establishing practical tools and techniques for vetting the quality of prospective banks and bank owners and managers. The literature recommends that regulators set sufficiently high minimum capital requirements to create appropriate incentives for sound management, yet, it is inconclusive on the criteria that regulators should use to determine the appropriate level of capital that banks require. The literature is also certain in regulatory preference for bank owners and managers who are 'fit and proper', but there is vagueness, on the suitability of methods for determining fitness and probity. Because of the indistinctiveness in the decisions facing regulators at the licensing stage, further research is required to aid the determination of the level of discretion that regulators should exercise in evaluating bank license applications. While a strict legal interpretation of the minimum legal requirements may preclude the inclusion of other factors that are unique to that bank, an inappropriate amount of regulatory discretion may encourage undesirable rent-seeking behaviour.

This is the first comprehensive study into the performance of the BoZ's bank monitoring and supervision techniques. It is hoped that this research has provided a basis for future research aimed at providing regulators in developing countries with appropriate indicators of potential financial distress in their banking system as a whole and within individual banks ex-ante. Future research should attempt to maintain a balance between the use of financial and non-financial indicators of bank failure. Far too often, the focus of research weighs heavily in favour of quantitative ratios, which, though useful, often show signs of distress long after the fundamental problems/errors/mistakes at a bank have occurred.

The research on the BoZ exit regulations and supervision practices confirmed much that already exists in the economic literature; the importance of early diagnosis, the need for a comprehensive approach, the usefulness of prompt corrective action rules, the benefits of a clear exit strategy and the cost of regulatory forbearance. However, the research also exposed other issues that need to be included in the regulatory research agenda. The issues identified in this study (political self regulation, regulatory personalities and personal relationships, and bureaucratically-institutionalised regulatory forbearance), though more subtle in nature, and therefore more difficult to quantify, are potentially of great significance to the effective implementation of prudential regulations, especially in developing countries.

The issues noted above suggest that future banking regulation and supervision research should move beyond the examining of the quality of individual banking regulations and supervisory tools and techniques, to a more comprehensive approach that also addresses the personal relationships between politicians, regulators, bankers and the public, and the bureaucratic structures within which these tripartite relationships operate.

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Appendix 1 Daily Mail [20 February 1995]

BOZ accused of failing banks

By HARRIET CHANDA

AN ECONOMIST has accused Bank of Zambia of failure to play its regulatory and supervisory role over operations of commercial banks in the country and hence liquidity problems which put customers' money at risk.

Mr Ivan Zyuulu made the accusation in Ndola at the weekend at the Budget analysis workshop.

Mr Zyuulu said there was need to establish a comprehensive insurance system in banks which was driven by private institutions and not government.

He said government was not the right institution to bail out banks in liquidity problems and advised that commercial banks set up a fund to which they could resort if there was a problem.

Mr Zyuulu is the head and research fellow at the Institute of Consultancy Applied Research and Extension Studies at the Copperbelt University.

He told participants, including Finance Minister Ronald Penza, that "banks should be allowed to burst just like any other company, the manufacturing companies are dying and nobody was helping them. "What makes the banks special?" he asked.

Mr Zyuulu said loss of confidence in the banking sector could be minimised if the measures he recommended were effected.

Mr Penza agreed that any business that goes burst must be allowed to do so if it is due to mismanagement.

He explained that government's role in assisting Meridien BIAO Bank was to prevent the colossal damage that may have resulted from the collapse of the fourth largest bank in the country.

He said all local banks may have gone under if Meridien BIAO was not helped and all cash would have gone back to the other three major banks, but to preserve the financial market and public confidence in it, government had to help.

Mr. Penza said the present situation would enable Meridien to re-think if it can survive and he expected to see the beginning of some mergers and re-investment.

He denied there was any separate prescription for Meridien BIAO aimed at favouring it but stressed that it was economically more sensible to bail it out to protect the financial market.

EDITORIALS

Revamp BOZ

WE welcome the appointment of Dr Jacob Mwanza as governor of the Bank of Zambia. He brings to the Central Bank a wealth of experience which he has acquired over the years as senior economic adviser to the Government.

The central bank plays a pivotal role in any economy in ensuring stability of the financial market. The role of the Bank of Zambia, particularly under the current liberalised economic regime, cannot be over-emphasised.

The bank needs to respond swiftly to a number of dramatic changes that are taking place in the economy to avoid undermining the stability and confidence that has been achieved so far in the financial and economic market.

The crisis that beset the Meridien BIAO Bank once again exposed the dismal performance of the inspectorate wing of the central bank which has lamentably failed in the past to closely monitor operations of all commercial banks currently operating in Zambia.

It is the central bank's prime responsibility to ensure that commercial banks adhere to the stipulated banking norms to facilitate smooth operations and guarantee the depositors' interests.

Instead of nipping it in the bud, the Meridien BIAO bank problem was allowed to fester until full-blown symptoms of a grave crisis became apparent to all.

It is quite obvious from what has transpired that Finance Minister Ronald Penza acted prudently by sanctioning the Government move to bail out the beleaguered bank which was faced with imminent closure.

Closure of a bank always has far-reaching ramifications which should have been foreseen by the central bank. Is the inspectorate branch of the Bank of Zambia so inept?

The Bank of Zambia should be restructured to make it more responsive to the challenges that the present economic environment poses. Armed with the new Banking and Financial Services Act of 1994, the new central bank governor has the full backing of the law to take appropriate measures against erring commercial banks.

Appendix 3 THE POST [28 February 1995]

'Central Bank supervisory capacity is inadequate'

By Nkonkomalimba Kafunda

THE supervising capacity of the Bank of Zambia over the country's commercial banks has been said to be inadequate by discussants at an Economic Association of Zambia (EAZ) extra ordinary meeting last Friday.

There was general consensus that the Bank has failed to perform its supervisory function over commercial banks.

"Why should we have a bank governor if he cannot make a decision when a commercial bank has liquidity problems. There is need to have financial sector policy to direct these institutions," argued a leading Lusaka business consultant, Sangayakula Sanga. He further added, in a paper for *The Post*: "The central bank seems to be overwhelmed by the increase in the number of banks since we have not seen any form of leadership from the Bank. No wonder the inability of the central bank to react quickly to the Meridien Bank crisis. The response has been a tense and rather incomplete statement from the Minister of Finance."

Finance minister Ronald Penza expressed displeasure with Bank of Zambia's handling of the Meridien problems.

"Fifteen months ago I sent a letter to the Bank of Zambia asking them about the position of Meridien bank. I received assurances that all was well. Six months later I sent another letter. Again was told all was well. Until I was contacted by the President while in London about two weeks ago when the situation became very serious," Penza said.

'BOZ lacks credibility'

TOP management of Bank of Zambia has been criticised for lack of confidentiality by releasing customers' information to the public.

By Sun Reporter

A cross section of banking analysts told The Sun that the Bank of Zambia is losing credibility by the day as its top management is failing to maintain confidentiality.

A Lusaka based economist Mr Alfred Mumba said that the recent happenings at Meridien BIAO Bank were mostly caused by staff of the Bank of Zambia who went round telling the public that the Bank was about to close.

He cited an example when he was having a drink at Hotel Inter Continental and senior Bank of Zambia official was telling his friends that he was travelling with the former Bank of Zambia governor Mr Dominic Mulaisho to Kasama to seek the authority of President Chiluba to close the Bank on Monday.

Mr Mumba said he heard this director who he named tell his friends gentlemen that superstructure of Meridien will be reduced to a rubble on Monday. One banker who supported the bailing out of Meridien BIAO Bank said the continued release of information by BOZ officials will continue to jeopardise the bank's good will.

He said, "when the Government made its stand clear that it was going to back Meridien BIAO, depositors expressed confidence in the Bank's position."

He added, however, that Bank of Zambia continued release of adverse information is creating concern in the banking circles. Officials from Meridien BIAO Bank are understood to have brought this issue to the new BOZ Governor Dr. Jacob Mwanza who is understood to be carrying out his own investigations on who is leaking the information.

Three weeks ago during the height of Meridien BIAO crisis Mr Mulaisho travelled to Kasama with some members of top management to brief the President about the impending closure of the Bank.

President Chiluba is said to have refused to see Mr Mulaisho's advisers and insisted that he could not see him alone since his advisers had already advised him (Mulaisho) on what action to take on Meridien BIAO.

Mr Mulaisho is understood to have told the President that the only way out was to close Meridien and the President refused to sanction the closure until he had consulted the Minister of Finance Mr Ronald Penza who advised the President against this action.

MULAISHO_fired

Appendix 5 Macroeconomic Indicators of Financial Distress.

Category	Indicators
Capital account	International reserves, capital flows, short term capital flows, foreign direct investment and the differential between domestic and foreign interest
Debt profile	Public foreign debt, total foreign debt, short-term debt, shares of debt classified by type of creditor and by interest structure, debt service and foreign aid.
Current account	The real exchange rate, the current account balance, the trade balance, exports, imports, the terms of trade, the price of exports, savings and investments
International variables	Foreign real GDP growth, interest rates, and price level
Financial liberalisation	Credit growth, the change in the money multiplier, real interest rates, and the spread between bank lending and deposit interest rates
Other financial variables	Central bank credit to the banking system, the gap between money demand and supply, money growth, bond yields, domestic inflation, the "shadow" exchange rate, the parallel market exchange rate premium, the central exchange rate parity, the position of the exchange rate within the official band, and M2/international reserves
Real Sector	Real GDP growth, the output gap, employment/unemployment, wages, and changes in stock prices
Fiscal variables:	The fiscal deficit, government consumption, and credit to the public sector
Political variables	Dummies for elections, incumbent electoral victory, change of government, legal executive transfer, illegal executive transfer, left-wing government, and new finance minister; also degree of political instability (qualitative variable based on judgement)
Institutional /structural factors	Openness, trade concentration, and dummies for multiple exchange rates, exchange controls, duration of the fixed exchange rate periods, financial liberalisation, banking crisis, past foreign exchange market crises, and past foreign exchange market events (devaluation's, revaluations, decisions to float, and widening of exchange rate bands)

Source: Kaminsky et al (1998)

Appendix 6 Schedule of Countries used by Honohan (1997)

A (Macro)	B (Micro)	C (Government)	D (Control)
Argentina 1980-1982 Chile 1981-1983 Mexico 1994 Uruguay 1982-1985 Norway 1987-1993 Sweden 1990-1993	Colombia 1984-1985 Kenya 1993- Malaysia 1985-1986 Nigeria 1991-1995 Thailand 1983-1988 Venezuela 1994	Cameroon 1989-1995 Egypt 1991 Hungary 1987 Pakistan 1980s Philippines 1981-1987 Poland 1991	Honduras Switzerland Malawi Morocco Portugal Syria

Source: Honohan (1997)

Appendix 7 Gonzalez-Hermosillo (1999) Indicators of Bank Distress

Variable	What the variable measures
Proximate indicators of fragility	
❑ Ratio of non-performing loans to total assets ❑ Ratio of non-performing loans minus loan reserves to total assets ❑ Ratio of non-performing loans to total loans	❑ High level of problem loans indicates pervasive bank problems
❑ Ratio of equity capital to total assts ❑ Ratio of equity capital plus loan reserves to total assets ❑ Ratio of equity capital plus loan reserves minus non-performing loans to total assets	❑ High level of capital represents a cushion to absorb shocks ❑ Bank's capital and loan reserve coverage of problem loans
Market Risk	
❑ Ratio of commercial and industrial loans to total assets (US) ❑ Ratio of agricultural production loans to total assets (US, Mexico)	❑ High market risk if concentration on boom sectors, in areas highly dependent on cyclical economic conditions, or in sectors with returns significantly higher than market (high betas)
❑ Ratio of construction loans plus loans secured by multifamily, non-residential, and farm real estate to total assets (US) ❑ Ratio of loans secured by 1-4 family real estate to total assets (US), Ratio of housing loans to total assets (Mexico) ❑ Ratio of consumer loans to total assets ❑ Ratio of unsecuritised loans to total assets	❑ Commercial real estate loans tend to be particularly risky because they typically have long gestation periods
Credit Risk	
❑ Ratio of non-performing loans to total assets	❑ The greater the ratio, the greater the bank's portfolio is subject to default risk. High loan ratios may be associated with weak internal controls and underwriting standards
❑ Average yield on loans	❑ High yields may indicate that the bank is originating high-risk loans. Low yields may indicate That risk is not priced properly
❑ Difference between average loan yield and deposit interest rates	❑ High spreads may mean that the bank is taking risky loans. Low spreads may mean that the bank is efficient
Liquidity Risk	
❑ Ratio of large certificates of deposit to total assets (US)	❑ Large deposits not insured may be volatile
❑ Ratio of deposits from the public to total assets (Mexico, Colombia)	❑ Deposit runs would induce the banks liquidity
❑ Ratio of fed funds purchased plus other borrowed funds to total assets (US). Ratio of deposits from other banks to total assets (Mexico, Colombia)	❑ Interbank deposits. Peer banks may have better information about a bank's weak financial condition
❑ Ratio of investment securities to total assets	❑ Liquid assets. Bank's ability to deal with deposit withdrawals
❑ Ratio of interest expenditures to total deposits	❑ High deposit rates to attract deposits may be indicative of liquidity problems or bank's perceived risk

Source: Gonzalez-Hermosilio (1999)

Appendix 7 Gonzalez-Hermosillo (1999) indicators of Bank Distress Cont...

Variable	What the variable measures
Moral Hazard	
❑ Ratio of insider loans to total assets (US)	❑ Conflict of interest
❑ Ratio of interest income on loans, fees and leases to total assets	❑ Banks loading up on commissions, up-front fees and high interest rates on projects unlikely to be sound
Regional/macro-economic	
❑ Oil prices (US)	❑ Regional terms of trade shocks in the US
❑ Price of exports (Colombia)	❑ Terms of trade shocks in Colombia,
❑ Change in nominal exchange rate (Mexico)	Devaluation shock in Mexico (exchange rate defined as domestic price of foreign currency
❑ Change in state personal income (US)	❑ Economic activity by state in the US
❑ Short term real interest rate	❑ Potential interest rate shock

Source: Gonzalez-Hermosillo (1999)

Appendix 8 Selected Episodes of Financial Instability 1970-1998

Date	Event	Main feature
1970	US Penn Central Bankruptcy	Collapse of market liquidity and issuance
1973	UK secondary banking	Banking Failures following loan losses
1974	Herstatt (Germany)	Banking Failures following loan losses
1982	LDC debt crisis	Banking Failures following loan losses
1984	Continental Illinois (US)	Banking Failures following loan losses
1985	Canadian Regional Banks	Banking Failures following loan losses
1986	FRN market	Collapse of market liquidity and issuance
1986	US Thrifts	Banking Failures following loan losses
1987	Stock market crash	Price volatility after shift in expectations
1989	Collapse of US junk bonds	Collapse of market liquidity and issuance
1989	Australian banking problems	Banking Failures following loan losses
1990	Swedish Commercial paper	Collapse of market liquidity and issuance
1990-1	Norwegian banking crisis	Banking Failures following loan losses
1991-2	Finish banking crisis	Banking Failures following loan losses
1991-2	Swedish banking crisis	Banking Failures following loan losses
1992-6	Japanese banking crisis	Banking Failures following loan losses
1992	ECU bond market collapse	Collapse of market liquidity and issuance
1992-3	ERM crisis	Price volatility after shift in expectations
1994	Bond market reversal	Price volatility after shift in expectations
1995	Mexican crisis	Price volatility after shift in expectations
1997	Asian crisis	Price volatility after shift in expectations and banking failures following loan losses
1998	Russian default and LTCM	Collapse of market liquidity and issuance

Source: Davis (1999)

Appendix 9 Instruments of Financial Restructuring

Instruments	Corresponding Asset/Liability	Balance sheet effect	Liquidity effect	Income effect	Country example
New Private actions					
Issue equity	Assets/equity rise	Grows	Improves	Increases	U.S.A (1990s), Mauritania (1993)
Issue subordinated debt	Assets/debt rise	Grows	Improves	Increases	U.S.A (1990s)
Issue other debt	Assets/debt rise	Grows		Increases	Passim
Provide real assets	Assets/equity rise	Grows	Improves if sold	Maybe	U.S.A (thrifts, (1980s)
Revalue assets	Equity rises	Grows	Improves	None	Japan, U.S.A
Government actions					
Provide cash	Assets/Tier 1 equity rise	Grows	Improves	Increase	Egypt (1991), Finland (1991-94), Mauritania (1993), Philippines (1986), Sweden (1991)
Provide negotiable bonds	Assets/equity rise	Grows	Improves	Should increase	Poland (1993-94), Chile (1982-83), Ghana (1990),
Provide non-negotiable bonds	Assets/equity rise	Grows	Improves*	Should increase	Latvia (1993), Mauritania (1993)
Purchase equity	Assets/equity rise	Grows	Improves	Should increase	Egypt (1991), Finland (1991-1994), Mauritania (1993),
Write down claims	Liabilities fall	Shrinks	Improves	Costs fall	Argentina (1994-95), Chile (1982-1984), Cote d'Ivoire (1991), Estonia (1992), Philippines (1986)
Swap deposits for equity	Debt falls/equity rises	Constant	Improves	Costs fall	Kenya (public deposits, 1986-1989), Malaysia, (private deposits, 1986-88)
Swap deposits for bonds	Liabilities substitution	Constant	Improves	Costs fall	Argentina (1989-1990)
Make long term loans	Tier 2 Capital increased	Grows	Improves	Increases	Argentina (1994-1995), Azerbaijan (1995), Finland, (1991),
Make short term loans	Assets/debt rise	Grows	Improves	Rise	Argentina (1994-1995), Chile (1982-1983), Latvia (1993),
Assume liabilities	Write off bad debts	Shrinks	Improves	Increases	Argentina (1995), Chile (1983), Finland (1991), Latvia (1995), Mauritania (1986), Philippines (1986), Lithuania (1995)
Place deposits	Assets/deposits rise	Grows	Improves	Depends	Azerbaijan (1995), Hungary (1987), Mexico (1995), Moldova
Aid public or private borrowers, sometimes with guarantees	Asset (value) rise	Quality	Improves	Increases	

Source: Garcia (1997:48). *The extent of the liquidity improvement will depend on the terms of the debt; the bank does not have the option of liquidating the debt if needed.
**If the asset is impaired and not fully provisioned, assets, equity and balance sheet appear to grow

Appendix 10 Central Bank Instruments and Bank Restructuring by Performance Groups

Country	Role of the Central Bank
Substantial progress countries	
Peru Sweden	The central bank played a limited role in the bank restructuring process. In Peru, the central banking law was changed restricting remaining central bank activity in banking
Spain	The central bank played a lead role; however, its lending was done indirectly through a deposit insurance agency jointly by the banks. While bank restructuring was successful, it entailed very high costs (15 percent of GDP)
Cote d'Ivoire	The central bank initially lent to government to help reduce government arrears on bank loans. The government phased out the central bank role as part of concomitant reforms of bank restructuring activity.
Moderate progress countries	
Finland Korea	In both countries, the central bank played a limited role. Nonetheless, in Finland, the central bank assumed equity stakes in one bank and organised a loan work out agency for another bank.
Hungary Poland	Reserve requirements and remuneration were adjusted to increase bank liquidity. In Hungary, the central bank provided bridge loans, some direct credit to banks and consolidated bonds. In Poland, the central bank discounted bonds of recovered banks.
Chile Ghana	In Chile, the central bank assumed a major role in the restructuring process, including extensive direct lending to enterprises through commercial banks (pass-through loans) Bank restructuring was extremely costly (33% of GDP).
Slow progress countries	
Kuwait	The central bank played a key role in the bank restructuring process by providing liquidity through a broad application of discounting, repurchases, special facilities, as well as through 'special deposits' at negative real rates held with commercial banks. The central bank also became involved in debt collection and other aspects of the debt restructuring process.
Mauritania Tanzania	The central bank engaged in significant long term lending to insolvent banks.

Source: Dziobek and Pazarbaşioğlu, (1997:130),

Appendix 11 Garcia (1997) Criteria for Restructuring

1. *Cost effectiveness*. Financial resources are always limited; the need to minimise total as well as fiscal costs is obvious. However, lowest cost is not the sole criterion, particularly of defined over the short term; short term cost cutting can result in higher costs over the longer term.
2. *Ease of implementation.* The key here is feasibility, given existing constraints on skills and institutional resources. Ease of implementation may also encompass the degree to which political consensus can be achieved. As with costs, however, the easiest path in the short term may result in more difficulties later.
3. *Equitable distribution of losses*. Financial restructuring distributes the bulk of existing stock of losses, particularly where staffing costs or higher fees to bank customers are used to generate earnings for re-capitalisation. Thus, the instruments chosen for restructuring should reflect the policy decisions made about how losses should be distributed.
4. *Minimisation of cost to the public sector*. Sound fiscal management dictates that concern be focused not only on the government budget but also on the broader public sector expenditure and debt profiles.
5. Fostering strong internal governance. Restructuring instruments must provide an incentive structure that encourages responsible ownership and sound management, which will be the first lines of defence against banking problems in future. Holding owners and managers responsible for the performance (and losses) of their bank is critical; instruments that bail them out would fail in this regard.
6. Consistency with sound macro-economic policy. A bank restructuring programme that impairs macro-economic balance, for example, by creating too great a fiscal burden, or failing to rebuild confidence and stem disintermediation, will deprive the economy of the stability required for growth and development but also as a foundation for sound banking.

Source: Garcia, 1997, 44-46

Appendix 12 Critically Heuristic Boundary Questions in the 'is' and 'ought' Modes

The 12 critically heuristic boundary questions in the *is* mode	**The 12 critically heuristic boundary questions in the *ought* mode**
1. Who is the actual *client* of the system design, i.e. who belongs to the group of those whose purpose (interests and values) are served, in distinction to those who do not benefit but may have to bear the costs or other disadvantages?	1. Who ought to be the client (beneficiary) of the system to be designed or improved?
2. What is the actual *purpose* of the system design, as being measured not in terms of declared intentions of the involved but in terms of the actual consequences?	2. What ought to be the purpose of the system, i.e. what goal ought the system be able to achieve so as to serve the client?
3. What, judged by the designs consequences, is its built in measure of success?	3. What ought to be the systems measure of success (or improvement)?
4. Who is the actual decision taker, i.e. who can actually change the measure of success?	4. Who ought to be the decision taker, i.e. have the power to change the system's measure of improvement?
5. What conditions of successful planning and implementation of the system are really controlled by the decision taker?	5. What components (resources and constraints ought to be controlled by the decision taker?
6. What conditions are not controlled by the decision taker, i.e., what represents 'environment' to him?	6. What resources and conditions ought to be part of the systems environment, i.e. not controlled by the systems decision taker?
7. Who is actually involved as planner?	7. Who ought to be involved as designer of the system?
8. Who is involved as 'expert', of what kind is his expertise, what role does he actually play?	8. What kind of expertise ought to flow into the design of the system, i.e. who ought to be considered an expert and what should be his role?
9. Where do the involved see the guarantee that their planning will be successful? e.g. in the theoretical competence of experts? In consensus among experts? In political support on the part of interest groups? In the experience and intuition of the involved, etc.). Can these assumed guarantors secure the design's success, or are they false guarantors?	9. Who ought to be the guarantor of the system, i.e. where ought the designer seek the guarantee that his design will be implemented and will prove successful, judged by the system's measure of success (or improvement)?
10. Who among the involved witnesses represents the concerns of the affected? Who is or may be affected without being involved?	10. Who ought to belong to the witness representing the concerns of the citizens that will or might be affected by the design of the system? That is to say, who among the affected ought to get involved?
11. Are the affected given an opportunity to emancipate themselves from the experts and to take their fate into their own hands, or do the experts determine what is right for them, what quality of life means to them, etc? That is to say, are the affected used merely as a means for the purposes of others, or are they treated as 'ends in themselves' (Kant), as belonging to the client?	11. To what degree and in what ways ought the affected be given the chance of emancipation from the premises and the promises of the involved?
12. What world view is actually underlying the design of the system? Is it the world view of some (some of) the involved or (some of) the affected?	12. Upon what world views of the involved or the affected ought the systems design be based?

Midgley (2000:141)

Appendix 13 List of Licence Applications (1990-1998)

Category	Name of Bank
1. Successful applicants that have not failed	Indo-Zambia Bank (1985) Finance Bank (1988) United Bank of Zambia (1997) Bank of China (1997) First Alliance Bank (1995) Investrust (1995) Cavmont Merchant Bank (1993) New Capital Bank (1992)
2. Successful applicants that subsequently failed	Meridien Bank (1984) African Commercial Bank (1987) Manifold Investment Bank (1987) Capital Bank (1989) Commerce Bank (1994) Chase Trust Bank (1995) Credit Africa Bank (1994) First Merchant Bank (1994) Prudence Bank (1994) Safe Deposit Bank (1996)
3. Unsuccessful applicants	Royalty Bank of Zambia (1996) Continental Bank (1996) Mercantile Bank (1996)

Appendix 14 Licence Evaluation Review Checklist

Name of bank:
Date of licence application:
Licence rejected/approved:
Date of licence rejection/approval:
Date of commencement:
Months in Operation:
Date of Closure:

1 Licensing authority
- (a) **Which regulatory authority evaluated the licence application?**
- (b) **Did the regulatory authority use established criteria for this licence application?**

What was the nature of the criteria set

2. Licence evaluation criteria
- (a) **Was the criteria used consistent with those applied to banks already in operation**

3.	Rejection of Applications **(a) What were the reasons for rejecting this bank licence application?** **(b) Who made the decision to reject the application?** **(c) Did the authorities request for additional information requested before rejecting the application?** **(d) What Information did the authorities request?** **(e) Did the applicants appeal against the decision? / Did they succeed?** **(f) How weeks did evaluation of the licence take?**
5.	**Assessment of shareholders and capital** (a) For foreign applicants, was a letter from the home supervisor obtained? (b) Where inquiries made to the registrar of companies? (c) Were inquiries made to the court judgement register to confirm that the shareholder had not been convicted of any substantial crime? (d) Did the authorities make any inquiries with the police concerning the existence of any investigations into criminal activity on the part of the shareholder? (e) Is there evidence that the authorities conducted a "fit and proper" test? (f) Is yes, what was the nature of the test conducted on major shareholders and management (g) How much was the initial capital proposed by the applicants (h) What are the sources of capital indicated in the proposal (i) Was the capital proposed sufficient to cover a) Start up expenses b) Act as a buffer against initial losses c) Provide funding of loans and investments (j) Did the authorities make any inquiries as to the source of capital? (k) Did the applicants provide any independent verification of the proposed capital? (l) Did the applicants provide an auditor's statement on their net worth? **(m) Provide a trend analysis of capital from inception to closure (or five years if still operational).**
6.	**Regulatory Capital requirements** a) What was the minimum amount of capital required by Bank of Zambia at the time? b) What was the amount in dollars? **c) Did the authorities request the applicants to provide additional capital more than the required minimum?**
7.	**Directors and senior management** a) For foreign applicants, was a letter from the home supervisor obtained? b) Where inquires made to the registrar of companies? c) Where inquiries made with the court judgements register d) Where police inquiries made e) Is there evidence that the authorities conducted a "fit and proper" test? **f) Is yes, what was the nature of the test conducted on major shareholders and management**

8.	**Board of Directors** a) Proportion of Executive Directors on the Board b) Proportion of shareholders that sit on the Board. c) Are the roles of Board Chairman and Managing Director combined **d) Presence of an Audit Committee on the Board**

9.	**Business Plan Assessment**
	a) Did the applicants submit a detailed business plan with the application?
	❑ Industry analysis
	❑ Competitive analysis
	❑ Bank analysis
	    ❑ Organisational structure
	    ❑ Administrative structure
	    ❑ Risk analysis
	    ❑ Income analysis
	    ❑ Expense analysis
	b) Was the business plan evaluated for its reasonableness
	❑ Industry analysis
	❑ Competitive analysis
	❑ Bank analysis
	    ❑ Organisational structure
	    ❑ Administrative structure
	    ❑ Risk analysis
	    ❑ Income analysis
	    ❑ Expense analysis
	c) Did the authorities perform any consistency tests?
	❑ Regulatory capital projections
	❑ Growth in staff numbers and expenses
	❑ Interest income projections and earning assets growth
	❑ Consistency of projected interest income and projected inflation rates.
	❑ Growth of credit portfolio and deposit growth consistent with growth in customer base
	❑ Projected rate of bank growth consistent with industry growth rate.
	❑ Other
	d) Was an assessment made of the financial strength of the principal shareholders of the bank?

11.	Bank of Zambia/Ministry of Finance Consultations a) If the Ministry of Finance was responsible for evaluating the licence, was Bank of Zambia consulted? **b) At what stage of the licence review process was the Bank of Zambia consulted? What concerns, if any, did the Bank of Zambia raise?**
12.	**International co-operation** (a) If the applicants were foreigners, was the home regulator requested to provide consent or a statement of "no objection"? **(b) Was a response to this request received?**

13.	False Information (a) Is there evidence of false information having been provided in the bank licence application? **(b) What action, if any, did the BoZ or Ministry of Finance take?**	
14.	Post Licence bank monitoring **(a) Was the bank treated differently from the established banks when it commenced operations?** **(b) How long did this difference in treatment last?**	

Appendix 15 Basel Core Principles Methodology Notes on the Licensing of Banks

a) The licensing authority has the right to set criteria for banks. These may be set in law or regulation.
b) The criteria for issuing licenses are consistent with those applied in ongoing supervision
c) The licensing authority has the right to reject applications if the criteria are not full filled or the information provided is inadequate.
d) The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision
e) The licensing authority determined the suitability of major shareholders, transparency of ownership structure and source of capital
f) A minimum initial capital amount is stipulated for all banks
g) The licensing authorities evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria includes: (1) skills and experience in relevant financial operations consumerate with the intended activities of the bank and (2) no record of criminal activities or adverse regulatory judgements that makes that person unfit to hold important positions in a bank.
h) The licensing authorities review the proposed strategic & operating plans of the bank. This includes determining that an appropriate system of corporate governance will be in place.
i) The operational structure is required to include, inter alia, adequate operational policies and procedures, internal control procedures and appropriate oversight of the banks various activities. The operational structure is required to reject the scope and degree of sophistication of the proposed activities of the bank.
j) The licensing authority reviews pro-forma financial statements and projections of the proposed bank, this includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principle shareholders of the bank.
k) If the licensing authority & the supervision authority are not the same,
l) the supervisor has the legal right to have its views considered on each specific application
m) In the case of foreign banks establishing a branch or a subsidiary, prior consent (or a statement of "no objection" of the home country is obtained.
n) If the licensing or supervisory authority determines that the licence was knowingly based on false information, the licence can be revoked
o) The licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the licence approval are being met.

Appendix 16 Bank Licensing Working Papers

Date	Type	From	To	Subject	Issues
7 April 1986 **Bank 7/D/1**	Letter	Governor - BoZ	The permanent Secretary - MoF	Establishment of a new banking Institution	❑ "…the bank is of the opinion that the banking system has expanded adequately enough for a small economy like ours. We entirely endorse the views of the Ministry that the country is already over subscribed by the number of the commercial banks operating in the country."
5 June 1986 **Bank 7D/2**	Letter	Permanent Secretary	Governor - BoZ	Performance of the banking system	❑ "…I decided to undertake some research on the current situation regarding the performance of existing banks and have come up with the attached statistics. …In light of the additional information, I would be grateful if you would kindly re-examine this matter critically and give me the banks final decision on whether or not our Minister should authorise the bank to establish another bank in the country. (Statistics not on file)
22 Sept 1986 **Bank 7/D/3**	Letter	Company Secretary Leasing finance Bank Limited	The permanent Secretary - MoF	Application for banking licence	❑ "Further to our recent discussions with the Hon M/Finance and yourself when we drew your attention to an undertaking by the former Min. of Finance to granting us authority to operate as a commercial bank…" ❑ Documents (1) Completed application form (2) Memorandum and articles of association (3) deposit receipts confirming the funding of the paid up capital (Receipts from Bank of Credit and Commerce)

Appendix 17 Intervention and Closure Working Papers

Date	Type	From	To	Subject	Issues
24 April 1995 **Bank 7/D/1**	Letter	Assistant Director – Bank Inspections	Director - FSSD	Bank monitoring report	❑ The bank has failed to keep the core liquidity ratio since 10 April 1995. I spoke to the Managing Director who explained that the problem is more administrative than financial because the person in charge of treasury is on leave. The one sitting in does not know what to do hence the present problem. I explained to the Managing Director that the explanation was not acceptable in spite of it being true. I further asked that a solution be found immediately to bring the level of liquidity to an acceptable level. To this the Managing Director assured that the position would be corrected by today 24 April 1995.
4 May 1995 **Bank 7/D/2**	Minute	Assistant Director – Bank Inspections	Director - FSSD	Bank monitoring report	❑ The persistent failure by the bank to keep the minimum core liquidity ratio during the past two weeks is of concern to us. I have spoken to the Managing Director of the Bank on 21 April 1995 and he promised to rectify the problem by 24 April 1995. To date the improvement promised has not happened. This has prompted me to draft a letter for your signature to the bank. The letter asks the bank to give a proposal and timeframe of resolving this problem.
9 May 1995 **Bank 7/D/3**	Minute	Assistant Director – Bank Inspections	Director - FSSD	Bank monitoring report	❑ I spoke to the Managing Director on Thursday and asked him to address the issue of the bank's liquidity. Apparently the bank has been keeping ratios below the mark of 20% required by the BoZ. The manager explained that the bank was buying treasury bills of K20 million almost every week to improve the liquidity ratio but indicated that this amount was not enough. As at yesterday, 8 may the ratio had climbed to 18.8%
29 May 1995 **Bank 7/D/4**	Minute	Senior Inspector – Bank Inspections	Acting director - FSSD	Bank monitoring report	❑ The bank improved its core liquidity ratio from 18% to 22.7% after it increased its treasury bill holdings by K20 million. We have emphasised to the management to continue increasing its treasury bills holdings in order to maintain the required liquidity ratio.

Appendix 18 Specific Word Analysis Schedule

Explanatory Concept	Qualitative Evidence	Documentary Evidence
"Regulatory Exemptions"	[PD/021097]	[Bank 18/D/2] [21] [Bank 7/D/74]
"Rumours"	[CI/BOZAD/70] [CI/FBD/138]	[Bank 5/D/37] [45] [65] [Bank 12/D/14] [23]
"Size does not matter"	[WIC/RPSI/8] [CI/BOZAD/14] [CI/GOV/77] [PD/061295/97] [107] [134][PD/050397/159]	[Bank 18/D/40] [Bank 4/D/70] [Bank 12/D/1] [2] [9] [Bank 7/D/1] [16]
"Impact Meridien's Closure"	[Bank 5/D/60] [75] [97] [98] [119] [Bank 18/D/23] [40] [54] [62][Bank 14/D/18] [35] [Bank 4/D/17][PD/220295/28] [PD/061295/87] [134][PD/150395/46]	
"Solvency and "illiquidity"	[WIC/RPI/12] [14][CI/GOV/29] [50] [77][CI/BOZAD/10] [70] [CI/FBD/141] [147] [148][CI/BOZI/26] [28] [PD/061295/87]	[Bank 5/D/48] [82] [85] [92] [100] [119] [120] [Bank 18/D/12] [16] [17] [33] [38] [40] [51] [62][Bank 15/D/5] [7] [12] [Bank 2/D/12] [17][Bank 4/D/17] [19] [20] [42] [45] [46] [57] [61] [80] [83] [85] [86][Bank 12/D/9] [16] [18] [28] [Bank 7/D/10] [18] [25] [73]
"Public confidence"	[CI/GOV/77] [81] [83] [85] [CI/FSSD/15] [25] [29][CI/BOZAD/14] [56] [CI/FBD/28] [57] [142][CI/RCEO/12] [14] [PD/220395/25] [28] [38] [46] [67] [87] [113] [138] [139] [159] [166] [175] [179] [183] [186] [BA/310197/3] [BA/31098/5]	[Bank 5/D/69] [73] [75] [83] [98] [108] [110] [119][Bank 18/D/2] [27] [40] [52] [58] [Bank 14/D/16] [35] [42] [44] [Bank 2/D/11] [12][Bank 4/D/2] [17] [41] [49][Bank 12/D/5] [6] [9] [Bank 7/D/11][Bank 9/D/16]
"Personality/style of Governor"	[CI/GOV/37] [48] [98] [102] [42] [44] [87] [89][FSSD/D/23]	
"Quality of Regulatory advice"	[CI/GOV/113] [23] [42] [48] [52] [83] [104]	
"Frustration"	[WIC/FAI/24] [CI/GOV/4] [CI/FSSD/21] [CI/BOZAD/28] [74][CI/BOZI/24]	[Bank 4/D/83]
"Evidence"	Prosecution[Bank 12/D/33]	
	Lack of/misleading[CI/BOZAD/ [66] [70] [FBD/D/132] [146] [150] [156] [160]	Lack of/misleading[Bank 12/D/37] [Bank 4/D/8]
		Request for[Bank 4/D/31] [33] (Capital) [Bank 12/D/12] (Loans) [Bank 7/D/11] (Capital)[Bank 5/D /45] (Rumours)
	Mismanagement[CI/FSSD/5][CI/FBD/142]	Mismanagement[Bank 5/D/36] [50] [113] [119]

Appendix 18 Specific Word Analysis Schedule Cont ...

Political	Will[CI/FFSSD/22][CI/BOZAD/14]	Will[Bank 2/D/12]
	Pressure[CI/GOV/4] [20] [41] [CI/BOZAD/63] [85] [32][CI/BOZI/32]	Pressure
	Implications	Implications[Bank 2/D/12]
	Interference[WIC/FAI/37][CI/GOV/113] [CI/BOZAD/42][PD/061295/121]	Interference
	Environment[CI/GOV/8][CI/FFSSD/9]	Environment
	Blessings[CI/GOV/23]	Blessings
	Process[CI/GOV/36]	Process
	Platform[CI/GOV/87]	Platform
	Connections[CI/GOV/98][CI/FSSD/4] [CI/FSSD/5][CI/BOZAD/74]	Connections
	Influence[CI/GOV/104][CI/BOZAD/42]	Influence
	Support[CI/GOV/111][CI/BOZAD/16]	Support
	Events[CI/FSSD/9]	Events
	Climate[CI/BOZAD/15] [28]	Climate
	Offices[CI/GOVAD/20]	Offices
	Repercussions[CI/GOVAD/20]	Repercussions
	Protections[CI/GOVAD/58]	Protections
	Establishment[CI/BOZAD/60]	Establishment
	Level[CI/FBD/20]	Level
	Reasons[CI/FBD/61]	Reasons
	Compromise[CI/RCEO/11]	Compromise
	Gimmicks[PD/061295/136]	Gimmicks
"Politically"	Unpalatable[CI/BOZAD/20]	
	Sensitive[CI/BOZI/13] [Bank 18/D/23]	
	Unacceptable[CI/RCEO/10]	
	Acceptable	Acceptable[Bank 5/D/82]
"Fraud"	[CI/FSSD/7][CI/BOZAD/46][62] [CI/FBD/80] [86] [100] [117] [138] [146] [158][CB/BOZI/13] [14] [17] [38] [CI/AR/2][PD/061295/87]	[Bank 4/D/21] [24] [29] [39] [Bank 12/D/33] [34][Bank 7/D/73][Bank 5/D/2] [4] [5] [14] [27] [43] [48] [50
"Plans"	***Recapitalisation*** [WIC/RPSI/8]	***Recapitalisation*** *[Bank 5/D/119]*[Bank 15/D/10] [13][Bank 4/D/48] [57][Bank 12/D/11] [13] [28][Bank 7/D/15] [39] [40]
	Survival[CI/GOV/79] [81] [CI/FSSD/D/33][CI/BOZAD/13] [60]	***Survival[Bank 4/D/15] [41]*** [Bank 12/D/23][Bank 9/D/19] [Bank 5/D/7] [12] [Bank 18/D/12] [17] [18] [33] [52] [59] [63]
	Contingency	Contingency[Bank 4/D/42]
	Restructuring	*Restructuring[Bank 4/D/64] [65] [66] [71] [73] [74][Bank 7/D/65]*[Bank 5/D/36] [37] [69] [82] [83]
	Branch expansion[Bank 7/D/13]	***Branch expansion***
	Forex[Bank 7/D/84]	
	Business Plan[Bank 9/D/3][Bank 2/D/4] [Bank 14/D/23]	***Business Plan***
	Reopening	*Reopening[Bank 14/D/53]*

Appendix 19 Concept Analysis Schedules

Theoretical concept	Qualitative Evidence
Lack of political and regulatory **accountability**	**[PD/220295/31]** "...What are you going to do with the BoZ?" *[PD/220295/32] "...The BoZ firstly, is being restructured in order to respond to what has happened, completely restructured.... Yes, unless I do that, next time this thing will collapse on our face. We need to create a restructured BoZ and that is all I can say at the moment."* **[PD/150395/45]** "...I do not agree with and disappointed with it the BoZs supervisory role in monitoring the financial statements, which is supposed to appear in the Government Gazette, what is to be putting banks every month. Out of everything, which was passed in this Act, nothing has been implemented. No Quarterly reports are put in the Government Gazette. In that context, I support the Government for the steps it took in trying to get the BoZ better organized and streamlined because it has failed in its supervisory capacity. In that Context, please, I urge the Government that it has to supervise the BoZ like it supervises commercial banks." **[PD/100895/80]** "...Firstly – I would like hon. Members of the Opposition to hear me well – banking is a business like any other business. People choose to do business with a customer or an institution of their choice. It is not the Government's responsibility to tell citizens who they should do business with or which bank they should do business with. So I would like hon. Ben Zulu to understand that the risk is not part of the Government, the assurance is not on the part of the Government, but these matters are those that should be decided in their daily course of business be each one of the citizens who choose to do business with institutions." **[PD/050397/158]** "...we have seen a very sad development in the banking sector of our country, important local banks in the name of Meridien BIAO Bank and the Bank 18 folded up and others were about to sink. So, I would like to urge the hon. Minister to closely monitor the BoZ Supervision of commercial banks."
Lack of regulatory **responsibility**	**[PD/220395/25]** "...the BoZ should realize that the supervisory power it has to regulate the banking sector in this country. What has happened in the last three weeks about the Bank 5 fiasco is unfortunate and we cannot forgive the BoZ." **[PD/220395/2]** "...the Central Bank appears to be very badly-managed, although we are doing everything in our powers as a Government to strengthen it by providing all those instruments. But it appears as if we need to do a little more than what we have done so far and I am glad to say that the hon. M/Finance has told us that something very drastic will be done vis-à-vis the board of the bank. The Board is not only unprofessional, but it still consists of Former UNIP elements and no wonder, therefore, that we have such failures as the Bank 5 because we have not strengthened the supervision element of the bank." **[PD/150395/46]** "...The supervisory capacity at the BoZ needs to be reviewed and enhanced as a matter of urgency to enable the bank identify, in good time, problems in the financial market and take corrective measures."

Appendix 20 Conference presentations and research publications

1. Maimbo, S. (2001) "**The Design, Development and Implementation Of Commercial Bank Licensing Policy in Zambia (1980 –2000)**" Development and Business Finance: Policy and Experiences in Developing Countries, Manchester, 5-6 April 2001

This paper reviews the bank licensing process in Zambia between 1980 and 2000. It considers the design, development and implementation of the commercial bank licensing process between 1980 and the year 2000. The paper argues that the weaknesses in the licensing procedures for new commercial banks were significant contributing factors to the bank failures of 1995 and 1996/97. It presents evidence that there was insufficient regard given to the quality of prospective owners, directors and managers of new commercial banks, the minimum amount of capital required, the development of reasonable business plans and the financial strength of the owners. The paper evaluates the concept of regulatory failure at the licensing stage in the light of the failure of the Registrar of Banks to minimise the risk of unsuitably qualified individuals gaining access to banking licenses. The paper concludes that, although the BoZ has significantly enhanced the licensing process, there remain important institutional weaknesses that undermine the effectiveness of its licensing policies and procedures.

2. Maimbo, S. and Mavrotas, G. (2001) "**Financial Sector Reforms and Savings Mobilisation in Zambia**", International Conference on Finance and Development: Evidence and Issues, Nairobi 10-11, July 2001

The paper's focus is on the relationship between financial sector reforms and savings mobilisation in Zambia. The paper examines the linkages between financial sector reforms undertaken in Zambia in the 1990s and savings institutions in the country with a particular emphasis on the impact of the reforms on savings mobilisation. The paper also discusses issues relating to the structure and characteristics of both banks and non-bank financial institutions, especially microfinance institutions, and the channels through which they affect savings. The paper identifies problems associated with the functioning of financial sector in Zambia and the way they have contributed to the relatively poor performance of savings in the country in recent years. The paper concludes by deriving a set of policy guidelines for strengthening the linkages between financial sector reforms and savings in the country with important implications for poverty-reducing growth.

3. Maimbo, S., (2000) **Bank Regulation and Supervision in Tanzania, Uganda and Zambia**, *Journal of Financial Regulation and Compliance* Vol. 8. No. 4, London.

This article describes the problems of bank regulation and supervision found Tanzania, Uganda and Zambia, highlighting the institutional weaknesses facing bank regulators. It also reviews the recent banking regulation and supervision reforms designed to strengthen the regulatory and supervisory capacity of the central bank in all three countries. The paper also considers the efficacy of the reforms in mitigating financial distress.

4. Maimbo, S. (2000). **The Prediction and Diagnosis of Bank Failures in Zambia.** *Finance and Development Working Paper Series* No. 13, The university of Manchester, Manchester.

The diagnosis and prediction of bank failures through the development of an effective early warning system is currently an important issue at the BoZ. The bank failures of the 1995 and 1997/98 brought into question the ability of the central bank to diagnose the financial condition of banks or act promptly in effecting remedial measures for failing institutions. This paper evaluates the method of financial analysis currently employed by the BoZ and considers the merits of a new method of analysis proposed to the BoZ by an external consultant. The paper makes recommendations on how to improve the diagnosis and prediction of bank failures by incorporating non-financial factors into the process of analysing bank performance. The objective of the paper is to provide a simple, non-econometric, yet practical policy instrument for regulators and supervisors in small developing countries.

5. Brownbridge, M., and Maimbo, S. (2001) "Can Prompt Corrective Action Rules Reduce Regulatory Forbearance in Developing Countries", **Development and Business Finance: Policy and Experiences in Developing Countries, Manchester, 5-6 April 2001**

A major weakness of bank regulation is excessive "regulatory forbearance", which can be attributed in part to the scope for discretionary intervention on the part of the bank regulator. Therefore, bank regulation might improve if regulators use predetermined intervention rules to reduce regulatory discretion by reducing the scope for regulatory discretion by subjecting intervention policy to a set of rules. The best-known examples of such rules are the "Prompt Corrective Action" (PCA) provisions enacted in the US in 1991. This paper examines whether the introduction of PCA rules is appropriate and feasible in developing countries. The paper provides empirical evidence on the incidence and cost of regulatory forbearance in selected developing countries – including Uganda, Zambia, and Thailand – through an examination of regulatory intervention in distressed banks in these countries. The paper then outlines the potential benefits of incorporating PCA rules into banking regulation in developing countries, and discusses the feasibility of implementing PCA rules. The paper concludes that if PCA rules are to contribute to improving bank regulation in developing countries, they should be introduced as part of a more comprehensive set of prudential reforms, which strengthens both the operational independence of the bank regulators and their accountability to the public. Further, reforms should improve on-site examination capacities of the regulators; strengthen accounting standards in the banking industry, and raises public and political understanding of the need for strong and impartial bank regulation.

6. Maimbo, S. (2000) "**The Regulation and Supervision of Microfinance Institutions in Zambia**" Development Studies Association International Conference on Financial Regulation, London, November 2000.

This paper reviews the recent proposals for the regulation and supervision of the micro-finance sector in Zambia. It argues that because there is insufficient experience with the regulation and supervision of microfinance institutions, both in practice and in the academic literature, the BoZ should not impose an excessive level of prudential regulations. The development of microfinance regulatory theory is still in its infancy and does not provide sufficient guidelines for regulators faced with a growing microfinance sector.

7. Maimbo, S., (2001) **"The challenges of the Africa growth and opportunity act for Zambian micro-finance institutions and their clients"** *Journal of African Business, New* York.

This paper evaluates the challenges the Africa Growth and Opportunity Act presents for Zambian microfinance institutions and their clients. It argues that micro finance institutions need to create structures that will facilitate the growth of micro enterprises into larger more economically viable enterprises. They need to create growth linkages between themselves and other financing institutions, such at venture capital firms, for some of their clients with the potential to reach the export market. Unless micro finance recipients grow to more economic levels of activity, the Act will not have a positive impact for them. They currently do not have the products, size or capacity to exploit the opportunities presented by the Act, nor do they have the capacity to deal with its inherent threats.

8. Maimbo, S., (2001). **Explaining Regulatory Failure**. Paper presented at the International Conference on Finance and Development: Evidence and Policy, 10-11 July 2001, Nairobi, Kenya.

This paper discusses regulatory failure within the context of the 1995 and 1997/98 bank failures in Zambia. It starts by acknowledging the difficulties that exist in establishing credible techniques for measuring the quality of on-going bank regulation and supervision performance and criterion for distinguishing between regulatory failure and regulatory success. It then proceeds to detail the choice of instruments the Bank of Zambia employed in responding to increasing financial distress amongst local banks. Using 'excessive regulatory forbearance' as an indicator of 'regulatory failure', the paper examines why regulatory forbearance occurred; why the Bank of failed to enforce the required corrective action in a timely and consistent manner, even at the risk of encouraging and permitting fraudulent and wrongful trading. Through in-depth interviews and documentary analysis, the paper concludes that delays in regulatory decision-making were not always the result of direct political interference, but rather, bureaucratically institutionalised regulatory forbearance.

9. Kirkpatrick, C., and Maimbo, S. (2001). **The Implications Of The Evolving Microfinance Agenda For Regulatory And Supervisory Policy**. A Paper presented at the International Conference on Finance and Development: Evidence and Policy, 10-11 July 2001, Nairobi, Kenya.

This paper discusses the implications of the evolving micro finance agenda for regulatory ans supervisory policy. Five years after the notable paper by Berenbach and Churchill (1997) on micro finance regulation and supervision, the appropriate level of government supplied regulation in the industry remains unclear. Although subsequent literature has successfully identified the basic options available to regulators – no regulation, self-regulation, existing banking regulation, and special regulations - literature is yet to establish a clear set of core principles which national regulators can translate into specific performance benchmarks, guidelines, rules and regulations. The considers the implications of the recent trends in providing the poor with financial intermediation services on regulatory policy design and discusses the alternative regulatory models that are being proposed to match the pace of innovation, diversity and development in the micro finance industry. It concludes with suggestions of areas in which future research might be usefully directed.

(a) **Cost of borrowing regulations, 1995 (effective November 1995).** These regulations require a bank or financial institution to disclose by means of a written statement the cost of borrowing to the borrower, at or before the time at which the loan is made.
(b) **Payment of fees regulations, 1995 (effective November 1995).** These regulations set out the annual licence fees to be paid by banks and financial institutions and the penalties for failure to pay such fees.
(c) **Return of unclaimed funds regulations, 1995 (effective November 1995).** These regulations require a bank or financial institution to submit to the Registrar an annual return in respect of all funds in that bank or financial institution for which no transaction has taken place and no statement of account has been requested or acknowledged by a person in whose name the funds were being held, for a period of ten years or more.
(d) **Reserve account regulations, 1995 (effective November 1995).** These regulations require, a bank or financial institution to transfer part of its retained earnings to a reserve fund.
(e) **Disclosure of deposit charges and interest regulations, 1995 (effective November 1995).** These regulations require a bank or financial institution to disclose to its customers and to the public, by means of a written statement, all charges on deposit accounts.
(f) **Capital adequacy regulations, 1995 (effective November 1995).** These regulations prescribe the minimum capital requirements for banks and financial institutions.
(g) **Fixed assets investment regulations, 1995 (effective November 1995).** These regulations prohibit a bank or financial institution from making investments in fixed assets, which will result in all such investments exceeding the amount of its regulatory capital.
(e) **Foreign exchange management and risk exposure regulations (effective 21 March 1996).** The suspension of the Exchange Control Act led to an increased level of activity in the foreign exchange market. This contributed positively to banks' earnings. However, the FSSD has recognized the potential impact that adverse movements in exchange rates (the exchange risk) can have on the banks' financial condition. Therefore, in order to address such risks and ensure that banks' exposures are minimized, these regulations were issued, among other things, to limit individual banks' exposure to exchange rate risk to 20% and 25% of regulatory capital for single currency and overall exposures respectively.
(f) **Large loans regulations (effective 21 June 1996).** The financial 'sickness' of a bank borrower or group of related borrowers can have serious impact on a bank if that borrower or group of related borrowers represent a large concentration of risk to the bank. Recognizing this, the large loans regulations were issued with the primary aim of limiting concentration of loans to a single borrower or a group of related borrowers, thereby minimizing the effect of loss to the bank in the event their failure. The regulations limit a bank's large loans exposures (exposures of 10% or more of regulatory capital) to 25% and 600% of regulatory capital for single borrower and total large loans exposures respectively.
(g) **Insider loans regulations (effective 31 March 1996).** The FSSD also recognized that loan exposures to directors, shareholders and others concerned in the ownership and management of banks either directly or indirectly can be quite problematic as these loans easily drift into non-performing status and their terms do not usually reflect arm's length dealing. In this regard the insider loans regulations were issued with the objective of limiting a bank's loan exposures to insiders to 5% and 100% of regulatory capital for single and overall exposures respectively.
(h) **Fixed assets investment regulations (effective 31 March 1996).** The aim of these regulations is to control investment in fixed assets by banks. The regulations are in response to the need to restrict banks from making excessive investments in fixed assets, as these do not directly contribute to the core business of banking
(i) **Classification and provisioning of loans regulations (effective 1 January 1997).** The primary aim of these regulations includes among other things; to standardise the loans classification process and give guidance on minimum provisioning levels. However, because of the likely adverse impact of the classification ant provisioning of loans regulations particularly on the earnings and consequently on regulatory capital, some banks have been given until 31 December 1997 to fully comply with the regulation. This exemption was given under Section 18(4) of the BFSA 1994.

Source: FSSD Annual 1995 Report, FSSD 1996 Annual Report

Appendix 22 The 1995 Bank Failures Summary

Date Bank Seized	Reason(s) For Failure	Measures Taken by BoZ to Avert Failure
Meridien BIAO		
Seized on 19 May 1995. Subsequently placed into compulsory liquidation on 18 August 1995.	Non-performing bank placements with the foreign parent bank. High level of non-performing loans. Excessive connected lending to related parties. High level of insider borrowing.	Meridien BIAO Bank received immense funding from BoZ and GRZ. Requested shareholders to recapitalise the bank. Disapproved branch expansion plans. Appointed a joint Managing Director, Mr. Kaitano Chungu to co-manage the operations of the bank. Appointed Mr. John Cruickshank as Chairman for the Board. Directed the bank to curtail new lending. Directed the bank to recall loans and advances. GRZ attempted to merge the bank with ZNCB to become ZAMBANK
African Commercial		
Seized on 13 November 1995 and Subsequently placed into compulsory liquidation on 21 August 1997.	High level of non-performing loans leading to negative regulatory capital as defined in the Capital Adequacy Regulations. High level of insider borrowing; and Interference by shareholders and directors	Availed the bank of an overdraft for the purpose of meeting depositor demands and clearing shortfalls. Requested the shareholders to recapitalise the banks Disapproved branch expansion plans Directed the bank to curtail new lending Directed the bank to enhance its debt recovery efforts. Removed the Managing Director Mr. William Fearon from office.
Commerce Bank		
Seized on 29 November 1995 Restructured and re-opened on 5 December 1997	Under-capitalisation Over reliance on high cost of funds Poor lending practices leading to poor asset quality Excessive connected lending to related parties High level of insider borrowing Image affected because of the common shareholding with ACB	Availed the bank an overdraft facility to help it meet depositor payouts and clearing shortfalls. The shareholders were asked to recapitalise the bank. Directed the bank to curtail new lending Directed the bank to recall the recoverable loans. Directed the bank to reduce on the level of management staff. Directed the bank to effect reduction in its overhead expenses Directed a shareholder, Mr. Musa Siame to relinquish his shares. Disapproved branch expansion plans.

Source: BoZ

Appendix 23

Appendix 24

Appendix 25 The 1997/8 Bank Failures Summary

Date Bank Seized	Reason(s) For Failure	Measures Taken by BoZ to Avert Failure
Credit Africa		
Seized on 28 November 1997. Subsequently placed into compulsory liquidation on 6 March 1998.	Under-capitalisation High level of non-performing loans Over reliance on high cost funds Excessive connected lending to related parties High level of insider borrowing Malpractice by directors. Excessive lending without adequate security or none at all.	Availed the bank an overdraft facility intended to assist the bank meet depositors' demands and short term clearing shortfalls. Shareholders were asked to recapitalise the bank. Directed bank to recall all recoverable loans. Issued instructions to limit the level of withdrawals per depositor. Stationed BoZ Inspector on site to monitor the day-to-day operations of the bank. Disapproved branch expansion plans. Removed the executive powers from the Executive Chairman, Mr. Zahid Nizam, which left him as an ordinary Chairman. Appointed an audit firm Ernst and Young to conduct an investigative audit following certain findings by the BoZ Inspectors.
Prudence		
Seized on 18 October 1997. Subsequently placed into compulsory liquidation on 18 January 1998.	Paid high interest rates on foreign deposits, hence high cost of funding. Excessive advertising cost and overheads. Inexperienced management. Family-controlled and ineffective board.	Availed the bank and overdraft facility to help it meet depositor payouts and clearing shortfalls. Shareholders were requested to recapitalise the bank. Disapproved branch expansion plans. Appointed a Curator for close to two years. Directed the bank to curtail new lending. Restricted expenses. Requested the Chairman, Mr. Ravi Devalia to resign. Removed from office the managing Director.
Manifold		
Seized on 4 December 1997 Subsequently placed into compulsory liquidation on 6 March 1998.	Under-capitalisation High level of non-performing loans.	Availed the bank an overdraft facility intended to assist the bank meet depositors' demands and short term clearing shortfalls. Issued instructions for the bank to curtail new lending Shareholders asked to recapitalise the bank. Directed the bank to enhance debt recovery. Stationed BoZ Inspectors on-site to closely monitor the day-to-day operations.
First Merchant		
Seized on 2 February 1998. Placed into receivership with a view to restructuring.	Under-capitalisation. Malpractice by directors. Negative press reports led to a run on the deposits.	Availed the bank an overdraft facility. Shareholders were requested to recapitalise the bank. Disapproved branch expansion plans. BoZ officials were placed on site to closely monitor the day-to-day operations.

Source: BoZ

Appendix 26 Entry Regulations and Supervision Practices References

[LI/FBOZG/2] 'Another example is the way in which Meridien Bank was licensed. We received an instruction from State House to licence the bank and what followed thereafter was sheer formality.'
[Bank 18/D/5] '...and your briefing later to the effect that his Excellency the President has since given the go ahead for the registration of the African Commercial Bank.'
[Bank 25/D/2] '...I forward herewith a formal application on behalf of the Bank of Credit and Commerce international Group to open a subsidiary in this country...'
[Bank 14/4/4] 'I wish there was an effective way, such as involving SITET when we reach such stage of an application. However, I have written to the lawyers for such information, which may not wholly be relied on. Besides I have already written to BoZ for their views'
[LI/BoZAD/51]' It is only cases where the person has been convicted that would warrant the rejection of a licence application.'
[LI/BoZAD/53] ' Again, we can only act of cases where the individual has been convicted of a crime. Remember that in the eyes of the law, a person is innocent until proven guilty. We can not prevent people from entering the banking sector purely on suspicion or accusations of misdeeds that have not be proven as fact before a court of law.'
[LI/FboZG/4] ' BCCI was a criminal organisation and the BoE warned us about certain individuals. In fact we cornered one individual who was involved in money laundering and had him deported. However, one way or another, they found themselves back in Zambia and were allowed to live here and carry on in business for a very long time. These guys have a lot of influence with politicians and there is very little that you can do about it. '
[LI/FFSSD/2] ' The biggest problem we have is that banks tend to be owned by individuals who are very well connected politically. '
[LI/FTC/4] 'They neither had the technical know-how, nor did they have the time. Remember that it was not a full time job, as most people think. The functions of Registrar of Banks were discharged by the officer responsible along side his other day-to-day activities which took preference to licensing commercial banks. '
[LI/FTC/8] 'Yes the pressure to license banks was there, but it was really concerned with the length of time it took to process and application, and not really anything to do with the applicants wanting to circumvent any of the requirements. After all, the requirements in place to obtain a banking license were so minimal; K20 million, a memorandum of association, articles of association, what else...a filled bank license application form.'
[LI/BoZAD/4]' But remember that the ultimate authority at the time was the Registrar of Banks and Financial Institutions at the Ministry of Finance. BoZ was only consulted at the discretion of the Registrar.'
[LI/BoZAD/10] ' But remember that the ultimate authority at the time was the Registrar of Banks and Financial Institutions at the Ministry of Finance. We were not involved in that decision.'
[LI/BoZAD/29]' You must remember that the BoZ did not have the authority to grant banking licences. That responsibility was with the Ministry of Finance. I therefore ca not speak for events that took place before my time. '
[LI/FTC/10] ' you can easily imagine the problems that I had when I suggested that the role of Registrar of Banks should be moved from the Ministry of Finance to the BoZ. I literally put my own job on the line! Literally! I got a lot of criticism for the idea. It took a lot of effort to persuade people that the role of Registrar was better placed within the central bank. '
[Bank 14/D/34] 'I recommend that (since all the requirements have now been met and other government organs consulted) the application be considered for registration...'
[Bank 13/D/18] '...the BoZ has no objection to Bank 13 being given the licence.'
[Bank 13/D/29] 'The BoZ has no objection to the Bank being registered. '
[Bank 4/D/8] ' the registrar of banks is recommending that you approve registration of this bank. Comments from BoZ on the registration of this bank are contained in their letter to us '
[Bank 16/D/9] ' After examining the application, I am pleased to advise that the BoZ has no objection to Bank 16 being given the licence '

Appendix 27 Definitions and Interpretations of Key financial Ratios

DEFINITION	INTERPRETATION
CAPITAL	
Shareholders equity to total assets (equity capital + Share premium + Statutory reserves + retained earnings + revaluation reserves + general reserves + profit & Loss)/ (Total assets)	This is a crude measure of the extent to which a bank's total assets are financed by the shareholders equity
Debt to shareholders equity (all debt in excess of one year)/(Equity capital + share premium + statutory reserves + retained earnings + revaluation reserves + general reserves + profit & loss)	Measures the basic net worth at a point in time. Also referred to as the leverage ratio.
Net non performing loans to shareholders equity (net non performing loans / Shareholders equity)	Measures the severity of non-performing loans in relation to shareholders equity. It provides a useful insight to the extent to which shareholders equity is being eroded.
Tier 1 capital to risk weighted assets **Total capital to total weighted assets**	These ratios express the primary and regulatory capital as a percentage of the total risk weighted assets. They indicate the margin of protection available to both depositors and creditors against unanticipated losses that may be experienced by the bank. Thus they include the banks resilience to economic difficulties.

ASSET QUALITY	
Earning assets total assets (balances with banks abroad + net loans + treasury bills and government securities + bills of exchange)/ (total assets)	Provides an indication as to the quality of assets of the bank. It highlights the proportion of the banks' asset that can be relied upon to generate income for the bank. A high level of earning assets indicates good quality.
Non performing loans to total assets	Indicates the percentage of total loans that have deteriorated and have been adversely classified as a percentage of the banks total assets portfolio. Where loans are a significant portion of total earning assets an increase in this percentage can seriously hinder the earning capacity of the bank
Non performing loans to total loans	Loans and advances usually represent the single largest asset of most banks. Thus monitoring the quality of the banks loan portfolio is of the utmost importance. The greater the ratio the higher the credit risk the bank is exposed to.
Allowance for loan losses to total loans	Provides useful insight into the quality of a banks loan portfolio and bad debts coverage, and the adequacy of loan loss provisions. However, this ratio may not be as useful as it ought to be due to reluctance on the part of the banks to write off unrecoverable loans, which inflates the ratio.
Allowance for loan losses to total no performing loans	A test of the adequacy of the allowance for loan losses. It reflects the extent to which the bank recognises how badly its total loan portfolio has been impaired.

EARNINGS	
Return on assets (Income before tax/ average assets for the month)	Measures the net income generated from the employment of the total assets of the bank. If reasonable accounting principles are consistently applied to banks with similar asset structures, a bank with a higher return on assets is inherently sounder than one with a lower ratio.
Return on equity (income tax/shareholders equity)	Measures the rate of return on the shareholders equity investment. In an inflationary environment likely Zambia the rate should ideally be at least that of the ruling inflation rate so as to enable the bank to maintain its equity base in real terms, assuming no dividends are paid out
Net interest margin (total interest income –interest expense/total interest income)	Identifies and evaluates the core earring capacity of the bank. A negative or declining ratio is an important indicator of treasury management problems that require attention.
Interest rate spread (Average interest rate on loans – average interest rate on deposits)	This indicates the interest rate gap between the loans and deposits of a bank. Together they represent the primary interest earning asset and interest expense item respectively for most banks. The greater the gap the more profitable a bank will be while the opposite is true.
Loans yield rate (Interest income from loans)/(Gross loans – non performing loans)	This is the effective return on the banks investment in loans
Government securities yield rate (Interest income from government securities)/(Government securities)	This is the effective return on the banks' investment in government securities.

LIQUIDITY	
Liquid assets ratio (Short term assets: Cash due from banks, balances with banks abroad, Treasury Bills and Government securities, Interest receivable, bills of Exchange, balances with Bank of Zambia)/(Short term liabilities: total deposits, liabilities to bank of Zambia , liabilities to other banks, Interest payable, Bills Payable and other liabilities)	A rather crude yet useful measure of a banks liquidity. It reflects the banks' ability to meet its short-term liabilities with its short-term assets. A bank that does not have to rely on the repayment of its loans in order to meet its obligations is "insulated" against its non-performing portfolio.
Total deposits to total asset (Core deposits: Demand, savings, and Time/ Total assets)	Measures the extent to which the bank assets are financed by the deposits of its customers. The greater the ratio the greater its vulnerability to liquidity problems in the event of a run on the bank.
Gross Loans to total deposits (loans before deducting allowance for loan loss/ total deposits)	Measures the extent to which a bank is able to mobilise deposits from the public to support its operations and the extent to which it is able to lend these deposits. A higher ratio is traditionally associated with a greater element of risk since this indicates lower liquidity vulnerability to institutional lenders, adverse economic conditions, and or, the consequences of a deposit run. A ratio of 50% and above is considered adequate.

Source: Financial System Supervision Department

Appendix 28 Exit Regulations And Supervision Practices References

Meetings

[Bank 2/D/3] 'We had a meeting with the bank's General Manager and the branch Deputy Manager on 28th April 1995. In the meeting it was explained to the bank officials that the BoZ supervisors were not happy with the way the bank was operating...'

[Bank 2/D/5] 'I have had fruitful discussions with the bank's General Manager. It is clear to him what problems the bank has itself into e.g. a large credit exposure to CUSA and the high ratio of loans to deposits of 103%... '

[Bank 2/D/9] ' Following our letter of 7 June 1995 to the bank, the bank's general Manager was called in yesterday to make a commitment on how the bank intended to resolve its liquidity, deposits and loan problems...'

[Bank 4/D/31] ' It was agreed that a further meeting would take place on Tuesday 2 April After year end to review the results and ensure that all matters discussed above were proceeding according to schedule.'

[Bank 4/D/40] ' Next meeting: With the Board of Directors and shareholders 30 May 1996.'

[Bank 4/D/41] ' Mr Mukushi admitted that the banks overall condition was weak. This was the first time he spoke during the meeting and his stance was that of confrontation. He lashed out at the BoZ for not providing what he described as adequate assistance. '

[Bank 4/D/49] ' He went further to explain that it has been difficult for him to conduct any meaningful marketing for the bank in the absence of entertainment and other allowances to him.'

[Bank 4/D/51] ' Mr ... informed Mr ... that BoZ cannot accept the capitalisation of an incomplete and idle building which will not even be opened as a branch. '

[Bank 4/D/63] ' Governor would like to meet you on Monday 20 January 1997 at 15.00 hours to discuss the above mentioned subject.'

[Bank 7/D/21] 'Several meetings were held with the bank's Managing Director, Mr. ..., and the Finance Manager, Mr. ..., to discuss the financial condition of the bank '

[Bank 5/D/35] 'There is clear evidence of related party loans by MOBS breaching all prudent banking norms and the Bank 5's Group's own credit policies. '

[Bank 5/D/40] ' After our meeting with Mr ...and the other officers of Bank 5Bank of Saturday, I have been giving some thought as to how we can manage to help the bank. '

[Bank 5/D/46] 'Dr Kani and I had two meetings today with Bank 5Bank. The first was with Mr ..., and Mr ..., Financial Controller. The second meeting was with Mr ..., Chairman, Mr ..., Mr ... and another individual from the bank'

[Bank 5/D/57] ' Mr ... provided the Governor with a balance sheet and income statement as at 30 Sept 1994'

[Bank 5/D/63] ' meeting scheduled with ZCCM for tomorrow [adv: tomorrow may well be too late and that he should try to get some relief from ZCCM today.'

[Bank 5/D/96] ' The meeting was intended to clarify the following issues with Bank 5bank's external auditors '

[Bank 5/D/83] ' Discussion Points: The Bank 5Recovery Plan has been rejected by the BoZ Policy Committee. '

[Bank 5/D/93] ' Circulate this copy with my comment to all your inspection staff, Mr ..., Mr ... and myself. Then lets have a meeting on Friday morning at 08:00hrs.'

[Bank 9/D/10] ' The meeting was called to discuss the capital position of Bank 9.'

[Bank 14/D/5] ' An Inspector [named] and I have had two meetings with the Management of the bank to discuss the banks exposure in the interbank borrowing and the level of non-performing loans.'

[Bank 14/D/10] ' I spoke to the bank's chief inspector about the need for their management to come and see us to resolve a number of issues '

[Bank 14/D/22] ' This morning, Dr ..., Dr ... and myself met with Mr ..., Managing Director of Bank 14."

[Bank 12/D/8] ' On Friday 28 July 1995 Mrs ... and I met Messrs ...(General Manager) and ... (second General Manager). The purpose of our meeting was to discuss the bank's recent liquidity problem and find solutions for resolving it.'

[Bank 12/D/14] ' The Chairman told the meeting that the story of Bank 12 was different from Bank 4.'

[Bank 12/D/16] ' In a meeting held in the Governors office on Tuesday 31 December 1996 with the representatives of Bank 12 it was agreed that the overdraft, excluding penal charges, should not be allowed to exceed six billion Kwacha (K6 billion) at any time.'

[Bank 12/D/29] ' From the discussion held regarding the possibility of capitalisation and removing the bank from the present quagmire. It is clear that fresh capital injection may not be available, at least not in the next six months.'
[Bank 18/D/10] ' A meeting was held in the Governor's Office with Messrs ... and ...of Bank 18 to discuss the bank's serious liquidity problem.'
[Bank 18/D/26] ' Yesterday, we had a meeting with The Chairman and the banks lawyer on the possible recovery of the properties of .... '
[Bank 18/D/29] ' Serenje: Pleaded with the Governor to allow him at least 3 to 4 weeks and hopes, and was confident that he will have sold off his assets in the UK on the London Stock Exchange and will have sufficient capacity and money to met his obligations.'
[Bank 18/D/33] ' In view of these concerns the Governor asked Mr Serenje to discuss his plans for settling the latter's obligations to the Bank 18.
[Bank 18/D/38] ' Meeting with the Chairman and Acting managing Director'

Caution Letters

[Bank 2/D/3] ' In the meeting it was explained to the bank officials that the BoZ supervisors were not happy with the way the bank was conducting its treasury affairs. '
[Bank 2/D/7] ' On several occasions during the month of May the bank failed to meet the core liquidity ratio of 20%. A warning letter has been sent'
[Bank 2/D/10] ' We wrote to the bank on 20 June 1995 asking them to take action on the treasury management problems. We have asked the bank to appoint competent managers to key positions especially that of chief accountant. Furthermore, we have asked that the bank should find new investors in addition to Dr ... whose reputation in the business community is not so good.'
[Bank 2/D/13] 'Safe Deposit Bank's financial position is poor and its going concern is in doubt without: (1) fresh cash injection from existing shareholders (2) the bank widening its deposit base (3) improving the margins (4) recovering the outstanding amounts from CUSA (Z) Limited - Warning letter sent'
[Bank 4/D/23] ' Some time last year the owners of the Mukushi group of companies which includes Bank 4 decided that being benefactors of all companies no interest should be charged to the group companies. '
[Bank 4/D/47] ' We write to express our concern about the failure of your bank to submit correct supervisory returns for the month ending June 1996...'
[Bank 4/D/55] ' We regret to advise that your request has been declined because of the unfavourable situation your bank is currently experiencing. As we have earlier stressed, emphasis must be on recoveries and not additional advance. '
[Bank 4/D/72] ' We find it disturbing to note that no action has been taken in this regard and we therefore request you to immediately communicate our recommendations to the chairman of the Mukushi group, with copy to the undersigned.'
[Bank 4/D/84] ' I note with disappointment that despite the precarious financial condition of the bank you have continued to disregard BoZ directives meant to improve the performance of your bank... '
[Bank 7/D/32] '...failure to comply will result in our evoking of section 127 (1) of the Banking and Financial Services Act, 1994, which provides for a fine not exceeding five million Kwacha or to imprisonment for a term not exceeding two years,'
[Bank 7/D/35] ' Admission to TZCH will be in accordance with TZCH Rules. Banks are required to lodge collateral with the BoZ.'
[Bank 7/D/49] '...I wish to order that your bank should by 30 September 1997 (1) resolve all your liquidity problems (2) recapitalise and meet the minimum regulatory requirements of K2 billion'
[Bank 7/D/63] '...We note with disappointment that despite our circular No. 3/57 dated 2 may 1997 your bank has not published its monthly Statements as required under section 61 (4) of the BFSA.'
[Bank 7/D/66] '...I am disappointed to learn that your bank paid K3.4 million for repairs for your residential property and K5.1 million 12 months rental advance for the property you want to occupy without seeking BoZ authority '
[Bank 7/D/68] '...the Bank has decided to give you up to 31 Oct to recapitalise and restructure your bank.'
[Bank 7/D/71] ' The bank has recently paid 216 pounds sterling (K467,208) for telephone bills at the Chairman's house in the UK without informing us.'
[Bank 7/D/73] ' So I should be grateful if you would co-operate with BoZ to ensure that your bank is properly capitalised so that it can continue to play its role in Zambia's economy.'

[Bank 7/D/76] '...You have 7 working days in which to show cause why disciplinary action should not be taken ...'
[Bank 5/D/12] ' account at BoZ had been overdrawn for the second consecutive week reaching K8 billion at 30 December 1993.'
[Bank 5/D/18] ' BoZ expressed their concern regarding the liquidity position of the Bank 5.'
[Bank 5/D/19] ' BoZ requests Bank 5 to terminate the I-Bond Scheme because it infringes on certain aspects of the Securities Act, 1993.'
[Bank 5/D/23] ' BoZ expressed concern that Bank 5 had failed to deliver $800, 000 which was offered for sale from foreign exchange dealing'
[Bank 5/D/33] ' The bank's recent inadequate liquidity has been a source of concern both for yourself and the BoZ...'
[Bank 5/D/36] '...we have been concerned about the bank's relatively small holdings of liquid assets, its inability to meet the core liquid assets ratio and the loss of deposits'
[Bank 5/D/39] ' Balances with banks abroad: Why is the amount in other assets – Bank 7L K12m not recorded here?'
[Bank 5/D/52] '...We are disappointed in the bank's efforts so far to obtain assistance from other related and Bank 7 units.'
[Bank 5/D/62] ' BoZ expressed concern that ZCCM had withdrawn some K4.8 billion from the Bank 5 facility during January 1995.'
[Bank 9/D/8] ' This was in contravention of section 8 (2)(a) and 9 (2)(a) of the BFSA (Foreign Exchange Risk Management Exposure) Regulations...You bank is requested to strictly observe the provisions of these regulations.'
[Bank 15/D/3] ' The bank has been reprimanded and strongly cautioned against future breach of any provisions of the Act.'
[Bank 12/D/24] ' We urge you to implement our instruction.'
[Bank 18/D/4] ' We have written to Mr ... to resign his seat on the board, as he is Chairman .'

New Capital Plans

[Bank 2/D/3] 'We also requested that the bank provide us with a business plan. The Managing Director promised us that he would have one ready for us in a weeks time.'
[Bank 2/D/9] ' Following our letter of 7 June 1995 to the bank, the bank's general Manager was called in yesterday to make a commitment on how the bank intended to resolve its liquidity, deposits and loan problems. '
[Bank 2/D/10] ' We wrote to the bank on 20 June 1995 asking them to take action on the treasury management problems. ... Furthermore, we have asked that the bank should find new investors. '
[Bank 2/D/11] ' We have on many occasions spoken and recently written to the bank about their inability to meet the liquidity requirements and their narrow deposit base. '
[Bank 2/D/14] ' The following matters are being followed up (1) recovery of non-performing loans, (2) increase of capital to meet the regulatory capital by June 1996.'
[Bank 2/D/15] ' The following matters are being followed up (1) recovery of non-performing loans, (2) increase of capital to meet the regulatory capital by June 1996.'
[Bank 4/D/41] 'Draft accounts reveal a large deficit on the capital and reserves account of K3.488 billion after adjusting for non-performing loans (K2.802 billion) and other assets (K906 million.)'
[Bank 4/D/64] ' We have requested the management of Bank 4 to compile their proposed restructuring plan and submit for our review by 27 January 1997.'
[Bank 4/D/65] ' We will expect your plan for our assessment by Monday 27 January 1997.'
[Bank 4/D/71] 'I have taken note of the new submission of the nature of the problem at hand I shall not allow another extension of the submission date '
[Bank 4/D/74] ' Capital: we are, however, disappointed that nothing concrete has been on this, ...our estimate indicate that your deficit is in the range of K20 billion (including BoZ overdraft of K9 billion).
'

[Bank 7/D/14] ' BoZ requested plans/strategy indicating how the bank will recapitalise '
[Bank 7/D/15] ' Reminder that the BoZ had not yet received the plans/strategy of the bank.'
[Bank 7/D/49] '...I wish to order that your bank should by 30 September 1997 (1) resolve all your liquidity problems (2) recapitalise and meet the minimum regulatory requirements of K2 billion'
[Bank 5/D/13] 'Unit holders will in effect be co-owners of the assets of the fund.'
(Bank 5/D37) 'a contingency plan required on how the bank expects to salvage itself from the current liquidity problems.'

[Bank 5/D/108] 'We note with delight the optimism you foresee in turns of deposit growth and the sources of permanent funds generation to restore your liquidity. However, we have several comments and queries which need further input from your good selves'

[Bank 5/D109] ' We note with delight the optimism you foresee in terms of deposit growth and the sources of permanent funds generation to restore you liquidity. However, we have several comments and queries which need further input from yourselves:'

[Bank 15/D/3] ' The bank has engaged the services of Equator Bank to source an appropriate foreign partner for the bank who will be expected to inject fresh capital. The bank has been requested to provide alternative options on standby should the Equator option fail.'

[Bank 15/D/5] ' A new memorandum of understanding is to be executed to supersede the one signed on 18 May 1996.'

(Bank 15/D/4) ' There is remote possibility that the bank will recapitalise itself to meet the regulatory needs.'

(Bank 14/D22) ' Mr ... proceeded to explain how he believes he will meet the liquidity requirements and he mentioned 3 or 4 large loans which are due for payment in the next month which should resolve the liquidity problem.'

[Bank 12/D/11] ' The capital issue is yet to be resolved and during this month we have written to the bank advising that the earlier approval of the issue of equity shares in return for real estate valued at K1.3 billion which increases the bank's paid-up capital to K1.8 billion from K0.5 billion is being fully reconsidered.'

[Bank 12/D/13] ' The bank has not yet submitted any recapitalisation plans as requested for in 1995. We have also asked the bank to do so by August 1996.'

[Bank 12/D/19] ' Kindly...reverse core liquidity charges amounting to K1,324,747,078.25 which have been waived.'

<u>Bank Inspections</u>

[Bank 4/D/22] ' We would like to carry out an examination of its operations to determine whether or not it is in a sound financial condition and operating safely '

[Bank 4/D/62] ' I have authorised the underlisted officers to carry out an on-site inspection of the bank (1) A (2) B (3) C '

[Bank 4/D/67] ' The inspection report found the following ...'

[Bank 4/D/76] ' I am enclosing the summary of the man findings. Kindly study the findings and let me know the date and the time when we can meet to discuss the findings in my office.'

[Bank 7/D/24] '...we intend to commence an inspection of your bank on 13 January 1997'

[Bank 7/D/44] ' Full inspection report'

[Bank 5/D/26] ' A team of four inspector were assigned to investigate specific issues of Bank 5 between 6 February and 17 February 1995.'

[Bank 5/D/66] ' Please not that you should by now have concluded your findings on the various issues each one of you was required to investigate.'

[Bank 5/D/84] ' Bank Inspection report'

<u>Audit Reports</u>

[Bank 4/D/41] ' The auditors asked if BoZ would allow adjustments in loan loss provisions based on the security held and stagger the items to be written off over a period of time so as to disguise the financial position of the bank.'

[Bank 7/D/21] 'The bank completed another twelve months without having it's accounts audited.'

[Bank 7/D/23] '...You are requested to furnish us with the current situation regarding the suspended audit of the Bank'

[Bank 7/D/60] 'we write to express our concern over the delay in finalising Bank 7's audited financial statements for the years ended 30 June 1996 and 1997'

[Bank 4/D/40] 'Auditors: (1) the profit of the bank was totally fictitious.'

[Bank 5/D/63] ' Coopers and Lybrand had been made aware of the need to accelerate the audit of the bank and they had agreed to do so.'

[Bank 5/D/71] ' There is a problem of accounting for certain items in the banks books. This raises questions as to the extent to which we can rely on some of the management information reported to the BoZ.'

[Bank 5/D/81] 'The bank has informed the BoZ that the external audit was to be completed by 28 Feb 1995. '...I spoke with the auditors today to discuss some matter and that he expected the audit of the bank to be finalised within a week.'
[Bank 5/D/82] ' The external auditors have not yet finalized their audit f bank's financial year which ended 31 December 1994'
[Bank 5/D/104] "...I write to inform you that owing to the BoZ's and the Govt's substantial financial stake in the Bank 5, we are requesting for a meeting with yourself as soon as the bank's audit is finalised.'
[Bank 5/D/111] ' C&L expected to present their report next week revealing a negative net work of K13 billion.'

<u>BoZ lender of last resort facility</u>

[Bank 4/D/21] 'The Board was therefore asked to consider and if deemed fit: (1) ratify the overdraft of K5.9 billion incurred by Prudence as at 29 January, 1996 with a waiver on the penalty interest for non compliance on core liquid ratio of K994 million.'

[Bank 4/D/69] ' Ratify the overdraft of K8.5 billion incurred by the bank until 27 January, 1997.'
[Bank 4/D/82] ' If BoZ wants Prudence Bank and Bank 12 to remain open, the Board must approve additional overdraft facilities in accordance with section 42(3) of the BoZ Act of 1996 to enable the two banks purchase the required collateral. '
[Bank 7/D/41] 'In the last two weeks your banks current account has been constantly overdrawn. On a number of occasions, you have assured us that the O/D would be adjusted the same day. These assurances have not been fulfilled as the overdrafts have persisted'
[Bank 7/D/79] ' The BoZ has had to extend an overdraft to your bank to sustain operations. The overdraft stood at K700.4 million as at 28 November 1997'
[Bank 5/D/44] 'Under this arrangement you are authorised to reduce your statutory reserves to a minimum of K2 billion, that will enable you to utilise about K4.5 billion between now and 2 February.
[Bank 5/D/76] ' BoZ Loans: (1) 7th Feb: K4,512,300000; (2) 7Th Feb: K5,000,000,000; (3) 16th Feb: K6,393,000,000
[Bank 5/D/82] ' We should disabuse ourselves of the fiction that what we are providing to Bank 5 is short-term liquidity support.'
[Bank 5/D/107] ' As you are aware the Government and the BoZ have in recent weeks extended a total of K31.4 billion to your bank broken down as follows.'
(Bank 14/D/16) ' In view of the present liquidity situation that we are facing we are now requesting you to grant us a temporary loan of K3 billion to be secures against our statutory bonds valued at K3,348,000,000 for the period up to 30 September 1995.'
(Bank 14/D/18) ' I would like to know from you what impact this request, if approved, would have on the current Monetary Policy Stance.'
[Bank 12/D/12] ' With regard to reducing the overdraft I suggest that the BoZ should open a separate account where all repayments on secured overdrafts should be channelled.'
[Bank 12/D/16] ' In a meeting held in the Governors office on Tuesday 31 December 1996 with the representatives of Bank 12 it was agreed that the overdraft, excluding penal charges, should not be allowed to exceed six billion Kwacha (K6 billion) at any time.'
[Bank 12/D/18] ' You will be aware that from time to time we have been faced with a number of institutions which are clearly insolvent meaning that the shareholders have lost all their investment and should therefore have no further claim at all.'
[Bank 12/D/20] 'the interest accrued thereon is still due and therefore continues to be reflected in our calculation of what is due from yourselves.
[Bank 18/D/2] 'Another option would be to provide an extended overdraft by the BoZ to accommodate withdrawals. The bank's deposits at the moment are in the region of K8 billion. So an overdraft of about K^ billion can be considered.'
(Bank 18/D/22) 'Today the bank lost K165 million through the clearing. With the ratio at -30%, the next ratio will be no better than this'
(Bank 18/D/40) 'The worst consequence has been the overdrawing of the current account with the BoZ for an indefinite period.
[Bank 18/D/43] ' I wish to advise that at its 248th Meeting the Board of Directors of the BoZ considered, approved and resolves that the overdraft in the current account of Bank 18 with the BoZ be limited to a maximum of K8 billion.'

[Bank 18/D/45] ' I refer to your letter dated 26 Sept 1995 to Bank 18 advising that the Board had approved an overdraft limit of K8 bn and wavering of penalty interest on the overdraft.'
[Bank 18/D/46] ' However, please not that the bank should not be allowed to exceed the authorised limit of K8 billion.'

Merger

(Bank 2/D/12) 'Mergers and Acquisitions: In situations where the problem is not systemic, a decision may be made to merge an ailing financial institution with a conservatively leveraged one., that has a complimentary mix of financial procedures, services and target markets'
[Bank 4/D/77] '...my own view is that the paper provides a feasible solution for dealing with the four institutions involved in a way that would minimise disturbance to the financial system.'
(Bank 7/D/38) ' The scenario presented is based on combining the balance sheets of the said banks and splitting the resultant entity into one with good assets and one with inferior assets.'
(Bank 7/D/57) ' in the interest of Zambia it would be better for BoZ to find a buyer of Bank 7. This appears to be the best solution.'
(Bank 7/D/65) '...we would strongly urge you to consider selling off the entity to potential buyers or alternatively you may consider merging your institutions with another much stronger entity.'
[Bank 15/D/5] ' The Central Bank of Kenya has requested BoZ opinion with regard the financial condition of Chase Trust Bank in view of ABC's request to take over Bank 15.'
[Bank 15/D/11] ' The good entity would assume the private liabilities and the entity with the inferior assets would assume the liabilities of the public sector...'
(Bank 14/D/35) ' that I think as supervisors of the financial system we should take measures now to mitigate the effects of the bank failures.'
(Bank 12/D/9) ' that I think as supervisors of the financial system we should take measures now to mitigate the effects of the bank failures.'
(Bank 12/D/26) ' The scenario presented is based on combining the balance sheets of the said banks and splitting the resultant entity into one with good assets and one with inferior assets.'
(Bank 18/D/40) ' The scenario presented is based on combining the balance sheets of the said banks and splitting the resultant entity into one with good assets and one with inferior assets.'
(Bank 18/D/42) ' A review of the combined balance sheet of Bank 18 and Bank 16 was carried out to assess whether that would be a better option for turning around Bank 18.'
(Bank 18/D/44) '...Although not fully completed, our review to date discloses that the position of the bank is even more precarious that was apparent from the preliminary information supplied and that the need for urgent action if even more pressing. '
(Bank 18/D/47) 'and I am pleased to enclose a copy of the offer which has been made to the Board of Directors of the Bank 18 in relation to a proposed restructuring of Bank 18 resulting in a partial merger with the ...Bank.
(Bank 18/D/48-59) ' negotiations for the take over of the bank...'

Legal and Accounting Exemptions

[Bank 7/D/16] ' Request the M/Finance to exempt the bank from the K2 billion capital requirement and instead reduce this to K500 million until 31 December, 1998 after which date the normal statutory requirement will apply.'
[Bank 7/D/62] ' I am pleased to inform you that the BoZ has approved your request to suspend the capitalisation of accrued penalty charges on the shortfalls on the core liquid assets ratio.'
[Bank 7/D/74] 'In view of the negotiations going on with potential buyers of the bank we apply that we be given temporary dispensation from compliance with S 61(4) which requires that we publish our financial position in one of the daily newspapers.'
[Bank 9/D/4] ' BoZ through the bankers Association had requested those banks who may be adversely affected by the new provisioning regulations to apply to bank of Zambia for consideration as provided for by regulation 18 (4) .'
[Bank 9/D/13] 'The bank has since applied for the one year exemption for making provisions that on its non-performing loans and this has been granted on the understanding that the bank makes efforts to realise the security held on the non-performing loans.'
[Bank 15/D/10] ' The directors have been given up to 31 January 1997 to inject further capital into the bank.'

(Bank 14/D/36) ' I am pleased to inform you that rather than the BoZ allowing your holdings of government bonds to be included in the computation of your banks core liquid assets, it has been decided that the same be released to you with immediate effect.'
[Bank 12/D/14] 'Therefore, in an effort to save Bank 12 from collapsing the committee was asked to consider and if deemed fit to: (ratify the overdraft of K4.3 billion with a waiver of penalty interest of K1.102 billion for non-compliance with the core liquid ratio.'
(Bank 18/D/21) 'I would recommend notwithstanding the contradiction, to delay the publication of the accounts for one month'

<u>Closure/Receivership</u>

(Bank 4/D/45) 'The bank is insolvent and cannot continue to operate under its current structure, without endangering depositors and creditors.'
(Bank 4/D/61) ' You will be aware that from time to time we have been faced with a number of institutions which are clearly insolvent meaning that the shareholders have lost all their investment and should therefore have no further claim at all.'
(Bank 4/D/69) ' Approve the suspension of the operations of Bank 4 and place it under receivership pursuant to section 94 of the Banking and Financial Services Act No. 21 of 1994.'
(Bank 4/D/86) 'Bank 4 is technically insolent under S.86 of the BFSA 1994. In addition to the liquidity problems that continue to exist, there is a large deficit on the capital and reserves account of K14 billion.'
[Bank 4/D/89-91] ' THAT Bank 4 limited be seized and put into receivership with immediate effect pursuant to Section 94.'
[Bank 7/D/25] ' It is disheartening to start compromising or negotiating with individual shareholders when we know very well that it is the same people that have run down the institutions.'
[Bank 7/D/81] '...The Governor has authorised the closure of Bank 7 Zambia Limited.'
[Bank 7/D/83] ' Receiver of Bank 7 limited has today, Thursday, 4th December 1997 taken possession of the said bank with immediate effect.'
(Bank 5/D/52) ' But at some stage, we have to conclude that the situation is hopeless, and that we can do no more. We are perilously close to that decision.'
[Bank 5/D/119] ' In the opinion of the BoZ, Bank 5 Zambia limited is now almost certainly insolvent.'
[Bank 5/D/120] ' The Governor of the BoZ, Dr Mumbwa today announced the closure of Bank 5 with effect from 17:00 hours on 19th May 1995.'
[Bank 9/D/16] ' Bank 9 was seized and placed in receivership on 2 February 1998 following initially, a failure by the bank to meet depositors' demands to withdraw money.'
(Bank 12/D/22) ' The Bank is clearly in the deep end and is relying on BoZ for it's continued operation.'
(Bank 15/D/7) ' You will be aware that from time to time we have been faced with a number of institutions which are clearly insolvent meaning that the shareholders have lost all their investment and should therefore have no further claim at all.'
(Bank 15/D/8) ' Place the bank under receivership as provided for under section 81 of the BFSA should the bank's plans to inject new capital fail to materialise by 31 January, 1997
[Bank 14/D/44] ' Bank 14 was put under receivership on 29 November 1995 in accordance with of the Banking and Financial Services Act No. 21 of 1994.'
(Bank 12/D/21) ' Suspend the operations of Bank 12 and place it under receivership pursuant to section 94 of the Banking and Financial services Act No. 21 of 1994.'
(Bank 18/D/22) ' One way of minimising the effects of a run on the bank is to limit withdrawals per week per individual account until a solution to the liquidity is found. This is a better option to a complete closure which has more serious implications.'
[Bank 18/D/61] ' Please do not pay any cheque drawn on Bank 18 account because there are no funds. Today's clearing should be reversed immediately'

<u>Management removal</u>

(Bank 2/D/8) '... there is need for recruitment of competent management.'
[Bank 4/D/34] '....I therefore appeal to you to reconsider your decision in terminating Mr Ndola's services.'
[Bank 4/D/88] ' The entire Board of Directors and the acting Managing Director of Bank 4 were removed on September 15 1997 for failing to comply with the BFSA.'

[Bank 5/D/101] 'As you are aware the BoZ in consultation with the Government has taken the decision to reconstitute the Board and Management of Bank 5.'
[Bank 5/D/102] 'I am very pleased to inform you that you have been appointed as Joint Managing Director of the Bank 5 Zambia Limited in the interim period with immediate effect...'
[Bank 5/D/103] 'I am very pleased to inform you that you have been appointed as an interim Chairman of the Bank 5 Zambia Limited with immediate effect...'
[Bank 5/D/96] 'Most managers have no qualifications. This is a very serious lapse. Promotions have not been on merit.'
[Bank 5/D/98] 'It would be preferable if Bank 5's present shareholders would agree to change the members of the Board as well as the present senior management.'
[Bank 5/D/117] 'I have been informed that during the last board meeting Mr Anzsar was in attendance as an alternate for Mr Kabwe. Also in attendance, was Mr Kapotwe...how can the bank allow the two access to the bank to attend board meetings?'
[Bank 9/D/15] 'problems associated with the negative reports that arose from the due diligence on Mr Rajamani, the chief financial officer, conducted by the BoZ.'
(Bank 14/D/31) 'Mr Serenje should immediately resign as Chairman of the bank on moral grounds. Mr Khan should similarly be removed from the management of the bank. As explained earlier he is responsible for unsafe and unsound practices in the bank.'
(Bank 14/D/35) 'Change of management: There may well be cases where the problems of a bank are not yet serious and these are primarily the creation of management.'
(Bank 14/D/41) 'In accordance with Section 3 (a), (b), and (d) I therefore have to ask your Board of Directors to remove Mr Serenje from the Board of Your Bank with immediate effect.'
(Bank 14/D/43) 'I have spoken with Mr Serenje in regard to his position in the bank. He is agreeable to resign as Chairman and Director of the Bank. However, he wishes to combine the subject of his resignation with his liabilities with our bank,
[Bank 18/D/11] 'We should seriously consider removing the Managing Director and his deputy for disregarding Guideline No.1 when the troublesome advances were made. Section 37 (1) of the Act should apply.
[Bank 18/D/39] 'Mr Serenje has been advised about your decision to freeze his shares, with particular reference to those shares now held by a company called'

Curator

[Bank 4/D/21] 'authorise BoZ to appoint a curator to oversee the operations of Bank 4 Limited should need arise.'
[Bank 4/D/29] 'Despite the passing of a multitude of reversing entries and internal transfers, most of the larger transactions having visited several different suspense accounts before finding a resting place, the position has not been corrected.'
[Bank 4/D/32] 'I refer to my letter dated 27 February 1996 wherein I instructed that no further payments in respect of salary, fees or bonuses and no non cash benefits should be paid to or on behalf of the Chairman without the prior approval of the BoZ.
[Bank 4/D/43] 'Mr ... presence in Bank 4 is intended to be for a short period only while we look for someone to take over from him.'
[Bank 7/D/67] 'THAT a curator be appointed to act on behalf of the BoZ in accordance with the provisions of the Act.'
[Bank 12/D/14] 'the bank be and is hereby authorised to appoint a curator to oversee the operations of Bank 12 should the need arise.'
(Bank 12/D/18) 'My purpose of writing to you is to find out whether legally under the Act, BoZ can completely take over an institution and pay off the existing shareholders a token price of say K1.'
(Bank 12/D/21) 'Authorise the BoZ to appoint a receiver as provided for under the Banking and Financial services Act No. 21 of 1994.'
(Bank 12/D/22) 'The Bank is clearly in the deep end and is relying on BoZ for it's continued operation.'

Resident Inspector

[Bank 7/D22] 'An inspector has been placed in the bank to oversee the bank operations.'
[Bank 7/D/51] 'In order for us to closely monitor the situation in the bank at this critical time, I have with immediate effect authorised SI Wilson Kalumba to be stationed at Bank 7 until further notice...'

(Bank 5/D/51) 'I would propose that we send in one or two people into the bank to do an analysis of trends in deposits, outstanding letters of credit and loans over the last month or two.
[Bank 5/D/56] 'The data should show on a daily basis (Since the beginning of Mid January) (1) clearing position (2) interbank borrowing (2) deposits outstanding (3) holdings of treasury bills.'
[Bank 12/D/32] 'An inspector has been placed in the bank to oversee the bank operations.'

Members of Parliament

[PD/150395/45] '...But what I do not agree with and disappointed with it the BoZ's supervisory role in monitoring the financial system... '
[PD/150395/45] ' Out of everything, which was passed in this Act, nothing has been implemented. No Quarterly reports are put in the Government Gazette. In that context, I support the Government for the steps it took in trying to get the BoZ better organized and streamlined because it has failed in its supervisory capacity. '
[PD/220395/24] ' The Board is not only unprofessional, but it still consists of Former UNIP elements and no wonder, therefore, that we have such failures as the Meridien Bank because we have not strengthened the supervision element of the bank.'
[PD/050397/158] '...So, I would like to urge the hon. Minister to closely monitor the Bank of Zambia Supervision of commercial banks.'
[PD/220295/31] '...What are you going to do with the Bank of Zambia?'
]PD/150395/45] '...In that Context, please, I urge the Government that it has to supervise the Bank of Zambia like it supervises commercial banks.'
[PD/150395/46] '...The supervisory capacity at the Bank of Zambia needs to be reviewed and enhanced as a matter of urgency to enable the bank identify, in good time, problems in the financial market and take corrective measures.'
[PD/150395/45] 'This question we have to ask ourselves. Is it autonomous or not? Is it under the remote control of the Government and how much does the Government interfere?
[PD/150395/55] 'If he says we should not do a particular thing, the government should listen. The solution is not to remove and replace him with someone else. That is not the solution, He is the advisor.'
[PD/170295/17] '...How much money has the Government, through the Bank of Zambia, given to Meridien BIAO Bank Zambia Limited for it to survive?'
[PD/150395/38] 'The hon. Minister was not able to tell us how much has been put into Meridien BIAO Bank Zambia Limited. We are very concerned because this is taxpayer's money...'
PD/150395/49a] '...example, Mr. Speaker, do we know how Meridien BIAO Bank is going to pay back the loan? What are the repayment arrangements? ... That is not enough. How long will it take Meridien to pay back ...? We have not been told that.'
[PD/150395/49b] '... hon. Minister refused to ell us how much money had been loaned to the bank. Is it not our right to know that? Do the people of Zambia not have a right to know? Why do they not want to tell us what is involved?'
[PD/150395/53] '...The hon. M/Finance is not giving us facts because there are hidden. Why can we not conclude on behalf of the people that some Ministers are involved in such transactions and that is why they are hiding information?'
[PD/150395/62] '...But now, we have an opaque system coming from the Government. We do not even know how much is involved. It is only today that we are told that about K50 billion is involved. That is a lot of money.'
[PD/220395/26] ' We have a standing policy that we should not bail out institutions that cannot stand on their own. But what have we seen so far? We have bailed out Zambian National Broadcasting Corporation but we have allowed Zambia Airways Corporation to go. We have bailed out Meridien Bank, which is a private institution when we have allowed Bank 1 to go.'
[PD/061295/115] ' May I know from the hon. M/Finance why Andrew Sardanis, the man who has taken Government money put in his Bank to save him, but remitted it outside Zambia, is still a free man in this country. .... May I know who he is and why he is being protected.'

Minister of Finance

[PD/220295/28a] '...the issues surrounding Meridien Bank did not begin today. They began over fifteen months ago. That time I wrote to the Central bank and told them that I had information that seemed to suggest that we might have a problem on out hands. The Central Bank wrote back to me, assuring me that there was no problem. Last year, I, again, sent my special advisor to do some work for me in the

bank. He came back with what we thought were indicators. Again, the Central bank assured me that things were all right. Three months ago, we went back to the central bank and I said, 'Friends, we seem to have a problem' and no proactive work was coming through. In the last three weeks, the matter has become heavy and hot and that time the forecast changed and when it changed, it was like a time bomb. I was faced with a serious crisis and the answer was either the economy dies and Meridien Bank dies with us.'
[PD/220295/28b]People are likening the intervention in assisting the financial system to a company like UBZ and Zambia Airways Corporation Limited. The difference if very simple.
[PD/150395/46] '...the reaction of my Government to the Meridien BIAO Bank situation in the last month or so was in good faith and deterred panic that would have been thrown into the financial market or our country which has consequently going to destroy the financial base that this country has been struggling to establish for the last thirty years.

<u>BoZ Governors</u>

[CI/GOV/4] ' The political pressures that you are subjected to are insurmountable. The sheer frustration of the job is staggering. '
[CI/GOV/18a] ' BoZ independence is a fallacy that only exists in the heads of a few academics.'
[CI/GOV/18b] '...they will not succeed. The Government will not legislate an act that reduces its influence over the Bank of Zambia. It is too important an institution.
[CI/GOV/18c] '...In any case, even if the law was changed it would simply be ignored. This is not a country were laws are obeyed. Every single day we breach the constitution with impunity.'
[CI/GOV/48] 'I insist that it is all an issue of personality. Regardless of the amount of legislation guaranteeing independence'
[CI/GOV/37a] '...That will depend on the incumbent M/Finance and the Bank of Zambia Governor. Their personal relationship has as an important role to play as their legally defined relationship...'
[CI/GOV/37b] 'If the Bank of Zambia is successful in removing the clause, it will be a welcome change,
[CI/GOV/42] 'Individual style. It all boils down to individual style and experience.'
[CI/GOV/44] 'I tried to run the Bank as independently as I could. Mind you, that was not easy. Those were the days when Francis Kaunda thought he owned this country; he had the entire Ministry of Finance dancing to his tune and naturally thought that his influence could extend to the Bank of Zambia...'
[CI/GOV/23a] '...The department was undergoing a lot of changes during that period. When I arrived at the Bank of Zambia, I found a grossly understaffed and ill-equipped department.
[CI/GOV/23b] In fairness to their efforts, it was the political process of regulation, rather than then the professional process that was a problem for the banking sector in 1995.'
[CI/GOV/104] 'Secondly, the supervisory process at the time was bad. Although training had started, it had not yet matured. Just when ... the staff were reaching a point where they might be in a position to adequately supervise the sector, the crisis emerged.'
[CI/GOV/48] ' Interestingly enough, there were very few qualified bank supervisors worldwide. I remember calling on the BoE for assistance and they said they did not have anyone to spare.'
[CI/GOV/20] 'It all boils down to the failure of the Governor to take action when required to do so because of political pressures'
[CI/GOV/27] '...However, when we made the appropriate recommendations to the Minster of Finance, our decision was rejected. We made a very strong case for the banks closure, ... The Minister rejected that advice.'
[CI/GOV/115] 'I was not privy to the discussions held between Penza and Mulaisho but I am aware that it was common knowledge that Meridien International was in serious problems.'
[CI/GOV/33] '...The M/Finance was kept informed at all time of the events taking place at Meridien. It is not true that we kept him in the dark. But then he was a politician, what do you expect?'
[CI/GOV/87] 'When you recruit professional people to responsible positions, then you must allow them the freedom to exercise their expertise. I prefer to allow people the freedom to take charge of the functions that they are entrusted.'
[CI/GOV/79] 'They [meetings]are part of the supervisory process. You must give the sponsors of the bank an opportunity to present their options for rescuing the bank. We look at these plans and agree on a timetable for their implementation.'
[CI/GOV/85] 'Well, it boils down to the level of efficiency in the Department. It is important that all options are fully explored in dealing with failing institutions.'

[CI/GOV/72] '...as Governor; one must ensure that in all decision that you make, you take into account the broader consequences on the economy and the stakeholders. Politicians should not be taken by surprise.
[CI/BoZAD/6] How well we responded to the banking problems depends on the level of response that you are dealing with. There is the very high level involving the Governor, and the M/Finance, and possibly the President.

Financial System Supervision Directors

[CI/FFSSD/23] '...I have served under three Ministers of Finance, three Boards of Directors and two Governors. I have learnt that the pressures and concerns are dependent on the nature of the relationship that I have had with theses three groups.'
[CI/FSSD/15] 'Operational independence is extremely important in the supervisory process. Without that independence, it is next to impossible to maintain direct contact and influence with the commercial banking system.'
[CI/FFSSD/21] '... If you go to the Ministry of Finance for example, you will find that there are many educated people. Examine the papers that they have written and you will be amazed at the level of quality – excellent! Unfortunately, the level of interference is so high that all those professionals are simply frustrated.'
[CI/FFSSD/5a] '...there is the problem of political connections. These connections can be so strong that the supervisor is rendered completely and hopelessly impotent.'
[CI/FFSSD/5b] 'The only way was to suspend the availability of the overdraft facility. That effectively was the only way in which we could close the bank. But then, effecting such action alone was itself an administrative and bureaucratic nightmare.'
CI/FFSSD/25] ' I can tell you Sam that nobody in the Bank of Zambia, nobody Sam, understood the figures coming out of the bank. Bank of Zambia continued to lend in the absence of management accounts. A lot of mistakes was due to the lack of understanding. People would use a balance sheet that was six months old to make lending decisions. '
[CI/FFSSD/35] 'I remember that when I joined the division in 1995 I asked for the latest information in all the banks. I was given a balance sheet for one bank, which was three months old, another, which was six months old, and another which was twelve months old! It was not possible at the time to have a consolidated view of the entire financial system.'
[CI/FFSSD/7a] 'We understood the problems very well. We could see what was happening. We did have, nevertheless, our own supervisory shortcomings. The biggest problem we had was that we lacked the teeth to do any thing.'
[CI/FFSSD/7b] 'We understood the problems very well. We could see what was happening. We did have, nevertheless, our own supervisory shortcomings. The biggest problem we had was that we lacked the teeth to do any thing. We did not have the power to do anything.
[CI/FSSD/29] ' It is only rarely that we take very controversial decisions. In the case of Mukushi and Mr Phiri, we decided to remove them from office without first notifying the Minister. '

Financial System Supervision Assistant Directors

[CI/BoZAD/86] ' It is not our duty at our level to fight the politics – that is the for the Director and the Governor to do. '
[CI/BoZAD/58] ' This is especially difficult in an environment where the owners and directors of commercial banks are better connected to politicians than ourselves. They interact with each other more closely than we do with them for a variety of reasons.'
[CI/BoZAD/42a] 'The second form of political influence is subtler. That is we deliberately do not act because we know that nothing will be done given certain extenuating circumstances. If anything is done, you end up losing you job.'
[CI/BoZAD/42b] 'That is the reality of regulating banks in a highly politicised banking system in a developing country where politicians are both judge and jury.'
[CI/BoZAD/26] 'Although we often claim that we understood the problem, the depth of the Meridien Crisis caught us by surprise in the sense that Bank of Zambia had been deceived by the flamboyant activities of the bank ...to event think, that that the bank would collapse was sacrilege. '
[CI/BoZAD/70] 'In 1995, we did not have the manpower or the technical capacity to be on top of thins at Meridien. Although we heard rumours of problems at the bank, we lacked the hard evidence to do something concrete about the problems'

[CI/BoZAD/70] 'In the second set of banking crisis – Prudence, CAB, Manifold and so on, our understanding of the problem was far much better. We knew exactly what was going on. We knew who was breaching which regulations, which bank was insolvent and which one was not.'
[CI/BoZAD/4] 'We understood the problems very well. As a department we have very capable individuals. Although there is still room for further capacity building, we had the capacity to conduct basic assessments of the bank's financial condition. We knew which banks were financially distressed and which were not.'
[CI/BoZAD/14] 'Its hard to say, because you have to examine each individual bank to determine that. However, there are two general points I want to point out. Firstly, in the case of Meridien Bank, we were working with financial data that was at least six months old; at the very best of times three months old.
[CI/BoZAD/6] 'When a problem was detected in a bank, we entered into correspondence with the bank. Thereafter we held several meeting with the bank to discuss the problem. It is only after all avenues were explored that sanctions and other actions were applied to the bank. Usually that was the time that the press got excited and criticised the Bank of Zambia for being inactive.'
[CI/BoZAD/56] 'We cannot move into an institution the day that we hear something is going wrong. We cannot manage every financial institution in the country. Even if we wanted to, we do not have the capacity to do so.'
[CI/BoZAD/78] 'Such action required the approval of the Governor and the M/Finance. Getting that consent was not easy because of concerns that doing so would precipitate a run on the bank.'
[CI/BoZAD/16] 'I think the BoZ did explore all the possible options'
[CI/BoZAD/28] 'As usual, the response was slow, filled with a lot of correspondence, meetings and other non affirmative action.'
[CI/BoZAD/38] 'The point is not whether we explored all the options or not, but rather, which options were we really in a position to implement. Perhaps, our weakness, was that we explored the options too late in the banks life cycle...We may have explored a number of options for the banks that failed, but the effort was too late and ...too little to make a difference.'
[CI/BOZAD/12] 'Not very confident. In most cases, management presented very unrealistic proposals. Especially where business assumptions and targets were concerned'
[CI/BOZAD/32] 'Bad, plain and simple! There was a lot of mistrust on both parties... Even if the Bank of Zambia had decided to recapitalise all the banks in the banking system, then would still have crumbled under the weight of bad management.'
[CI/BOZAD/76a] 'It varied from one stage to the next. In the initial stages, it was cordial and mature. However, as the level of financial deterioration continued, the relationship became more desperate and in the end it was almost always acrimonious.'
[CI/BOZAD/76b]. 'The Bank owners and managers wanted to take on more risk, we wanted them to be more prudent in their approach; two very different views on how to save a failing bank.'
[CI/BOZAD/78] 'I was not very confident. You only had to look at the financial condition of the major shareholders group companies to realise that some of the shareholders had no intention of saving the bank in the first place. They simply could not, even if they wanted to. Sadly, we continued to give them more and more time.'
[CI/BOZAD/62] 'we have come across some shareholders and directors of doubtful repute. Once the realisation that the Directors were acting fraudulently, we were quick to dismiss the management and appoint our own team'
[CI/BOZAD/30a] 'Often times, instructions were disregarded or implemented half-heartedly. Once the bank owners and mangers realised that they could defy one regulatory order, it became easier for them to defy the next and so on.'
[CI/BOZAD/30b] 'It became a meaningless exercise of exchanging correspondence for not apparent purpose other than that of going through the motions.'
[CI/BOZAD/10a] 'Management's attitude towards our recommendations determined the nature of our relationship with them. Some times, management was in denial of the problems they faced. In such cases, they came back with one story after another, until they ran out of stories to tell.
[CI/BOZAD/10b] In other cases, perhaps more dangerously, the management appeared to cooperate with our directives and recommendations, but in effect were doing the exact opposite when they returned to their bank.
[CI/BOZAD/14] 'there was a measured reluctance to implement strong regulatory action because the political will to close them was not there. Remember that 1996 was an election year. We knew it, and worse still, the bank owners knew it too – and took advantage of the situation.

[CI/BOZAD/40] 'Once the Bank of Zambia had decided to extend overdraft facilities to the Bank, it was too late to expect anything concrete from the bank. Once that point had been reached, it was time for the banks to prepare their retirement packages.
[CI/BOZAD/38] 'It is pointless to explore the possibility of a bank merger when the bank has so little value left in it. How can you sell a bank with negative value.'
[CI/BOZAD/36] 'A waste of time. What is the purpose of telling a bank to stop lending when it has nothing to lend.

Financial System Supervision Bank Inspectors

[WIC/RPSI/35] '... you fail to tie performance and reward, a simple basic requirement for any institution'
[WIC/FAI/37] '...Information, they say, is delayed significantly, and it only reaches them when the situation is so bad that the natural reaction for them, is why do you want to move it right away, it becomes so radical.'
[WIC/NBFI/12] '...an inspector writes to the Assistant Director stating, 'these people are sucking out money from an insolvent bank,' you write, and then the Assistant Director removes it saying, 'this is too strong'
[WIC/NBFI/14a] '...Now we have an opportunity to even tell that Board that we should stop this man. You put it in writing, but then someone tells you that the Governor has already approved, take out your recommendation, you know...'
[WIC/RPSI/34] '...I believe in putting things on paper at all levels. And whether people take action or not, is a different issue. Because it also creates a data base; a historical sequence of events.'
[WIC/RPI/13] '...and the politicians are not even involved.'
[WIC/NBFI/14b] '...we have suggested a lot of thing in some of these new banks but some, it not a lot, of thing do not go to the Board of the Bank of Zambia, even to the Governor, or to the management meeting, because our bosses say (1) this language is too strong; (2) Governor has already approved – but there is no letter to say that he has approved. I think, within Bank of Zambia, there is a serious problem.'
[WIC/RPI/35] '...if I came to the departmental level, we also have a horrible weakness, which also weakens our recommendations in that every paper we write is a historical paper, we have failed to do sensitivity analysis.'
[WIC/FAI/43] 'Talking about the nature of the reports that come from the supervision department, indeed, we need to move away from being historians, to inventors of the future. Our reports, really, should reflect more of what is likely to happen in the future.'
[WIC/RPI/21] '...We are not very sure because nothing is documented'
[WIC/RPSI/95] '...We need to devise rules and regulations that will encourage information flows. ... We need to do that urgently. The reason we have failed to implement that effectively is that we like to hide facts from the public.'
[WIC/FAI/40] '...he very things that they had rejected, things if they had been implemented last year, by now things might have improved.'
[WIC/RPSI/97] '...It is not uncommon for directors to search for clauses in the law that will protect them from not doing their job.'
[WIC/FAI/98] '...my supervisor came and told me, 'look, you have find some clause in the law which will allow this bank not to publish its quarterly financial statements.' Now this is my supervisor, who of all people should be in the forefront encouraging me to ensure that I implement the law at all times.'
[WIC/RPSI/26] '...Bank of Zambia is the only place where, what you get is not tied to what you do, there are no consequences for your action'
[WIC/RPSI/35]'... you fail to tie performance and reward, a simple basic requirement for any institution'
[WIC/FAI/10] 'Bank of Zambia has messed up in so many ways but no adverse action has been instituted on the people who have been given the responsibility of running the Bank of Zambia.'
[WIC/FAI/59] '...The problem gets back again to who is overseeing us. And if they are there overseeing us, then what are they doing about what we are doing? If they don't ask questions, if they do not push us around, there will surely be no change.'
[WIC/RPI/25a] '...So those are the issues that we have, whom do we serve? Who is our master?'
[WIC/FAI/24] '...if it does not bother the government, when public funds are getting lost like this, really, who shall it bother?'
[WIC/RPI/25b] 'Maybe it does not bother the public because it is the public which puts in place the government'

[WIC/RPI/16][WIC/RPI/19][WIC/RPI/22] '...with an internal audit inspection, some of these issues will reach the Governors office as reports from the internal audit department as to what issues have arisen and which issues are being tramped on.'
[WIC/FAI/17][WIC/FAI/18] '...Internal audit is ruled out because, who do internal auditors report to? The same person we are saying might have a problem in making decisions.'
[WIC/RPSI/32] '...No one wants to take responsibility because taking responsibility means making mistakes.
[WIC/RPSI/48] '...Simply because no one wants to take responsibility for making decisions in the financial sector. I can not under stand why people are so scared. Especially when they are so well protected by the law. ...'
[WIC/RPSI/50] In fact, even the firing process in the Bank of Zambia is so long, there is literally no way, in which you can be fired.'
[WIC/RPSI/92] '...well, my father was a member of the board [of the Bank of Zambia] and he said, 'Basically, we really did not make decisions, because they were already made!' [93] Because the Chairman of the Board is the CEO!'
[WIC/RPFAI/53] '...It is better to be forthright, let us tell the world that we do not make the decision at the Bank of Zambia, If you want to identify the real decision makers, then go to Ministry of Finance, Go to the politicians. Let them take responsibility for the mess that they create in the financial sector. Right now, they are not in the picture. Let us make them responsible for the mess that they create.'
[WIC/RPSI/29] 'Because I will tell you, I have been looking at both Acts, and in my opinion, the BFSA, in its current form, for this kind of market, and the nonsense that goes on, is very strong. It is more than adequate.'
[WIC/RPSI/32] '...we are importing the legislative advancements that are obtaining in these other regions back home, which we can't even enforce.'
[WIC/FAI/59] 'The problem we have is that of enforcement, because the law is there you know what you are supposed to do, but you can't. Even removing someone who is part of you when he does wrong in a certain bank; you can't'
WIC/RPSI/99] '...what I find also disconcerting is the level of knowledge of the actual laws that we are supposed to be enforcing. Too many people in the department do not know what is contained in the Banking and Financial Services Act.'
[WIC/FAI/24] However, over time, you do a good job, you are frustrated, you do a good job you are frustrated. After a while you say to your self, 'what is there for me to suffer for?' I can avoid all these problems and still earn my salary at the end of the month.'
[WIC/RPSI/75] '...the maximum time I now spend on Bank of Zambia work is three and a half hours. [77] 'the truth is that I found that it was of no use. People even started making fun of me; 'hard working, hard working!' You become a laughing stock. Ya! You come in at 08:30, read your newspapers, have your coffee, leave at 10:00hrs and come back at 12:00; see what has been dropped on your desk; go to lunch, come back at 14:30; go down to north gate then go home. Even supervisors come round the see you are not at your desk, they say, 'ok', go away, and at 16:20 he says see you tomorrow. Meanwhile, it's been two weeks since he gave you a job to do.

Former Bank Owners/Directors

[CI/FBD/2] '...The big banks connived with the IMF and the Bank of Zambia was used to implement their devious plans...'
[CI/FBD/12] '...As I said they were pawns in the process.'
[CI/FBD/4] '...They did not know what was going on. They too were pawns in the whole process. I mean, what do you expect when the Governor is on the IMF payroll? Bank of Zambia wanted to look goody goody to the IMF and so they implemented these measures without regard to the local banks and our specific situation.'
[CI/FBD/88] '...the bank has no independence from central government what so ever. It never has and probably never will. Even the present situation is not so favourable. Jacob is not the sort of man to assert himself. In a way, he knows how to achieve things in his own way. When he is directed to do certain things, he simply does nothing. But hey, he is an old man, nearing the end of his career, why rock the boat?'
[CI/FBD/21] '...Remember that all these things were taking place within and election year. Fortunately, the Government came to our assistance. We did a lot of running around, meeting that politician there and this politician here. That is how we survived between from February 1995.'
[CI/FBD/2] '...The Big boys were uncomfortable and used the Bank of Zambia and the Governor.'

[CI/FBD/106a] The other problem with Bank of Zambia was that the quality of its inspectors was very poor. Barclays Bank inspectors were more concerned with the Inspectors from London than from Bank of Zambia.'
[CI/FBD/106b] 'They must not be allowed to borrow from banks and become indebted to the extent that some of them were. Preferably they must have some banking experience. How could they honestly inspect institutions that they did not understand?'
[CI/FBD/158] 'Bank of Zambia still treats bankers as 'gentlemen', which bankers are supposed to be. The reality is, however, that the banking system had been infiltrated by very sophisticated financial criminals. Unless Bank of Zambia adopts a criminal mind and approach in investigating bankers and their activities, it will fail to come up with something concrete.'
[CI/FBD/74] '...The government of this country destroyed the bank. The pressures on the bank were real, but the manner in which the Bank of Zambia and the Government handled the problem was a total disaster.'
[CI/FBD/76] '...the environment under which things were taking place was not very conducive. Firstly, the Bank of Zambia was leaking like a sieve with information about the bank.
[CI/FBD/24] '...If anything the reality was Bank of Zambia was feeding the authorities with a lot of falsehoods.'
[CI/FBD/4] 'However, as soon as we started to pick up, as soon as we started to improve, Bank of Zambia moved in and closed the institutions. How do you close an institution after you have pumped in K12 billion Kwacha? Let me as you Mr Maimbo, what logic is there in such action? Tell me, eh?'
[CI/FBD/108] 'In a general sense the measures came too late and did not, in my opinion deal with the root cause of the problems. When we asked our Managing Director why he had not implemented some of the measures that Bank of Zambia directed, he simply said that he did not have the authority of the Board of Directors. I was shocked that Bank of Zambia had accepted such an explanation. The Bank of Zambia had more powers than the both the Managing Director and the Board of Director.'
[CI/FBD/10] 'It was not a bottomless pit. An additional K2 to K3 billion Kwacha would have resolved the problems of the bank.'
[CI/FBD/14] '...They did not do anything. They could have easily merged all five banks if they had wanted to, but they didn't, in fact, they couldn't have under the present arrangements. I mean how much was involved in saving all the banks. Only about $4 million. It was peanuts. It could have been done if the will to do so was there.'
[CI/FBD/74] I put it across to the gentlemen that the bank was indeed facing serious liquidity problems for a number of reasons. However, with liquidity support of approximately US$ 5 million I could turn around the bank could be turned around. I even told them that I would personally take over the running of the bank as General Manager. I even wrote to the President to explain my proposal but the reply was not very positive. If you promise not to write about it, I'll show it to you.

Social and cultural norms and practices

[PD/061295/87] '...Zambia's experience clearly shows that economic reform is never easy; overcoming bad business habits, counter productive attitudes and institutional weaknesses take a long time and large amounts of effort. Reversals and set backs often occur. The financial disruption this year is an example, our challenge, however, is to overcome the difficulties and press ahead.'
[WIC/FAI/59] '...It is a cultural problem; it is a pervasive problem that transcends from the highest office in the land to the man on the street'
[WIC/RPI/45] '...It's a culture problem'
[WIC/RPSI/52] '...I think also, we do not look into the cultural aspects of the country we live in. I am thinking a lot, about how Governor does not seem to know what is going on in the Bank. So I remember whether it is a question of whether; I remember when I was at government school, when the teacher told you something you were told not to question him or her, you were taught not to question your parents, it was drilled into you not to question anyone who was older than you. So if you have a different opinion, you were brought up not to state that opinion even when the person you are talking to is blatantly and obviously wrong! So I wonder if we are not taking that mind set into the work environment.'
[WIC/RPSI/78] '...It is a deliberate culture because no one wants to be accountable, no one wants to take responsibility for anything in the bank'
[CI/GOV/119] 'Essentially the core of the law is adequate. I think that the real issue is creating an environment in which the central bank is able to get on with the business of regulation and supervision. The level of politicisation in the regulatory process needs to be reduced significantly. Only then will the department succeed in acting professionally.'

Government bails out Meridien

By MOSES MBEWE and MUTALE MWAMBA

GOVERNMENT will assist Meridian BIAO Bank from its financial problems by providing it with financial assistance, and restore calm at the institution where several clients have closed their accounts amid speculations of the bank folding up [illegible]

Finance Minister Ronald Penza said in Parliament yesterday the liquidity situation at Meridien BIAO was posing a serious concern for the state of liquidity of the economy as a whole.

He said the Bank of Zambia as the lender of last resort will help the Meridien BIAO with whatever liquidity needed to its financial system to enable it meet its immediate obligation.

But some backbenchers contended that Government's action to bail out the bank from its financial malaise did [illegible] reports that it was headed for closure.

"The government of Zambia has been carefully monitoring recent developments in the liquidity situation at Meridien BIAO," the minister told Parliament.

He however said that any other bank which might require similar assistance will receive full support of the government and the Bank of Zambia in meeting its liquidity problems. The Minister assured the bank's customers that their deposits were safe.

He explained that the move has been prompted to protect national interests and contain a possible collapse of the bank and stabilise its position.

Mr Penza lamented that Zambians have for the last three years worked very hard to reform the economy and it would be unfortunate to lose the battle just now.

He said the action should not be seen as a programme to rescue the bank as government was merely trying to save it from collapsing.

Scores of depositors with the bank in Lusaka and Ndola closed their accounts when word went round that it was facing liquidity difficulties because it had not retained the required K400 million reserve with the central Bank.

But the bank's chairman, Mr John Kapotwe denied that it was closing and appealed for calm from clients.

Mr Penza told Parliament that Government will not allow potential disruptions in the Financial sector that could destroy what had been accomplished.

"We have ome too far to allow our achievements to be put at risk," he said, adding that this kind of provision to the banking system would minimise risks.

The Bank Of Zambia explained yesterday that the depreciating exchange rate was partly due to the requirements to import maize and mealie-meal arising from shortages in the country and increased economic activity following the decline in interest rates and increased liquidity.

In a statement, the central bank explained that the decline in the interest rates and the increased economic activity had also led to increased imports.

' It would be disastrous for all indigenous Zambian banks if it were to collapse'

ASIANS DENY CREATING MERIDIEN RUMOUR

McNie - the move by government was a very positive and welcome

SOME representatives of the Asian banking community have denied allegations that they contributed to the rumours that caused the Meridien crisis.

"We would stand to lose if anything happened to them. It would be disastrous for all indigenous banks if Meridien were to collapse. Our deposits have not improved from the time the Meridien trouble started. The only ones who could benefit are the international banks," said Benny Muntanga, general manager of Credit Africa Bank.

By Chilombo Mwondela

"We are happy that Meridien is being helped out. The country cannot afford to have a bank of its size closing down, said Noel Nkhoma, marketing and public relations director at Finance Bank.

The Bankers' Association chairman and also managing director of Barclays Bank, Michael McNie, said government's decision to have the central bank bail out Meridien was a positive move which was welcomed by Zambia's banking community.

'It would have seriously affected the economy of this country otherwise'

"Minister Penza's statement was very welcome and we have all been reassured by it. It would have seriously affected the economy of this country otherwise," said McNie.

Last Friday, finance minister Ronald Penza declared that with immediate effect, the Meridien BIAO Bank and any other bank which requires similar assistance will receive the full support of the government and Bank of Zambia in meeting its liquidity demands.

Banking sources revealed that Meridien had been running overdrafts of about four to five billion kwacha daily over the last two weeks. And on February 12, Bank of Zambia governor, Dominic Mulaisho, issued a ten-day ultimatum to the bank to put its affairs in order otherwise run the risk of liquidation.

It was revealed that the bank had invested heavily in west Africa and the continual devaluation of the CFA Franc had weakened the bank's financial position.

Meridien spokesman Larry Kalala refused to explain the bank's position and only gave the minister's statement concerning government's decision.

The government last week is believed to have mobilised a major proportion of the rescue package from the state-owned Zambia National Commercial Bank

•Meridien Rescue Cost K4.9bn

After the problems were reported in the Press, Meridien Bank management maintained a conspicuous silence on its operational problems even after Government demanded that it be furnished with full details.

Addressing an Economic Association of Zambia (EAZ) meeting on the bail out of Meridien Bank, Mr Penza said it would have been imprudent to let the bank collapse without carrying out an impact analysis survey on the economy.

He said any action taken to shut down the bank would have upset the confidence Government had managed to instil in the private sector development over the last three years.

He, however, said there was no need for the Government to have been the one to take up the decision to instil confidence in the financial market when the central bank.

under the new Banking and Financial Services Act, had the power to effect the bail out.

Mr Penza said the central bank had made up its mind that the only direction for Meridien was to close down and quick action had to be taken by Government to transfer funds from Bank of Zambia

He said during the period the interbank market had collapse and the three major commercial banks sat back and decided not to render support to Meridien.

He hailed the spirit the Zambian indigenous banks showed during the crisis saying, it was important that Zambians supported their own initiatives. Zambia's economic development could suffer without the support of the private sector, adding that if Meridien had been allowed to collapse there was going to be a catastrophe in the financial market

And former Zambian representative at the economic commission for Africa Dr Emmanuel Chileshe supported the Government intervention saying, Meridien Bank was the only truly indigenous bank that had features like moving its headquarters to Lusaka.

Dr Chileshe however noted that Meridien had developed beyond its capacity and should have calculated the risks of spreading its operations in a short time.

Another discussant Mr Sangayakula Sanga called for the provision of a financial sector policy as a way of reversing the ambiguity in the financial market

He criticised the central bank's continued silence and arrogant stance taken by Meridien during the crisis instead of coming out in the open to clear the air.

Mr Sanga questioned why Government only decided to remove the governor instead of the entire board of directors of the central bank. "At the end of the day the failure of the central bank in performing its role did not lie in the governor alone but in the entire board," he said.

It was important that the board of directors of the central bank was revitalised

Ex-Bank of Zambia Governor Mr Francis Nkhoma said it was saddening that it had to take the entire minister of Finance to be muddled up in bailing out of a Zambian bank.

He criticised the foreign banks operating in Zambia for their negative stance and remaining aloof when they could have rendered assistance.

Mr Nkhoma said even the largest banking networks had problems and could themselves be in similar crisis. There was no absolute security in banking

BOZ risks K27.6 billion in Meridien Bank crisis

By Staff Reporter

By mid-day last Friday the Bank of Zambia had exposed the government by K27.6 billion on the Meridien BIAO Bank crisis, it has been revealed.

"What the government has done may prove to be the biggest financial scandal in this country if things backfire or the public comes to know," claimed a well placed senior official at the Bank of Zambia.

"By mid-day today (Friday February 24) the bank had committed K27.6 billion with the Meridien crisis without any adequate security, and the paying is continuing. We don't know how much money we will end up committing to this crisis," he revealed, adding: "The government did not know what it was committing itself to, and the realisation may come too late. They should not have thrown out the central bank's decision to close Meridien Bank.

"I know they will be very quick to refute this information if it is published. But it is very correct," he said.

"Meridien has no adequate security for this type of money. A second mortgage on Meridien center and one on their abattoir may simply not be enough. We don't even know what other mortgages that maybe attached to the abattoir because we have not seen any of their title deeds," he observed, adding: "And just before their crisis got out of hand they were negotiating with a Dutch company, NGI, to buy some of their shares, but they have pulled out."

Last Friday at an Economic Association of Zambia meeting called to discuss the Meridien crisis finance minister Ronald Penza revealed that the government did not fully know the magnitude of Meridien Bank's problem, but government was never the less committed to saving the bank and consequently saving the country's financial sector from total collapse.

When further asked by a member of the audience how confident he was about solving a problem whose magnitude he did not know, Penza evaded the question.

Kaunda, NP say there's an explosive report on Meridien Bank:

No Meridien report exists - BOZ

By Sipo Kapumba

The Bank of Zambia (BOZ) has denied the existence of a confidential report on the troubled Meridien BIAO.

BOZ spokesman, Kabinga Pande, told the Sun last week no such report exists because the Central Bank was still investigating the cause of the problems at Meridien BIAO.

"No such report exists, it does not make sense to have a report but still ask the people to do a report again," he said referring to the management officials appointed by BOZ to salvage the bank from possible closure.

However, a financial expert told the Sun the report exists and names government officials who received bribes from the bank in exchange for various favours.

He said the report showed the extent of moral decay among the people entrusted with power in Zambia.

"The report is explosive and quite frightening," he said.

The National Party has also said the report exists and has challenged government to tell the nation the truth about what has been going on in the troubled bank.

Former president, Kenneth Kaunda, has charged that Meridien BIAO bank was bailed out because some senior government officials had got huge loans from it. The Central Bank has also appointed a new chairman John Cruickshank replacing John Kapotwe.

A joint managing director Kaitano Chungu and a financial controller, John Mpundu have also been appointed.

The management team which was named last month will assist in running the bank for six months.

PANDE...BOZ still investigating

Penza quizzed over Meridien bail-out

By JOY CHUBA

FINANCE Minister Ronald Penza yesterday told Parliament that the Bank of Zambia (BOZ) was undertaking a detailed evaluation of Meridien Biao Bank's operations to protect the resources which the government had provided to the bank.

But Mr Penza, who read a ministerial statement to the House on government action to bail out the bank, was at pains to explain to the members of Parliament the amount of money the central bank released to bail out Meridien Bank.

He said BOZ would soon recommend plans to government which would in turn ensure their implementation.

"This episode has taught us of the need for increased vigilance in our supervision of the banking system.

"Changes at the Bank of Zambia reflect the government's commitment to strengthen supervision as a cornerstone of prudent financial management," Mr Penza said.

He said government action to bail out Meridien Bank provided time for the bank to be restructured and re-capitalised to avoid the spread of the panic which [illegible] emerging in the financial system.

He also defended the government move to bail out the Zambia National Broadcasting Corporation (ZNBC), saying there was no special "bail out" and that the support was not part of a package.

He said the government support to Meridien Bank was not by way of grants but loans secured against tangible assets.

On the fluctuating exchange and interest rates, Mr Penza attributed this to the high demand for foreign exchange and portfolio shift by asset holders to short-term securities.

He said the exchange rate had been appreciating and showed signs of stabilising, adding that the central bank was purchasing foreign exchange from the bank, than selling it.

"We have just experienced a massive financial shock, yet the main impact has been a rise in the exchange rate and an increase in interest rates," he said.

Meanwhile, the [illegible] and Maintenance of Children, Preferential [illegible] Claims in Bankruptcy and Commission for Investigations (Amendment) Bills came up for report and third reading stages.

Penza defends Meridien Bank bail out

FINANCE Minister Ronald Penza has defended Government's decision to bail out Meridien BIAO Bank from its financial problems to preserve confidence on the financial market.

Mr Penza said if the bank was not assisted, it would have meant that all local banks would have gone under because of the distortions the bank would have created on the financial market.

Answering questions during a Budget analysis workshop organised by the Zambia Institute of Management at Savoy Hotel in Ndola, Mr Penza said Meridien Bank was the fourth largest bank in Zambia and its closure would have had colossal effects on the market.

A workshop participant from the Copperbelt University had described the bailing out of the bank as "an incentive for financial mismanagement of clients' money."

The participant observed that to have a comprehensive banking system, banks should be private-sector driven rather than Government-driven and suggested that commercial banks should create a fund to protect depositors instead of waiting for Government assistance.

"Commercial banks should be allowed to go bust like any other company. They should not be given preferential treatment," he said.

But Mr Penza said while he agreed that banks should be allowed to go bust like any other company in a liberalised economy, Government had a duty to prevent the adverse effects of bank closures on the market.

Meridien BIAO was bailed out to preserve confidence on the financial market and to enable the bank to restructure its operation.

— Zana.

OPINION

RUMOUR mongering, that ancient art of gossip, aimed at besmirching the good character or standing in society of a person or institution is the greatest evil of man.

Where rumour surfaces, it must not be spared. It must be crushed immediately. It is extremely dangerous because it spreads like cancer.

We commiserate with Meridien BIAO who fell victim to a vicious rumour that the bank was to cease its operations because of serious liquidity problems. The rumour which started the rounds last year was left to ferment like leaven to flour. What has happened over the past 72 hours is very well known. Scores of people, especially individual account holders, rushed to withdraw their deposits.

This obviously would not have happened if the bank had taken the necessary steps to defuse the rumour by way of statement like the one issued by the chairman of the bank Mr John Kapotwe. This is a clear case of shutting the stable after the horses have bolted.

However it is a great relief to most Zambians who bank with Meridien that its financial base is solid. You cannot fault people for panicking after the experience of Capital Bank. It however serves as a big lesson to most institutions in our country not to take rumours for granted.

Rumour should be treated like an insect that sits on your body and bites you. Your immediate reaction is to crush it.

Overseas and local investors including individuals were going to lose confidence in indigenous banks in preference for foreign operated banks.

Meridien BIAO needs support. It is the largest indigenous bank with a network throughout the continent. Its policy of employing Zambians to head overseas networks is unequalled.

Which other bank operating in Zambia has ever done that?

The Government and the Bank of Zambia through its supervising Ministry of Finance must guard against any machinations aimed at discrediting local banks.

In a similar vein, Government must guard against the dictates of foreign influence from whatever quarter. We must put our national interest first.

Meridien BIAO is a shining example of an international banking network which has confidence in Zambia. Its origin is strongly bound to Zambia and so are its investments which are being made solid.

Some so-called local banks are busy channelling their profits through the back door to their overseas accounts in America, Canada and elsewhere. These are the kind of investors masquerading as Zambians that do not deserve our sympathies.

Profile Analysis: The report begins with the Profile Analysis of an institution. This gives, at a glance, the current condition of an institution as well as any deterioration or improvements from the date of last on-site inspection. The monitoring rating is obtained from the composite rating schedule at section 6 below.

Principal Officers: Contact information on the principal officers of an institution is contained in section 2. This is to facilitate on-phone clarifications of issues arising from the analysis.

Nature of Operations: Analysis of an institution's financial condition begins with its structure and nature of its operations. A bank's structure allows an analyst to gain insight into the reasons for its performance, as well as enabling the analyst to determine its risk profile. This background information is useful. As will be seen under composite rating, the analyst's understanding of the unique circumstances of an institution is a significant component in the final composite rating. The composite rating is more than just a simple arithmetic average of the system's component ratings.

Supervisory Action in Place or Pending: This section lists the nature of the supervisory action in place or pending (say, where investigations are still going on to establish a condition necessitating the envisaged supervisory action). Details of these supervisory actions and the rationale for implementing them are contained in section 7

Current Supervisory Strategy: This section highlights the current as well as the recommended approach to supervising a particular bank. The supervisory strategy for an institution is based on a risk profile developed from previous inspection findings, including the supplement, if any, to the full scope inspection as well as off-site monitoring findings. In view of the rapid rate at which innovations to traditional banking are introduced, analysts will be reassessing the adequacy as well as the appropriateness of the current supervisory strategy the department is pursuing. From off-site monitoring, an analyst may notice a trend that is out of character for a particular institution and may in this section propose, from time to time, a scheduling of a targeted inspection as a supplement to the full scope inspection. The inspection may involve a bank's new business activity or strategy unfamiliar to an analyst; deficiencies in an important area of a bank's operations; or perhaps a significant sudden decline in earnings (that may or not be trend-setting). It is envisaged that this way analysts will become more proactive rather than reactive.

Composite rating: Financial analysis is performed to assess the current condition of a financial institution, diagnose problem areas and provide the best possible estimate of its future condition. The components covered in the composite rating are the traditional **CAMEL** components of off-site monitoring which have been expanded to incorporate a more detailed analysis of an institution's foreign exchange position. Each component is rated on a scale of 1 to 5 based on the established rating standards. The ratings are divided into system's rating and analyst's rating. This analyst's uses those ratios for each component whose magnitudes are deemed to capture the condition of that component. This is a purely quantitative rating. The column for the analyst's rating provides for the adjustment of the system rating to incorporate other qualitative factors, which the analyst finds compelling to include, based on the analyst's detailed insight into the circumstances of an institution. The analyst's rating of each component is then used to compute the composite rating for the supervised financial institution. Through the monthly monitoring of data and the application of the composite rating standards to this information, the identification of potential operating problems or changes in the condition of supervised institutions can be determined.

Compliance to Supervisory Actions: In this section an institution's compliance to instituted supervisory actions and regulatory requirements is discussed. The analyst highlights the rationale for the recommended supervisory action as well as any issues that require follow-up. For new banks (up to five years in operation) additional areas to be covered include a review of the bank's compliance to licence approval conditions as well as other issues such as compliance to financial objectives presented in the license application. **Source: BoZ**