Kenneth Kaoma Mwenda

Banking Supervision and Systemic Bank Restructuring

An International & Comparative Legal Perspective

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BANKING SUPERVISION AND SYSTEMIC BANK RESTRUCTURING: AN INTERNATIONAL AND COMPARATIVE LEGAL PERSPECTIVE
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For my parents
ACKNOWLEDGMENTS

In a work of this kind, it is not without difficulty that I record my indebtedness to all the people who have inspired me at different stages of my career. Their silent and unwavering support remains a great pillar and foundation from which I continue to draw some strength.

The original idea for this book was conceived out of somewhat unusual circumstances. The concept of the book came through while I was still in active academia. At that time, I served as a full time law lecturer at a leading UK law school, the University of Warwick Law School. Initially, the book was intended as a possible dissertation for further graduate studies at Yale University Law School. I had, for some time, been considering to move over to the US to continue my academic career there before returning to Africa. The thought of having a balanced experience of Anglo-American traditions struck me as a brilliant way forward in building my academic career. Hence, it was only appropriate at that time, and as a market entry strategy, to undertake some further advanced graduate studies in American jurisprudence on corporate and banking laws. Law, unlike the natural sciences and other social sciences, is often a jurisdiction-sensitive discipline. Thus, one has to undergo some conversion to adapt to the new context and jurisdiction. So, this is how the story started.

I had just won a highly competitive graduate fellowship to pursue further advanced studies at Yale Law School, US. I, however, found myself at a crossroads. I had a second offer to consider. The World Bank had just offered me an attractive position. I knew that the World Bank offer would also enhance my career profile, but I did not know which way to go. In my mind’s eye, I could see that I had to take account of all factors so as to reach a seasoned and thoughtful decision. While I enjoyed academic work very much, I also knew that I had a soft heart for work relating to the fight against poverty and injustice in the world. Either way, getting to Yale or joining the World Bank, I knew that the dream had to live on. Yale Law School, probably the leading law school in the US, had its doors open. For a moment, I remained undecided. However, after thoughtful consideration, I decided to go to Washington DC, US, to take up the World Bank position. It was a difficult choice, but it had to be made. The choice was made lighter by the fact that I had already re-fuelled sufficiently at Oxford. Yes, indeed, it was time to put into practice the theory that had been accumulated over the years. It was also time to reflect and re-focus some of the theory that had been embedded in me against what goes on in the real world. The World Bank was, therefore, a good opportunity.

Throughout my graduate student days at Oxford, I had developed a strong interest in the areas of corporate law and banking law. This book, therefore, reflects some of those dreams while I was a Rhodes Scholar at Oxford pursuing the two year BCL degree. The book is, indeed, a sequel to my last three books: Legal Aspects of Corporate Capital and Finance; Contemporary
Issues in Corporate Finance and Investment Law; and Zambia’s Stock Exchange and Privatisation Programme: Corporate Finance Law in Emerging Markets.

I have benefited tremendously in writing and working with a number of senior academic colleagues. However, although I have been inspired and influenced by many, at various levels of consciousness, the sound and heartbeat of my work remains my own. Their input, however, has always helped me to sharpen my focus on a number of intellectual issues. Individuals whose names I have managed to acknowledge here by no means represent the full list of friends and colleagues to whom I owe my many thanks. First, and most important of all, and making it possible for me to accommodate the intrusion of active scholarship in my private life and also amidst a busy working life, the Heavenly Father must be thanked earnestly.

My acknowledgments would be incomplete without recording the inspiration that I have drawn – and continue to draw – from professional colleagues, family and friends who include my very dear parents, Mr Joseph T Mwenda and Mrs Esther M Mwenda; Professor Mwelwa C Musambachime, Zambia’s Permanent Representative to the United Nations, and former history professor at the University of Namibia; Professor Gerry N Muuka of Murray State University, US; Professor David A Ailola of University of South Africa; Professor Upendra Baxi of the University of Warwick (former Vice Chancellor of Delhi University and the University of South Gujarat); Professor Muna B Ndulo of Cornell University, US and formerly with the UN, Vienna; Professor Melvin L Mbao of University of the North-West, South Africa; Professor John McEldowney of the University of Warwick, UK; Professor Mike McConville of the University of Warwick, UK; Professor Dan D Prentice of Oxford University, UK; Professor Hugh Beale of the University of Warwick, UK; Professor Oliver S Saasa of the University of Zambia; Professor Chola Chisunka, Fitchburg State College, US; the late Professor Lawrence Shimba, formerly of the University of Zambia and former Minister of Higher Education, Zambia; the late Dr Anthony Mulimbwa, formerly of the University of Zambia and the National University of Lesotho; Dr Harry Chitambo of the University of Zambia; Dr Lordwell Witika of the University of Zambia; Dr Alfred Chanda of the University of Zambia; Dr Beatrice M Kamuwanga of the University of Zambia; the Hon Mr Justice Sandson S Silomba of the High Court for Zambia; His Excellency Gen Sibamba, Zambia’s Ambassador to the Republic of Germany and former Army Commander, Republic of Zambia; His Excellency Professor Moses Musonda, Zambia’s High Commissioner to the UK and former Pro-Vice Chancellor, University of Zambia; Dr Caleb M Fundanga, Senior Economic Adviser, Africa Development Bank (ADB) and former Executive Director, ADB, Côte d’Ivoire; Dr Mpazi Sinjela, Director, United Nations WIPO Academy, Geneva; Mr Ko-Yung Tung, General Counsel and Vice President, Legal Department, the World Bank; Mr W Paatii Ofosu-Amaah, Deputy Chief Counsel, Legal Department, the World Bank; Mr Mohan G Gopal, Chief Counsel, East Asia
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Once again, I must acknowledge my debt to my colleagues and friends who supported me at the launch of one of my recent books, *Legal Aspects of Corporate Capital and Finance*. A special tribute is also due to a friend who passed away while giving his unfailing support to the launch of that book. Prince Bambino Kalumbi, your support was ever inspiring and encouraging. May your soul rest in peace. Not many knew or understood the secret of the art that was in you. I miss your great sense of humour. We were together the day of your tragic passing away. Sangu and yourself had welcomed me in London as I was transiting to Zambia from Washington DC. It was a pleasant reunion for all of us. All seemed fine. But, shortly after I arrived in Zambia, I received news that you were gone. I was struck with shock and disbelief. The Lord has His plans for everyone of us and His ways are not our ways. Bambino, thank you for believing in me and for allowing me to be myself. Brothers like you are hard to replace.
PREFACE

This book looks at contemporary legal issues in prudential banking supervision and systemic bank restructuring. The book covers developments in countries such as the UK (including European Union practices), Bulgaria, Denmark, Estonia, Finland, Germany, Italy, Latvia, Norway, Russia, Sweden, Australia, New Zealand, Thailand, the Philippines, Korea, Singapore, Malaysia, Japan, Canada, the US, Zambia, and some Latin and South American States. An international and comparative perspective is provided.

Discussions in the book are underscored by the theme that effective prudential banking supervision takes place mainly where there is rational combination of various legal and extra-legal tools for supervision. In the commercially sophisticated world in which banks increasingly find themselves, the multi-faceted nature of banking business raises a number of complex and intertwined issues. For example, how do we supervise activities of banks that relate to non-banking financial services? Further, how do we restructure banks engaged in such activities and what is the approach to restructuring the whole banking system if it fails?

A contingency approach that deals with each case on a case by case basis is highly desirable. To illustrate, it could be inquired as to the nature and variety of the tools that are needed to supervise and restructure banks in a group entity? Can the accounts of such a group entity be analysed using ‘consolidated accounting’ principles? What would happen if the legal system of that country does not provide for or recognise consolidated accounting principles? Should there be proposals to introduce international accounting standards in that country immediately? And what about the historical and socio-economic reasons that explain why such accounting standards are missing? Should we disregard these factors? These are only a few of the many strategic issues that come to the fore in systemic bank restructuring and banking supervision. Indeed, there are more questions than answers. For example, are the tools to be used in the restructuring of an individual bank or a group entity the same as those needed in the case of a failed banking system? Is there a specific toolkit for each of these situations, or should we adopt a pragmatic approach of proceeding on a case by case basis? Are legal tools sufficient on their own? Or, are accounting and finance tools the solution? How do we address matters such as ‘contagion’ to stop the failure of a bank from spreading to other parts of the financial services industry? Do banks stand in isolation from other units in the financial services industry? And just how do we tell what is a bank and what is not for purposes of enabling the regulatory authority to undertake its supervisory functions?

This book is divided into eight chapters. Chapter 1 looks at the legal meaning of the terms ‘bank’ and ‘banking business’. An argument is made that the definitions of ‘bank’ and ‘banking business’ should be compatible with the practice of banking in a particular country. Chapter 2 examines developments in banking law relating to the Basle Committee’s Core Principles for Effective Banking Supervision. That chapter also looks at
pertinent issues in systemic bank restructuring and argues that restructuring, *ceteris paribus*, is a means of ushering in an efficient and effective regulatory framework for banking supervision. An argument is also made that, while there is no single toolkit for banking supervision that provides for fully contingent rules to deal with bank crises, effective and prudential banking supervision can be undertaken best through the adoption of interdisciplinary tools and approaches to supervision. Chapter 3 looks at contemporary issues facing a modern legal framework for banking supervision. It is argued, among other things, that, in undertaking banking reforms, an important objective to consider is the need to develop a stable banking system which allocates credit on a market basis.

Chapter 4 examines the obligation bank shareholders to pay up for their shares. The chapter argues that the enforcement of this shareholder obligation by bank supervisors can provide a means of preventing the dilution of a bank’s capital. While it is common knowledge that the gearing ratio of many banks involve both equity and debt investments, bank supervisors often preoccupy themselves with addressing the debt stream.

Chapter 5 of the book looks at the regulation of non-traditional banking institutions such as collective investment schemes. The nexus between activities of some banks and those of institutions such as stock exchanges is highlighted and discussed. Collective investment schemes are identified as a major vehicle through which some banks participate on the stock exchange. How can activities of a bank in this instance be regulated? Is the bank shielded by the fact that the main actor on the market is the collective investment scheme? Further, which institution has the power to regulate the conduct of business here? Is it the Securities and Exchange Commission or the central bank? Would the idea of a single regulator provide a solution to the problem?

Chapter 6 deals with the regulation of financial information by banks. An earlier version of Chapter 6 was published as a law journal article in the *Web Journal of Current Legal Issues* (2000) 2 Web JCLI). The author is grateful to the editors of the *Web Journal of Current Legal Issues* for permitting contributors to that journal to re-use their works as they desire so long as they acknowledge the journal as the original place of publication. An argument is made in Chapter 6 of this book that, while Chinese walls can afford a good opportunity for financial institutions to manage confidential information of clients, these walls can be ineffective when designed poorly.

Chapter 7 of the book looks at how to deal with stock market abuses by banks. Such abuses could relate to offences such as insider dealing. Again, the issue of whether a single regulator for all financial services would be appropriate is raised.

Chapter 8 provides important lessons of experience in systemic bank restructuring. Issues such as heavy reliance on capital adequacy requirements in bank supervision are addressed. Also, the issue of whether deposit
insurance provides effective and efficient means of protecting investors is tackled. All these matters are discussed to show how their absence or presence could impact on the efficacy of the legal framework for banking supervision. The interpretations and conclusions expressed in the book are, nonetheless, entirely those of the author. They do not necessarily represent the views of the World Bank, its executive directors or the countries they represent. I remain accountable for any shortcomings in the book.

The law is stated on the basis of materials available to me as at 11 September 2000.

Kenneth Kaoma Mwenda
Legal Department
The World Bank
Washington DC
September 2000
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INTRODUCTION

CONTEXT OF THE STUDY

Whereas much of the literature on the legal aspects of banking deals with the banker-customer relationship, encompassing such tasks as deposit-taking, providing letters of credit and facilitating export credits, this book looks at contemporary issues in prudential banking supervision and systemic bank restructuring. Indeed, no attempt is made to look at such issues as the legal aspects of bill of exchange payments, since such aspects of the law are covered under banking and international trade law, as well as under commercial law.

As the title of the book – *Banking Supervision and Systemic Bank Restructuring: An International and Comparative Legal Perspective* – suggests, this work is not just about analysing legislation relating to banking supervision. Rather, the work provides an interdisciplinary analysis of contemporary issues in banking supervision and systemic bank restructuring. In the main, the work focuses on legal issues in banking supervision and systemic bank restructuring. Further, a number of financial, economic and political considerations underpinning a multi-faceted regulatory framework for banking supervision are examined.

All in all, the book covers developments in countries such as the UK, the US, continental European States (and relevant EU practices), Eastern European States, Australia, New Zealand, Italy, and Latin American States. An international and comparative study is therefore provided. Indeed, the book not only discusses issues that are of international significance, but it also provides lessons of experience on systemic bank restructuring and banking supervision.

In this book, various aspects of the common law are examined and an underlying thesis is advanced that effective prudential banking supervision takes place mainly where there is a rational combination of various legal and extra-legal tools for supervision. Included in the study is an examination of the regulatory framework governing the supervision of other bank-related financial services. Indeed, the regulatory framework governing collective investment schemes in a country such as Zambia is examined. Here, as explained in Chapter 3, the Zambian legal framework is chosen as a case study, since Zambia has experienced some attempts at undertaking systemic banking restructuring. Also, Zambia’s stock exchange, the Lusaka Stock Exchange, like many other emerging markets, has been experiencing some liquidity problems. In order to overcome such constraints, there is now an imperative need for banks to run collective investment schemes on the stock...
markets. However, in running collective investment schemes, do Banks in Zambia fall entirely under the Banking and Financial Services Act 1994, or do they fall under a different regulatory framework altogether? These are some of the issues that will be examined in Chapters 5, 6 and 7 when we look at the relationship between banks and securities regulation. Acknowledging the changing nature of banking business today, Cranston observes:

With multifunctional (‘universal’) banking prudential regulation of a bank is needed in respect not only of core banking, but other activities as well – securities, insurance and so on – where they threaten contagion of the financial system.

Since this book provides a multi-faceted approach to prudential banking supervision, issues such as why bank shareholders should pay up for their shares will be examined as well. A multi-faceted approach to banking supervision, emphasising, among other things, that bank shareholders should pay up for their shares, could impose some degree of self-discipline on banks. Such discipline would reduce the costs of regulators in monitoring the maintenance and non-dilution of a bank’s share capital. Here, the importance of getting bank shareholders to pay up for their shares in full is meant to promote investor protection under prudential banking supervision. As Cranston observes:

As with mergers and acquisitions, some jurisdictions have a special regime for bank insolvencies. Thus, from the 19th century, the United States developed special rules for the liquidation of banks. Under them, shareholders might be required to inject extra funds in the event of bank failure, liquidations were to be handled speedily, and government was given a monopoly power to close banks. The justification was the special character of banks, in particular the problem of systematic risk. By reassuring depositors, the special rules were supposed to reduce systematic risk. In more recent times the rationale for special laws for bank insolvency has been to minimise calls on the deposit insurance fund. Since the American experience is that banks are particularly prone to insider abuse, this is the basis for some of the especially strict rules imposed on insiders in a bank insolvency.

**Defining ‘bank’ and ‘banking business’**

Given that this book deals with the legal aspects of banking supervision and systemic bank restructuring, it is imperative that we first define the terms ‘bank’ and ‘banking’ business, before delving into the intricacies of the subject at hand. Indeed, as we shall see in Chapter 2, Core Principle 2 of the Basle Core Principles for Effective Banking Supervision provides as follows:

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2 Cranston, 1997, p 68.
The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word ‘bank’ in names should be controlled as far as possible.

Similarly, the Banking and Financial Services Act 1994 of Zambia provides that:

1. A person other than a bank shall not, without the consent of the Bank of Zambia (the central bank), use the word ‘bank’ or any of its derivatives in any language, or any other word or symbol indicating the transaction of banking business, in its name or in any prospectus, advertisement or statement of any kind published or made to describe its business in Zambia.

2. A person shall not falsely represent to the public or any member of the public–
   (a) that the person holds a licence to conduct any financial service business; or
   (b) that the person is licensed to conduct any financial service business of a particular kind.

3. Any person acting in contravention of this section shall be guilty of an offence and shall be liable on conviction to a fine not exceeding 10 million kwacha or to imprisonment for a term not exceeding five years, or to both.  

Closely related to the above statutory provision is s 119 of the same statute, which provides as follows:

Notwithstanding anything in the Companies Act to the contrary, the Registrar of Companies shall, upon being notified by the Bank of Zambia that any company–

(a) incorporated under a name that includes the word ‘bank’ or any of its derivatives in any language; or

(b) whose memorandum of articles prescribed, as its object or one of its objects, carrying on a banking business or a regulated financial service business, or a particular kind of banking or financial service business,

is in fact not licensed to carry on such a business and is not going to be granted a licence of the appropriate kind, the Registrar of Companies is hereby empowered to, and shall forthwith, take such steps as are necessary to dissolve and deregister the company.

At common law, there have been several attempts to define the terms ‘bank’ and ‘banking business’. The courts have been preoccupied with treating as a bank institutions that undertake the business of banking. But, then, how do we define ‘banking business’? The courts have not given a satisfactory definition of the term ‘bank’, although they have succeeded in spelling out some of the characteristics which must be fulfilled if an institution is to be...
treated as carrying on the business of banking. In *United Dominions Trust Ltd v Kirkwood*, Lord Denning MR, drawing on the usual characteristics of banking, as spelt out in *Paget’s Law of Banking*, ruled:

There are therefore, two characteristics usually found in bankers today: (1) they accept money from and collect cheques for, their customers and place them to their credit; (2) they honour cheques or orders drawn on them by their customers when presented for payment and debit their customers accordingly. These two characteristics carry with them also a third, namely; (3) they keep current accounts, or something of that nature, in their books in which the credits and debits are entered.

In the *Kirkwood* case, the Court of Appeal observed that an institution could qualify as a bank even if it did not carry on the exclusive business of banking. Here, what really mattered was that the institution was carrying on, among other activities, the business of banking and that that business constituted a substantial whole of the activities of the institution. Arora observes, however, that in *Re Roe’s Legal Charge*, the court emphasised that it was not concerned with the size of clearing activities of an alleged bank in comparison to the number of clearings of other recognised banks. Thus:

Where the usual characteristics associated with the banking business were not satisfied, the court could take into account the commercial reputation enjoyed by the institution; if the institution was treated as a bank within the commercial community, then the courts would recognise it as such. On that approach, the evidence produced by UDT in *United Dominions Trusts Ltd v Kirkwood* was sufficient to establish its status as a bank.

The words ‘*bona fide*’ carrying on the business of banking were held in *United Dominions Trust Ltd v Kirkwood* to involve two requirements:

(a) the banking transaction must not be negligible in size when compared to the rest of the business;

(b) the transactions relied on must genuinely be banking transactions and not merely a disguise for other transactions of a different legal nature.
However, to qualify the argument advanced by Arora\textsuperscript{15} – that, where the usual characteristics associated with the banking business were not satisfied, the court could take into account the commercial reputation of the institution – it is now argued that an institution’s reputation alone, as Harman LJ rightly noted in the *Kirkwood* case,\textsuperscript{16} is not sufficient. To confirm the status of an institution as a bank, other factors must be considered too. These factors include the core business undertaken by the institution. Some scholars have argued, however, that the shortcoming of the analysis in *United Dominions Trust Ltd v Kirkwood*, on the meaning of banking business, is that it cannot now be regarded as sufficient:\textsuperscript{17}

First, it ties itself to payment through the cheque system, thus excluding traditional savings and co-operative banks, quite apart from merchant (investment) banking. More importantly, cheques are only one way in which payments are effected: indeed, before too long, cheques will have had their day … Moreover, to universalise the *Kirkwood*, or any, definition ignores the point that definitions are developed in a particular context. The notions of a ‘bank’ and ‘banking’ will bear different shades of meaning turning on the issue. Broadly, the jurisprudence about the meaning of banking has arisen in three contexts. The first revolves around regulation: for example, is a particular body in breach of the law since it is carrying on banking business in the jurisdiction without a banking licence? Secondly, some legislation confers a privilege or protection on ‘banks’ without defining them, and the issue becomes whether a particular body can take advantage of it. For example, under s 4(1) of the Cheques Act 1957 [UK statute], bankers (undefined) who convert cheques by collecting them for customers have a defence if they can establish that they acted in good faith and without negligence. Thirdly, those seeking to avoid a payment obligation have occasionally argued that it arose on an illegal contract, which is void or unenforceable because it is owed by or to an unlicensed bank.\textsuperscript{18}

In Zambia, as in many other jurisdictions, there has been legislative intervention in the definition of terms such as ‘bank’ and ‘banking business’. Section 2 of Zambia’s Banking and Financial Services Act 1994 provides that:

In this Act, unless the context otherwise requires –

‘bank’ means a company that holds a banking licence;

\textsuperscript{15} Op cit, Arora, fn 5, p 15.
\textsuperscript{16} For a similar view, see, also, explanation below (fn 17).
\textsuperscript{17} See, eg, *op cit*, Cranston, fn 2, p 4. Also, Professor Ellinger, commenting on the *UDT v Kirkwood* case, as quoted in Sealy and Hooley, 1994, p 553, observes: ‘It is clear that the three judgments in the *Kirkwood* case take divergent views regarding the importance of reputation for determining whether or not a given institution is a bank. As a rigorous analysis of law, Harman LJ’s view is to be preferred. According to the common law definition, a bank is an institution that actually carries on banking business; not an institution which has the reputation of doing so or of being a bank. This definition postulates an objective test. Lord Denning, and to a lesser extent Diplock LJ, propounded a test based on subjective criteria …’

\textsuperscript{18} Op cit, Cranston, fn 2, pp 4–5.
‘banking licence’ means a licence granted under s 4;

‘banking business’ means the business of receiving deposits from the public and the use of such deposits, either in whole or in part, for the account of and at the risk of the person carrying on the business, to make loans, advances or investments, and includes any custom, practice or activity prescribed by regulation as banking business;

‘company’ means a body corporate incorporated under the Companies Act or the Co-operative Societies Act;

Stating clearly in its definition of ‘bank’ and ‘banking business’ that ‘unless the context otherwise requires’, the Banking and Financial Services Act 1994 of Zambia provides definitions which are somewhat in line with the contextual approach advocated by Cranston.19 However, under the Zambian statute, defining a bank as simply a company that holds a banking licence raises a number of illogical difficulties. I have argued elsewhere that the Companies Act 1994 of Zambia does not place any statutory obligation on companies, either at incorporation or at any other time, to furnish the Registrar of Companies with a memorandum of association.20 One of the consequences of this feature is that it is not easy to tell what the objects of the company/bank are. Indeed, the objects could be anything but paddling in ‘illegal’ waters. We are therefore left to look at evidence as to whether or not the company had as its substantial business the activity of ‘banking’. The problem is thus circular. Again, we return to defining what constitutes ‘banking business’. In my humble view, much more preferable is the broader definition offered by Isaac J in the Australian High Court case of Comrs of the State Savings Bank of Victoria v Permeuan, Wright and Co Ltd.21 In that case, Isaac J’s analysis, which was later rejected by Lord Denning MR in the Kirkwood case, postulated as follows:

The essential characteristics of the business of banking are … the collection of money by receiving deposits upon loan, repayable when and as expressly or impliedly agreed upon, and the utilisation of the money so collected by lending it again in such sums as are required. These are the essential functions of a bank as an instrument of society. It is, in effect, a financial reservoir receiving streams of currency in every direction, and from which there issue outflowing streams where and as required to sustain and fructify or assist commercial, industrial or other enterprises or adventures … The methods by

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19 On Cranston’s analysis, see above, p 2. The EU First Banking Directive, Art 1, defines a bank as ‘an undertaking’ whose business is to receive deposits or other repayable funds from the public and to grant credit for its own account. By contrast, the interpretation and application section of the Canadian Bank Act (as amended in 1992) defines a bank as follows: ‘… “bank” means a bank to which this Act applies.’

20 See Mwenda, 32(1), 1999, p 126.

21 (1915) 19 CLR 457. See, also, Re Bottomgate Industrial Co-operative Society (1891) 65 LT 712.
Introduction

which the functions of a bank are effected – as by current account, deposit account at call, fixed deposit account, orders, cheques, secured loans, discounting bills, note issue, letters of credit, telegraphic transfers, and any other methods that may be developed by the necessities of business – are merely accidental and auxiliary circumstances, any of which may or may not exist in any particular case.22

Deposit-taking

It has already been established that the Banking and Financial Services Act 1994 of Zambia provides that, unless the context otherwise requires, ‘banking business’ relates to receipt of deposits from the public and use of such deposits to make loans and investments. What, then, is ‘receiving deposits’? Or what, in other words, would constitute ‘deposit-taking’ by banks?

The Zambian Banking and Financial Services Act 1994 defines ‘deposit’ as follows:

... ‘deposit’ means subject to sub-s (2), a payment of a sum of money –
(a) on terms that it is to be repaid, with or without interests or premium of any kind, and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it; and
(b) that is not referable to the provision of property or services or the giving of security,
whether or not evidenced by any entry in a record of the person receiving the sum, or by any receipt, certificate, note or other document;
...23

Sub-section 2 of the above statutory provision then continues:

In this Act, except as otherwise provided by regulation, ‘deposit’ does not include a sum paid –
(a) by a bank;
(b) by one company to another at a time when the companies are associated with each other or affiliated;
(c) to a person by another person who, at the time it is paid, is by virtue of this section an associated person;24

23 Banking and Financial Services Act 1994, s 2.
24 Banking and Financial Services Act 1994, s 2(3) provides that: ‘... (b) two persons are associated if: (i) one person is a company of which the other person is an officer or director; (ii) one person is a company that is controlled de jure or de facto by the other person; (iii) one person is a partnership of which the other person is a partner; (iv) both persons are members of a voting trust or other arrangement relating to the shares of a share issuer; or (v) one person is the spouse, parent, child, brother or sister of the other person’s parent, child, brother or sister; (c) two or more persons are affiliated if all are companies that are controlled, de jure or de facto, by the same person; ...’
(d) by a person who, at the time it is paid, is a director, controller, manager or shareholder of the person receiving it;
(e) which is not to be repaid and may not be demanded within five years following the date of its payment;
(f) as the purchase price of a security, having a face amount of one million kwacha or greater, the issue or trading in which is lawful under the Securities Act 1993; or
(g) between persons or in circumstances prescribed by regulation.

Let us stop to think critically about the definition of ‘deposit’ spelt out above. First, as a preliminary note, it must be emphasised that statutory definitions of ‘banking’ differ from country to country.\textsuperscript{25} Whereas, on the one hand, some jurisdictions have legislation which defines as a bank any body recognised as such by a governmental authority,\textsuperscript{26} other jurisdictions adopt a formulary approach, which defines banks in terms of a few, generalised characteristics.\textsuperscript{27} A third approach simply lists activities that are treated as banking by legislation.\textsuperscript{28} As Cranston observes:

Whether the list or formulary approach is adopted, it is clear that bodies may act like banks yet not be categorised in law as banks. If taking deposits \textit{from the public} is defined as the essential ingredient of banking then the finance house able to fund itself from the wholesale markets, or the co-operative taking deposits from within its membership, would probably not be caught. If banking means deposit taking coupled with \textit{making loans}, an investment fund will be able to avoid classification as a bank by using its moneys to purchase short term government paper or other money market instruments. Economists sometimes refer to such bodies as ‘non-bank banks’ or ‘non-bank financial intermediaries’. That they may escape the banking net is not necessarily a bad thing – it depends on whether this thwarts the legislative aims.\textsuperscript{29}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{25} Eg, Bradgate, 1995, pp 545–46, notes: ‘Although many statutes refer to “banks”, “banking” and “bankers”, there is no comprehensive legal definition of “bank” or “banking”. The Bills of Exchange Act 1883 defines a bank as “any body of persons, whether incorporated or not, who carry on the business of banking”, leaving open the question of what is “the business of banking” ...’
\item \textsuperscript{26} See \textit{op cit}, Cranston, fn 2, p 6.
\item \textsuperscript{27} See \textit{op cit}, Cranston, fn 2, p 6.
\item \textsuperscript{28} See \textit{op cit}, Cranston, fn 2, p 6.
\item \textsuperscript{29} See \textit{op cit}, Cranston, fn 2, p 7.
\end{itemize}
\end{footnotesize}
Conclusion

This chapter has examined the legal meaning of the terms ‘bank’ and ‘banking business’. It was argued that the definitions of ‘bank’ and ‘banking business’ must be compatible with the practice of banking in a particular country. However, a question could be raised: how can we tell, for example, if a corporate entity that has gone bust is a bank for purposes of insolvency distributions? Is it not the position in many countries that in order to protect investors and ensure investor confidence in the market, the regulatory authority in charge of banking supervision can either close down an insolvent bank or supervise its reorganisation? Indeed, it is such issues that underpin the importance of defining what constitutes a ‘bank’ and ‘banking business’. Thus, this chapter has shown the relevance of defining the terms ‘bank’ and ‘banking business’, and has further endeavoured to provide meaningful definitions of the terms.
CHAPTER 2

CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION AND SYSTEMIC BANK RESTRUCTURING

The Core Principles for Effective Banking Supervision have become the most important global standard for prudential regulation and supervision. The vast majority of the countries have endorsed the Core Principles and have declared their intention to implement them. As a first step to full implementation, there should be an assessment of the current situation of a country’s compliance with the Principles. Such an assessment should identify weaknesses in the existing system of supervision and regulation, and form a basis for remedial measures by government authorities and the bank supervisors. Such assessments are typically conducted by the countries themselves or by various outside parties. The Basle Committee on Banking Supervision has decided not to make assessments of its own due to a lack of necessary resources; however, the Committee is prepared to assist in other ways, inter alia by providing advice and training. Committee members may also individually participate in assessment missions conducted by other parties such as the IMF, the World Bank, regional development banks, regional supervisory organisations and private consultants. ‘Peer reviews’ are also possible, whereby supervisory experts from one country assess another country and vice versa [Basle Committee on Banking Supervision, Core Principles Methodology, October 1999].

INTRODUCTION

Whilst it is acknowledged that there is no single toolkit for banking supervision which provides for fully contingent and exhaustive solutions to banking crises, it is argued that effective and prudential banking supervision can be undertaken through the adoption of interdisciplinary tools and approaches to supervision. Fields such as banking law, corporate finance, and corporate and securities law are rich sources of the law for effective banking supervision. Indeed, the range of tools varies from context to context. This chapter begins by looking at the Basle Core Principles for Effective Banking Supervision. In the preceding chapter, we noted that Core Principle 2 of the Core Principles for Effective Banking Supervision calls for clear definitions of activities that are subject to banking supervision. We also noted that Core Principle 2 stresses the importance of controlling the use of the word ‘bank’ in the names of institutions. In the present chapter, we will examine the legal aspects of prudential banking supervision before looking at the salient features of systemic bank restructuring. Generally, banking reforms can have an impact on the efficacy of the legal framework for banking supervision.
The Basle Core Principles for Effective Banking Supervision

In September 1997, the Basle Committee on Banking Supervision published its report on the ‘Core Principles for Effective Banking Supervision’. The report reads in part:

Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. The need to improve the strength of financial systems has attracted growing international concern ... Several official bodies, including the Basle Committee on Banking Supervision, the Bank for International Settlements, the International Monetary Fund and the World Bank, have recently been examining ways to strengthen financial stability throughout the world ... In developing the Principles, the Basle Committee has worked closely with non-G10 supervisory authorities. The document has been prepared in a group containing representatives from the Basle Committee and from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Nine other countries (Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore) were closely associated with the work.

In essence, the Basle Core Principles comprise 25 basic principles that need to be in place for a supervisory system to be effective. These principles cover the following areas:

• preconditions for effective banking supervision – Principle 1;
• licensing and structure – Principles 2 to 5;
• prudential regulations and requirements – Principles 6 to 15;
• methods of ongoing banking supervision – Principles 16 to 20;
• information requirements – Principle 21;
• formal powers of supervisors – Principle 22; and
• cross-border banking – Principles 23 to 25.

It is the view of the Basle Committee that the Core Principles for Effective Banking Supervision should serve as a basic reference for supervisory and other public authorities in all countries and internationally. The Committee argues that ‘national agencies should apply the Principles in the supervision

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1 See Basle Committee on Banking Supervision, 1997, p 1: ‘The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, the UK and the US. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.’

2 Ibid, pp 1–2.

3 Ibid, p 2.

Core Principles for Effective Banking Supervision and Systemic Bank Restructuring

of all banking organisations within their jurisdictions\(^5\) and that ‘the Principles are minimum requirements and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries’.\(^6\) However, it is not yet clear whether these Principles have crystallised into customary international law. Cranston observes, for example, that pronouncements made by the Basle Committee can only constitute soft law, because they depend for their implementation on jurisdictions adopting them and giving them force.\(^8\) There is also growing evidence showing that developing countries have only undertaken skin-deep compliance with the Basle Committee’s Core Principles.\(^9\) Thus, the requisite degree of State practice and \textit{opinio juris} remains to be seen. In determining whether the Basle Core Principles have crystallised into customary international law, it is important to take into account the degree of State practice and the weight of \textit{opinio juris} attached to the Principles.\(^10\)

Other evidence pointing to the growing body of international legal rules on banking supervision include the 1983 Concordat by the Basle Committee.

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5 Op cit, Basle Committee, fn 1, p 2.
6 Op cit, Basle Committee, fn 1, p 2.
7 That said, there is evidence of a growing body of international legal rules on banking supervision. Whether these rules constitute customary international law or not is an issue that raises a number of interesting questions. On examples of such rules, Cranston, 1997, p 111, observes: ‘The 1975 Concordat was replaced by the 1983 Concordat which reformulated and supplemented the earlier principles [see Committee on Banking Regulations and Supervisory Practices, \textit{Principles for the Supervision of Banks’ Foreign Establishments}, May 1983, Basle, reprinted [1983] 22 ILM 901], in particular, to take account of the subsequent acceptance of the principle that the soundness of an international bank cannot be fully evaluated unless regulators can examine the totality of its business worldwide, through the technique of consolidation. The principle of consolidated supervision, as the Concordat explained, is that parent banks and parent supervisory authorities monitor the risk exposure of the banks or banking groups for which they are responsible, as well as the adequacy of their capital, on the basis of the totality of their business, wherever conducted. This principle does not imply any lessening of host authorities’ responsibilities for supervising foreign bank establishments which operate there, although full implementation of the principle may well lead to some extension of parental responsibility. Consolidation should not be applied to the exclusion of the regulation of individual banking establishments on an unconsolidated basis by home and host authorities. The Concordat notes that consolidated supervision presupposes access to all the relevant information about operations of an international bank, although bank secrecy laws in some countries prevent this.’
8 See \textit{ibid}, Cranston, p 112: ‘As with other Basle pronouncements, the 1983 Concordat is soft law. It has depended for its implementation on jurisdictions adopting it and giving it force. Within the European Community, the principle of consolidated supervision became a legal requirement as a result of the First Consolidated Supervision Directive.’
9 Seminar lecture by Honohan, 13 January 2000.
10 For a detailed read on how customary international law can be evidenced, see, generally, Starke, 1989; Cassese, 1994; Harris, 1991; Dixon, 1990; and Mwenda, 12(2), 1997.
As Cranston observes, the Basle Committee on Banking Supervision later issued the 1992 Basle Statement as a supplement to the 1983 Concordat.\textsuperscript{11} This statement was issued in response to the BCCI crisis. In outline, the statement contained the following reformulation of the principles in the 1983 Concordat:

... (1) all international banks and banking groups should be supervised by a home country regulator which capably performs consolidated supervision; (2) a cross-border banking establishment must receive the prior consent of both the host country regulator and the bank’s (and if different, banking group’s) home country regulator; (3) home country bank regulators must have the right to gather information from the cross-border banking establishments of a bank or banking group; and (4) if a host regulator determines that any one of these minimum standards is not met, it can ultimately restrict or prohibit an international bank from operating.\textsuperscript{12}

The development of these international legal rules on banking supervision and the adoption of the legal rules by States (as seen in the banking laws of many States) shows that the rules are beginning to crystallise into customary international law. Indeed, the Basle Committee continues to advocate:

Supervisory authorities throughout the world are encouraged to endorse the Basle Core Principles. The members of the Basle Committee and the 16 other supervisory agencies that have participated in their drafting all agree with the content of the document ... The chairperson of the regional supervisory groups are supportive of the Basle Committee’s efforts and are ready to promote the endorsement of the Core Principles among their membership.\textsuperscript{13}

In spite of all these efforts by the Basle Committee and the international community to develop an international law of banking supervision, there are a number of constraints that must be overcome before such a goal is realised. Many countries will need to make substantive changes in their legislative framework and in the powers of their supervisors because many supervisory authorities do not at present have the statutory authority to implement all the Principles.\textsuperscript{14} Following below is a list of all the Core Principles:\textsuperscript{15}

13 See \textit{op cit}, Basle Committee, fn 1, p 3.
14 See \textit{op cit}, Basle Committee, fn 1, p 3.
15 See \textit{op cit}, Basle Committee, fn 1, pp 4–7. For lack of space in this chapter, no attempt is made to provide a lengthy discussion on the Basle Committee’s Core Principles for Effective Banking Supervision. However, the reader is advised to read the two documents prepared by the Basle Committee: that is, the document on the Core Principles and that on the Core Principles Methodology.
LIST OF CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Preconditions for Effective Banking Supervision

1 An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

2 The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word ‘bank’ in names should be controlled as far as possible.

3 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, at a minimum, should consist of an assessment of the banking organisation’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 supervisor should be obtained.

4 Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5 Banking supervisors must have the authority to establish criteria for reviving major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

6 Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those in the Basle Capital Accord and its amendments.

7 An essential part of any supervisory system is the evaluation of a bank’s policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8 Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan reserves.

9 Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within portfolio
and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10 In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm’s length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11 Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12 Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13 Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14 Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal and external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15 Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict ‘know your customer’ rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16 An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17 Banking supervisors must have regular contact with bank management and thorough understanding of the institution’s operations.

18 Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

19 Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20 An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.
21 Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers

22 Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-Border Banking

23 Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24 A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25 Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

The Basle Committee contends that the fundamental precepts in drawing up the Core Principles for Effective Banking Supervision are as follows:16

(a) the key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors;

(b) supervisors should encourage and pursue market discipline by encouraging good corporate governance (through an appropriate structure and set of

16 See op cit, Basle Committee, fn 1, p 8.
responsibilities for a Bank’s board of directors and senior management)\(^1\) and enhancing market transparency and surveillance;

(c) in order to carry out its tasks effectively, a supervisor must have operational independence, the means and powers to gather information both on and off site, and the authority to enforce its decisions;

(d) supervisors must understand the nature of the business undertaken by banks and ensure to the extent possible that the risks incurred by banks are being adequately managed;

(e) effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources allocated accordingly;

(f) supervisors must ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management, and effective control systems and accounting records; and

(g) close co-operation with other supervisors is essential, particularly where the operations of banking organisations cross national borders.

**IMF STANDARDS FOR SOUND BANKING**

In September 1999, exactly two years after the Basle Committee announced its Core Principles for Effective Banking Supervision, the International Monetary Fund (IMF) postulated some standards on a framework for sound banking. Closely related to the Basle Committee’s Core Principles, the IMF standards for sound banking provide as follows:

The spillovers from crises in emerging market financial systems, and their potential to disrupt the financial systems of other economies, have been more widely recognized in the wake of the financial crisis in East Asia. Indeed, weak financial institutions, inadequate bank regulation and supervision, and lack of transparency lie at the heart of the economic crises in these economies. These experiences have underscored not only the importance of a sound banking sector for macroeconomic stability, but also the influence of macroeconomic and structural policies, as well as strong governance, on the soundness of the

\(^{17}\) The Basle Committee observes that their analysis refers to a management structure composed of a board of directors and senior management. See *op cit*, Basle Committee, fn 1, p 8: ‘The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the notions of the board of directors and the senior management are used ... not to identify legal constructs, but rather to label two decision making functions within a bank.’
banking system ... The IMF draws on practices that have worked well in some countries, applying them, with adaptation to suit local needs, to others. In addition, the IMF has supported strongly the development by the Basle Committee of its Core Principles for Effective Banking Supervision, a set of 25 principles that can be applied to the banking systems in both developing and transition economies. This document provides a standard that the IMF can use in encouraging member countries to strengthen their regulatory frameworks and supervisory capabilities. Together with the World Bank, the IMF is also encouraging members to consider the appropriateness of a wider range of public policies that impinge on the health of their financial systems.

Framework for sound banking

The IMF’s Executive Board has broadly agreed that achieving the following objectives would strengthen financial systems:

- strengthening internal governance by bank owners, boards of directors and managers;
- increasing transparency and the role of market forces;
- limiting distortions imposed by public sector policies;
- controlling risk through regulatory and supervisory oversight;
- strengthening the broader structural framework; and
- fostering national and international supervisory co-ordination.

Further, the IMF is working with other agencies on finalizing a code for transparency in monetary and financial policies. This code identifies desirable transparency practices for central banks in their conduct of monetary policy and for central banks and other financial agencies in their conduct of financial policies. In addition, the recently established financial stability forum (set up under the aegis of the Group of 7) will make an important contribution as a vehicle for strengthening co-operation among national agencies and international expert groups with responsibilities for financial regulation and oversight.18

In trying to restore a sound banking system, the IMF observes, the case of State owned banks and that of former centrally planned economies pose special problems.19 In the case of State owned banks, the privatisation or closure of these institutions worked well in many countries.20 Indeed, the principle of loss sharing among the State, the banks, and the public was seen an integral part of successful bank restructuring.21 Problems in centrally planned economies, on the other hand, were seen, for example, when countries of the former Soviet Union began to embark on market-oriented

reforms in 1991–92. These reforms led to the emergence of a two tier banking system that created central banks and transformed specialised State banks into notionally independent commercial banks. 22 The IMF argues that many of the latter institutions, lacking experience in credit evaluation, engaged in aggressive lending to enterprises to which they had ownership or other ties. 23 Thus:

At first, the consequences of poor credit evaluation were masked by high inflation. But then successful stabilization programs began to cut inflation sharply, revealing the banks’ underlying weaknesses and touching off a panic. Banking crises can also be sparked – as in Latvia – when the Government moves to impose stronger prudential standards, and the extent of bank weaknesses is exposed to the public. 24

In light of such evidence, the IMF standards for sound banking postulate further.

**What the IMF can do**

The IMF’s main channels for promoting banking system soundness in member countries are its ongoing multilateral and bilateral surveillance, program design, and technical assistance:

- **surveillance.** The IMF seeks to improve a country’s macroeconomic environment and policies through a regular dialogue with its national authorities. A sound banking system contributes to macroeconomic stability; therefore, a greater focus on banking sector issues helps identify potential weaknesses in the financial system that could have major macroeconomic implications. The IMF, in co-operation with other institutions, will be deepening its surveillance by a further increase in the coverage of financial sector issues and emphasizing its quest for transparency. Such efforts are designed to lessen the frequency and diminish the intensity of banking system problems in the future. Toward this end, the IMF is taking steps to ensure that the monitoring of a country’s economic and financial policies is continuous, comprehensive, and probing. In this regard, two years ago, the IMF published a study, ‘Toward a Framework for Financial Stability’, a kind of road map for this work which, together with the Basle Core Principles, provides an important reference point for its continuing work with the national authorities;

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Core Principles for Effective Banking Supervision and Systemic Bank Restructuring

- **IMF-supported programs.** Efforts to strengthen member countries’ banking systems and improve supervision are reflected in the design of IMF-supported programs. The IMF frequently assists members in identifying and diagnosing banking system problems; designing – in conjunction with the World Bank – strategies for systemic reforms and bank restructuring; and ensuring that such strategies are consistent with, and supported by, appropriate macroeconomic and other structural policies;

- **IMF technical assistance.** This has helped to strengthen the financial infrastructure of member countries through advice on improving their monetary and fiscal management; foreign exchange and capital market development; the design of payment systems and deposit insurance arrangements; the development of the legal framework for banking, as well as prudential regulations and supervisory capabilities, in particular, regarding the entry and exit of banks; and strategies for bank systemic restructuring.\(^{25}\)

The IMF has identified some of the sources of problems relating to poor performance of banking systems. These problems, which the IMF tries to address in its standards on a sound banking system, include the following.

### IMF’S IDENTIFICATION OF SOME SOURCES OF BANKING SYSTEM PROBLEMS

**Sources of banking system problems**

- Weak internal governance of banks leaves the system vulnerable to macroeconomic shocks.
- Financial deregulation, competition and innovation outstrip the capacity of banks to manage risks prudently.
- Financial deregulation takes place before adequate prudential regulation and supervision are in place.
- Weak and insolvent financial institutions are allowed to continue operations, thus weakening the entire system.
- Capital account liberalization occurs before the soundness of the domestic financial system and macroeconomic policy is assured.
- Declining business profits, together with excessive corporate indebtedness, lead to a deterioration in asset quality.

Over-expansionary monetary and fiscal policies spur lending booms, excessive debt accumulation, and over-investment in real assets, which drive up equity and real estate prices to unsustainable levels.

In an effort to promote sound banking, the IMF observes further:

Although national authorities bear primary responsibility for addressing banking problems, globalization of financial flows – and its attendant risks – calls for concerted international efforts to avert financial crises. Efforts have been made by the Basle Committee to broaden guidelines for sound banking practices and to make them applicable to all countries. The IMF strongly supports this initiative and, through its near universal membership, will contribute to the dissemination of the principles and practices established by the Basle Committee and other international bodies, and encourage member governments to implement them. Thus, over time, such a process can contribute to a harmonization of financial policies and practices internationally. The experience gained in the IMF’s surveillance and technical assistance work is being usefully shared with these international expert groups.

Even with such policy pronouncements, the field of prudential banking supervision is not free from problems. Bank supervisors often use various types of methods for evaluating the soundness of a particular bank or a banking system. For example, the use of the CAMEL ratings system involves adoption of a shorthand method that regulators often use to evaluate banks on the basis of capital adequacy, asset quality, management, earnings and liquidity. Each of these categories (making up the acronym CAMEL) is given a rating of one to five. Here, one is the best rating. Also, a ‘multiple eyes’ approach can be instituted, and this involves use of such techniques as private credit rating of banks, subordination of debts, and prudent enforcement of disclosure requirements and accounting practices. In addition, other methods can be used, say, on the weighting of credit risk. Clearly, banking supervision is a minefield fraught with complexities and difficulties, and one which continues to attract academic debate and commentary. Recently, The Economist magazine observed:

The Basle Committee’s attempts to update its rules on banking capital are running into serious trouble. At first glance, it all seems to be going smoothly enough. On 22 November 1999, the European Commission issued proposals to update the regulations governing how much capital European financial institutions must set aside as a cushion against the risks they take. These are closely based on the recommendations of the Basle Committee, which is trying to modernise its regulations. But the implication, that revisions to the Basle Accord, first proposed in June, are going well, is wide off the mark. Basle is proving mighty hard to fix. That seems odd. Almost everybody agrees that the rules need to be changed so that the capital that banks have to set aside is more closely linked to the risks they are running. The question is: how? Big banks
want to be able to use their own sophisticated (in their own eyes, at least) in-house risk management models. These reflect the benefits of their diversified portfolio and of other ways of mitigating risks, such as the use of credit derivatives. But the Basle folk, while accepting that this was good stuff, responded that these models were insufficiently tested over a long period to be used now – though they held out the prospect that they might be in the (distant) future. Instead, the Committee offered two other approaches. The first is a modification of the original accord. At present, there are four broad categories, or ‘risk buckets’, into which a loan is placed. But curiously, these bear little relation to actual riskiness … More generally, if the capital required to support a loan takes no account of a loan’s riskiness, then banks will – and do – take advantage of the anomaly. That is, they will shed high-quality assets that they think should not require as much capital as the Basle rules demand. Instead, they will add assets that, in their opinion, should demand more capital than the rules say. In other words, banks have tended to plump for lower-quality assets. This was a big reason why regulators were so keen to change the rules … Nor, for their part, are banks keen on the reform. They think they are better-informed about their borrowers than are the rating agencies.27

Legal aspects of systemic bank restructuring

Closely related to aspects of prudential banking supervision is the idea of systemic bank restructuring. It has been argued that banking supervision is only a part of wider arrangements needed to promote stability in financial markets.28 Indeed, one way in which banking supervision can be improved is by pragmatically employing aspects of systemic bank restructuring. As Joseph Stiglitz, the former senior vice president and chief economist of the World Bank, observes:

Restructuring the banking system is even more difficult in many developing countries, for several reasons. First, there is less technical, legal, and institutional capacity for tasks like asset resolution. Secondly, the fraction of the banking system with bad assets and insolvencies is often far larger; there are fewer healthy banks to take over the weak banks. Thirdly, the banking systems may be more complex, with a mixture of State and private banks. The State banks may carry with them an implicit guarantee for depositors. A government announcement that it will not guarantee the private banks can easily generate a run on the private banks, especially if the government shuts down some banks but leaves doubts about the health of some of the remaining banks.29

27 See (1999) The Economist, p 75. Here, it must be pointed out that, outside the US, few companies carry ratings.
28 Op cit, Basle Committee, fn 1, p 11.
Against this background, a question could be posed: what do we mean by ‘systemic banking restructuring’? Some studies undertaken by the IMF show that systemic bank restructuring aims to improve bank performance – that is, restore solvency and profitability, improve the banking system’s capacity to provide financial intermediation between savers and borrowers, and restore public confidence.\(^{30}\) It is argued that:

Roughly speaking, financial restructuring tries to restore solvency (net worth) by improving banks’ balance sheets. A bank can improve its balance sheet by raising additional capital (for example, receiving cash from existing or new owners or from government), by reducing liabilities (for example, writing down the value of certain debts), or by boosting the value of assets (for example, raising the recovery value of problem loans and collateral). Operational restructuring affects profitability. Measures can include renewed attention to business strategy, improved management and accounting systems, and better credit assessment and approval techniques. Operating costs may be cut by eliminating branches and staff. To add to the banking system’s capacity for intermediation, restructuring usually means improving supervision and prudential regulation. Sometimes other measures, such as providing deposit insurance and a lender of last resort, are also needed.\(^{31}\)

Closely related to the view of the IMF is the view of a senior World Bank official. She observes:

Although bank restructuring is fairly common practice in a healthy banking system, this term usually refers to the failure of individual banks. When there is widespread evidence of banking failures that affects more than 20% of a banking system’s total deposits, the package of institutional and regulatory programs used to resolve failed banks and return the banking sector to sustainable health is referred to as ‘systemic bank restructuring’.\(^{32}\)

Indeed, the range of measures adopted by governments in systemic bank restructuring includes: ‘... both macroeconomic diagnoses of the multiple underlying causes for systemic problems and microeconomic efforts to improve banking supervision; correct weaknesses in the legal, accounting and regulatory framework; and rehabilitate or resolve individual insolvent banks.’\(^{33}\) But, to succeed, systemic banking restructuring will have to depend on a host of factors which include some of the preconditions for effective banking supervision, and these are:\(^{34}\)

(a) sound and sustainable macroeconomic policies;
(b) a well developed public infrastructure;

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\(^{30}\) Op cit, Dziobek and Pazarbasioglu, fn 19, p 2.
\(^{31}\) Op cit, Dziobek and Pazarbasioglu, fn 19, pp 2–3.
\(^{32}\) Op cit, Waxman, fn 29, p 1.
\(^{33}\) Op cit, Waxman, fn 29, p 1.
\(^{34}\) Op cit, Basle Committee, fn 1, p 11.
(c) effective market discipline;
(d) procedures for efficient resolution of problems in banks; and
(e) mechanisms for providing an appropriate level of systemic protection (or public safety net).

Although providing sound and sustainable macroeconomic policies is generally not a function of banking supervisors, it is argued that law and policy makers must adopt a comprehensive and holistic approach in structuring and instituting systemic banking restructuring. Such a strategy is important in addressing the broad spectrum of issues that arise in the rescue of banks and the financial sector. Indeed, as a prerequisite for accomplishing effective banking supervision, there is a need also to introduce a system of efficient business laws, including corporate, insolvency, contract, consumer protection and private property laws, that are not only consistently enforced, but that provide a mechanism for fair resolution of disputes as well. In addition, and as part of a well developed public infrastructure, comprehensive and well defined accounting principles that command wide international acceptance must be put in place. Equally important is the need to have effective market discipline – with limited government intervention – through provision of financial incentives to reward well managed institutions and arrangements that ensure that investors are not insulated from the consequences of their decisions. Fulfilment of these objectives requires an adequate flow of information to market participants.

Furthermore, there is a need to ensure that not only are procedures for efficient resolution of bank problems set in place, but that there are also mechanisms for deciding on an appropriate level of systemic protection. As the Basle Committee observes:

Deciding on the appropriate level of systemic protection is by and large a policy question to be taken by the relevant authorities (including the central bank), particularly where it may result in a commitment of public funds. Supervisors will also normally have a role to play because of their in-depth knowledge of the institutions involved. In order to preserve the operational independence of supervisors, it is important to draw a clear distinction between this systemic protection (or safety net) role and day to day supervision of solvent institutions. In handling systemic issues, it will be necessary to address, on the one hand, risks to confidence in the financial system and contagion to otherwise sound institutions, and, on the other hand, the need to minimize the

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35 Op cit, Basle Committee, fn 1, p 11.
36 In this vein, the Basle Committee (see op cit, fn 1, p 12) observes that market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives.
37 Op cit, Basle Committee, fn 1, p 12.
distortion to market signals and discipline. Deposit insurance arrangements, where they exist, may also be triggered.38

Some lessons of experience in systemic bank restructuring

In a pre-crisis scenario, both in the case of individual bank restructuring and systemic bank restructuring,39 one of the major constraints is the lack of incentives for bank managers and supervisors to recognise and resolve insolvent institutions.40 While acknowledging that there has been considerable attention paid to adopting the Basle Committee’s capital standards for assessing the riskiness of bank assets, Waxman observes that it is still quite difficult for bank supervisors and managers to admit that a bank is facing losses that cannot be corrected within the established rehabilitation time as set out by law or regulation.41 This feature is attributed to factors such as inadequate accounting standards that permit a continuous rollover of non-performing loans, the political risk to imposing costs on taxpayers or bank owners, and a governmental interest in maintaining a banking institution to provide funds to a particular economic segment.42 However, in undertaking systemic bank restructuring, a clear understanding of what has worked or failed in the past is important in guiding countries that are formulating their own plans for reforms. As Dziobek and Pazarbasioglu observe, ‘this is particularly true since the plans so often are forged under crisis conditions – including runs on banks and capital flight – when speed is essential’.43 Indeed, prompt corrective action is a key ingredient of successful banking reform. Thus:

… countries making substantial progress all took action within a year of the emergence of their banking problems. They also effectively diagnosed the nature and extent of the problems, identified the underlying causes, and designed a restructuring strategy to address them all systematically. In all 24 countries (the countries that were surveyed), systemic problems had multiple causes, and chances for success were greatest when the causes were diagnosed accurately, then addressed swiftly and comprehensively.44

38 Op cit, Basle Committee, fn 1, p 13.
39 See below for a distinction between individual and systemic bank restructuring.
40 Op cit, Waxman, fn 29, p 3.
41 Op cit, Waxman, fn 29, p 3.
42 Op cit, Waxman, fn 29, p 3.
43 Op cit, Dziobek and Pazarbasioglu, fn 19, p 5.
44 Op cit, Dziobek and Pazarbasioglu, fn 19, p 5.
In a study on Argentina, Chile, Egypt, Finland, Ghana, Hungary, Indonesia, the Ivory Coast, Japan, Korea, Kuwait, Latvia, Mauritania, Mexico, Peru, the Philippines, Poland, Spain, Sweden, Tanzania and Zambia, Dziobek and Pazarbasioglu observe that a number of countries that made slow progress faced more problems. Such problems included difficulties in correcting taxation policies that distort incentives in banking; refusal or failure by governments to acknowledge and confront problems facing State owned banks; and collapse of export prices or soaring world interest rates, often triggering the banking crises and forcing the countries to undertake comprehensive reform.

In the case of individual bank restructuring, which focuses on problems faced by individual or group company banks (for example, banks in a parent-subsidiary relationship), Waxman identifies a number of strategies for restructuring. A government can employ these strategies in the pre-crisis period of a bank and the strategies include the regulatory forbearance techniques used by the US regulators in the 1980s to address the deteriorating condition of the savings and loans industry. Other techniques relate to strategies such as government-encouraged mergers and direct government support through the use of the flow technique for problems of liquidity in the early stages of a banking crisis. Here, the flow technique is often employed where banks have at least some positive capital and the problem is a truly temporary or timing mismatch of asset and liabilities. The other form of direct government support, the stock technique, is employed mainly where the government recognises that the problem is far greater than a temporary liquidity shortfall and instead goes to the very heart of the bank’s ability to survive.

On the implementation of systemic bank restructuring, it is argued that invariably the first action a government must take in a systemic bank crisis is to restore public confidence in the banking system’s ability to repay deposits. Once the public confidence has been lost, the level of deposit insurance or other structural support for bank deposits becomes irrelevant. In order to restore confidence, the government must provide a new level of deposit

45 Op cit, Dziobek and Pazarbasioglu, fn 19, p 5.
51 See ibid, pp 40–41, 181. See, also, op cit, Waxman, fn 29, p 6.
52 See op cit, Waxman, fn 29, p 10.
support. This can take the form of government guarantee for the increased borrowings by the deposit insurance fund, but most often the government, through an executive decree or emergency legislative act, provides an outright guarantee of all deposits for a substantial time, as happened in Thailand, Indonesia and South Korea.\footnote{See \textit{op cit}, Waxman, fn 29, p 10.}

One other way of restoring confidence in the banking system is by strengthening prudential regulations.\footnote{See \textit{op cit}, Waxman, fn 29, p 11.} This can be done by incorporating or adopting, within the laws of a country, some useful international regulatory norms such as aspects of the Basle Accord on capital adequacy and the Basle Core Principles for Effective Banking Supervision. Equally important is the need to have a regulatory structure that provides for timely disclosure of financial information on performance of banks.\footnote{That is, assuming that the information is not legally classified as confidential or not being subject to disclosure.} However, for these measures to be workable, there is a need to enhance the regulatory compliance mechanisms and, if necessary, to reorganise the bank regulatory agencies.\footnote{See \textit{op cit}, Waxman, fn 29, pp 12–13.} Once public confidence is restored, a legal process for government intervention must be set up. Here, a number of preconditions are vital in restoring public confidence. For example, Waxman lists some of these conditions as:\footnote{\textit{Op cit}, Waxman, fn 29, pp 14–17.}

(a) ensuring that the deposit insurance system or other government entity has sufficient funds to handle the crisis or authority to raise such funds quickly and efficiently;

(b) ensuring that the government has the legal authority necessary to promptly intervene failed banks;

(c) establishing a process for evaluating bank insolvency;

(d) establishing a mechanism for intervening in failed banks;

(e) government assistance linked to government ownership; and

(f) government assistance to existing shareholders.

Apart from the need to restore public confidence in the banking system and to establish a legal process for government intervention, the setting up of a mechanism for the recovery of non-performing loans is another way in which systemic bank restructuring can be employed.\footnote{For a detailed discussion on this, see \textit{op cit}, Waxman, fn 29, pp 18–20.}
Beyond banking supervision and systemic restructuring

While it is acknowledged that individual bank restructuring and systemic bank restructuring can improve the financial health of the banking and financial services sector, it is argued that an efficient and effective regulatory framework alone cannot provide for adequate means of preventing the collapse of banks. Indeed, banks do take risks and, as a consequence thereof, some banks will collapse even where systemic banking restructuring is employed. Be that as it may, what are some of the measures that can be employed beyond banking supervision and systemic restructuring to ensure a healthy banking and financial services industry?

A study undertaken by the IMF shows that experience holds very few clues to the direct relationship between bank restructuring efforts and economic conditions in a particular country. The report reads:

While an environment of strong economic growth helps bank restructuring operations, the study’s empirical results give examples where measures have succeeded even where the economic situation remained weak. This is consistent with the principle that prompt government action is required to take difficult and unpalatable measures, without waiting for a serendipitous upturn in the economy ... In all the experiences studied, the trend of inflation was the most consistent development; it declined in nearly all countries in the years after bank restructuring began ... Although bank restructuring programs may be initiated in a time of economic stagnation or severe recession, positive economic growth helps banks to resume lending and return to profitability.

What must be appreciated in restoring the financial health of a banking and financial services industry is that an economy is an open system which has various subsystems at different recursive levels within, outside and around it. Therefore, if we concentrate on repairing a system as if it were ‘closed’ off from its subsystems and from its internal and external environments, we will find ourselves grappling with the same issues all over again. There has to be a fine balance between individual bank restructuring and systemic bank restructuring. Indeed, bank restructuring should not only focus on financial and operational restructuring. Rather, it must be viewed in a holistic sense while we apply a comprehensive formula to the issues at hand. In this regard, it is acknowledged that, although systemic bank restructuring is helpful in general, such reform must be accompanied by individual bank restructuring to avoid adopting a reductionist approach of dealing with one problem while overlooking the other. A reductionist approach which places emphasis on dealing with one part of the system while leaving the other out can only promote temporary financial health of the banking sector. Indeed, problem solving must be seen as a continuous culture of restoring good health to the

59 Op cit, Dziobek and Pazarbasioglu, fn 19, p 10.
60 Op cit, Dziobek and Pazarbasioglu, fn 19, p 10.
banking and financial services sector. The essential questions to ask, therefore, are as follows:61
(a) how can we design the most efficient organisational processes and arrange their implementation?
(b) how can we achieve effective organisation?
(c) what options should we decide upon that debate technical and human issues that characterise organisational activities and lead to decisions on what to do about them?
(d) why should a design or a decision be adopted that merely serves the interests of dominant groups, rather than balancing individual and organisational needs, taking into account the physical, biological and social environments?

In undertaking a creative approach to problem solving, a holistic view of the problem must be grasped. This means that we must engage in a creative mode of generating viable options and methods. We must also be in a position to make choices about these methods before we can implement them. But the process is not a linear one. Rather, it is in a circular, continuous, back and forth motion. Time and time again, we may have to revisit our choices and see if we can generate more options before implementing these as well.

Generally, almost all organisations exhibit four major organisational characteristics and to address issues in all the four areas, a meta-paradigmatic approach is necessary. The four areas here are as follows:62
(a) organisational processes – that is, the flow of events and controls over these flows;
(b) organisational design – that is, the organisation of functions, their coordination and control;
(c) corporate and individual cultures in the organisation – that is, mediation of behaviour in terms of people’s relationship to social rules and practices; and
(d) organisational politics – power and potency to influence the flow of events.

For example, some banks are run and controlled by powerful individuals who are well connected politically. How do we deal with such situations?

To design an effective problem solving strategy for systemic bank restructuring and individual bank restructuring, we must take on board issues such as those raised above. It is less helpful to take a reductionist approach by simply looking at the balance sheet to see where the bad debts fall or if there are any loans that were given without collateral. Indeed, we must ensure that the methods chosen for problem solving are capable of addressing all the four characteristics of the organisation. Such an analysis can then be extrapolated

to higher systemic levels so that the link between, say, an efficient and effective regulatory framework for banking supervision and that for the securities regulation is taken into account. As we shall see in the latter parts of this work, there is a thin line between the business of banking and that of securities trade and financial services. It explains why, for example, prudential banking supervision should not only focus on losses made by a bank. Supervisors must be able to look at other related issues as well. Issues such as whether the development of a securities market should be emphasised so as to improve the liquidity position in the economy, with an expected spill-over effect leading to good performance of the money markets, should be addressed. It must be pointed out that banks can opt for various strategies of survival. Supervisors must be able to assess the riskiness of these strategies. Typically, strategies for corporate (or bank) rescue could include both formal and informal approaches to rescue. The strategies range from engaging in schemes of arrangement with creditors, implementing total quality management, implementing business process re-engineering, using total systems intervention, permitting secured creditors to make critical financial decisions, contracting for debt subordination, assigning receivables, making use of rules of insolvency set off, and obtaining finance through the Quistclose purpose trust, to issues such as capitalisation and fresh issue of shares. Indeed, this broad picture provides an important milestone beyond banking supervision and systemic bank restructuring.

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63 Eg, an evaluation of the equity finance stream of a bank would be equally important.

64 Belcher, 1997, pp 11–12, observes: ‘Good management of a company involves not only the running of the company in its present form, but increasingly means the development of the company through time. Management effort in the areas of financial planning, especially in periods of rapid growth in sales, brand maintenance, product development coupled to product lifecycles and the management of research and development activities are vital to this process. Companies are rarely static; they are either adapting to the changing social and economic environment or moving towards distress and failure. If rescue is defined simply as the avoidance of distress and failure, all management activity can be thought of as constant and repeated rescue attempts. This extremely broad definition of what constitutes rescue can be contrasted with a very narrow definition based on legal rescue procedures. Between the two extreme views of rescue as the on-going maintenance of company health, and rescue as the operation of formal legal procedures which offer emergency aid in a situation of imminent failure, there lies a whole spectrum of management activity and outside intervention that could be labelled company rescue ... Rescue will be defined as a major intervention necessary to avert failure of the company.’
Conclusion

This chapter has examined both the Basle Committee Core Principles for Effective Banking Supervision and the legal aspects of systemic bank restructuring. It was argued that, while there is no single toolkit for banking supervision which provides for fully contingent and exhaustive solutions to banking crises, effective and prudential banking supervision can be undertaken through the adoption of interdisciplinary tools and approaches to supervision. Fields such as banking law, corporate finance, and corporate and securities law were identified as rich sources of law for effective banking supervision.

The chapter noted further that, while individual bank restructuring and systemic bank restructuring can improve the financial health of the banking and financial services industry, an efficient and effective regulatory framework alone cannot provide for adequate means of preventing the collapse of banks. It was argued, therefore, that the application of systems thinking to organisational issues, as part of a continuous problem solving strategy, is desirable in achieving sustainable development of the banking and financial services industry.
CHAPTER 3

CONTEMPORARY ISSUES FACING A MODERN LEGAL FRAMEWORK

In the year 1996, the banking and financial services industry has made significant strides to recoup the lost confidence that resulted from the closure of three indigenous banks in 1995 (Meridien BIAO Bank (Z) Ltd, African Commercial Bank (Z) Ltd and Commerce Bank (Z) Ltd). The turbulence experienced in that year has been attributed to the weak financial structure that banks and financial institutions have been operating under. The challenge of the (Bank of Zambia) Financial System Supervision Department has been to strengthen this structure and to implement a more effective and efficient supervisory environment. This has been achieved through constant close supervision and implementation of various regulations during 1996. The most significant of the regulations was the Capital Adequacy Regulation. The Capital Adequacy Regulation prescribes that commercial banks and all other deposit-taking institutions have a minimum regulatory capital of K2 billion; and non-deposit-taking financial institutions a minimum of up to K250 million. As regards non-bank financial institutions (NBFI), effective regulation and supervision has so far been impeded because the Banking and Financial Services Act (BFSA) was drafted primarily to regulate the activities of commercial banks. In spite of the absence of a specific regulatory framework, I am pleased to note that the growth in the number of NBFI is extremely encouraging and is contributing to the much needed diversity of financial services available in the financial sector. The Department through a study funded by the United Nations Conference on Trade and Development (UNCTAD) is working to create and strengthen the prudential regulation of these institutions. It is hoped that once this is in place it will greatly enhance the supervisory role in this sector. The Bank of Zambia (BOZ) is looking towards 1997 as yet another challenging year for the Department as it strives to strengthen its staff base and improve supervisory capacity. The possibility of creating a deposit insurance scheme to protect depositors’ funds and boost customer confidence will be another major task for the department in the year ahead. I am confident that we will continue to develop the necessary legal framework, competent supervisory skill and expertise to ably meet the challenges ahead of us [Dr Jacob M Mwanza, Governor of the Bank of Zambia, Financial System Supervision Annual Report (1996)].

INTRODUCTION

Chapter 2 looked at the Basle Core Principles for Effective Banking Supervision and addressed some of the pertinent issues affecting systemic bank restructuring. This chapter examines contemporary issues affecting the efficacy of a modern legal framework for banking supervision. The Zambian
legal framework is chosen as a case study since Zambia has experienced some attempts at undertaking systemic banking restructuring. At the outset, it must be pointed that the only aspects of the Zambian legal framework that are addressed relate to pre-insolvency operations of banks.¹

In this chapter, it is argued, among other things, that, in undertaking banking reforms an important objective to consider is the need to develop a stable banking system which allocates credit on a market basis. Generally, this objective must be accomplished before capital markets are even liberalised. As Caskey observes:

Costly financial crises have taught the lesson that liberalisation must not proceed until prudential standards are in place, supervisors are capable of overseeing bank activities, banks are adequately capitalised, and banks have the ability to operate profitably and prudently … Advice is to begin with banks since banks underpin the rest of the financial system and are the fundamental source of finance for most firms … Hold off on development of securities markets, but the nature of privatisation will affect this advice. For example, an approach that distributes shares or vouchers widely will require relatively quick development of securities markets.²

The legal framework for banking supervision in Zambia

Some aspects of banking reforms were undertaken in Zambia at the time of introducing the Banking and Financial Services Act 1994. This statute, which repealed and replaced the previous banking law in Zambia, deals with the regulation of the conduct of banking and financial services.³ It also provides safeguards for investors in and customers of banks and financial institutions.⁴ In general, the Banking and Financial Services Act 1994 applies to all banks and financial institutions,⁵ whether or not constituted by any Act of

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¹ The bulk of the law on insolvency of banks in Zambia is found in the Banking and Financial Services Act 1994, Chapter 7, and the Companies Act 1994. Indeed, that aspect of the law is not the focus of this work. For further readings on recent developments relating to insolvency of banks, see the following seminar papers: Asser, 1999; and Waxman and Annamalia, 1999. Both Mr Asser’s paper and Ms Waxman and Ms Annamalia’s papers were presented at a conference on ‘Building effective insolvency systems’, hosted by the World Bank in Washington DC, 14–15 September 1999.


³ See preamble to the Banking and Financial Services Act 1994, and s 131 of that statute.

⁴ See preamble to the Banking and Financial Services Act 1994.

⁵ Financial institutions are described in the Banking and Financial Services Act 1994, s 2, as ‘a person that holds a financial institution’s licence’. A financial institution’s licence, on the other hand, is described in the same statutory provision as ‘a licence under s 10 of the statute’, and s 10 then reads: ‘… a licence authorising the applicant to conduct any regulated financial services business.’ But what is financial services business? Financial services business is described in the Banking and Financial Services Act 1994, s 2, as ‘the business of performing or offering to perform any financial services to the [cont]
Parliament. The requirements of the Banking and Financial Services Act 1994 are, however, not binding on the Bank of Zambia, except in so far as the Act expressly imposes a duty on that bank. A similar analogy is extended to statutory bodies such as the Development Bank of Zambia and the Export and Import Bank. This explains why Chapter 1 of this book looked at definitions of terms such as ‘bank’ and ‘banking business’. Indeed, in that chapter, we argued that how can we tell if a corporate entity that has gone bust is a bank for purposes of insolvency distributions?

In a study undertaken by this author in Zambia, it was noted that the Central Bank of Zambia does not supervise non-traditional ‘banking’ institutions such as the Development Bank of Zambia (DBZ) and the national pensions institution (the latter body was, at that time, known as Zambia National Provident Fund). It was observed further that when the Banking and Financial Services Act 1994 of Zambia came into force, the central bank was at that time supervising DBZ. Later, DBZ made representations to the Zambian Government that the central bank had no powers to supervise it since it was a statutory body established under a different piece of legislation. Thus, the central bank was forced to abate its supervisory role over DBZ and the Government then asked the central bank to provide a report on how such institutions could be supervised. In spite of all these problems, the central bank maintains a seat on the board of DBZ.

Apart from the coming into force of the Banking and Financial Services Act 1994, there are also efforts to introduce legislation on money laundering in Zambia. As the Bank of Zambia observes:

5 [cont] public, but does not include banking business’. In Chapter 1, we looked at the meaning of the term ‘banking business’ under the Banking and Financial Services Act 1994 and noted that ‘banking business’ is the business of receiving deposits from the public and the use of such deposits, either in whole or in part, for the account of and at the risk of the person carrying on the business, to make loans, advances or investments, and includes any custom, practice or activity prescribed by regulation as banking business.

6 Banking and Financial Services Act 1994, s 3.
7 Ibid.
8 Ibid.
9 Interview with Mr Marshall Mwansompelo. The interview revealed that the Bank of Zambia has a departmental unit dealing with the supervision of non-traditional banking institutions such as leasing companies, bureaux de change and other credit finance companies.
11 Although it is important that a modern legal framework for bank supervision regulates against money laundering, this work highlights only salient features of money laundering, since a meaningful discussion of such an offence can only be best undertaken in a separate dissertation altogether. See, eg, Gilmore, 1992; Bosworth-Davies and Saltmarsh, 1994; and Dine, 1995, pp 105–27. Under international law, the UN Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances (Vienna Convention) 1988 calls on State signatories to criminalise money laundering, to assure that bank secrecy is not a barrier to criminal investigations and to promote removal of legislative impediments to investigation, prosecution and international co-operation.
There is a growing global concern over money laundering, and Zambia is no exception. Explained in simple terms, money laundering is the ‘washing of dirty money’ into the financial system thereby legitimising proceeds of illegal activities such as drug trafficking. Money laundering not only undermines public confidence in the financial system, it also causes distortions in the economy in terms of significant influence on key economic variables such as money supply which do not derive from economic activity. As there is no law against money laundering at present, a committee (on which the Bank of Zambia has a representation) has been established with the objective of drafting legislation to outlaw money laundering.12

In addition, there are some efforts to introduce legislation on deposit insurance.13 However, these efforts are far less concerted than efforts on the introduction of legislation on money laundering. As the Bank of Zambia observes:

Deposit Insurance Scheme: It is evident from past experience, particularly the failure of three banks in 1995, that banking instability can have serious adverse

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12 See the Bank of Zambia website. In a recent World Bank study, Ofosu-Amaah, Soopramanien and Uprety, 1999, pp 53–55, define money laundering as follows:

Money laundering is the process of transformation of the form or usage of ill-gotten proceeds of economic crimes, with a view to obscuring the source or origin of such proceeds. The term ‘money laundering’ has traditionally been associated with drug-trafficking offences. Today, however, money laundering has come to be regarded as an essential element in the fight against corruption. Its scope has been extended to apply generally to all economic crimes, including corruption offences. As in the case of drug trafficking, the purposes of money laundering legislation is to ensure that crime does not pay, and that no amnesty is provided after the fact to perpetrators of serious economic crimes … In the UK, legislation creating money laundering offences in connection with drug trafficking was first introduced in 1986. But it was not until the Criminal Justice Act of 1993, amending the Criminal Justice Act of 1988, that money laundering provisions were extended generally to cover other forms of criminal conduct … The Swiss Criminal Code now makes it an offence for anyone to commit an act the effect of which is to impede the identification of the source, discovery, or confiscation of assets that he knows, or should have known, came from a crime … The offence is punishable in Switzerland, even if the underlying crime has been committed abroad, provided, of course, that the set of circumstances that constitute the underlying crime amounts to a crime under both Swiss law and the foreign law.

Cf EU Directive on Money Laundering, adopted on 10 June 1991, which provides in Art 1 that the offence of money laundering involves:

(a) conversion or transfer of property in the knowledge that such property is derived from criminal activity, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in committing such crime to evade the legal consequences of his action;
(b) concealment or disguise of the nature, source, location, disposition, movement, rights with respect to or ownership of property in the knowledge that such property is derived from criminal activity or from an act of participation in such crime;
(c) the acquisition, possession or use of property in the knowledge, at the time of receipt, that such property was derived from criminal activity or from an act of participation in such crime; and
(d) participation in, association or conspiracy to commit, attempts to commit and aiding, abetting, facilitating and counselling the commission of any of the actions established in the previous paragraphs.

13 See Bank of Zambia website.
effects on a nation’s economy because it can impair a nation’s payments mechanism, reduce the nation’s savings rate, diminish the financial intermediation process, and inflict serious harm on small savers. To prevent these adverse effects, the Government has created a variety of institutional arrangements designed to preserve banking stability. These arrangements have included banking laws and regulations that set the ground rules for bank operations and attempt to constrain undue bank risk taking; the laws and regulations are intended to provide a framework for the supervision and examination of banks to ensure compliance with laws and regulations and lender of last resort facilities designed to prevent temporary bank liquidity problems from turning into insolvency. In addition to these more traditional arrangements, the Government is in the process of developing and setting up a deposit insurance scheme. The primary purpose of the scheme is to preserve public confidence in the banking system, provide the Government with a formal mechanism for dealing with failing banks, and ensure that small depositors are protected in the event of bank failures.14

In general, most governments insure liabilities of major banks in a crisis. Such deposit insurance is important because the closure of these banks, or even an interruption in their supply of credit, would be too costly to the economy.15 Put simply, these banks are too big to fail. Indeed, as Caskey observes:

People know this (that these banks are too big to fail) and believe that the liabilities of these banks are effectively insured. This is implicit deposit insurance. Such beliefs may be supported by past actions of the government and are supported by the actions of other countries.16

Caskey argues further that, given this situation, it is better to introduce explicit deposit insurance.17 It is pointed out thus:18

(a) implicit insurance of liabilities of TBTF (too-big-to-fail) banks gives them a competitive advantage over small banks, reducing competition in the banking system;
(b) it is better to collect insurance premiums in stable periods to build up a fiscal reserve to help meet the expense of covering the liabilities of failed banks;
(c) incentive problems will be minimised if the system is explicit and unambiguous.

In spite of the many arguments that are advanced in favour of deposit insurance, it must be noted that there are also some shortcomings to such insurance systems. Indeed, deposit insurance can expose a government to significant contingent expenses.19 The insurance of deposits entails that

14 See, generally, Bank of Zambia website.
16 Ibid.
17 Ibid.
18 Ibid.
19 For an elaborate discussion on this, see ibid, p 2.
insured depositors have very little incentive to monitor banks for risks. As a result thereof, banks can, and often do, take on greater risks. This feature is called the ‘moral hazard’ problem.

A further shortcoming of using deposit insurance is that banking regulators have limited means to supervise risk taking by banks. In addition:

Some banks may indeed be Too-Big-To-Fail. But it is better to leave some ambiguity about whether or not the government will insure the liabilities of these banks for this provides some element of market discipline, reducing the moral hazard problem. Such a policy is referred to as constructive ambiguity …

… countries that do not adequately regulate and supervise banks ought not to offer generous deposit insurance. They might consider much more limited deposit insurance that lowers the risk of a large loss to the government.

The Banking and Financial Services Act 1994

Although the Banking and Financial Services Act 1994 of Zambia deals with the legal aspects of banking supervision and prudential regulation in Chapter 6 of the statute, this work examines not only Chapter 6, but other relevant parts as well.

The competent authority for authorising banking and financial services business

In Zambia, while the Registrar of Banks and Financial Institutions, in consultation with the Minister of Finance, has the statutory power to authorise a company to conduct banking or regulated financial services business, it is

20 See op cit, Caskey, fn 15, p 2.
22 The Registrar is appointed by the Minister of Finance pursuant to provisions of the Banking and Financial Services Act 1994, s 20:

The Minister, on the recommendation of the Bank of Zambia, shall appoint a Registrar of Banks and Financial Institutions to administer the Register and to exercise and perform such other functions as are conferred or imposed upon him by or under this or any other Act or by the Governor of the Bank of Zambia, and may designate an employee of the Bank of Zambia as the Deputy Registrar of Banks and Financial Institutions who shall be subject to the control and directions of the Registrar and be competent to exercise and perform any of the powers and functions of the Registrar … The Registrar and Deputy Registrar shall each hold office for a term of five years unless removed for negligence of duty or misconduct, and shall be eligible for re-appointment.

23 See ibid, s 4(1): ‘Upon application by a company, the Registrar, in consultation with the Minister, may grant a licence authorising the company to conduct banking business.’ Further, s 10(1) of that statute provides: ‘Upon application by any person, the Registrar, in consultation with the Minister, may grant a licence authorising the applicant to conduct any regulated financial service business.’ Cf Banking and Financial Services Act 1994, Chapter 6.
the central bank – that is, the Bank of Zambia – which is empowered by law to act as the competent authority for supervising banks. As a general rule, a person other than a bank is not allowed to conduct or offer to conduct banking business. Similarly, a person other than a bank or financial institution is prohibited from conducting or offering to conduct any regulated financial services business. Banks and financial institutions are only permitted to engage in business covered by a banking or financial services licence or by the Banking and Financial Services Act 1994.

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25 Ibid, s 17.
26 Ibid.
27 See ibid, s 17(3). Under s 8, authorised activities of a Bank, in addition to taking of deposits, include the following (cf definition of ‘financial services’, in s 2 of the same Act, which replicates most of the provisions here):

   Except where the conditions attached to a particular licence otherwise provide, a banking licence shall be taken to authorise its holder to engage in any of the following activities in addition to banking business:

   (1) making loans and extending credit to any person on the security of property of any kind or unsecured;

   (b) dealing as a principal or as an agent in–

   (i) bills of exchange, promissory notes, cheques, travellers’ cheques and like instruments;

   (ii) the currency of Zambia and, subject to the regulations made under this Act, in the currency of any other country and foreign exchange transactions; and

   (iii) gold, silver or platinum bullion or coins;

   (c) providing money transfer services and facilities;

   (d) the issue and administration of payment, credit or debit cards and, in cooperation with others, the operation of payment, credit card and debit card systems;

   (e) providing guarantees, letters of credit and other assurances of payment;

   (f) financial leasing;

   (g) factoring, with or without recourse;

   (h) acting as a trustee of any trust, executor or administrator of any estate or in any fiduciary capacity for any person;

   (i) acting as a financial agent for any person;

   (j) acting as a selling agent in connection with any equity or debt securities that are in the course of distribution by the Privatisation Agency established under the Privatisation Act 1992 or as an advisor to that Agency with respect to any aspect of the privatisation of any parastatal organisation;

   (k) provide safekeeping and custodial services for financial assets and securities;

   (l) providing merchant banking advice and services; and

   (m) dealing as a principal or as an agent for its customers in financial futures and options and in exchange, currency and interest rate swap agreements ...

... [cont]
Banking and financial services licences

In general, an application for a banking or financial services licence must be in such form and accompanied by such fees as prescribed by regulation. In spite of this broad and seemingly open-ended requirement, an applicant for a banking licence, in contrast to one for a financial services licence, is expected to provide at least the following particulars:

(a) the memorandum of association and articles of association of the company;
(b) the address where its head office is located and the names and permanent residential addresses of its directors and the name and permanent residential address of its chief executive officer, chief financial officer or chief operating officer;
(c) the name and permanent residential address of every subscriber for any class or series of shares issued by the company in a number that will exceed one per centum of all the shares of that class or series, whether such shares carry the right to vote in all circumstances or not;
(d) the addresses of each branch proposed to be opened by the company and, in the case of a mobile office, the area proposed to be served;
(e) full particulars of the business it proposes to conduct under the authority of the licence;
(f) the amount of its capital; and
(g) such assurances and evidence of the foregoing as the Registrar may require to be given by the applicant.

Clearly, for purposes of consolidated supervision, as noted in Chapter 2 of this book, an applicant must provide information on addresses of each branch.

27 [cont] (2) Any service or activity that a bank may provide or perform by virtue of this section it may provide or perform through a subsidiary.

(3) The Minister, on the recommendation of the Bank of Zambia, may by regulation prescribe the meaning to be given to any expression used in this section and not otherwise defined for the purposes of this Act.

28 Banking and Financial Services Act 1994, ss 4(2), 10(1) and (2).

29 See explanation above, fn 27, on what constitutes financial services and how that differs, if any, from authorised activities of a bank. Yet, the statute does not spell out the same type of requirements in the case of an application for a banking licence or a financial services licence. The Banking and Financial Services Act 1994, s 10, dealing with applications for financial services licences, has no stringent requirements akin to those for a banking licence.

30 Banking and Financial Services Act 1994, s 4(2)(a), (b), (c), (d), (e), (f) and (g).

31 In that chapter, it was pointed out that Core Principle 20 of the Basle Core Principles for Effective Banking Supervision provides that: ‘An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.’ Adding to that, Core Principles 23 and 24 provide for an international and cross-border dimension to consolidated banking supervision by stating the following:

(23) Banking supervisors must practice global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by ... [cont]
proposed to be opened by the company. The applicant must also provide information on any other related matter, such as the names and addresses of the shareholders. This statutory requirement complements the Basle Core Principles for Effective Banking Supervision. What, however, poses some interesting questions is the requirement for the applicant to provide particulars on the memorandum and articles of association of the company. I have argued elsewhere, and in Chapter 1 of this book, that, while the Zambian Companies Act 1994 requires a company to provide articles of association at incorporation, the Act does not require a company to provide a memorandum of association at any time. The legal implications of this omission have been explored at some length and there is no need to regurgitate such analysis here. Suffice it to say the requirement for an applicant of a banking licence to provide a memorandum of association could be interpreted along the following lines:

1. Although the Companies Act 1994 is silent on whether or not a company must furnish a memorandum of association at incorporation, the requirement under the Banking and Financial Services Act 1994 directs an applicant for a banking licence to prepare a memorandum of association solely for the purposes of licensing and supervision. As we shall see below, this distinction is of great significance to the interpretation of the statutory provision in issue.

2. Alternatively, it could be argued that the requirement under the Banking and Financial Services Act 1994 is meaningless since the Companies Act 1994, under which the company was incorporated, did not require a memorandum of association at incorporation or at anytime thereafter.

At close examination, the requirement that an applicant for a banking licence should prepare a memorandum of association solely for the purposes of licensing and supervision must stand. The reasons for advancing this view are mainly twofold: first, the preamble of the Banking and Financial Services Act 1994 stresses the importance of providing safeguards for investors (which could take the form of licensing and supervision); and, secondly, the Banking and Financial Services Act 1994 is an independent piece of legislation and

31 [cont] by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

(24) A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

Indeed, the Banking and Financial Services Act 1994, s 9(4), permits banks to operate branches outside Zambia once they obtain the necessary consent from the Bank of Zambia.

32 Cf Core Principles 23 and 24 of the Basle Core Principles for Effective Banking Supervision.

33 See Mwenda, Penn, 1999, pp 30–34.

34 See, generally, Mwenda, 32(1), 1999.
cannot therefore be superseded by a competing statute which has no provisions of an overriding nature.

*Grounds upon which the Registrar may refuse to grant a licence*

In deciding whether or not to grant a banking licence, and in deciding what conditions should be attached to such a licence, the Registrar of Banks and Financial Institutions can have regard to the capital adequacy of the applicant; the financial condition, resources and history of the applicant and the applicant’s associates and affiliates; the character and experience of the directors and major shareholders and of persons proposing to be concerned in the management of the business to be undertaken under the authority of the licence; the convenience and needs of the community intended to be served by that business; and the prospects for profitable operation of that business.35 In addition to the foregoing:

The Registrar shall refuse to grant a banking licence if the memorandum and articles of association of the applicant do not contain such provisions as may be prescribed by regulation in order to ensure adequate participation by the shareholders in the affairs of the bank.36

The legal problems associated with the requirement that an applicant for a banking licence should furnish a memorandum of association have already been discussed above. Here, suffice it to say that that requirement is reinforced by a possible refusal to grant the applicant a licence if he or she does not submit a memorandum of association.

*Duration of licences and some of the terms to be found in licences*

Under the Banking and Financial Services Act 1994, a licence granted to an applicant remains in force until it is revoked by the Registrar of Banks and Financial Institutions.37

Furthermore, a licence is subject to such conditions as the Bank of Zambia thinks fit to specify in the licence when it is granted.38 Where the conditions are varied under the Banking and Financial Services Act 1994, the licence is

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36 Ibid, s 6.
37 Ibid, s 14.
38 Ibid, s 13(1).
subject to conditions attached to it for the time being. Without limiting the
generality of this requirement, conditions of a licence could:

(a) contain such restrictions as to the nature and scope of the business to be
conducted by the licensee as the Bank of Zambia thinks fit to impose; and
(b) provide for the payment, on such terms and calculated in such manner as
the conditions may specify, of annual or other periodic licence fees.

Generally, there is no property in a licence, and a licence is not capable of
being bought, sold, leased, mortgaged or in any manner transferred, demised
or encumbered. An exception is, however, provided where, in the event of
an amalgamation of banks under the Banking and Financial Services Act 1994
and on such terms and conditions as the Bank of Zambia may approve, a
licence can be transferred from one party to another.

**Grounds upon which the Registrar can revoke a licence**

As a general rule, the Registrar of Banks and Financial Institutions, after
consultation with the Minister of Finance, can revoke a licence if it appears to
the Registrar that the application for the licence was fraudulent or contained a
materially false statement. A licence can also be revoked where the licensee
has failed to comply with any condition or qualification of its licence or with
any order of the Bank of Zambia under the Banking and Financial Services Act
1994. Further still, a licence can be revoked where the licensee is seriously or
persistently in breach of any provisions of the Banking and Financial Services

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39 Banking and Financial Services Act 1994, s 13(1). It must be observed further that, under
s 13, and upon application made by a licensee, the Bank of Zambia may, by order in
writing, vary the conditions for the time being attached to a licence. In deciding
whether to grant the variation, the Bank of Zambia has to give regard to conditions on
which a licence may not be granted (as spelt out above) and to the public interests as
well. Appeals against decisions to impose certain conditions on a licence follow the
same procedure as that in the case of appeals against decisions of the Registrar to
revoke or refuse to grant a licence (for a discussion on this procedure, see pp 43–47.
40 Ibid, s 13(2).
41 Ibid, s 15.
42 Ibid.
43 Ibid, s 16(1). Elsewhere, I have examined the issue of what constitutes ‘materiality’: see
Mwenda, 18(2), 1997, p 157. See, also, SEC v Texas Gulf Sulphur Co 401 F 2d 833; and
Cady Roberts and Company 40 SEC 907, p 911. In the Cady Roberts case, the principle in
American securities law, that a fact is material if it would, were it known, affect the
investment judgment of those with whom the insider is dealing, was criticised by
Commission Cary. He argued that the principle produced uncertainty and confusion,
and suggested the direct effect of the market value of securities as a test in addition to
the ‘investment judgment’ principle.
44 See Banking and Financial Services Act 1994, s 16(1).
Act 1994 or regulations under the Act or any of the conditions of its licence, or where the licensee fails to commence to conduct business authorised by the licence within a period of 12 months following the grant of the licence or ceases or announces its intention to cease to conduct that business.

**Appeals against decisions of the Registrar**

An applicant for a banking licence whose application has been refused by the Registrar of Banks and Financial Institutions or the Bank of Zambia has the right to make his or her case in writing to the said Registrar or the Bank of Zambia to reconsider the decision over the granting of a licence. This procedure applies, *mutatis mutandis*, to appeals against decisions of the Registrar or the Bank of Zambia regarding the revocation of licences. If, after receipt of any representations from the applicant or person affected by its decision, the Registrar or the Bank of Zambia reaffirms its decision, the applicant or other person (hereinafter called the ‘appellant’) may, within seven days of receipt of the notice reaffirming the decision, notify the minister that he or she desires to appeal against the decision. It must be noted that:

The decision of the Registrar or of the Bank of Zambia, as the case may be –

(a) does not take effect until the expiry of the period limited by sub-section … for giving notice of an appeal; and

(b) where a notice of appeal is lodged within that time, is further stayed pending the outcome of the appeal …

Within seven days after receipt of a notice of appeal, the Minister shall convene an Appeal Tribunal, consisting of a Chairman who is an advocate of the Court of not less than seven years’ standing and two other persons having such qualifications as may be prescribed by regulation in relation to the kind of appeal concerned or, in default of such prescription, as the Minister may consider appropriate.

In carrying out its functions, the Appeal Tribunal has powers to determine its own procedure and is not bound by rules of evidence. The Tribunal determines an appeal on its merits, having regard to provisions of the Banking and Financial Services Act 1994 and the public interest. A decision of the Registrar or the Bank of Zambia can be varied or quashed by the Tribunal. The

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44 Banking and Financial Services Act 1994, s 16(1).
45 Ibid.
46 Ibid, ss 4(3) and 111.
47 Ibid, s 16(2).
48 Ibid, s 112(1).
49 Ibid, ss 112 and 113.
50 Ibid, s 114(2).
51 Ibid, s 114.
decision of the Tribunal is therefore final and binding on the parties to the appeal except as to any point of law.53 In cases where the appeal is allowed, it is the duty of the Registrar or the Bank of Zambia, as the case may require, to give effect to the decision of the Tribunal.54

**Directors and managers of banks and incorporated financial institutions**

While the Registrar of Banks and Financial Institutions authorises persons to conduct banking and financial services business, the grant of such licence *per se* does not automatically entitle a licensee to act as director or manager of a bank or an incorporated financial institution. Section 31 of the Banking and Financial Services Act 1994 clearly states that:

1. Notwithstanding anything in the Companies Act, a person shall not be a director or an officer of a company that proposes to obtain a licence, and shall not be elected as a director or an officer concerned in the management of a bank or incorporated financial institution –
   a. if the person is not a natural person of or above the age of 21 years;
   b. if the person is an undischarged bankrupt;
   c. if the person has been convicted of a felony or any offence involving dishonesty and has not been fully pardoned for such offence;
   d. if the person has been declared or otherwise adjudged in any official proceedings to be mentally incompetent to manage affairs; or
   e. if the person is under suspension or has been removed from office by order of the Bank of Zambia under this Act.

2. Any person who is director or an officer concerned in the management of a bank or incorporated financial institution shall forthwith cease to hold office upon –
   a. becoming bankrupt, suspending payments or compounding or proposing a compromise with that person’s creditors generally;
   b. being charged with a felony or any offence involving dishonesty;
   c. being declared or otherwise adjudged in any official proceedings to be mentally incompetent to manage affairs; or
   d. being suspended or removed from office by order of the Bank of Zambia under this Act.

3. A person who has been a director or an officer concerned in the management of a licensee whose licence has been revoked shall not, without the approval of the Bank of Zambia, act or continue to act as a director or be directly concerned in the management of any bank or incorporated financial institution.

In spite of the above statutory provision, a major derogation from the black letter law has been noticed on a number of occasions. In a study undertaken

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53 Banking and Financial Services Act 1994, s 115.
54 Ibid.
by this author, it was revealed that a major constraint facing the regulatory framework for banking supervision in Zambia includes the inability of the Bank of Zambia to extricate itself from political pressure and interference.\textsuperscript{55}\  For example, it was noted that, whilst it was the view of the Bank of Zambia that, under the Banking and Financial Services Act 1994, a person who was a director of a bank that has since collapsed cannot be appointed as a director of another bank or financial institution – without being cleared by the Bank of Zambia – there have been cases in Zambia where the law has been flagrantly disregarded. Indeed, some ineligible individuals have been granted permission by the Bank of Zambia to act as directors and managers of banks and financial institutions at the request of some senior State officials.\textsuperscript{56}\  Whether such departures from the law can be treated as ‘regulatory forbearance’ or not, on the part of the Zambian Government, is an issue that is fraught with political overtones and illogical difficulties. Indeed, as one commentator observes:

Only investors and people with reputable and honourable backgrounds should be allowed to venture into banking to avoid the continued closure of banks … the Bank of Zambia was to blame for the many bank closures in the country because it allowed people with questionable characters to operate banks. It is the Bank of Zambia which has allowed characters with obscure, even dubious, backgrounds to establish banks quite often on the basis of political considerations … The people of Zambia should not be used as guinea pigs on whom those experimenting on banking should do their research.\textsuperscript{57}

It is interesting to note further that s 31(4) of the Banking and Financial Services Act 1994 adds:

A person shall not be a director of more than one bank or incorporated financial institution.

At close examination, it is clear that this statutory provision does not only address directors’ qualifications. It also provides important safeguards against possible insider lending to directors who could be holding the position of director in related banks and financial institutions.\textsuperscript{58}\  A further provision to curb the possibility of insider lending postulates that a majority of the

\begin{itemize}
\item[(1)] A director or officer of a bank or incorporated financial institution who –
\item[(a)] is a party to, or has a material interest in, a contract or a proposed contract with the bank or institution; or
\item[(b)] is a director or officer of, or has a material interest in or a material relationship to, any person who is party to a contract or a proposed contract with the bank or institution, shall disclose in writing to the bank or institution the nature and extent of his interest or relationship.
\end{itemize}

\textsuperscript{55} Interview with Mr Marshall Mwansompelo.
\textsuperscript{56} See, generally, ibid.
\textsuperscript{57} See article on website of The Post newspaper: 8 December 1997 issue.
\textsuperscript{58} Also, Banking and Financial Services Act 1994, s 35(1), dealing with disclosure of interests, places a further obligation on fiduciaries such as directors not to benefit unfairly from their insider position:
members of the board of directors of a bank shall be persons who are not officers or employees of the bank. The importance of this provision is that – at least, on paper – it allows employees the freedom to act diligently by not getting intimidated into advancing loans to directors. To buttress this safeguard, the Banking and Financial Services Act 1994 codifies a number of common law duties of directors by requiring every director or officer concerned in the management of a bank or incorporated financial institution, in exercising the powers and discharging the duties of that person’s office, to:

(a) act honestly and in good faith and in the best interests of the bank or institution as a whole; and

(b) exercise the care, diligence and skill that a prudent person would exercise in comparable circumstances.

The common law position is further reflected in s 36 of the Banking and Financial Services Act 1994, which deals with the liability of directors and other officers for issuing false or misleading statements, with intent to deceive. Section 36 also covers the liability of such officers where they obstruct an audit examination. However, it is difficult to appreciate the extent to which this statutory provision would apply to directors and officers who have ceased to operate as directors or officers after obstructing an audit examination, or after issuing false or misleading statements. Further, would an intentional omission leading to a false or misleading picture on the financial position of the bank attract liability? In general, however, the Banking and Financial Services Act 1994 provides indemnity to directors, former directors and other officers of the bank or financial institution against all costs, charges and expenses, including any amount paid to settle an action or satisfy a judgment. Here, the expenses must have been reasonably incurred, in good faith and in the interests of the organisation. They cover costs incurred by a person in respect of any civil, criminal or administrative action or proceeding to which the person was made a party by reason of being or having been a director or officer, or having acted at the request of the bank as a director or officer of a company of which the bank is or was a shareholder. The indemnity provision does not, however, cover actions by or on behalf of the

59 Banking and Financial Services Act 1994, s 32(1).
60 Ibid, s 33. For further readings on duties of directors at common law, see, generally, Prentice, 1990; Pennington, 1987; Loose, Yelland and Impey, 1993; and Mwenda and Wiseberg, 1999.
61 Cf Caparo Industries plc v Dickman [1990] 1 All ER 568. The Caparo case has been followed at first instance in Morgan Crucible Co plc v Hill Samuel Bank Ltd and Others [1990] 3 All ER 330. See, also, Derry v Peek (1889) 14 App Cas 337; and Hedley Byrne and Co v Heller and Partners Ltd [1964] AC 465. In the Hedley Byrne case, liability was said to arise because the defendant assumed a duty to speak, and therefore to speak carefully.
62 Banking and Financial Services Act 1994, s 34.
63 Ibid.
bank or institution concerned or the Bank of Zambia to procure a judgment in its favour.64

*Anti-competitive conduct*

As a general rule, the Banking and Financial Services Act 1994 prohibits a bank from making arrangements with another bank with respect to the rate of interest on a deposit by any person.65 The Act also prohibits such arrangements with respect to the rate of interest or charge on a loan to any person, the amount of any charge to any person for the provision of a financial service, or the provision of, or refusal to provide any financial service to, any person.66 One exception here is that banks can enter into the following agreements:

(a) for the performance of a financial service by one bank to another;

(b) evidencing a syndication or other agreement for the provision of credit and other banking services to a person by two or more banks;

(c) for the underwriting or distribution of any security by a bank or a group of person including a bank; or

(d) for the exchange of statistics or audit information, the development and use of systems, forms, methods, procedures and standards, the use of common facilities, joint research and development or any matter in connection therewith.67

A second exception to the above prohibitions is that the restrictions apply only to banks and do not cover financial institutions. However, in providing financial services, goods or other services, both banks and financial institutions are prohibited from requiring persons to engage in collateral contracts as a precondition to enter into contracts with the bank or financial institution.68

**Chapter 6 of the Banking and Financial Services Act 1994**

In Zambia, the core statutory rules governing banking supervision and prudential regulation are found in Chapter 6 of the Banking and Financial Services Act 1994. Under these rules, a bank is required to maintain a reserve account and before declaring any dividends it must transfer to its reserve account, out of the net profits of each year after due provision has been made for taxation, the minimum amount prescribed by regulation.69 The Bank of

64 Banking and Financial Services Act 1994, s 34.
65 Ibid, s 40(1).
66 Ibid.
67 Ibid, s 40(3).
68 Ibid, s 41.
69 Ibid, s 69(1).
Zambia may regulate the amount required to be transferred to the reserve account, the method of computing that amount, the form of the reserve account and any other matter it considers necessary to give effect to the foregoing.\textsuperscript{70}

It must be observed that, in general, no bank is allowed to declare, credit or pay any dividend or make any transfer from surplus if to do so would result in an impairment of the capital adequacy requirements of the Banking and Financial Services Act 1994.\textsuperscript{71} However, with the approval of the Bank of Zambia, a bank can declare, credit or pay any dividend or make any transfer from surplus even if such act were to impair the reserve account requirements.\textsuperscript{72} Here, it must be stressed first, that there has to be approval of the Bank of Zambia and, secondly, that the affected requirements relate to the reserve account and not provisions on capital adequacy. Indeed, the Bank of Zambia may permit a reduction of the reserve account when the relevant payment or transfer is made for the purpose of increasing the capital, and when the Bank of Zambia is satisfied that that is the only practicable means of preventing an impairment of the bank’s capital or of enabling the bank to make provisions that the Bank of Zambia considers to be necessary.\textsuperscript{73}

\textbf{Liquid assets}

As a further safeguard, banks are required at all times to maintain liquid assets\textsuperscript{74} amounting to not less than such percentage of its total or such portion

\textsuperscript{70} Banking and Financial Services Act 1994, s 69(2).
\textsuperscript{71} Ibid, s 69(3). See below on capital adequacy requirements.
\textsuperscript{72} Ibid, s 69(4).
\textsuperscript{73} Ibid, s 69(5).
\textsuperscript{74} Section 70(4) provides that liquid assets are ‘assets that are transferable free of any charge or lien whatsoever and that are of the classes described in the First Schedule to this Act’. Schedule 1 then stipulates that:

The following are the classes of assets that qualify as liquid assets for the purposes of this Act:

1. notes and coins constituting the currency of Zambia and such foreign exchange in the form of currency notes as may from time to time be prescribed by regulation for the purposes of this clause;
2. reserves in excess of those required under the Bank of Zambia Act 1985 that are held by way of demand deposits in current account in the Bank of Zambia;
3. the net balance by which all credit balances held at branches in Zambia or at any branch in a country prescribed by regulation for the purposes of this clause exceed all debit balances so held;
4. treasury bills and other securities issued by the Government and with an original term to maturity of not more than 182 days; and
5. bills of exchange, promissory notes and other negotiable instruments eligible for re-discount by the Bank of Zambia, within such limits as may be prescribed by regulation for the purposes of this clause.
of its liabilities to the public in Zambia as the Bank of Zambia may by instrument in writing prescribe specifically for it or, in default of such prescription, as the Minister of Finance, on the recommendation of the Bank of Zambia, may by regulation prescribe for banks of its class or description.\(^75\) This requirement applies provided that:

(a) the percentage in either manner prescribed shall not be greater than fifty per centum;
(b) the distribution of amounts between the various classes of liquid assets may be made at the discretion of each bank; and
(c) no bank may be required to maintain any higher percentage than any other bank of the same class or type.

(2) Any variation in a regulation made for the purposes of sub-s (1) shall take effect –

(a) if it provides for a decrease, immediately; or
(b) if it provides for an increase, only after reasonable notice thereof has been given in writing to each bank affected by the variation, and only if the variation does not increase the liquid asset requirement of any bank by more than fifteen per centum.\(^76\)

Indeed, towards the end of 1997, the Bank of Zambia reduced the core liquid assets ratio from 38.5% to 35.5% in a bid to increase investible resources of commercial banks.\(^77\) In general, however, and notwithstanding sub-s (1) of the above statutory provision, the Banking and Financial Services Act 1994 prohibits a bank from augmenting its liquid assets during any month of the year by an amount in excess of 10% of the aggregate of its liabilities as at the close of the last business day of the preceding month.\(^78\) Where the liquid assets of a bank are less than the amount for the time being prescribed in respect of it, the Bank of Zambia may order the bank to pay to the Bank of Zambia, as a fine, interest on the amount of the deficiency, with respect to each day or part of a day that the deficiency continues, at an annual rate not exceeding the highest annual rate fixed, at the time of the offence, by the Bank of Zambia under the Bank of Zambia Act 1985 for any of its operations.\(^79\)

Further additional safeguards for investors can be found in other parts of the Banking and Financial Services Act 1994. One of these safeguards provides as follows:

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\(^{75}\) See Banking and Financial Services Act 1994, s 70(1). See, also, 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.

\(^{76}\) Ibid, s 70(1) and (2)

\(^{77}\) See op cit, The Post, fn 57.

\(^{78}\) Banking and Financial Services Act 1994, s 70(3).

\(^{79}\) Ibid, s 71.
A bank shall not –

(a) mortgage, charge or grant security to any person over any asset of the bank otherwise than –

(i) in the ordinary course of business; or

(ii) to the Bank of Zambia to secure short-term liquidity advances made by it under the Bank of Zambia Act; or

(b) acquire an asset that is subject to a mortgage, charge or other security interest in favour of any person, except to satisfy a debt or other liability to it.80

The Banking and Financial Services Act 1994 provides other safeguards by placing some limitations on the grant of advances.81 A number of these limitations relate to matters such as a bank cannot, without prior approval of its board of directors, engage in a contract with a related person (for example, a shadow, de jure or de facto director82 of that bank or some other insider);83 a bank cannot directly or indirectly grant an advance against the security of its own shares;84 a bank cannot directly or indirectly grant credit, or guarantee debts of any person, so that the total value of any such grants, advances and guarantees with or in respect of any one person is at any time more than 25% of the regulatory capital (as defined by regulation) of the bank;85 and, a general prohibition against insider lending (secured or unsecured) to shadow,

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80 Banking and Financial Services Act 1994, s 72.
81 Ibid, s 73.
82 Defining a shadow director, the Companies Act 1994, s 203(4) provides that: ‘A person not being duly appointed director of a company, on whose directions or instructions the duly appointed directors are accustomed to act shall be deemed to be a director for the purposes of all duties and liabilities imposed on directors.’ By contrast, the Banking and Financial Services Act 1994, s 2, defines de facto control as ‘direct or indirect influence of a kind that, if exercised, would result in the person controlling the company in fact, and includes any such influence exercisable by virtue of any such influence over, or the de jure control of, another company or other companies’. De jure control is then defined – in the same statutory provision – as the ‘beneficial ownership of more than fifty per centum of any class of the issued voting shares of the company’. Cf Goode, 1997, pp 444–68, where he argues that a shadow director, in contrast to a de facto director, normally acts through someone. A de facto director, by contrast, often acts in person. On the other hand, a de jure director, as the name suggests, is a person that is duly appointed as director.
83 See Banking and Financial Services Act 1994, s 74. In Zambia, the collapse of banks such as Capital Bank (Z) Ltd is one of the cases supporting the importance of regulating against insider lending.
84 Ibid, s 73(2).
85 Ibid, s 73(1). See, also, Large Loans Regulations (effective 21 June 1996). The Bank of Zambia observes (at the Bank of Zambia website) that 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. Recognising 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 minimising the effect of loss to the bank in the event of failure of such borrowers.
*de jure* and *de facto* bank directors. In general, however, to obtain a waiver on a number of these limitations, a bank must seek the approval of the Bank of Zambia.

Other exceptions to the limitations are found in Sched 2 to the Banking and Financial Services Act 1994. Indeed, while s 73 of the Banking and Financial Services Act 1994 spells out in great detail the list of these limitations, Sched 2 provides the following exceptions:

1. A transaction –
   
   a. secured by a pledge of bills of exchange or promissory notes that have been issued for the price of goods purchased and sold in the ordinary course of trade; and
   
   b. having an original term of maturity no greater than one hundred and eighty-two days or such longer period as may be prescribed by regulation.

2. A transaction having an original term to maturity not greater than two hundred and seventy days and which is –
   
   a. secured by readily marketable assets, covered to their full insurable value by all perils insurance and having an ascertainable market or other value, as security, as found in good faith by an officer of the bank concerned, of at least fifty per centum more than the amount of the obligations thereby secured;
   
   b. secured in some other manner satisfactory to the Bank of Zambia; or
   
   c. a loan made to or guaranteed by the Government, a board or agency of the Government or a local authority that is enforceable by the bank within sixty days after demand following default.

86 Banking and Financial Services Act 1994, s 73(3). See, also, Insider Loans Regulations (effective 31 March 1996). The Bank of Zambia (at Bank of Zambia website) recognises 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.

87 See, generally, Banking and Financial Services Act 1994, s 73.

88 This provision raises a number of illogical difficulties. For example, what constitutes ‘some other manner satisfactory to the Bank of Zambia’? The statutory provision here is not clear. In any event, it is not helpful to provide for such wide discretionary powers, since in some societies where corruption is rife these powers can be abused by the regulators.

89 See Banking and Financial Services Act 1994, Sched 2.
Equity investments

As a general rule, banks are prohibited from acquiring equity interests in a person, property or project in an amount greater than 15% of the total of all equity interests in the person, property or project.90 Equity interests are defined as follows:

... ‘equity interests in a person’ means –

(a) in the case of a company, any share issued by the company, whether or not a voting share, and any other security issued by the company, the terms of which entitle the registered holder or bearer to a share in the profits of the company; and

(b) in the case of a partnership, association or other group of persons acting in concert, any right to share profits of the person;

‘equity interests in a property or project’ means an ownership interest and includes any right to share in the profits of operation or proceeds of disposition of the property or project.91

In addition to the limitation on banks to invest in equity interests, a bank is prohibited from investing, in the aggregate, more than 70% of its regulatory capital (as defined by regulation) in equity interests in any person, property or project.92 However, the two limitations set out above are inapplicable in the case of an investment or investments by a bank in the shares of a subsidiary, if the aggregate of all such investments by the bank does not exceed 100% of its regulatory capital (as defined by regulation).93

Where there are some funds in a bank which are presumed to be abandoned, the bank, as a constructive trustee, is prohibited by statute from treating such funds as an investment in its portfolio.94 The bank must report to the Bank of Zambia on the amount and nature of such funds. Indeed, the bank must pay the funds to the Bank of Zambia upon the expiration of a time limit set by the law.95 To enforce such prudential rules, the Bank of Zambia may cause an examination to be made of a bank to determine whether it is in a sound financial condition and operating safely and that the requirements of the Banking and Financial Services Act 1994, the Bank of Zambia Act 1985 and

90 Banking and Financial Services Act 1994, s 75(1). As an exception to the general rule here, Banking and Financial Services Act 1994, s 75(4) provides as follows: ‘... does not apply to an acquisition by a bank of an equity interest in realisation of any part of the collateral provided to the bank in a credit transaction with any person, if the bank, within two years following its acquisition or such longer period as the Bank of Zambia may allow, disposes of any equity interest in excess of the limits imposed by this section.’
91 Ibid, s 75(5).
92 Ibid, s 75(2).
93 Ibid, s 75(3).
94 Ibid, s 76(2).
95 Ibid.
other laws of Zambia have been complied with in the conduct of its business.96 Further, it must be noted that:

78(2) When, in conducting an examination of a bank ... the Bank of Zambia considers it necessary to do so, the Bank of Zambia may at the same time cause a like examination to be made of any other company in Zambia that is a subsidiary, associate or affiliate of the bank concerned.

79(1) A bank shall:

(a) produce, and cause each company that is a subsidiary, affiliate or associate of the bank to produce, for the inspection of any examiner appointed by the Bank of Zambia, at such times as the examiner specifies, all books, accounts and records relating to its business in Zambia; and

(b) supply all information concerning its business in Zambia as may reasonably be required by the examiner within such time as the examiner specifies.97

Disciplinary measures

Where a bank refuses to comply with an order of the Bank of Zambia, or refuses to permit an examination to be made, or has otherwise obstructed such an examination, the Bank of Zambia can take disciplinary action. Equally, the Bank of Zambia may take disciplinary action where it is of the opinion that an authorised examination shows:

(a) that the bank concerned conducts its business in an unlawful manner or engages in a course of conduct that is unsafe and unsound;98 or

(b) that for any reason (other than insolvency) the bank is unable or likely to become unable to continue its operations in the ordinary course.99

The disciplinary measures that the Bank of Zambia may take include appointing a person (that is, a curator) who, in its opinion, has had proper training and experience, to advise the bank on the implementation of such measures as may be specified by the Bank of Zambia to rectify the matter (and whose remuneration, as fixed by the Bank of Zambia, shall be paid by the bank concerned); or suspend the bank’s licence for a period not exceeding six months; or revoke or restrict the bank’s licence.100 When a curator is

96 Banking and Financial Services Act 1994, s 78(1).
97 Ibid, ss 78 and 79.
98 There is no statutory definition of ‘unsafe and unsound’ practices under the Banking and Financial Services Act 1994. This leaves wide discretionary powers to the Bank of Zambia to determine what is ‘unsafe and unsound’ practice. However, as noted earlier, in a society where corruption is rife or where politicians often interfere in the operations of a regulatory authority, such statutory provisions could provide for a leeway for some politicians to punish banks whose shareholders and directors are unpopular with the government.
100 Ibid, s 81(2).
appointed, the bank and every director, officer, agent and employee of the bank must act in accordance with every instruction given by the curator concerning the bank or any part of its property, administration, operations or business that is regulated by or under the Banking and Financial Services Act 1994. If a bank fails to comply with the instructions of a curator, disciplinary measures can be taken against the bank as specified above.

It is important, also, to stress that a curator must comply with any written instruction of the Bank of Zambia, and in all other matters must act honestly and in good faith in what the curator reasonably believes to be the best way to restore a bank to sound financial and operating conditions. That said:

(7) Acts or omissions of the bank in accordance with a direction of the curator shall be binding upon the bank, but no person shall have any right or claim against the curator or the Bank of Zambia as a result of any direction given by the curator in good faith in accordance with this Act.

(8) The curator shall advise the Bank of Zambia within six months following the curator’s appointment whether in his opinion the bank can be restored to a safe operating condition within a reasonable time, or should be wound up.

(9) The Bank of Zambia shall not be bound to accept the advice of a curator under sub-s (8).

The juxtaposition in which the curator finds himself or herself raises a number of issues. Although the curator is appointed by the Bank of Zambia, he or she is essentially an agent of the distressed bank and thus occupies a position akin to that of an administrator under the English Insolvency Act 1986. The curator owes fiduciary duties to the distressed bank to act honestly, competently and in good faith and, further, to take into account interests of the various stakeholders. At the same time, the curator must observe, with due diligence, written instructions from the Bank of Zambia.

102 Ibid, s 81(5).
103 Ibid, s 81(6).
104 Ibid, s 81(7), (8) and (9).
105 For a good discussion on the juxtaposition facing an administrator (appointed by a court) under the UK Insolvency Act 1986 see, generally, Goode, 1997.
Capital adequacy and special reserve or liability insurance

In setting out the capital adequacy requirements, the Minister of Finance, on the recommendation of the Bank of Zambia and in line with internationally accepted guidelines and the nature of the bank’s business, prescribes the minimum required capital for every class or description of bank.\(^{106}\) As at December 1996, the capital adequacy regulation required commercial banks and all other deposit taking institutions to have a minimum regulatory capital of K2 billion.\(^{107}\) By contrast, non-deposit taking financial institutions were required to have a minimum regulatory capital of up to K250 million.\(^{108}\)

Furthermore, as part of the safeguards for investors in banks, the Banking and Financial Services Act 1994 requires banks to maintain a special reserve account, to an amount which the Bank of Zambia considers adequate, reserved exclusively for the purpose of making good any loss resulting from the negligence or dishonesty of any of its directors, officers or employees.\(^{109}\) The Act also requires a bank to insure itself against such loss, to an amount which the Bank of Zambia considers adequate, with a person approved by the Bank of Zambia carrying on insurance business or the business of guaranteeing against such loss, or to undertake such other commitment as the Bank of Zambia may consider acceptable.\(^{110}\)

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106 Banking and Financial Services Act 1994, s 83.
107 See Mwanza, 1996 (Governor of the Bank of Zambia at Bank of Zambia website). See, also, the unreported Zambian case of Royalty Bank (Z) Ltd v Bank of Zambia (at the Bank of Zambia website) where, in November 1994, Royalty Bank was licensed as a Bank under the Banking Act (CAP 700) which required that banks commence operations with a minimum regulatory capital of K20 million. A month later, in December 1994, the Banking and Financial Services Act 1994 was enacted. The new requirement was that banks maintain a minimum regulatory capital of K2 billion. Royalty Bank took out an interim injunction (\textit{ex parte}) to restrain the Bank of Zambia from effecting the requirements of the Banking and Financial Services Act 1994. The court discharged the interim injunction and no further steps to prosecute the action were taken. Later, the Bank of Zambia revoked Royalty Bank’s licence for banking business.
109 Banking and Financial Services Act 1994, s 82(a).
110 \textit{Ibid}, s 82(b) and (c).
Conclusion

This chapter has examined some of the contemporary issues affecting the efficacy of a modern legal framework for banking supervision. It was noted that the Zambian legal framework provides an interesting case study, since Zambia has experienced some aspects of systemic banking restructuring. It was argued, among other things, that in undertaking banking reforms, an important objective to consider is the need to develop a stable banking system which allocates credit on a market basis.

Further, it was noted that, apart from the coming into force of the Banking and Financial Services Act 1994, there are now efforts to introduce legislation on money laundering in Zambia. It was, however, argued that there are limited efforts to strengthen the regulatory framework for banking supervision by introducing legislation such as a Deposit Insurance Act. The introduction of deposit insurance, it was argued, is important because the closure of some troubled banks, or even an interruption in their supply of credit, would be too costly to the economy.
CHAPTER 4

BANK SHAREHOLDERS AND THEIR OBLIGATION TO PAY UP FOR SHARES

A bank shall not issue in its capital or other security (other than a bonus share or share in lieu of dividend or other prescribed security) unless it receives the full face amount thereof in Zambian Kwacha or the foreign currency equivalent in Kwacha at the time of issue [s 83(5) of the Zambian Banking and Financial Services Act 1994].

INTRODUCTION

Commenting on Core Principle 4 of the Basle Core Principles for Effective Banking Supervision, the Basle Committee notes that with regard to transfer of bank shares:

In addition to licensing new banks, banking supervisors should be notified of any future significant direct or indirect investment in the bank or any increases or other changes in ownership over a particular threshold and should have the power to block such investments or prevent the exercise of voting rights in respect of such investments if they do not meet criteria comparable to those used for approving new banks. Notifications are often required for ownership or voting control involving established percentages of a bank’s outstanding shares (these established percentages typically range between 5 and 10%). The threshold for approval of significant ownership changes may be higher than that for notification.1

Given that this book looks at systemic bank restructuring and the efficacy of a regulatory framework for banking supervision, it is imperative also to look at why shareholders of commercial banks, merchant banks and corporate banks must pay up for their shares.2 Indeed, this is particularly important in the case of State-controlled banks that are being privatised and in cases where banks are merging. In 1996, for example, Zambia witnessed the first bank merger.

1 Basle Committee on Banking Supervision, 1997, p 19.
2 This chapter proceeds on the premise that a bank is a body corporate as defined in the Banking and Financial Services Act 1994 of Zambia, s 2: ‘... “bank” means a company that holds a banking licence.’ Wherever the terms ‘company’ or ‘corporation’ appear in this book, they must be construed, mutatis mutandis, as applying to the word ‘bank’ as well. Banking institutions discussed in the chapter are construed as bodies corporate having a share capital. Thus, members (shareholders) of these bodies corporate enjoy limited liability conditioned not by the aspect of limited liability by guarantee, but by the notion of paid-up share capital. There will be no attempt in this book to look at the forms and nature of legal payment for shares. I have addressed such issues elsewhere: see Mwenda, 1999, Penn, Chapters 2, 3 and 4.
First Merchant Bank (Z) Ltd and Safe Deposit Bank, both indigenous banks, merged to become First Merchant Bank (Z) Ltd.

Closely related to the issue of why bank shareholders should pay up for their shares is the framework set out by the Banking and Financial Services Act 1994 on the regulation of ownership and control of banks in Zambia. The Act reads as follows:

(1) Shares issued by a bank shall be only of such classes or series as may be approved by the Bank of Zambia.

(2) A person shall not, without the prior approval in writing of the Bank of
Zambia –
   (a) acquire any beneficial interest in the voting shares of a bank; or
   (b) enter into any voting trust or other agreement,
   that would enable the person to control more than twenty-five per centum of the total votes that could be cast on any general resolution at a general or special meeting of the bank.

(3) No bank shall register any transfer of its voting shares to any person if, as a result of the transfer, the person would contravene sub-s (2).

(4) Where a person (in this sub-section referred to as the ‘shareholder’) acquires an interest in or control over voting shares in contravention of sub-s (2), a person shall not, in person or by proxy, exercise the voting rights of any voting share owned or controlled by the shareholder other than such shares as are registered in the name of the shareholder on the share register of the bank.\(^3\)

In dealing with the question of why bank shareholders should pay up for their shares, equally important is the case of a bank that is being taken over. Generally, in a takeover, there will be a significant direct or indirect investment in the bank or an increase or other changes in ownership. Viewed from a law and economics angle, the debate on bank shareholders paying up for their shares helps to place in context the notion of investor protection under banking supervision.\(^4\)

\(^3\) See Banking and Financial Services Act 1994, s 23.

\(^4\) Eg, as a means of regulating against insider lending, \textit{ibid}, s 24, prohibits a person who has \textit{de jure} control or \textit{de facto} control of a bank from owning shares in the capital of, or acquiring or maintaining \textit{de jure} or \textit{de facto} control of, any other bank. This statutory provision does not, however, preclude any person from acquiring all the voting shares in the capital of a bank for the purpose of implementing an amalgamation of two or more banks in accordance with the Banking and Financial Services Act 1994. Under s 25, the amalgamation of a bank – together with the transfer by a bank to any other company of the whole or more than the prescribed part of its assets or liabilities in Zambia otherwise than in the ordinary course of its business – constitute the two ways in which a ‘corporate restructuring transaction’ can be undertaken. Having said that, it must be noted that s 26 prohibits a bank from effecting a corporate restructuring transaction with a company that is not a bank. However, the statutory provision does not prohibit a bank from effecting a corporate restructuring transaction with another bank. The only qualification here is that the bank must obtain the written consent of the bank of Zambia before effecting such a corporate restructuring transaction.
Bank Shareholders and their Obligation to Pay up for Shares

In a sense, the discussion also places in context the concept of capital adequacy. Generally, where there is a financially distressed bank, which later goes into insolvency, it is less costly for the liquidator to deal with a fully paid-up share capital than to pursue unpaid-up shareholders. Ideally, where the called-up share capital has not been paid up, the liquidator might incur high transaction and litigation costs in pursuing the unpaid-up shareholders.

Obligations of bank shareholders to pay up the called-up share capital

Are there any legal justifications, at the verge of a bank’s insolvency, for the bank’s creditor to enforce obligations of the shareholders to pay up for the shares allotted to them? What about the rule in the US Supreme Court case of Handley v Stutz, which says that shareholders are exempt from the obligation to pay up for the shares at a par value equal to that of newly issued shares where the company is in financial distress and the market value of the shares at the time of issue is less than par? This chapter argues that the legal justifications for a creditor to enforce the share payment obligation of shareholders rests not only on one theoretical premise, but on a number of thematic reasons. One of the reasons is to protect investors against some of the consequences of a bank going bust; that is, there is a need to ensure that at least the share capital account of the bank is well maintained and the called-up share capital has been paid up.

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5 We have already looked at capital adequacy requirements in Zambia. In general, however, it must be added that – as Cranston, 1997, pp 92–93, observes: 'Capital adequacy rules are perhaps the outstanding example of convergence at the international level in bank regulation … Capital adequacy standards are to provide a cushion of capital which may protect depositors' funds in the event of a bank incurring significant loss … In formulating the Basle Capital Accord many issues had to be resolved. What should count as the capital of a bank (or owner’s own funds) other than paid-up share capital? …'

6 Here, creditors could fall under various categories. On the one hand, the ordinary depositor, who holds a client’s account at the bank, will be treated as an unsecured creditor. On the other hand, it is possible that the bank will have obtained some further finance from secured creditors. Such secured creditors are often holders of floating and/or fixed charges. It must be noted that in regard to all creditors the ranking of priorities and claims can be altered through debt subordination agreements. I have examined this aspect of the law elsewhere: see Mwenda and Laszczynska, 1998. On the ranking of priorities and claims, see, also, generally, Goode, 1988; Goode, 1997; Wood, 1995; Goode, 1995; Oditah, 1991; and Gough, 1996.

7 See Hamilton, 1989, pp 73–75. The reason for giving shares a par value is mainly historical. At a time when it was envisaged that the nominal value of shares would be so large that a substantial proportion would be left uncalled, the introduction of the par value concept was a convenient yardstick to measure the extent of liability of shareholders.

8 Handley v Stutz (1891) 139 US 417, 11 S Ct 530.
The fraud theory

The fraud theory, often referred to as the ‘holding out theory’ of shareholder liability, was first postulated in the *Hospes v North-Western Manufacturing and Car Co*,⁹ where it was held that the tort of misrepresentation provides the ground upon which the liability of shareholders to pay up for the allotted shares is based. As Manning and Hanks observe:

The basic rationale of the *Hospes* court was that the creditor had somehow received a representation from the *corporation* to the effect that the shares had been fully paid for; if in fact the shares had not been paid for, and if the company later became insolvent, the creditor could claim that he had been misled and could compel shareholders who had not paid in the par value of their shares to do so …

The most immediate effects of this beautifully representative expression … were to make it absolutely clear that: (i) the creditor had no cause of action against shareholders unless the company became insolvent (since no damage had been shown to the creditor); and that (ii) any creditor who extended credit to the corporation before the relevant stock (share) was issued was barred from complaining.¹⁰

A major shortcoming of the fraud theory is that it places liability for share payment on the shareholders when, in fact, it is the corporation that makes the representation about the paid-up share capital. Here, the law simply makes out a presumption of shareholder liability and does not even require the creditor to show that the shareholders made the representation which the creditor then relied upon. Despite these anomalies, it is clear that, under the fraud theory, liability of the shareholders crystallises only when the company becomes insolvent and when a creditor who has extended value after the shares have been issued institutes proceedings.¹¹

The trust fund theory

Story J, in his landmark opinion in *Wood v Dummer*,¹² said that shareholders are not permitted to take their assets out of a corporation, thus rendering the company insolvent, because the shareholders’ equity (the ‘capital stock’) is in the nature of a ‘trust fund’ for creditors.¹³

However, can the obligation of shareholders to pay up for the shares be extended to subsequent transferees if, in fact, the shares that have now been

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⁹ (1892) 48 Minn 174, 50 NW 1117.
¹⁰ Manning and Hanks, 1990, p 50.
¹¹ See *ibid*, pp 51–52.
¹² 30 F Cas 435 (No 17, 944) (CCD Me 1824).
¹³ See *ibid*, Manning and Hanks, p 50.
transferred are ‘watered’ shares? This issue pushes to the fore interesting juridical opinions. One view here is that ‘the creditor’s remedy, if he has one at all, must be against the initial share purchaser who underpaid – if the creditor can find him’.15 Laudable as this view may seem, it does not resolve the polemic. I have argued elsewhere that, under the English Companies Act 1985, while a public company faces restrictions in the way it deals with non-cash considerations, a private company does not generally face such constraints.16 Thus, a private company may, by agreement, allot shares as fully or partly paid up otherwise than in cash in return for the transfer of property or the rendering of services to the company.17 In the English case of Re Wragg Ltd,18 Wragg and Martin was a partnership managed by two persons. It was later registered as EJ Wragg Ltd, a private company, whereby the two partners and another person became directors. The company then bought the property of the partnership and an agreement was executed and registered. The company went into liquidation and the liquidator filed a misfeasance summons to obtain payment for the shares. It was held that ‘since the agreement could not be impeached, the adequacy of the consideration could not be gone into’. Similarly, in Brownlie and Others, Petitioners,19 decided after Re Wragg, Darling LJ ruled:

Where a company, in good faith, issues shares as fully paid-up in consideration of property transferred or services rendered, the court will not inquire into the value of that which was accepted by the company as an equivalent of money.20

In Zambia, the standard articles of association in Sched 1 to the Zambian Companies Act 1994 – these articles have been adopted by many Zambian companies – include articles governing the payment for shares. However, these standard articles do not state that issued shares must be paid up when the allotment is made. Regulation 15 of the standard articles simply permits company directors to accept partial or full payment from an allottee before a

14 Op cit, Hamilton, fn 7, p 75: ‘Stock (shares) which was issued without a corresponding pay-in of assets valued at an amount equal to par was called ‘watered stock’ – stock issued not against assets but against water ... It must be emphasised that concepts of watered stock ... and the doctrines that came to surround them, were and are limited in application to the issue of stock, that is, sales by the corporation of its own stock. The doctrines do not in any way inhibit the shareholder’s freedom to sell his stock at any price he can get, or to give it away if he wishes. Similarly, a corporation holding shares of another corporation may, like any other shareholder, dispose of them at any price it wishes or can get. The reason why shareholders were held to pay in the par value of their shares is that that was the price exacted by the law for the corporate advantage of limited liability.’
15 See op cit, Manning and Hanks, fn 10, p 49.
16 Mwenda, 1999, Penn, p 60.
17 Ibid.
18 [1897] 1 Ch 796.
19 1898 6 SLT 251.
20 Ibid.
call is made on the unpaid amount. This indicates that when shares are allotted, an allottee can decide to pay immediately or in future. However, when a call is made on the unpaid-up share capital, the allottee must pay up.\(^{21}\) If a member fails to pay up the amount called on his shares at the time and place mentioned in the notice, he may be charged interest on the principal amount.\(^{22}\) There are other consequences of failing to pay up for the shares. Under reg 17, the company directors will be required to give what could be considered as the final notice, calling on the allottee to pay up the shares and to add interest to that. Failure to take heed of the notice may result in the shares being forfeited to the company.\(^{23}\) The company could then re-issue the shares to another person. In the standard articles, it is also provided that, during the period when the call for payment has not been made, the allotting company has a first and paramount lien on every share that has not been fully paid up.\(^{24}\) As long as part of the share capital has not been paid up, the lien will extend to dividends payable in respect of the issued, but unpaid-up, share capital.\(^{25}\)

It is interesting to note that the Zambian Companies Act 1994 does not prohibit the sale of shares at a discount. In fact, the statute makes no specific reference to the issue of shares at a discount. To illustrate, in the case of \textit{ZAMANGLO Industrial Corporation v Zambia Privatisation Agency and AG},\(^{26}\) the granting of a declaratory order for the acquisition of additional shares at a discount in a privatised company followed the disclosure by the plaintiff (the disclosure was not contested by the State, as defendant) that another shareholder, with similar standing as the plaintiff, had been issued additional shares at a discount.

What all this evidence shows is that the ‘trust fund theory’ can only be appreciated in a context which argues against depletion of assets that have already been paid in, and not assets that have not yet been paid in. Indeed, this view was the original construction of Story J in \textit{Wood v Dummer},\(^{27}\) although later cases took a departure which has since faced heavy criticism from proponents of the ‘fraud theory’.\(^{28}\)

\(^{21}\) Zambian Companies Act 1994, Sched 1, reg 9. Schedule 1 contains the standard articles of association. There is no mandatory obligation to adopt the standard articles. These articles can be modified or replaced altogether by other contractual rules.

\(^{22}\) \textit{Ibid}, Sched 1, reg 12.

\(^{23}\) \textit{Ibid}, Sched 1, regs 16 and 17.

\(^{24}\) \textit{Ibid}, Sched 1, reg 16.

\(^{25}\) \textit{Ibid}.

\(^{26}\) 1996/HP/706, unreported, Zambia High Court.

\(^{27}\) 30 F Cas 435 (No 17, 944) (CCD Me 1824).

\(^{28}\) See, \textit{eg}, \textit{op cit}, Manning and Hanks, fn 10, p 51.
Bank Shareholders and their Obligation to Pay up for Shares

The contract theory

When shareholders subscribe for shares and the company agrees to allot them the shares, a contractual arrangement of mutual obligations is established. It is pursuant to such contractual obligations that the shareholder must pay up for the allotted shares. Under the contract theory, shareholders must be held to the terms upon which they have acquired the shares and the creditor of the insolvent company must be permitted to enforce obligations of the shareholders.

Legislative inroads

It must be noted that there are instances when shareholders are under a general statutory obligation to pay up fully, and in cash, for the allotted shares. In Zambia, the case of bank shareholders, as shown in the quote at the beginning of this chapter, illustrates this point. Also, as I have argued elsewhere, the position of public companies in the UK provides a helpful example here. It has been shown already how legislation in countries such as the UK permits exceptions to the general statutory obligation of shareholders to pay up for shares in cash.

Conclusion

This chapter has argued that the legal justifications for a creditor to enforce the share payment obligation of shareholders rests not only on one theoretical premise, but on a number of thematic reasons which include the need to protect investors against the presence of a called-up share capital which has not been paid up. It was shown that investor protection is important in such cases and in situations where State controlled banks are being privatised. Equally important were cases of bank mergers and bank takeovers. It was argued that, generally, takeovers involve a significant direct or indirect investment in the bank or an increase or other changes in ownership.

In this chapter, the fraud theory was examined, the trust fund theory was analysed and the contract theory and the argument on legislative inroads were spelt out. In conclusion, however, there are a few more grounds upon which shareholders could be held liable for not paying up the called-up share capital. These grounds include first, a combination of the various theories discussed above, and secondly, the notion of misrepresentation suffered by the creditor if he or she were to rely on the debtor company’s poorly prepared balance sheet.

29 See op cit, Mwenda, fn 16, pp 48–68.
30 See above, p 63. See, also, op cit, Mwenda, fn 16, pp 48–68.
REGULATING NON-TRADITIONAL BANKING INSTITUTIONS SUCH AS COLLECTIVE INVESTMENT SCHEMES

INTRODUCTION

The nexus between the development of an effective regulatory framework for banking supervision and the importance of having an efficient and developed stock market was identified in Chapter 3. By comparison, this chapter gives the discussion in Chapter 3 a contextual focus by looking at the regulation of some of the non-traditional banking activities in Zambia. Such activities are varied in nature. In this work, only three types of activity falling along these lines are examined.

While this chapter looks at the regulation of collective investment schemes—that is, the institutions that serve as financial vehicles through which banks often accommodate small and risk investors on the stock market—Chapter 6 examines the use of Chinese walls in protecting the confidential information of clients. Thereafter, Chapter 7 looks at the regulation of activities such as insider dealing by banks on the stock market. Against this background, it is argued that, given the liquidity problem facing a number of stock markets in Africa, collective investment schemes can be used to galvanise resources for investment in these markets. The adoption of such measures could help to overcome liquidity constraints on the stock markets. Indeed, empirical evidence gathered by this author suggests that there is an urgent need to have collective investment schemes participate in the stock market in Zambia. The question, however, remains: if banks were to play an active role in setting up and running collective investment schemes in Zambia, would these schemes fall under the Banking and Financial Services Act 1994, or would they fall under a different regulatory framework? In countries such as the UK, a fused or integrated supervisory system has been adopted. In other countries, the adoption of such a system is still being debated. Should a country move towards a fused system of supervision, or should a twin or diffused system of different supervisory bodies be adopted, for example, a separate regulatory authority in charge of banking supervision and another in charge of supervising the securities, insurance and building societies industries? The context and sensitivity of each case matters. In the UK, for example, it has been observed that:

Prior to the Bank of England Act 1998, the bank’s core purposes and strategy included monetary stability, monetary analysis, monetary operations, banking activities, financial stability, supervision and surveillance. Part 3 of the 1998 Act

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1 See Mwenda, 1999, Penn, pp 103–04.
transfers responsibility for banking supervision and surveillance from the bank to the Financial Services Authority (FSA). The FSA has now acquired the powers, previously exercised by the bank, to supervise banks, listed money market institutions (as defined in s 43 of the Financial Services Act 1986) and related clearing houses (as defined in s 171 of the Companies Act 1989) …

Several developments have led to the transfer of these supervisory functions to the FSA. First, despite the Banking Act 1987 and the Financial Services Act 1986, the City continued to be rocked by financial scandals such as Maxwell, BCCI and Baring Brothers. In relation to BCCI, in particular, the bank’s supervision was found wanting by an independent report by the Board of Banking Supervision. Secondly, there had been considerable intervention from Europe that required change: the Second Banking Co-ordination Directive, the Investment Services Directive, and the Capital Adequacy Directive. Thirdly, there had been a shift of responsibility for regulating the financial services industry from the DTI to the Treasury in June 1992 with the aim of giving a single department of State control over the regulation of both securities and banking business. Fourthly, increasing internationalisation and conglomerations of the industry have necessitated a new initiative in relation to authorisation, regulation, surveillance and supervision of banking and financial services. ²

In general, however, the merits and demerits of any banking supervisory system depend on several factors which include historical, political, economic, and institutional and structural issues. We have seen, for example, how regional law in the European Union contributed to the transfer of banking supervision powers from the Bank of England to the FSA. Recently, and drawing on the northern European experience of three Scandinavian countries (Norway, Denmark and Sweden) that have practised integrated supervision for the past 10 years, a World Bank report noted:

… there are two main operative reasons for these countries having adopted this organisational form of regulation. The first is the desire to achieve economies of scale in regulation, an argument that is especially strong in the comparatively small countries of Norway, Denmark and Sweden. The second main reason is a desire to respond to the formation of financial conglomerates. In the Scandinavian countries, these primarily took the form of bancassurance groups; banking and securities markets activities had already been closely integrated for a number of years. In the UK, the rationale was based more on the growing integration of banking and securities activities, with the development of bancassurance playing a subsidiary (albeit still significant) role … Of special importance is ensuring that the structure of regulation is adapted to the underlying structure of financial markets. For example, there might be little point in integrating supervision if credit, securities, and insurance markets remain largely distinct … In a financial sector dominated by banks, with little role for capital markets or a highly integrated financial sector, there is … a strong case for an integrated approach. ³

Overall, as Taylor and Fleming observe, there is no one obviously correct organisational structure for integrated regulatory agencies.\(^4\) The choice to move towards an integrated system is only the beginning of the process, and the complex part lies in the implementation phase. Indeed, in every case – and on a case by case basis – sensitivity and care must be exercised in implementing an integrated supervisory system. The northern European cases suggest, for example, that once the decision to integrate has been made, the implementation phase should be made as short as possible and the merger should be followed by a well conceived change management process to overcome any cultural barriers arising from the previous fragmented structure.\(^5\)

**Collective investment schemes as a mechanism through which banks engage in non-traditional banking activities**

The Securities Act 1993 of Zambia defines a collective investment scheme as:

... any arrangements with respect to money or other property of any description, under which –

(a) provision is made for other persons taking part in the arrangements to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income ...\(^6\)

The Act provides for the establishment of three types of collective investment schemes in Zambia.\(^7\) The first type relates to schemes whose property is owned by ‘investment companies’. The second type relates to schemes administered as unit trusts. The third type of scheme relates to schemes operated by ‘open-ended investment companies’. There is a fourth scheme, the bond scheme, provided for by the Securities and Exchange Commission Code on Collective Investment Schemes. Rule 2 of that Code describes ‘bond schemes’ as schemes with the primary object of investing in debt securities having remaining maturity periods of one year or more. These schemes are not provided for in the Securities Act 1993. In contrast to collective investment schemes provided for in the Securities Act 1993, bond schemes have restrictions on products in which to invest. Furthermore, para 13 of the schedule to rr 4 to 7 of the Code establishes ‘self-managed schemes’ which are to be managed by their own board of directors, performing functions of a management company. These schemes are also not covered in the Securities Act 1993. Generally, in the case of schemes provided for under the Securities

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6  Securities Act 1993, s 72(a).
7  *Ibid*, s 72.
Act 1993, these are to be administered by bodies corporate called ‘operators’ of the scheme. The Act spells out that persons who can apply for an intermediary’s licence include trustees of unit trusts, operators of collective investment schemes, and any other person not prohibited by law.

Authorisation of collective investment schemes

The Securities and Exchange Commission has power to authorise the establishment of collective investment schemes in Zambia. The Commission also regulates the conduct of business of collective investment schemes. Thus, any banking institution intending to set up a collective investment scheme in Zambia must first seek the authorisation of the Securities and Exchange Commission.

Some empirical evidence on constraints affecting the legal framework

Under Zambia’s Securities Act 1993, it is a criminal offence to advise, invite and procure any persons to participate or advertise anything in relation to collective investment schemes without the authority of the Securities and Exchanges Commission. Constraints affecting the Zambian legal framework include evidence showing that institutions such as Manifold Global Fund had been operating collective investment schemes without obtaining authorisation from the Securities and Exchanges Commission. By December 1996, the Commission had not taken any legal action against Manifold Global Fund to stop Manifold from operating a collective investment scheme illegally.

8 Securities Act 1993, s 72.
9 See ibid, ss 18 and 21. For grounds on which a prospective applicant is disqualified from applying for an intermediary’s licence, see above. See, also, SEC Code on Collective Investment Schemes, r 4.1.
10 Securities Act 1993, s 73.
11 Ibid.
12 Ibid, s 74.
13 See interview with Mr Mumba Kapumpa: ‘Manifold Global Fund, although it was the very first collective investment scheme created in this country, it has never been brought on to the market because for some reasons the managers and organisers of that particular fund don’t seem to have faith in the capital market that we are developing. They have entirely refused and in fact any time now there is likely to be a court case where I am bringing them to court because they are operating illegally.’ See, also, interview with Mr Nduba Namoonde: ‘... I would like to take this privilege to comment on another collective investment scheme in Zambia called Manifold Global Fund. It’s unheard of ... just this morning I had a client who came to ask whether they still existed. I mean, you might even see a shareholder who doesn’t know that where she has put money, you know ... the institution is still in existence or it has gone under. The Securities and Exchange Commission has tried to ask Mr Chabi, the owner of whatever ... Manifold Global, to come to the fore so that ... you know ... he falls under the existing regulations, but they have not received any co-operation.’ (Efforts to reach Manifold Global Fund for their views proved futile.)
14 See explanations ibid.
that time, the Securities and Exchange Commission was simply contemplating the institution of legal proceedings against Manifold Global Fund.\textsuperscript{15}

\textit{The legal nature of unit trusts}

In countries such as South Africa, collective investment schemes are generally referred to as unit trusts.\textsuperscript{16} Generally, the underlying principle behind the concept of unit trusts is the same in many countries. Trustees purchase holdings in a large number of companies and then invite members of the public to purchase units in the trust fund.\textsuperscript{17} Unit trusts are therefore seen as a common means by which individual investors indirectly trade in securities on a securities or stock market.\textsuperscript{18} In the UK, there is a marked difference between unit trusts and other forms of collective investment schemes such as investment trusts.\textsuperscript{19} Many investment trusts under English law are closed-ended investment companies.\textsuperscript{20} They do not generally engage in open-ended investment.\textsuperscript{21} By contrast, unit trusts, as open-ended investment institutions, can easily invest in various portfolios in order to diversify the risks of investors and minimise chances of the investors losing out on their investment.\textsuperscript{22} Indeed, commenting on the distinction between open-ended investment and closed-ended investment, Hayton observes:

The capital held by the investment trust is \textit{fixed} (so that the fund is ‘close-ended’ unlike the ‘open-ended’ unit trust where the investment ‘kitty’ \textit{fluctuates} depending on numbers of new subscribers and numbers of unit holders requiring the managers to redeem their units) and the price of shares of the investment trust company reflects demand (whereas the price of units directly reflects the underlying value of the unit’s portfolio).\textsuperscript{23}

\textsuperscript{15} As in \textit{op cit}, interview, fn 13. It is somewhat unclear why the Securities and Exchange Commission did not appoint an investigating officer to inspect books of accounts and other documents relating to Manifold Global Fund. Indeed, the Commission has statutory powers to do so under the Securities Act 1993. Securities Act 1993, s 176, provides that it is an offence to obstruct the Securities and Exchange Commission or a public officer appointed under the Act from exercising any of his statutory duties.

\textsuperscript{16} See Unit Trust Control Act of South Africa, No 54 of 1986, s 1. See, also, Stock Exchanges Control Act of South Africa, No 1 of 1985, ss 17(4) and 16(a)(b).

\textsuperscript{17} See Parker and Mellows, 1983, p 3.

\textsuperscript{18} Eg, in the UK, South Africa and China (Hong Kong).

\textsuperscript{19} See Page and Ferguson, 1992, p 300; see, also, Financial Services Act 1986 (Restriction of Scope of Act and Meaning of Collective Investment Scheme) Order 1988 SI 1988/803, which amends the Financial Services Act 1986, s 75, Sched 1, paras 12, 13 and 14; Barc and Bowen, 1988, pp 981–86.

\textsuperscript{20} See, generally, materials cited \textit{ibid}.

\textsuperscript{21} See, generally, materials cited \textit{ibid}.

\textsuperscript{22} See Davis and Pointon, 1994, p 100.

\textsuperscript{23} Hayton, 1989, p 45.
In trying to provide a legal framework in which investor protection can be promoted, the Zambian Securities Act 1993 spells out that funds held under a collective investment scheme must be invested with the aim of spreading investment risks. One of the ways in which a collective investment scheme can spread its investors’ risks is by engaging in open-ended investment. We have already shown that unit trusts are one type of collective investment scheme that engages in open-ended investment. Indeed, open-ended investment reduces the risks on the investment returns in the sense that, where returns on one investment portfolio are not enough, returns on the other investment portfolio could make up for that.

Further distinctions between unit trusts and other types of collective investment schemes

Under the Securities Act 1993, unit trusts are collective investment schemes in which property is held on trust for the participants in the scheme by persons other than the operator of the scheme. Besides, whilst interests of investors in an open or closed-ended investment company would be described as ‘shares’, interests of investors in unit trusts are described as ‘units’. The Securities Act 1993 does not spell out the difference between shares and units. In practice, however, unit trusts, as trusts in the legal sense, can hold investments on behalf of investors. By contrast, investment companies will rarely hold interests as trustees of the investors. Thus, investors under a scheme set up by an investment company have interests in the shares in the investment company itself. The investors’ returns are, therefore, conditioned by issues such as the availability of distributable profits from which dividends can be distributed. Generally, the value of units (in the case of unit trusts) and shares (in the case of investment companies) will go up and down as the value of shares (or units) in which the fund is invested goes up and down. Also, the more specialised the investment scheme, the greater the risk, since specialisation reduces the prospects of spreading investment risks. Measures such as polarisation in the case of collective investment schemes may lead to specialisation. In its simple form, polarisation is seen where a person is

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24 Securities Act 1993, s 72; This explains ‘open-ended investment’. See, also, Trust Restriction Act, No 64 of 1970.
25 Securities Act 1993, s 72.
26 Ibid, s 72(c), (2)(b).
27 See Re Exchange Banking Co, Flitcroft’s Case (1882) 21 Ch D 519; Lee v Neuchatel Asphalte Co (1889) 41 Ch D 1; Verner v General and Commercial Investment Trust [1894] 2 Ch 239; Ammonia Soda Co Ltd v Chamberlain [1918] 1 Ch 266; Dimbula Valley (Ceylon) Tea Co Ltd v Laurie [1961] Ch 353; [1961] 1 All ER 769.
29 Ibid.
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authorised to sell investment products to an institution to which he is tied. This means that the tied person would sell only one type of product.

In Zambia, another distinction between unit trusts and investment companies is that, whereas operators of collective investment schemes such as those run by investment companies are bodies corporate, operators of unit trusts need not necessarily be bodies corporate. Individuals and associations such as partnerships can be operators (trustees) of unit trusts. Furthermore, whereas the standard of care for individual trustees is that of the ordinary prudent man of business acting honestly in relation to his own property, the standard of care required of companies holding property on trust is that of companies at similar levels. Generally, in Zambia, liability of trustees is to the full extent of their private estates, whereas that of members of operators (that is, operators that are bodies corporate) is limited by the concept of limited liability under company law.

Restrictive regulations on banking systems in emerging markets as a constraint

banks operating in emerging markets often face a number of constraints. These constraints include matters such as high reserve requirements or strong restrictions on where banks must place their reserves. As Barry and Lockwood observe:

In Mexico in the mid-1980s, for example, banks were required to maintain over 70% of their assets in Mexican Government securities. At an extreme, such

30 The Securities Act 1993 does not prohibit individuals from acting as trustees. The SEC Code on Collective Investment Schemes, r 3, simply stresses that the Code applies to schemes owned by, or managed by or on behalf of, open-ended investment companies.

31 Partnership law in Zambia does not cover partnerships with limited liability of partners. In Zambia, like in the UK, English Partnership Act 1890, s 9 – an Act of Parliament which applies to Zambia – provides that partners are jointly and severally liable for all debts and obligations of the firm incurred whilst they are partners, and after their death their estates are also severally liable for such debts and obligations.

32 See above.

33 Speight v Gaunt [1883] 22 Ch 727; the standard is higher for paid trustees, professionals and institutions. Similarly, equity doctrines apply to the standard required of trustees when they are undertaking duties to invest trust moneys or assets. The Securities Act 1993 is silent on this.


35 Barry and Lockwood, 1995, p 17. See also, generally, Montiel, Agmnor and Haque, 1995. In Zambia, for example, the collapse of Meridian Bank Ltd, a local bank that had rapidly grown into a multinational corporation with offices in the UK and the US, saw the repeal of the existing banking legislation in Zambia and the replacement of that law with a new banking code, the Banking and Financial Services Act 1994. This move was meant to strengthen the banking regulatory system in Zambia which, among other things, now includes stronger emphasis on investor protection. Furthermore, the Bank of Zambia Act 1985 does require banks to place a statutory stipulated minimum as reserves by way of demand deposits in current account in the Bank of Zambia.
restrictions and limits can lead to the development of large informal credit markets.36

In Zambia, related constraints on banks include the statutory guidelines on the levels of equity investment in a company. We looked at a number of these guidelines in Chapter 3. To recapitulate, the guidelines provide as follows:

(1) A bank shall not acquire any equity interest in any person, property or project in an amount greater than fifteen per centum of the total of all equity interests in the person, property or project.

(2) A bank shall not invest, in the aggregate, more than seventy per centum of its regulatory capital (as defined by regulation) in equity interest in any person, property or project.

(3) Sub-sections (1) and (2) do not apply to an investment or investments by a bank in the shares of a subsidiary, if the aggregate of all such investments by the bank does not exceed one hundred per centum of its regulatory capital (as defined by regulation).

(4) Sub-section (1) does not apply to an acquisition by a bank of an equity interest in realisation of any part of the collateral provided to the bank in a credit transaction with any person …37

Although it could be argued that such restrictions help to encourage diversification of investment portfolio by banks, and that that in turn leads to investor protection through the spread of investor risks, it is not entirely correct to assume that investment in a single portfolio necessarily leads to default and loss.

**Drawing distinctions between investment companies and open-ended investment companies in Zambia**

It is interesting to note that the Zambian Securities Act 1993 distinguishes an investment company, which owns the property that is subject to a collective investment scheme, from an open-ended investment company.38 The latter company denotes, first, a company whose scheme makes provision for the redemption or repurchase by the investment company of securities held by participants in the scheme. However, the Securities Act 1993 does not set the level of prices at which securities may be redeemed or repurchased.39 The

37 Banking and Financial Services Act 1994, s 75.
38 Securities Act 1993, s 72.
39 For the position in the UK, cf Authorised Unit Trust Scheme (Pricing of Units and Dealings by Trustee and Manager) Regulations 1988, Pt 4. See, also, Financial Services Act 1986, s 75(8)(b), which does not attract the Companies Act 1985, Pt 5, Chapter 7.
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SEC Code on Collective Investment Schemes, by contrast, simply provides the following formula:

1. Offer and redemption prices shall be calculated on the basis of the scheme’s net assets value divided by the number of units or shares outstanding.
2. Such prices may be adjusted by fees and charges for management of the scheme, which shall first be charged against investment income, next against dealing profits from the issue and redemption of units or shares in the scheme, and lastly against the capital value of the investments of the fund.
3. The amount or method of calculating such fees and charges shall be clearly disclosed in the offering document.40

The second feature of open-ended investment companies is that these companies are permitted by law to authorise participants in the investment scheme to sell their securities on a securities or stock exchange at a price related to the value of the property which is subject to the scheme.41 Thus, an open-ended investment company allows investors to unlock their capital out of the scheme. In contrast to closed-ended investment companies, open-ended investment companies may make fresh issues of shares to redeem investors’ securities. Here, investors can sell their securities to open-ended investment companies.

In general, the position is such that operators of investment companies receive dividends on the investments from the various companies in which investments have been made. After paying administration expenses, operators either distribute the remainder of the income among those who have purchased shares in the investment company, or reinvest the income to increase the value of the company, and so of the individual shares in it.42 Thus, in principle, a shareholder in an investment company has no legal or equitable interest in the shares and other assets owned by the company.43 His shareholding in the company will have a value depending not only on the value of shares and other assets owned by the company, but also on the investment and dividend policy of its directors.44

Constraints relating to protection of investors’ assets under a collective investment scheme

In many countries, collective investment schemes are an important institution through which investor protection is managed. Through these schemes, risk-

40 SEC Code on Collective Investment Schemes, para 33 of the schedule to rr 4–7 of the Code.
41 Securities Act 1993, s 72.
42 See op cit, Parker and Mellows, fn 17, pp 3–4.
43 Op cit, Hayton, fn 23, p 45.
averse investors can invest their capital in units of unit trusts for a better realisation of economic returns. In Zambia, however, like in many other emerging markets, the law on collective investment schemes does not adequately address the protection of assets of investors. Under the Zambian Securities Act 1993, apart from provisions on the Compensation Fund which apply generally to securities investment done through intermediaries on securities markets, there are no provisions in the Act on the need for collective investment schemes to protect small (usually risk-averse) investors from market abuses. Market abuses could range from investment companies misappropriating customer funds or not taking proper care in the selection of investment portfolio to matters such as investment companies profiting from use of inside information. Also, apart from the need to have securities legislation in Zambia redress these shortcomings, it would be prudent to provide for appropriate measures to protect investors who have interests in collective investment schemes (under an investment company) that are undergoing liquidation. But, as stated at the beginning of this chapter, if banks were to play an active role in setting up and running collective investment schemes in Zambia, would these schemes fall under the Banking and Financial Services Act 1994, or would they fall under a different regulatory framework?

It is submitted here that collective investment schemes set up by banks must be governed by the legal framework under the Securities Act 1993 and the SEC Code on Collective Investment Schemes. The implications of this are that, whereas banks remain under the prudential supervision of the Central Bank of Zambia, collective investment schemes set up by the banks fall under the supervision of the Securities and Exchanges Commission. There is, therefore, a need for the Central Bank of Zambia to co-ordinate with the Securities and Exchanges Commission in supervising and regulating banks and the collective investment schemes set up by these banks.

Conclusion

While looking at the ways in which banks in Zambia can set up and run collective investment schemes, this chapter also examined the legal framework governing collective investment schemes in Zambia. An underscoring theme was presented that, since the Lusaka Stock Exchange, like many other emerging markets, is faced with constraints relating to inadequate liquidity, the participation of collective investment schemes on the market could help to overcome liquidity constraints on the market. Indeed, some

45 See, generally, Porter, 1993; and op cit, Barry and Lockwood, fn 35.
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tempirical evidence was presented to show that there is an urgent need to have collective investment schemes participate on the Lusaka Stock Exchange.46

Further, an issue was raised that if banks were to play an active role in setting up and running collective investment schemes in Zambia, would these schemes fall under the Banking and Financial Services Act 1994, or would they fall under a different regulatory framework? Countries such as the UK were identified as having introduced a fused system of regulating both banking and financial services business. It was noted also that, in deciding whether a collective investment scheme falls under the supervision of the central bank or under a different regulatory authority, the sensitivity of each case and the legal rules applying to a particular situation must be taken into account. Indeed, it was observed that the merits and demerits of adopting any banking supervisory system – whether a fused system or a diffused system – depended on several factors which included historical, political, economic and institutional-structural issues.

CHAPTER 6

BANKS AND THE USE OF CHINESE WALLS
IN MANAGING CONFLICT OF DUTIES

Chinese walls are a crucial part of the regulatory system for securities markets. They legitimise what would otherwise be unacceptable, and unlawful, conflicts of interests within integrated securities firms.¹

That Chinese walls can be used to manage conflict of duties effectively, so as to protect clients from misuse or abuse of financial information by fiduciaries, such as banks, is by no means a thesis free from difficulty. Indeed, as a corollary to effective banking supervision, the sound management of confidential information by banks is an important element of promoting investor confidence in a banking system. This chapter examines the legal aspects of managing conflicts of duties through the use of Chinese walls to segregate client information. Indeed, the doctrines and principles of equity that are enunciated in the chapter obtain in many common law jurisdictions, including the US, Zambia and the UK. It must be noted, however, that the confidential information being guarded by Chinese walls relates to some of the knowledge acquired from clients or other fiduciaries. It is argued, thus, that while Chinese walls can afford a good opportunity for financial institutions to manage confidential information, these walls can be ineffective when designed poorly. Fiduciary obligations of banks are examined and an international and comparative analysis is provided.

Against this background, we now look at the nature and anatomy of a Chinese wall. What are Chinese walls and what are the characteristics and difficulties associated with such walls? Chinese walls, as was stated by the Law Commission in the UK,² are broadly ‘procedures for restricting flows of information within a firm to ensure that information which is confidential to one department is not improperly communicated (and this includes inadvertent communication) to any other department within the conglomerate’. In Zambia, for example, a Chinese wall can be erected under s 50 of the Banking and Financial Services Act 1994, which provides as follows:

(1) A bank or financial institution and every director, officer and employee thereof shall maintain the confidentiality of all confidential information

obtained in the course of service to the bank or institution and shall not divulge the same except –

(a) in accordance with the express consent of the customer, or the order of a court; or

(b) where the interest of the licensee itself requires disclosure.

(2) For the purposes of this section confidential information about a person includes information that is not public, concerning –

(a) the nature, amount or purpose of any payment made by or to the person;

(b) the recipient of a payment by the person;

(c) the assets, liabilities, financial resources or financial condition of the person;

(d) the business or family relations of the person; or

(e) any matter of a personal nature that the person disclosed to the bank in confidence.

It is clear from the above statutory provision that the Banking and Financial Services Act 1994 of Zambia defines ‘confidential information’ in a very broad sense. Indeed, categories of confidential information are not confined to those spelt out in the above statutory provision. They include other forms of non-public information obtained by a bank in a banker-customer fiduciary relationship. In the US, the National Association of Securities Dealers Inc (NASD) defines a Chinese wall as:

A term used to describe procedures enforced within a securities firm that separate the firms’ departments to restrict access to non-public, material information. The procedures help NASD members avoid the illegal use of ‘inside’ information.3

However, the term ‘Chinese wall’ should be distinguished from ‘firewall’. As Cranston observes:

Firewalls to segregate risks, such as those associated with securities activities, are said to be one answer to the contagion problem. To be effective they should insulate the banking side from calls for financial support when the securities side is in serious difficulty. The parent should be able to walk away from the securities subsidiary without fear that the corporate veil will be pierced. Indeed, with a true firewall the parent would be obliged to do this. This is because in practice it is difficult to separate the two sides in the public mind, which is never overly concerned with legal niceties. Even if the legal position is that there is no obligation to the securities subsidiary, public pressure will be for the parent to assist it.4

While procedures for setting up Chinese walls and the characteristics of these walls differ from one jurisdiction to another, and although Chinese walls are

3 See NASDQ website: http://www.nasd.com/glossary/c.html

4 Cranston, 1997, p 104.
meant to protect clients from abuse of financial information, in instances where Chinese walls are not designed properly they may not even manage conflict of duties effectively. Indeed, a recent report on Australia shows that:

A landmark ruling by an Australian court may mean the end for Chinese walls in the country, and cause problems for firms looking to merge. The Western Australia Supreme Court in Perth has ordered leading law firm Philips Fox to relinquish long standing client, Fletcher Construction, because of fears over a conflict of interests. Fletcher construction was involved in a dispute with another contractor, which had been represented by Hely Edgar for four years. However, when the firm later dissolved, the senior partner and staff went to Philips Fox. The judge dismissed claims that the Chinese wall would hold up and prompted the Western Australian Law Society to condemn the practice.

Addressing a closely related position in the UK, Berg observes that:

Commenting on a recent UK case, Barboutis, 1999, p 292, argues: ‘Apart from any consideration regarding legal parameters such as the acceptability of the legal treatment of accountants as solicitors, the consent of a former or present client, or the concept of attribution of knowledge, the fact remains that the Prince Jefri case was finally judged on the basis of only one question: whether and to what extent the measures taken by KPMG to protect the confidentiality of the information it possessed could be considered as adequate to protect this confidentiality. However, what must be emphasised is that this question was placed in concreto, in view of the adequacy of the particular Chinese wall adopted by KPMG in this specific case. Thus, the Court of Appeal held that these specific arrangements were adequate to protect the confidential information, while their lordships were of the view that these specific measures were not in the particular case adequate to preserve such confidentiality. Indeed, the injunction was granted and KPMG was restrained from acting, not on grounds that the Chinese wall is generally an ineffective means of legal defence, but because the particular measures arranged by KPMG in the specific case were inadequate. According to Lord Millett it was certain facts, such as that the Chinese wall was established ad hoc, that it operated within a single department and that personnel were in practice transferred over the Chinese wall, which mainly undermined the adequacy of the Project Lucy Chinese wall. And it is exactly at this point that one can identify the important change that the Prince Jefri case is bringing: for the first time the concept of the Chinese wall is judicially endorsed as an effective means of legal defence in connection with breach of fiduciary duties: both the decision of the Court of Appeal directly, as well as the decision of the House of Lords indirectly (by argumentum a contrario) endorse the concept of a permanently established and properly operating Chinese wall which effectively separates different departments of a firm. In essence, the Prince Jefri case does not represent the conviction of the Chinese wall: it represents the endorsement of the concept of a well established Chinese wall and the conviction of the improperly constructed and, as a result, permeable Project Lucy Chinese wall.’ See, also, Australian cases, eg, Mallesons Stephens Jacques v KPMG Peat Marwick [1990] WAR 357; Carindale Country Club Estate Pty Ltd v Astill (1993) 115 ALR 112. Cf the New Zealand case of Russell McVeagh McKenzie Bartlett v Tower Corporation (1998), unreported, September, New Zealand Court of Appeal (discussed in Barboutis, 1999, p 288), where a test of three fundamental questions was laid down, namely: first, whether confidential information is held which, if disclosed, may affect the concerned (former) client’s interests; secondly, whether there is a real or appreciable risk that such information will be disclosed; and, thirdly, whether the discretionary power of the court should be exercised in view of the significance of the special fiduciary relationship.

The first decision is that of Sir Nicolas Browne-Wilkinson, the Vice Chancellor, in *David Lee and Co (Lincoln) v Coward Chance* [1991] Ch 259. During the preparation of the action, there was an amalgamation between the firm of solicitors acting for the liquidators and the firm of solicitors which had previously acted for some of the main defendants. The liquidators, who had incurred considerable expense instructing their solicitors, wished the amalgamated firm to continue to act for them. The defendants objected that confidential information about their defence had been given to one or more of the partners in the amalgamated firm and that any leakage of that information would be highly damaging to their defence ... Browne-Wilkinson refused to allow the amalgamated firm to continue to act for the liquidators. He said: ‘When one has sensitive information in a firm or in any other group of people, there is an element of seepage of that information through casual chatter and discussion, the letting slip of some information which is not thought to be relevant but may make the link in a chain of causation of reasoning ... I am afraid that on the information that I have I am not satisfied that the amalgamated firm has demonstrated that the Chinese walls that they are proposing to erect will be sound-proof. Experience in this court demonstrates that the maintenance of security on either side of Chinese walls in the context of the city does not always prove to be very easy. I think it is a very difficult task.’ The second case is the majority decision of the Court of Appeal in *Re A Firm of Solicitors* (reported in (1991) *The Times*, 20 June). This also arose from a proposal that a large law firm should act in commercial litigation for one party, although it possessed confidential information concerning the other party to the litigation which it had obtained while acting for a client which was independent of, but closely associated with, that other party. Lord Justice Parker had no doubt that the law firm intended that their proposals for a Chinese wall would eliminate any risk of leakage and genuinely believed that these proposals would do so. However, he was not so satisfied that they would do so: ‘In my judgment, any reasonable man with knowledge of the facts in the case concerned, including the proposals for a Chinese wall, would consider that some confidential information might permeate the wall ... I doubt very much whether an impregnable Chinese wall can ever be created.’

**Salient features of a Chinese wall**

A typical Chinese wall will be characterised by rules and regulations that relate to confidentiality and segregation of information. However, given that information is intangible, it is often not too easy to identify ‘physically’ each and every characteristic of a Chinese wall. In certain instances, though, the physical characteristics of a Chinese wall can be identified. As Cranston observes:

Chinese walls ... are designed to stem the flow of information between different parts of the bank. Institutionally a Chinese wall can involve physical

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separation (in some cases the occupation of different buildings); separate files for the functions separated by the Chinese wall with no access for someone on one side of the wall to a file on the other side; consequent restrictions on physical access and controls on computer access and fail-safe systems; and controlled procedures for the movement of personnel between different parts of the bank. In some financial institutions Chinese walls are underpinned by stop lists and no-recommendation policies. The reason is that whereas under the Financial Services Act 1986 (of the UK), an effective Chinese wall by itself is regarded as a defence to the breach of some regulatory rules ... the common law sometimes requires more – disclosure or the cessation of the activity.8

In many cases, Chinese walls are designed as a set of rules, practices and business ethics that govern the fiduciary obligations of confidentiality and loyalty to clients. In essence, a Chinese wall will often be based not only on fiduciary law, but also on rules and guidelines from both within and outside the firm. To build such a wall effectively, the wall must be based on rules that are both enforceable and justiciable. Through the adoption of such rules market confidence in the regulatory framework can be enhanced. The information monitoring and compliance mechanisms – that is, in regard to confidentiality and segregation of non-public and material information – can thus be addressed by both the internal management of the firm and the regulatory authorities (for example, self-regulatory bodies such as NASD in the US). In a typical situation, such as the US, monitoring involves use of both external and internal resources. It must be noted, however, that external monitoring alone could prove less costly than a holistic and systemic approach to monitoring. That said, one of the major advantages of the holistic approach is that it provides for a better way (and a more transparent way) of screening both those inside the wall and those outside it.

Having looked at the major characteristics of a Chinese wall and how these walls are set up, it is submitted that some of the notable problems associated with Chinese walls are varied in nature9 and that they depend on several factors which include the efficiency of the regulatory framework and the enforcement mechanism. Indeed, problems that could arise, say, in the case of a Chinese wall in a law firm or investment bank, might be different from those arising in the case of a Chinese wall in an accounting or auditing firm or in a stockbroking firm. However, the common thread between all these institutions is the law of fiduciary obligations. An argument can thus be advanced on the importance of stopping insiders benefiting from the use of non-public and material information gained in their capacity as insiders. Indeed, information which is non-public must be guarded from members of the public. In countries such as the UK and many others, there have been efforts to reinforce Chinese walls with regulatory rules like the UK Conduct of Business Rules under the Financial Services Act 1986. As Jarvis observes:

8 See op cit, Cranston, fn 4, pp 31–32. See, also, generally, Bosworth-Davies, 1995.
9 For examples of some of these legal problems, see op cit, Berg, fn 1, pp 25–26.
Perhaps the most debated and important regulatory rule in this context (that is, in the case of the UK) is Core Rule 36 which the Securities and Investment Board (SIB) made under the powers given to it in s 48(2)h of the Financial Services Act 1986. Section 48(2)h gives the SIB power to make conduct of business rules ‘enabling’ the segregation of information within a firm. The question is to what extent the core rule allows firms to escape liability under fiduciary law for knowledge that they have acquired.10

Jarvis argues further that:

… on the issue of conflicts of interest the rule (Rule 36) is silent. SIB Principle 6 mentions Chinese walls as a method to control conflicts of interest. However, the courts require some evidence of the ‘sound-proof’ nature of a Chinese wall, as a series of law firm cases has shown which culminated in a comment by Parker LJ that he very much doubted whether an impregnable wall could be created except in very special circumstances … this shows a divergence of approach between the courts and the SIB …11

In the US, taking an example of the NASD, it is clear that some of its information monitoring techniques include the following:

**Other surveillance methods**

In addition to the on-line SWAT systems, regulators employ other longer range computer analyses and reports that provide analysts with necessary information to identify and investigate for unusual activity or indications of rule violation. Another critically important aspect of monitoring the markets is addressed through field examination programmes whereby regulators make on-site inspections of securities firms to review their sales and trading practices, to ensure fair dealing with customers, to verify accurate and complete trade reporting, to review for manipulative or fraudulent conduct, and to examine ‘Chinese walls’ and other procedures for controlling the flow of non-public information in order to help prevent illegal insider trading.12

**Management of fiduciary duties relating to non-public and material information as the raison d’être behind Chinese walls**

At common law, the question ‘Who is a fiduciary?’ provides an interesting starting point to an inquiry on the legal problems surrounding Chinese walls.

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10 Jarvis, 1996, p 111.
11 Ibid, p 112.
12 See NASDQ website: http://www.nasd.com/publications/secreg.txt
The nature and forms in which fiduciary duties present themselves cannot be reduced to one succinct statement. As Hannigan observes:

It is now generally agreed that the word ‘fiduciary’ does not of itself identify a single class of relationships, nor can fiduciary duties be reduced to a single set of rules and principles which apply to all such relationships. Before considering liability for breach of fiduciary duty, therefore, it is necessary first to determine whether ... would be regarded as fiduciaries and to whom they are fiduciaries; secondly, it is necessary to consider the particular duty or duties relevant to imposing liability ...

In line with the view that the word ‘fiduciary’ does not of itself identify a single class of relationships, we look at what judges have said in England, the US and Australia. In the English case of *Re Coomber*, Fletcher LJ observed:

... fiduciary relations are of many different types; they extend from the relation of myself to an errand boy who is bound to bring me back my change, up to the most intimate and confidential relations which can possibly exist between one party and another where one is wholly in the hands of the other because of his infinite trust in him. All these are cases of fiduciary relations, and the courts have again and again, in cases where there has been a fiduciary relation, interfered and set aside acts which, between persons in a wholly independent position, would have been perfectly valid ...

Similarly, in the American case of *Securities Exchange Commission v Chenery Corporation*, Frankfurter J stated:

... to say that a man is a fiduciary only begins the analysis, it gives direction to further enquiry. To whom is he a fiduciary ...?

The courts in Australia have often applied the ‘undertaking test’ when determining whether or not a fiduciary relationship exists.

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13 See *Securities and Exchange Commission v Chenery Corporation* (1942) 318 US 80. In the UK, the Law Commission, *op cit*, fn 2, as reproduced in Bamford, 1997, p 79, observed that: ‘Our legal system primarily deals with such conflicts by treating the relationship between the provider and recipient of such services as giving rise to fiduciary duties on the part of the provider and conferring on the recipient rights of action for breach of the obligations imposed on the provider. Broadly speaking, a fiduciary relationship is one in which a person undertakes to act on behalf of or for the benefit of another, often as an intermediary with a discretion or power which affects the interests of the other who depends on the fiduciary for information and advice.’ Indeed, the Law Commission Report (1995) simply lists down examples of fiduciary duties (ie, the ‘no conflict’ rule, the ‘no profit’ rule, the undivided loyalty rule, and the duty of confidentiality rule) without saying crucially the exact scope of the fiduciary’s obligations. The report acknowledges only that the consequences of breach vary according to the particular circumstances.

14 Sealy, 1962, p 69.
16 [1911] 1 Ch 723, p 728.
18 (1942) 318 US 80, p 85.
19 See Moffat, 1994, p 548.
[A fiduciary] is, simply, someone who undertakes to act for or on behalf of another in some particular matter or matters. That undertaking may be of a general character. It may be specific and limited. It is immaterial whether the undertaking is or is not in the form of a contract. It is immaterial that the undertaking is gratuitous. And the undertaking may be officiously assumed without request.20

Some fiduciary duties which Chinese walls attempt to manage

The duty to obey instructions of the customer21

The common law position is that in managing conflict of duties an intermediary’s duty to obey a customer’s instructions rests on questions of fact.22 What is important is to inquire whether or not an intermediary followed his customer’s instructions. If the instructions were not clear and the intermediary interpreted them on the basis of the clear part of the instructions, then the intermediary did discharge his fiduciary duty to obey the customer’s instructions.23 However, there are other instances when a fiduciary could find himself confronted with a conflict of interests. For example, as the UK Law Commission observes:

… the solicitors’ professional conduct rules provide that a solicitor should not accept instructions to act for two or more clients where there is a conflict or a significant risk of conflict between the interests of those two clients. The guidance envisages that Chinese walls can only be used in very rare cases following the amalgamation of two firms and then only when the best interests of clients permit the amalgamated firm to continue to act and the clients have received full and frank independent advice and have subsequently consented to the arrangement. The rules of actuaries and insurance brokers are also stricter. It would be undesirable if a firm could rely on the less strict SIB (Securities and Investment Board) rule as a defence to civil proceedings even though it had breached its own professional conduct rules.24

The duty to keep customers’ orders in confidence and with care25

At common law, an intermediary owes his customer a duty of confidentiality.26 However, the information being guarded must have the

20 See materials cited above in fn 19.
21 Mitchell v Newhall (1846) 15 M & W 308.
22 Ibid.
23 Ibid.
24 See op cit, UK Law Commission, fn 2, p 106; see, also, op cit, Berg, fn 1, pp 23–24, where that author discusses two important cases on this very point (which have already been discussed above, p 82).
26 Ibid.
necessary quality of confidence to merit protection. By contrast, if the information is 'public property and public knowledge', no duty of confidence arises.27

In general, an action for breach of confidentiality may be based on some express or implied contractual obligation,28 or on 'a broad principle of equity that he who has received information in confidence shall not take unfair advantage of it'.29 At common law, in determining whether or not a fiduciary ought to have known of the obligation of confidence, the courts30 have applied the 'reasonable man' test spelt out by Meggery J in Coco v AN Clark (Eng) Ltd:

It seems to me that if the circumstances are such that a reasonable man standing in the shoes of the recipient of the information would have realised that upon reasonable grounds the information was being given to him in confidence, then this should suffice to impose upon him the equitable obligation of confidence. In particular, where information of commercial or industrial value is given on a business-like basis and with some avowed common object in mind ... I would regard the recipient as carrying a heavy burden if he seeks to repel a contention that he was bound by an obligation of confidence.31

As a general rule, an intermediary must keep orders of his customer in confidence and with care. In Indata Equipment Supplies Ltd (Trading as Autofleet) v ACL Ltd,32 Simon Brown LJ, Otton LJ and Owen J held that, when a finance house with whom a broker was arranging finance for a client used confidential information provided by the broker as the basis for making an agreement directly with the client, thus cutting out the broker, the mere fact of the receipt of confidential information did not create a fiduciary relationship between the finance house and the broker so as to give rise to fiduciary obligations. However, a blatant disregard for what should be commercial ethics and practice in the misuse of confidential information did amount to a breach of the equitable doctrine of confidence, and could also constitute the tort of unlawful interference with business. Arguments on the distinction of fiduciary obligations from the equitable doctrine of confidence are of little

27 Per Lord Greene MR in Saltman Engineering Co Ltd v Campbell Engineering Ltd [1963] 3 All ER 413, p 415. See, also, Mustad and Sons v S Alcock and Co Ltd and Dosen [1963] 3 All ER 416.
30 See, generally, cases cited ibid.
relevance here. Suffice it to say that the court further ruled that, where parties enter into contractual relations at arm’s length and understand what they are agreeing to, there is little scope for the law to add the extra dimension of fiduciary duties to the relationship which they have selected.33

By contrast, where the intermediary is an organisation, such as a bank, and one of its departments is influencing the other departments by providing them with information on a client that is operating in competition with clients of the other departments, the transmission of information could prejudice the first client. Indeed, this would bring into play the concept of attribution of knowledge. In Kelly v Cooper,34 an intermediary acted for both the buyer and the seller. It was held that where the nature of the intermediary’s business is such that he deals with various parties in competition with each other, on either side of the buyer or seller, then the nature of the contracts between the intermediary and these customers respectively would determine whether or not there is a fiduciary duty to disclose instructions of one customer to the other. To overcome such problems, Chinese walls have been advocated by many commentators as a way of segregating information of customers.35 Even so, the law courts have usually taken the view that Chinese walls do not afford a solution to the problem of attribution of knowledge.36 A similar view has been advanced by the Law Commission in England. Addressing the position of law firms in England, the Law Commission observes:

... Chinese wall has not been seen as providing satisfactory protection for interests of the former client and, despite the existence of a wall, the courts have required the law firms not to act on behalf of the new client ...37

By contrast, the regulatory rules set by the Securities and Investment Board (SIB) in the UK are underscored by the view that Chinese walls do provide effective segregation of information in certain instances.38 As Bamford observes:

The SIB (Securities and Investment Board) rules however recognise that the different divisions of an integrated securities house may well find themselves in such a position. The rules therefore permit the house to continue to act in these situations subject to the imposition of ‘Chinese walls’ which effectively

33 See (1997) The Times, 14 August, per Otton LJ, p 28. The relationship of broker to finance house was held not to fall within the established categories already recognised by the law. The parties were at all times at arm’s length in the market. See, also, Clark Boyce v Mouat [1994] 1 AC 428.


35 See Lipton and Mazur, 1976, p 579; Lipton and Mazur, 1975, p 459; Chazen, 1976, p 552.


37 See UK Law Commission, Consultation Paper No 124, 1992, p 144; for a contrary but less persuasive view, see Supasave Retail Ltd v Coward Chance [1991] 1 All ER 668.

38 See, eg, SIB Core Rule 36.
Banks and the Use of Chinese Walls in Managing Conflict of Duties

prevent the transfer of contaminating information from one department to another. However, the legal rules dealing with the imputation of knowledge within companies might well have the effect of ignoring the existence of the Chinese wall arrangement and produce the result that a securities house was in breach of its contractual obligation to its client even though the individuals within the securities house were unaware that the company was performing an act which amounted to a breach of contract with one of its clients.39

In contrast to the viewpoint of the Securities and Investment Board, the Law Commission, in its 1995 Report, observes:

... a Chinese wall would not prevent the attribution of knowledge between the component parts of a company (although it might do so as between different companies which form part of a group) ... unless appropriate provision is made in the contract between firm and customer, a Chinese wall cannot in all cases be relied upon, as a matter of private law, to limit the fiduciary duties the firm owes to the customer.40

In the case of large partnerships, such as big law firms and big accounting firms in many parts of the Commonwealth, attribution of knowledge to partners would not be easy to prove. By contrast, the case of group trading companies provides a relatively straightforward case. Without proof of fraud or other factors that lead to the lifting of the corporate veil, attribution of knowledge to subsidiaries in a group or to the parent would flout the legal personality of these companies.41 Commenting on instances when the corporate veil can be lifted, Prentice observes:

There is a likelihood that the court will pierce the corporate veil in a parent–subsidiary situation where:

(a) the subsidiary is grossly under-capitalised,

(b) the affairs of the parent and the subsidiary are commingled, or

(c) the subsidiary is set up to enable the parent to perpetrate a fraud, although as regards this aspect of the rule the desire to limit liability does not constitute fraud.42

Thus, for group companies, such as bank subsidiaries and the holding or parent bank, attribution of knowledge could occur mainly where the

39 Op cit, Bamford, fn 13, p 78; see, also, Meridian Global Funds Management Asia Ltd v Securities Commission [1995] 2 AC 400.
40 Op cit, UK Law Commission, fn 2, p 97.
41 Adams v Cape Industries plc [1990] 2 WLR 657.
corporate veil has been lifted. On a similar note, the UK Law Commission observes:

We have already set out the … situation in respect of which we consider that the fiduciary should be protected. We consider that the new provision should address only the position of Chinese walls between departments in the same legal entity and should not be extended to Chinese walls between different companies within the same group. There are two reasons for this conclusion. First, there is not the automatic attribution of knowledge between different companies within a group which we consider operates between different departments within the same legal entity. As we have indicated, it is open to the companies within a group to organise their affairs so that attribution will not occur. Secondly, s 48(2)(h) [of the Financial Services Act 1986] deals only with Chinese walls within a single entity …

The duty to be loyal to customers

This fiduciary duty is closely linked to the fiduciary duty to obey customers’ instructions. We have already examined the latter and we noted how this obligation relates to the idea of managing conflict of duties. At common law, an intermediary owes a fiduciary duty of loyalty to his customers. This duty entails that the intermediary must not favour one customer over the other whenever he is acting in a dual capacity. However, some of the legal problems that could be encountered here include the view that – as in the case of Royal Brunei Airlines Sdn Bhd v Tan, where ‘knowing receipt’ was distinguished from ‘knowing assistance’, and thus making a third party that had knowingly received trust property liable to account as a constructive trustee – the effectiveness of using Chinese walls might be watered down by liability arising from either ‘knowing receipt’ or ‘knowing assistance’. To overcome such a problem, there would be need to show that the use of a Chinese wall has succeeded in shielding the fiduciary from ‘knowingly receiving’ the relevant information.

43 Also, different regional or local customs, recognised widely in various national jurisdictions, could require non-disclosure or full disclosure to be made to the affected clients. As the UK Law Commission (op cit, fn 2, pp 103–04), notes: ‘We have also indicated that we consider that a firm should be protected from a claim for breach of common law as well as equitable duty arising from the withholding of information or from the act of acting in the circumstances described above. This is because there may be a common law duty to use or disclose information that is quite separate from the fiduciary obligation. However, it is only where liability arises for those reasons alone that the firm should be protected.’

44 See op cit, UK Law Commission, fn 2, pp 102–03.

45 See above, p 86.


At common law, there is a duty on financial intermediaries to keep properly audited books of accounts. In preventing conflict of duties here, trusts law in many common law jurisdictions provides that culpable or innocent depletion of clients’ assets, by an intermediary (and/or any constructive trustee), will attract some equitable remedies. To illustrate, in *Brinks Ltd v Abu-Saleh and Others*, the defendant was a lady who had accompanied her husband on trips to Zurich, during which he laundered funds handed to him by a friend. The source of the funds was the theft, several years before, of gold bullion under the custody of Brinks Ltd. The theft had occurred because a security guard had assisted robbers to gain entry to the premises he was guarding. The argument in the case was that the lady concerned was liable to Brinks Ltd as a constructive trustee, following the principles laid down in *Royal Brunei Airlines Sdn Bhd v Tan* [1995] 2 AC 378 and *Brinks Ltd v Abu-Saleh and Others* [1995] 1 WLR 1478. The argument was that she had behaved dishonestly, and that her behaviour had assisted a breach of trust. The claim failed, on the basis that her presence on trips with her husband did not provide assistance in any relevant manner.

**Conclusion**

This chapter has examined the legal aspects of managing conflict of duties in situations where a bank uses Chinese walls to segregate confidential and material information obtained from clients. It was shown that, in certain instances, Chinese walls could afford a good opportunity to manage a conflict of interests. Ideally, Chinese walls are meant to protect clients from abuse or misuse of financial information by an intermediary or a fiduciary. Here, information could relate to knowledge acquired from the client or from other fiduciaries of the client. The chapter took an exploratory dimension in evaluating some of the legal problems associated with the use of Chinese walls in managing a conflict of duties.

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48 *Clarke v Tipping* [1846] 9 Beav 284; *Lord Chedworth v Edwards* [1802] 8 Ves 46.
In Chapter 5, the need to overcome the liquidity constraints facing emerging markets was identified. Indeed, banks must be encouraged to participate in public distribution of securities on markets such as the Lusaka Stock Exchange. The role that banks play in public distribution of securities can raise issues such as insider dealing by a bank, particularly where such institutions play the role of shadow or *de jure* director of a listed company. In fighting bank insider dealing – that is, in a case where a bank is committing insider dealing on the stock market – which regulatory authority is responsible for prosecuting the bank? Can we treat this as a function of banking supervision, and thus falling under the jurisdiction of the Bank of Zambia, or as an element of securities regulation and therefore falling in the hands of the Securities and Exchange Commission? Indeed, does the bank remain under the supervision of the central bank simply because it is a bank, or does it move into the jurisdiction of the Securities and Exchange Commission? In Zambia, the Securities Act 1993 vests supervisory powers over the securities industry in the Securities and Exchange Commission. Yet, s 77 of the Banking and Financial Services Act 1994 provides that:

(1) Where, in the opinion of the Bank of Zambia, a bank or any person on behalf of a bank is committing or pursuing or is about to commit or pursue on behalf of the bank any act or course of conduct that is considered by the Bank of Zambia as unsafe or unsound practice, the Bank of Zambia may 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 or unsound practice and to establish or maintain safe and sound practices in the conduct of the business of the bank.

(2) Where the Bank of Zambia is unable to obtain an agreement under sub-s (1) within a time, and in a form and content, satisfactory to the Bank of Zambia, or where the Bank of Zambia considers that the need for prompt action makes the negotiation of such an agreement impractical, the Bank of Zambia may direct the bank or any director, manager or other person concerned in its management to do either or both of the following:

(a) cease or refrain from doing the act or pursuing the course of conduct;
(b) perform such acts as, in the opinion of the Bank of Zambia, are necessary to rectify the situation.

The vagueness in the statutory definition of ‘unsafe and unsound practices’ leaves the Bank of Zambia with wide discretionary powers which could cover
activities such as money laundering and insider dealing. However, could such vagueness be treated as ‘constructive ambiguity’ which enables the central bank to regulate any activity under the sun so as to restore soundness to banking business? It is such issues which illustrate the importance of having supervisory institutions such as the Bank of Zambia and the Securities and Exchange Commission co-ordinate over the control of malpractices by banks. While powers of these institutions may overlap in certain areas, prudential banking supervision, nonetheless, requires use of a multi-faceted approach to problem solving. This view ties in with the issue raised in Chapter 5 on whether or not a country should adopt a fused system of supervision. That said, the downside of vesting wide discretionary powers in a State institution such as the Bank of Zambia, as noted earlier, is that the institution might end up being manipulated by the State to hold banks that are not supporting activities of the State as conducting ‘unsafe and unsound practices’.

Insider dealing

Generally, empirical evidence suggests that the low levels of liquidity on markets such as the Lusaka Stock Exchange have not attracted any insider dealing and have not led to any major malpractice by financial intermediaries. However, although there has been no evidence of insider dealing on the Lusaka Stock Exchange, our proposals to refine insider dealing rules in Zambia are proactive and are thus grounded in the economic argument that efficient legal rules can help to promote the development of a competitive stock exchange.

The Zambian Securities Act 1993 purports to address the law on insider dealing in one statutory provision. This section reads as follows:

1. A person to whom this section applies who deals, or counsels or procures another to deal, in securities of a company concerning which he has any knowledge that –
   (a) is not publicly available; and
   (b) would, if it were publicly available, materially affect the price of the securities ...

2. This section applies to –
   (a) any director, officer or employee of the company concerned;
   (b) any person associated in a professional capacity with that company; and
   (c) any person who obtains such information from any of the persons mentioned in para (a) or (b).

1 Interview with Dr Tukiya-Kankasa Mabula. See, also, interview with Mr Lewis Mosho.
2 Securities Act 1993, s 52.
The shortcomings of the above statutory provision are multifold. First, the provision covers only two types of insider dealers. Paragraphs 2(a) and (b) relate to primary insider dealers, whereas para 2(c) relates to secondary insider dealers. There is definitely a lacuna in the law here. The statutory provision does not cover liability of third parties who obtain and use information from secondary insiders. Secondly, whereas government securities can be traded on a securities market in Zambia, insider dealing law applies only to company securities. Section 52(1) of the Securities Act 1993 clearly refers to ‘deals, or counsels or procures another to deal, in securities of a company’. In drafting the Securities Act 1993, neither the drafter nor the Members of Parliament (when debating the Securities Bill) gave thoughtful consideration to a number of these factors. Indeed, the Securities Act 1993 does not even spell out the length of time in which an individual could be seen as an insider. For example, what happens to a former bank director who, after resigning from the bank (assuming the bank is listed on a stock exchange), communicates inside information about the bank to prospective investors? The Securities Act 1993 is silent on such matters.

Thirdly, under the Securities Act 1993, bodies corporate are excluded from the two categories of insider dealers. In s 52(1) of the Securities Act 1993, which reads in part ‘to deal, in securities of a company concerning which he has any knowledge’, the pronoun ‘he’ obviously refers to individuals. Thus, bodies corporate such as banks and those acting as underwriters, promoters or operators of collective investment schemes cannot be held liable for insider dealing in Zambia. The Securities Act 1994 does not, however, exclude members of unincorporated associations (for example, partners in a partnership) from the two categories of potential insider dealers.

Fourthly, under s 52 of the Securities Act 1993 one of the essential requirements that must be satisfied to warrant a conviction of insider dealing is that, for information to be treated as inside information, it must ‘materially’ affect the price of securities. Also, the information must not be available to the public. The criterion of defining what constitutes ‘materially’ (or ‘materiality’) is not spelt out in the Act. How, then, can a supervisory body such as the Bank of Zambia stop a bank from engaging in insider dealing under the ‘unsafe and
unsound practices’ provisions of the Banking and Financial Services Act 1994? In addition, under the Securities Act 1993, it is somewhat unclear whether fraudulent disclosure omissions by a bank\(^6\) that create inflated prices of securities could amount to insider dealing.\(^7\) Moreover, the weakness of the local currency entails that the more the currency depreciates in value, the greater the difficulty in proving the issue of ‘materiality’\(^8\). Illustratively, in the American case of *Cady Roberts and Co*,\(^9\) the principle in American securities law that a fact was material if it, if known, would affect the investment judgment of those with whom the insider was dealing was criticised by Commissioner Cary. He argued that this principle produced uncertainty and confusion. He therefore suggested the direct effect on the market value of securities as a test in addition to the ‘investment judgment’ principle. This dual test, however, does not establish certainty. How is market value to be determined in Zambia given a weak and fluctuating currency such as the Zambian Kwacha?

Fifthly, the Securities Act 1993 does not define what constitutes ‘knowledge’. Although no statute can readily be cited as an example of a foreign piece of legislation in which the term ‘knowledge’ has been defined, that argument alone does not defeat the view that clarity in the meanings of statutory provisions would facilitate a smooth interpretation of the statute. In Zambia, as noted earlier, s 52 of the Securities Act 1993 reads in part ‘who deals, or counsels or procures another to deal in securities of a company

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6 Eg, where a bank is issuing shares to the public and its directors deliberately decide to omit non-publicly available and material information from the listing particulars or prospectus.

7 Generally, unlike the duty of disclosure that exists under insurance law, there is no such duty under insider dealing law in Zambia. See Securities Act 1993, s 52. Cf *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co* [1994] 3 All ER 581, on the effect of an insured’s non-disclosure. However, since the Zambian Securities Act 1993, s 52(1), refers to an insider as an individual ‘who deals, or counsels or procures another to deal, in securities’, the dealing or the procurement of others to deal or the counselling of others to deal could be done while some material facts are being concealed. In this instance, though there is no general duty to disclose material facts other than those disclosed in the prospectus and the listing particulars, the price of the securities could be affected by the non-disclosure. The party advising or counselling or dealing might fraudulently choose not to disclose certain facts so that the price of the securities is affected materially. If this were to happen, the omission could lead to insider dealing. The prosecution would have to prove beyond reasonable doubt that the omission concealed relevant knowledge which was not publicly available. Consequently, this must be seen to have materially affected the price of the securities.

8 In *Pan Atlantic Insurance Co Ltd v Pine Top Insurance Co* [1994] 3 All ER 581, the House of Lords considered the statutory definition of ‘materiality’ and, by a bare majority, held that a fact is material if it is one which would have an effect on the mind of a reasonably prudent insurer considering whether or not to accept the proposed risk, even if it would not have altered his actual decision. Similarly, as Bradgate, 1995, p 709, observes: ‘In effect, therefore, a material fact is one which a reasonably prudent insurer would want to know when making an assessment of the risk ... the insurer can only avoid a policy on the grounds of non-disclosure of a material fact if the non-disclosure did actually induce him to enter into the contract.’

Banking Supervision and Insider Dealing

c Haring which he has any knowledge'. The term 'knowledge' is not defined anywhere in the Securities Act 1993. However, in Selanghor v Craddock (No 3),10 Ungod-Thomas J was of the view that 'knowledge' meant 'circumstances which would indicate to an honest and reasonable man that such design was being committed, or would put him on inquiry'. In Re Montagu's Settlements,11 it was held that 'knowledge' is not confined to actual knowledge, but includes actual knowledge that would have been acquired but for shutting one's eye to the obvious, or wilfully and recklessly failing to make such inquiries as a reasonable man would make. Similarly, in Baden Delvaux and Lecuit v Société Générale, it was pointed out that:

... knowledge can comprise any one of five different mental states ...

(i) actual knowledge;

(ii) wilfully shutting one's eye to the obvious;

(iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make;

(iv) knowledge of circumstances which would indicate the facts to an honest and reasonable man;

(v) knowledge of circumstances which would put an honest and reasonable man on inquiry.12

In contrast to the position in civil law, the criminal law position was spelt out in Nelson v Larholt13 where it was held that 'knowledge' meant more than constructive knowledge in the sense of shutting one's eyes to the obvious. In Warner v DPP,14 Lord Reid held that knowledge could include 'wilfully shutting one’s eyes to the truth'. Wilful, on the other hand, could mean deliberate or reckless acts or omissions.15

Theoretical arguments against insider dealing

In the field of economics, a number of studies have been undertaken on the effects of insider dealing.16 Arguments such as the hypotheses on weak form,

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10 [1968] 2 All ER 1073.
semi-strong and strong form efficient markets have been advanced by several writers.\textsuperscript{17} It is, however, not the purpose of this chapter to regurgitate such information. This section examines the theoretical issues underpinning legislation against insider dealing in many countries. In response to the question whether there is need to legislate against insider dealing,\textsuperscript{18} we argue that, although some studies show that there is no need to undertake such legislative measures, other studies confirm that insider dealing must be controlled if market transparency, fair trade and investor protection are to be promoted. I have examined elsewhere, in great detail, the efficacy of the law on insider dealing in Zambia.\textsuperscript{19} Here, I concentrate on theoretical aspects of the concept of insider dealing.

\textbf{Manne’s theory}

Scholars such as Manne argue that if directors or other insiders were permitted to trade on the basis of their inside knowledge, that would produce gradual adjustments in share prices on the market.\textsuperscript{20} The markets would react to increased buying or selling (which would then push the prices up or down) as the inside information gradually becomes public. Manne argues also that there is likely to be a surge or drop in market prices once a public announcement is made of price-sensitive information that has hitherto been kept as a carefully guarded secret.\textsuperscript{21}

One major shortcoming of Manne’s theory is that it treats insiders as rational investors whose market behaviour is not affected by constraints or market imperfections such as transaction costs, agency costs and information costs. Furthermore, Manne does not address the impact of insider trading on investor confidence in the market.

\textbf{The ‘investor confidence’ and the ‘fairness’ arguments}

Ashe, like Manne, argues that there is little evidence to suggest that insider dealing in fact works against investor confidence.\textsuperscript{22} Ashe observes that the underlying factor behind the enactment of insider dealing laws is that markets, to be successful, depend as much on the flow of information as on the liquidity of dealing.\textsuperscript{23} Ashe challenges the basis of the argument that if potential investors in the market do not have equal access to information, then

\begin{itemize}
  \item \textsuperscript{17} See, generally, materials cited \textit{op cit}, fn 16.
  \item \textsuperscript{18} See, generally, McVea, 1995, p 390; cf Campbell, 1996, p 185.
  \item \textsuperscript{19} See Mwenda, 18(2), 1997.
  \item \textsuperscript{20} See, generally, Manne, 1966.
  \item \textsuperscript{21} \textit{Ibid}.
  \item \textsuperscript{22} See Ashe, 1990, p 127.
  \item \textsuperscript{23} \textit{Ibid}, p 127.
\end{itemize}
the market will be seen as unfair and thus damaging to investor confidence. He submits, instead, that fairness is not necessarily the best basis for supporting insider dealing laws. There will be instances when there is unfairness on the market, such as when one investor has more skill than another, or when one investor does not have as much sophisticated research data as another. According to Ashe, it is therefore the public confidence argument which underscores the reasoning behind criminal sanctions for insider dealing – that for the public good, the criminal law needs to intervene. Ashe’s view that it is the public confidence argument which underscores the reasoning behind criminal sanctions for insider dealing has its own shortcomings. The argument overlooks the importance of civil sanctions for insider dealing and thus does not address the protection of property rights of victims of insider dealing.

In a 1985 study, ‘Insider trading and the exploitation of inside information’, it was observed that activities of insiders in fact sustained investor confidence in the market because insiders are seen as leading indicators, while others follow. This view has its own shortcomings too. Every market has its own distinct micro and macroeconomic features which could affect investor confidence and behaviour on the market. Indeed, as one South African study shows:

... the witnesses have been unanimous in the condemnation of insider dealing in all its forms.

Although this South African study does not document the reasons behind the mass condemnation, the study illustrates that not always will other investors follow behind insider investors. Thus, the ‘insider-signalling theory’ has its limitations.

The misappropriation theory and the hybrid theory

Other theories that try to explain why insider dealing should be legislated against include the ‘misappropriation theory’. Under the misappropriation theory, non-public price-sensitive information is regarded as a valuable commodity which is the property or akin to the property of a company:

The information does not belong to the individuals who make up the company. It is therefore inequitable and akin to theft for those individuals to make use of that information for their own gain. This theory does not require any loss to

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24 Op cit, Ashe, fn 22, p 127.
29 Ibid, p 57.
have been suffered in real terms – the offensive behaviour is seen as the unjustifiable gain or avoidance of loss. This equation of insider trading with misappropriation is perhaps the strongest argument in favour of criminal sanctions.  

The misappropriation theory, like other theories discussed above, has its own shortcomings. How do we prove, for example, elements of the offence of insider dealing if both the offence and the transactions must be treated together as constituting the actus reus? This makes proof of all of the elements of an offence to the criminal standard very difficult.

The ‘fairness and confidence in the market theory’ discussed by Ashe rests on the view that if, of two potential player in a market, one has price-sensitive information available and the other has not, that is unfair. Unfairness here is seen to lead to loss of confidence. This theory is sometimes taken together with the misappropriation theory. When this happens, proponents of the ‘hybrid theory’ may or may not assert that the ‘victims’ suffer loss as opposed to making a profit.

**Conclusion**

This chapter has argued that the control of insider dealing, committed by banks, is one of the ways in which prudential banking supervision can be undertaken. The chapter illustrated the importance of having different supervisory authorities, such as the Bank of Zambia and the Securities and Exchange Commission, co-ordinate over the control of insider dealing. The case of Zambia was taken as an example and it was argued that the Bank of Zambia and the Securities and Exchange Commission must co-ordinate over the control of such malpractices. It was noted, too, that prudential banking supervision requires use of a multi-faceted approach to problem solving. Further, the chapter argued that the downside of using wide discretionary powers in the statutory definition of ‘unsafe and unsound practices’ could lead to a situation where the State manipulated the central bank to hold banks that do not support activities of the State as conducting ‘unsafe and unsound practices’.

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31 See above, p 99.  
32 See *op cit*, Dine, fn 28, p 58.  
33 See *op cit*, Dine, fn 28, p 58.
... the probability of a banking crisis is higher during the period of transition when the prior information set is uncertain ... the probability of banking crisis is higher in the short period following the financial liberalisation ... the increase in the probability of crisis is much higher in countries with poor transparency. It is important, however, to note that this does not mean that countries should not liberalise their financial sector. Rather, the lesson is that countries should be more transparent, especially during a period of transition. In this sense, it is better to liberalise the financial system slowly in countries with poor transparency so banks have more time to get information and update their belief [Mehrez and Kaufmann, 2000, p 22].

While the preceding chapters in this book focused on conceptual and practical legal issues facing systemic bank restructuring and banking supervision in jurisdictions such as Zambia and other common law systems, this chapter provides an overview of lessons of experience in banking reform worldwide. Indeed, an international and comparative dimension is added and, as in the preceding chapters, an interdisciplinary approach is adopted. The adoption of such an approach sets the law in context by relating it to the economic, socio-cultural, political and financial considerations underpinning the legal framework. It is this feature that provides the underscoring theme in this chapter. The reformation of banking systems requires a good appreciation of interdisciplinary and meta-paradigmatic perspectives. To achieve such a holistic view of problem solving, various tools, methods and concepts can be utilised. As already noted in Chapter 2, problem solving is a continuous phenomenon that deals with the management of complexity and diversity. Thus, the present chapter places greater emphasis on examining both legal and extra-legal constraints affecting systemic bank restructuring.

Elsewhere, there have been works attempting to provide a legal analysis of the main issues affecting systemic bank restructuring. Some of these works have been insightful, while others have remained disappointing. The disappointing studies have often trodden on peripheral issues which are far removed from the real world in which disciplines such as law, economics,

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1 There is a dearth of legal literature and legal scholarship in the area of banking reform. Even the few publications that have been written on this subject hardly go beyond a superficial analysis of banking reforms; see, eg, Waxman, 1998.

politics, sociology and finance are intertwined. A good example here is that of a 22 page report by Waxman on systemic bank restructuring.\(^3\) That work, although bringing out a few snippets on lessons of experience in countries such as the US, Norway, Sweden, and Mexico, struggles to get some points across. It is, indeed, regrettable that the work falls squarely short of any significant or major intellectual contribution to banking reform. Why, for example, would a country rush into enacting legislation to provide for deposit insurance when the economic implications of introducing such a system have not even been well articulated? It is this lack of links in knowledge and the lack of a broader perspective that raises illogical difficulties in many a legal script on banking reform. Indeed, Waxman does not provide us with answers to questions such as that raised above. I have argued in the latter parts of this chapter that law does not exist in a vacuum. Its usefulness must, therefore, relate to the overall socio-political and economic fabric of society. In contrast to works such as that by Waxman, I have taken a departure from regurgitating that which is already known by many to pursuing a novel and intellectually richer discourse. Although not professing to provide an exhaustive discussion, this work goes beyond the confines of legal reasoning to bring in fresh and useful ideas from other disciplines. In this way, it is expected that the study will provide a richer and valuable contribution to the field of knowledge.

Lessons of experience from common law and civil law jurisdictions are examined in this chapter. The chapter addresses developments in jurisdictions such as the European Union (at the EU regional level), Germany, Russia, Kazakhstan, the US, Argentina, Italy, Malaysia, Finland, New Zealand, Australia, Norway, Denmark and Sweden. The position of the UK is also examined. Admittedly, the common law in the UK, whose development is often affected by legislative developments, has had a profoundly persuasive role in the development of law in many Commonwealth countries. It is against this background that the position of the UK is given further attention in this chapter.

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\(^3\) See, generally, *op cit*, Waxman, fn 1.
A model for integrated financial supervision

Commenting on the historical background to the introduction of the integrated model for financial supervision in many countries, Taylor and Fleming observe that, whereas in the past, financial supervision tended to be organised around specialist agencies for the banking, securities, and insurance sectors, in the last few years a number of industrialised countries have moved to integrate these different supervisory functions into a single agency. Indeed, an informal club of ‘integrated supervisors’ – comprising representatives from Australia, Canada, Denmark, Japan, Korea, Norway, Singapore, Sweden and the UK – met in Sydney, Australia, in early May 1999 for the first time. The theme of their meeting centred around issues of mutual interest concerning the application of the integrated model. Today, there are a number of transition economies and developing countries that are considering the adoption of such a model. For example, Latvia, Estonia, Bulgaria and Thailand are cases in point. However, although the recent adoption of an integrated model by the UK is seen by many as a novel development in the area of financial supervision, Denmark, Norway and Sweden had, by the mid-1980s, adopted variants of such a model. So, what are the lessons to be learned from these countries?

While an active debate on the advantages and disadvantages of the integrated model for financial supervision began only very recently, the decision to integrate the supervisory agencies in the Scandinavian countries took place as part of an evolutionary process. A number of public participatory forums were facilitated by the media in these countries. In addition, parliamentary debates and discussions within government ministries provided another source of public opinion on the cost and incentive structure of the integrated model. In the UK, where there has been considerable academic and practitioner debate on the merits and demerits of an integrated model, it has been argued that monetary and financial stability

5 Ibid.
6 Ibid. See, also, Sundararajan, Petersen, and Sensenbrenner, 1997, which not only identifies some of the priorities for deepening of banking reforms in the transition economies, but also illustrates that, since 1992, the central Banks of the Baltic States and the Commonwealth of Independent States have undertaken comprehensive reform of their monetary and exchange arrangements in support of their stabilisation efforts, with extensive technical assistance provided by the IMF and 23 central banks.
7 Ibid, p 2.
8 Ibid.
9 Ibid.
are interrelated. Thus, the following six reasons have dominated the debate:

(a) the rapid structural change that has taken place in financial markets was spurred by the acceleration in financial innovation. This has challenged the assumptions behind the original structuring of regulatory organisation. The question that arises here is whether institutional structure should mirror the evolution of the structure of the financial sector;

(b) the realisation that financial structure in the past has been the result of a series of ad hoc and pragmatic policy initiatives raising the question of whether – particularly in the wake of recent banking crises and dislocation – a more coherent structure should be put in place;

(c) the increasing complexity of financial business as evidenced by the emergence of financial conglomerates. This has raised the issue of whether a series of agencies supervising parts of an institution can have a grasp of developments in the institution as a whole;

(d) the increasing demands being placed on regulation and its complexity, in particular the development of a need for enhanced regulation of ‘conduct of business’ (for example, covering financial products like pension schemes and insurance offered to consumers);

(e) the changing risk characteristics of financial firms occasioned by financial innovation.

(f) the increasing internationalisation of banking, which has implications for the institutional structure of agencies at both the national and international level.

Central bank independence in the UK: the salient features of the financial economics underpinning the legal framework

Commenting on the issue of central bank independence, Taylor observes that, while the worldwide trend towards such independence has its roots in a number of factors, the most fundamental is a challenge in economic

10 See _op cit_, Taylor and Fleming, fn 4, p 2. The authors argue that: ‘An important issue in deciding to adopt a unified supervisory agency is to consider whether it should be concerned exclusively with prudential (that is, safety and soundness) regulation, or whether it should also have responsibility for conduct of business ... it should be noted only the UK, of the countries surveyed, has created a unified regulator with both prudential and conduct of business responsibilities.’


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orthodoxy. He observes further that the original nationalisation of the Bank of England took place against a policy background which largely accepted the need for governments deliberately to stimulate demand in the economy to ensure constant high levels of output and employment. In Taylor’s view:

This policy was largely inspired by the economic theories of John Maynard Keynes, and hence became known as the Keynesian demand management ... In the first few decades of the post-war era, governments sought to use their power to tax, borrow and spend (‘fiscal policy’) to ensure that unemployment stayed low. Inflation was not seen as a serious threat, and a modest amount could be accepted as the price of protecting jobs. Thus monetary policy was regarded as a subsidiary to fiscal policy as the main lever for influencing the level of economic activity, and interest rates were deliberately kept down to stimulate investment. In this environment it was natural to expect the central bank to play a subordinate role to government, and to follow policies which supported the broad policy objective of ensuring against the return to the mass unemployment of the 1930s ... This orthodoxy began to break down in the early 1970s. Governments throughout the developed world were then faced by both rising unemployment and rising inflation, something the Keynesian model of the economy failed to predict. The failure of demand-management policies permitted the emergence of a new economic orthodoxy which stressed the importance of controlling inflation as the key to ensuring successful long term economic performance.

Some decades later, and following a shift to inflation targeting (in October 1992) by the British Government, and after a relatively successful four and a half years of targeting inflation, the Government granted operational independence to the Bank of England. It can now be said:

Under the new arrangement, the inflation target is set by the Chancellor of the Exchequer in the annual budget, and the Monetary Policy Committee (MPC) – established following the decisions to grant independence, and consisting of Bank of England staff members and outsiders – sets interest rates to achieve the inflation target ... inflation targeting, while not entirely new in terms of the basic idea, is a rather significant step toward establishing a workable and well defined framework for monetary policy. It aims to be highly transparent in both the process and the result achieved by setting measurable objectives; by being explicit about the processes that link instruments with targets; and by setting procedures for accountability ... while the framework retains the notion of medium term rules – as advocated, for example, by the proponents of monetary targeting – to deal with inflationary bias in monetary policy, it nevertheless involves a partial return to the idea of explicitly attempting to stabilise major macro variables.

14 Ibid, p 11.
16 Samiei, Martijn, Kontolemis and Bartolini, 1999, p 4.
17 Ibid.
A fundamental implication of central bank independence, as noted by the IMF, is the separation of monetary and fiscal policies, with a virtually unavoidable impact on the policy mix.\textsuperscript{18} It is often argued that monetary policy is constrained by excessive gradualism, in the sense that decision making seeks to smooth interest rates relative to some optimal rule.\textsuperscript{19} The IMF notes that the granting of operational independence to the Bank of England has made decision making a more transparent, focused, and analytical process.\textsuperscript{20} It is now argued that the fact that inflation targeting uses expected inflation, as opposed to actual inflation, as an operational target (or as intermediate target), its significance is seen in the following:

It implies that factors, such as the output gap and fiscal policy, that play a role in the determination of future inflation, should in principle enter the decision making process, as well as the expectations of their path and future interest rate decisions. For example, tight product and labour markets would be expected to raise inflation, and within the inflation targeting framework, generate a monetary policy response even before actual inflation rose. Given the estimated lags between monetary policy and inflation, such forward looking behaviour is necessary to achieve the target.\textsuperscript{21}

It is important to point out that, despite all the improvements in monetary policy in the UK, and also given the apparent success of the framework in controlling inflation, the newly introduced regime, arguably, did not provide for sufficient protection against the inflationary bias.\textsuperscript{22} As the IMF notes, the ‘government remained in control of the policy process, and no institutional safeguards existed against the use of unsustainable politically motivated monetary policy decisions’.\textsuperscript{23} It was not until May 1997 that the UK Government took measures to remedy this deficiency by giving operational independence to the Bank of England.

The advantages of having central bank independence vary from context to context. Some of the advantages include views such as ‘central bank independence can increase the credibility of monetary policy by convincing private agents that the monetary authority has little incentive to create surprise inflation’.\textsuperscript{24} Further, in the case of political business cycles, the mere granting of central bank independence ‘would likely suffice to remove the distortion’.\textsuperscript{25} On the other hand, there is a likelihood of encountering some shortcomings if central bank independence is introduced without giving

\begin{thebibliography}{99}
\item \textsuperscript{18} \textit{Op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 17.
\item \textsuperscript{19} \textit{Op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 4.
\item \textsuperscript{20} \textit{See op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 4.
\item \textsuperscript{21} \textit{Op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 7.
\item \textsuperscript{22} \textit{See op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 7.
\item \textsuperscript{23} \textit{Op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 7.
\item \textsuperscript{24} \textit{See op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 10.
\item \textsuperscript{25} \textit{See op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 10.
\end{thebibliography}
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consideration to its objective function. Commenting on possible problems that could be encountered, the IMF observes:

... in the case of a permanent inflation bias associated with time inconsistent policies, given that surprise inflation would be the equilibrium outcome, the mere introduction of central bank independence, without reference to its objective function, would not be a sufficient step ... a credible commitment to price stability would be required.26

Put simply, inflation targeting combined with operational independence of the central bank, as exists in the UK, provides a suitable framework for a focused and credible monetary policy that is effective in reducing the inflationary bias in policy making.27 These are, indeed, some of the fundamentals in financial economics that provide a basis upon which a viable legal framework may be constructed.

The UK Financial Services Authority as a model of central bank independence

We saw earlier, in Chapter 5, that the Bank of England Act 1998 transfers from the Bank of England to the Financial Services Authority the Bank’s former banking supervision functions.28 Prior to the enactment of this piece of legislation, the legal pedigree for powers of the Bank to conduct financial supervision rested not only in provisions of the Banking Act 1987, but also in s 101(4) of the Building Societies Act 1986 and in provisions of the Banking Co-ordination (Second Council Directive) Regulations 1992. Under these laws, the core purposes and strategy of the Bank of England included monetary stability, monetary analysis, monetary operations, banking activities, financial stability, supervision and surveillance. The Financial Services Authority has now acquired the powers to supervise banks, listed money market institutions (as defined in s 43 of the Financial Services Act 1986)29 and related clearing houses (as defined in s 171 of the Companies Act 1989).30 The current structure under the Bank of England Act 1998 endeavours, among other things, to place a balance between the role of the Bank and that of the Treasury. As Blair observes:

This aspect is the one that has attracted the greatest amount of public attention. So far as the law is concerned, s 10 removes from the Treasury the power to

26 Op cit, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 10.
27 See op cit, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 21.
28 See Bank of England Act 1998, s 21. It is important to delineate clearly the roles of any other supervisory authority so as to avoid potential for conflict of interests. For further readings, see Lindgren, 1997.
29 Under consideration for repeal.
give directions to the Bank in relation to monetary policy. That said, the Treasury have important powers to condition the general strategy in relation to monetary policy. Critically, s 12 enables the Treasury to specify what price stability is to be taken to consist of, and what the government’s economic policy is to be taken to be. These are the two elements, and the only two elements, of the Bank’s statutory objectives in relation to monetary policy, though the second of them contains a subsidiary reference to objectives for growth and employment.\(^{31}\)

In general, the areas which are expected to be influenced in the aftermath of the enactment of the Bank of England Act 1998 include the following:\(^{32}\)

(a) overall stability of the financial system as a whole; and, in particular;
(b) stability of the monetary system;
(c) financial system infrastructure, especially payments systems;
(d) broad overview of the (financial) system as a whole;
(e) ability to conduct what loosely may be described as official support operations; and
(f) efficiency and effectiveness of the financial sector, with particular regard to international competitiveness.

Further arguments on advantages of an integrated model have been advanced by scholars such as Briault. In an occasional paper for the UK Financial Services Authority, Briault recognises that, apart from the noteworthy growth in financial conglomerates, the following are some of the factors that support the case for an integrated model for financial supervision:\(^{33}\)

(a) economies of scale and scope that arise because a single regulator can take advantage of a single set of central support services;
(b) increased efficiency in allocation of regulatory resources across both regulated firms and types of regulated activities;
(c) the case with which the integrated regulator can resolve efficiently and effectively the conflicts that inevitably emerge between the different objectives of regulation;
(d) the avoidance of unjustifiable differences in supervisory approaches and the competitive inequalities imposed on regulated firms through inconsistent rules which have arisen across multiple specialist regulators, and;
(e) if an integrated regulator is given a clear set of responsibilities, then it should be possible to increase supervisory transparency and accountability.

It was strongly believed that the system that existed prior to the introduction of the Financial Services Authority in the UK lacked transparency and

\(^{33}\) See, generally: Briault, 1999; and *op cit*, Taylor and Fleming, p 11.
adequate accountability partly due to its fragmented regulatory structure.\textsuperscript{34} By contrast, consolidated prudential supervision of multifunctional financial groups, it was argued, provided for an efficient way of managing risks related to different financial activities (for example, traditional retail banking and securities trading).\textsuperscript{35} Also, an integrated model for financial supervision was expected to be more publicly accountable and transparent.\textsuperscript{36} Today, the Financial Services Authority is expected to carry out prudential financial supervision in accordance with a number of EU directives in the area of financial services, all of which have been implemented in the UK. As Bartolini observes, ‘most recently, the EU’s Capital Adequacy Directive (CAD) and CAD 2 (implemented in the UK on 1 January 1996 and 30 September 1998, respectively) have extended the UK supervisory picture to cover market risk and have provided scope for internal value-at-risk (VaR) models to determine risk capital’.\textsuperscript{37} It is, however, argued that the UK regulators do retain significant flexibility with respect to these directives and other internationally agreed standards.\textsuperscript{38} An example often cited is that the UK typically sets capital ratios above the Basle Accord guideline of a minimum of 8\%.\textsuperscript{39} Another example is that of the UK setting required capital ratios in firm-specific fashion, taking into account credit and market risk factors specific to a firm’s business, and applying them on a consolidated basis to all financial firms within a group.\textsuperscript{40} Furthermore, the prudential requirements applicable to authorised firms place limits on maximum exposure toward single (or related groups of) counterparties.\textsuperscript{41} This entails that liquidity requirements emphasise two major areas; that is, securing an institution’s access to enough cash and high quality near-cash assets to meets its obligations, and provisioning for bad and doubtful debts.\textsuperscript{42}

That said, some of the shortcomings of an integrated model for financial supervision can be summed up as follows:

... advocates of a narrow role for central banks argue that if the central bank (or whichever institution performs the role of the LOLR)\textsuperscript{43} must provide liquidity assistance to avert a financial crisis, then it should do so only by providing

\textsuperscript{34} See \textit{op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 32.
\textsuperscript{35} See \textit{op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 31.
\textsuperscript{36} See \textit{op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 32.
\textsuperscript{37} \textit{Op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 27.
\textsuperscript{38} See \textit{op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 27.
\textsuperscript{39} See, eg, \textit{op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 27.
\textsuperscript{40} See \textit{op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 27.
\textsuperscript{41} See \textit{op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 28.
\textsuperscript{42} \textit{Op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 28.
\textsuperscript{43} The IMF argues, that while countries such as Germany, Japan and – recently – Australia have established separate functions of banking supervision and lender-of-last-resort (LOLR), the US, Italy and (to some extent) France have opted for a broad central bank role, combining both monetary policy/LOLR and banking supervision. For a detailed discussion, see \textit{op cit}, Samiei, Martijn, Kontolemis and Bartolini, fn 16, pp 36–37.
liquidity to the market at large, for example, through open market operations, leaving to the market the task of allocating liquidity to worthy borrowers. This conduct would minimise moral hazard, both for potential beneficiaries of liquidity rescues (which would have fewer incentives to assume socially excessive risks) and for other banks (who would need to step up peer monitoring and associated market discipline). Expanding the role of a central bank to include supervisory responsibilities may also significantly raise the cost of a supervisory failure, which would damage the central bank’s reputation and the credibility of its monetary policy. Furthermore, the mandates of banking supervision and of price stability are subject to a potential conflict of interest: a central bank responsible for supervision could lean towards lax monetary policy if this was perceived to avert bank failures ... A widely held view among advocates of an active LOLR mandate is that central banks (or whoever performs the function of LOLR) may deter the banks’ tendency to assume excessive risk by keeping details of the LOLR practices ‘constructively’ ambiguous, that is, by retaining discretion as to whether, when, and under what conditions, emergency liquidity support will be provided.44

An enabling environment for the UK regulatory framework

In order to accomplish its tasks, which include supervising wholesale markets in over-the-counter derivatives, the UK Financial Services Authority intends to establish a new single Financial Services Ombudsman to receive and handle consumer complaints.45 As the IMF observes:

... the FSA’s goal is to promote ‘awareness of the benefits and risks associated with different kinds of investment or other financial dealing’ while safeguarding ‘the general principle that consumers should take responsibility for their decisions’ (Financial Services and Markets Bill, cl 4(2)(a) and 5(2)(c)).46

... In practice, the FSA plans to protect consumers of financial services by intervening at several stages: (1) by vetting firms at entry, to ensure that only those found to be ‘fit and proper’ are permitted to conduct financial business;47 (2) by setting and enforcing prudential standards; (3) by using its

44 Op cit, Samiei, Martijn, Kontolemis and Bartolini, fn 16, pp 36, 41.
45 Op cit, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 29.
46 Bartolini (see op cit, fn 16, p 36) argues that one of the main innovations the regulatory reform has introduced into the UK financial system is the separation of the functions of banking supervision (now undertaken by the Financial Services Authority) from the provision of emergency liquidity (or the LOLR, for which the Bank of England will continue to be responsible).

47 Although, as noted in Chapter 3, similar provisions are found in Zambia’s Banking and Financial Services Act 1994, there is generally poor observance of this requirement in Zambia. Indeed, enforcement mechanisms are weak. We have already seen how some individuals who served as directors of failed banks have been given the go ahead by the Central Bank of Zambia to serve as directors of newly created banks. This circumvention and ‘political engineering’ of the legal order is found not only in developing countries, but also in a number of transition economies and developed countries. Whether this feature can be treated as regulatory forbearance that is designed to attract big investors/directors is a moot issue that is unlikely to generate any convincing arguments.
powers of investigation, enforcement, and restitution against firms that fail to meet expected standards; (4) by setting a ‘one-stop’ arrangement for resolving disputes between consumers and authorised firms – the single ‘Financial Services Ombudsman Scheme’; (5) by overseeing the compensation of investors when an authorised firm is unable to meet its liabilities ... Unsurprisingly, the approach taken by the FSA to balance consumer protection with the preservation of strong elements of *caveat emptor* – consumers must take significant responsibility for their own financial decisions – has spurred a lively debate in the UK.\(^\text{48}\)

Under the new system, which introduces the FSA, the existing five compensation schemes will be merged into a single compensation scheme, the UK Financial Services and Markets Compensation Scheme.\(^\text{49}\) One of the notable aims of FSMC is to safeguard partially consumers of financial services against failure of authorised institutions to deliver on their obligations.\(^\text{50}\)

*The concept of central bank independence in Germany, the European Union and the US*

Whereas the concept of central bank independence may have attracted broad support, there are several ways in which it can be provided for by legislation. Taylor observes that examples of an explicit constitutional provision enshrining the independence of central banks are relatively rare, although Chile and the Philippines have both used this model.\(^\text{51}\) By contrast:

Most countries have instead merely enacted laws to make their central banks independent, with some – most notably New Zealand – also employing a formal contract between government and central bank ... Germany and the US provide the leading examples of independent central banks, and there are several notable similarities between the arrangements existing in these two countries. Both have federal governmental systems and the structure of their central banks reflects this. The Federal Reserve System (Fed) comprises 12 regional federal reserve banks, ranging from New York to San Francisco and from Minneapolis to Atlanta. Each regional bank is headed by a president, who is elected by its member (commercial) banks ... Important decisions on monetary policy are taken by the Federal Open Market Committee (FOMC), which comprises the seven members of the Federal Reserve Board plus the president of the New York Fed, with four of the other regional presidents serving on a rotational basis for one year terms. The Bundesbank is similarly composed of regional (*Land*) central banks, the main difference from the Fed

\(^{48}\) *Op cit*, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 33.

\(^{49}\) *Op cit*, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 30.

\(^{50}\) *Op cit*, Samiei, Martijn, Kontolemis and Bartolini, fn 16, p 30.

being that all the regional presidents serve on the crucial committees concerning monetary policy. The similarity in structure of the two central banks is largely a product of the fact that the Bundesbank was promoted by the US occupation authorities after the Second World War. However, an especially important point is that although both Germany and the US have written constitutions, neither has enshrined central bank independence in them.\footnote{Op cit, Taylor, fn 51, pp 13–14. Although it is widely assumed that the Bundesbank was established under the German Constitution, the Bundesbank is actually a creature of statute, the Bundesbankgesetz of 1957. This 1957 statute provides as follows: ‘Without prejudice to the performance of its functions, the Deutsche Bundesbank shall be required to support the general economic policy of the federal government. In exercising the powers conferred on it by this Act it shall be independent of instructions from the federal government.’}

It is interesting to note that the German model of central bank independence strongly influences the European Union’s approach to central banking independence.\footnote{See op cit, Taylor, fn 51, p 16.} This influence is reflected in the 1992 European Union Treaty which establishes, among other things, the European System of Central Banks. The system of central banks is composed of the European Central Bank and the national central banks of the European Union Member States. In Art 105(1) of the EC Treaty, inserted by Art G(25) of the 1992 European Union Treaty, it is stated clearly that ‘the primary objective of the European System of Central Banks shall be to maintain price stability’. Summing up on the independence of the European System of Central Banks, Art 107 of the EC Treaty provides as follows:

When exercising the powers and carrying out the tasks and duties conferred upon them by this Treaty and the Statute of the European System of Central Banks, neither the European Central Bank, nor a national central bank, nor any member of their decision making bodies shall seek or take instructions from Community institutions or bodies, from any government of a Member State or from any other body.\footnote{As quoted in op cit, Taylor, fn 51, p 16.}

The concept of central bank independence is also reflected and provided for in the Basle Committee Core Principles for Effective Banking Supervision. We have already looked at the Core Principles in Chapter 2. It must be pointed that the growing evidence of States stressing the importance of having central bank independence raises a number of interesting issues in international law. As argued in Chapter 2, this evidence could point to crystallisation of norms of international law on central bank independence. Alternatively, it could be argued that the Basle Core Principle on central bank independence is a codification of State practice and \textit{opinio juris} attached to this practice.
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In the European Union, Art 108 of the EC Treaty entrenches the concept of central bank independence by requiring Member States to legislate to give effect to the required independence in respect of their national central banks.\textsuperscript{55} There are many other cases pointing to growing evidence on State practice and \textit{opinio juris} on central bank independence. New Zealand, for example, has a model which appears to be attractive for many British proponents of the concept of central bank independence.\textsuperscript{56} Indeed, New Zealand shares many constitutional features in common with the UK, and the statute establishing the independence of the New Zealand Reserve Bank (1989, No 157) explicitly recognises the Crown’s continuing right ‘to determine economic policy’.\textsuperscript{57}

\textit{Other lessons of experience on integrated financial supervision and central bank independence}

Among the Scandinavian countries, Norway was the first to move towards a model for integrated financial supervision.\textsuperscript{58} In 1986, after a long process of consolidating its regulatory system, Norway merged its Banking and Insurance Inspectorates,\textsuperscript{59} as Taylor and Fleming observe:

\ldots having been influenced by broadly similar considerations in making the move towards an integrated approach to regulation and having reaped many of the same benefits from this approach. Chief among these benefits has been obtaining economies of scale in the use of scarce regulatory resources in comparatively small, highly concentrated financial systems in which financial conglomerate groups predominate.\textsuperscript{60} \ldots Its Bank Inspectorate could trace its history back to the end of the last century, when it was established for the supervision of savings banks. The supervision of the commercial banks was added to its responsibilities in the 1920s. Banking supervision has thus never been formally part of the responsibilities of the Norwegian central bank, and hence the creation of a unified regulatory authority did not involve any significant dilution of the central bank’s range of powers. Indeed, a proposal in 1974 for the merger of the bank inspectorate with the central bank was defeated in parliament. In 1983 the Banking Inspectorate further acquired some of the functions of the securities bureau of the Ministry of Finance.\textsuperscript{61}

On the one hand, while the Ministry of Finance continued to be responsible for regulating the Oslo Stock Exchange,\textsuperscript{62} on the other hand, the Banking Inspectorate was entrusted with powers to undertake prudential supervision.

\textsuperscript{55} For a detailed discussion, see \textit{op cit}, Taylor, fn 51, pp 16–17.
\textsuperscript{56} See \textit{op cit}, Taylor, fn 51, p 17.
\textsuperscript{57} See \textit{op cit}, Taylor, fn 51, p 17.
\textsuperscript{58} See \textit{op cit}, Taylor and Fleming, fn 4, p 4.
\textsuperscript{59} \textit{Op cit}, Taylor and Fleming, fn 4, p 4.
\textsuperscript{60} Indeed, an integrated model represents a significant concentration of power, ensuring that its powers are not used to serve political rather than administrative purposes.
\textsuperscript{61} \textit{Op cit}, Taylor and Fleming, fn 4, pp 4–5.
\textsuperscript{62} The only organised financial market in Norway.
of specialist securities firms and investment management firms. It is evidently clear that, given that the Norwegian banks were already the most active participants in the securities markets, placing the supervision of non-bank securities firms under the Bank Inspectorate was simply a natural extension of its role in overseeing activities of securities firms. As Taylor and Fleming observe, since 1986, Norway’s single regulatory agency, the Kredittilsynet, has performed the regulation of banks, non-bank investment firms, and insurance companies, primarily in respect of their solvency. However, although the Norwegian regulatory agency is also responsible for the regulation of real estate brokers and auditing firms, it had, by November 1999, still not been granted the formal authority and responsibility to supervise the Oslo Stock Exchange. The transfer of these powers to the agency from the Ministry of Finance is expected soon.

In Sweden, the Finans Inspektionen, which is the institution charged with the responsibility of undertaking integrated financial supervision, was set up in 1991. Its counterpart in Denmark, the Danish Finanstilsynet, was established pursuant to a merger of that body’s banking and insurance regulatory agencies in 1988. Both the Swedish and Danish regulatory bodies have responsibilities akin to those of the Norwegian Kredittilsynet. In Denmark, as in the case of Norway, the banking supervisory authority had enjoyed a long history as an agency outside the central bank and it had also combined the prudential supervision of non-bank securities firms as part of its responsibilities prior to the creation of a fully integrated agency. However, as Taylor and Fleming observe, the creation of the Danish framework for integrated financial supervision was ‘largely an administrative arrangement, and there was no fundamental review of legislation governing its supervisory activities at the time of the merger’. As such, it is argued that the Danish integrated regulatory body operates under a number of different statutes inherited from predecessor organisations. Indeed, ‘the sector legislation has been adjusted and harmonised successively during the nineties. Similarly, its governance arrangements have not been fully unified’.

63 Op cit, Taylor and Fleming, fn 4, p 5.
64 Op cit, Taylor and Fleming, fn 4, p 5.
65 Op cit, Taylor and Fleming, fn 4, p 5.
66 See op cit, Taylor and Fleming, fn 4, p 5.
67 Op cit, Taylor and Fleming, fn 4, p 5.
68 Op cit, Taylor and Fleming, fn 4, p 7.
70 See op cit, Taylor and Fleming, fn 4, p 6.
71 Op cit, Taylor and Fleming, fn 4, p 6.
In Sweden, the creation of the Finans Inspektionen was prompted by the banking crisis that hit Sweden in 1990–91. There was also a political desire by Sweden to keep up with developments in other Scandinavian countries which had already established a framework for integrated financial supervision. In addition, and apart from the fact that Sweden, unlike Norway and Denmark, is a member of the Basle Committee on Banking Supervision and, thus, most likely to be attracted to achieving economies of scale and enhancing its international presence, there is also a long history of enhanced links between the banking and insurance sectors in Sweden.

By contrast, Finland has opted not to adopt a fully integrated approach to financial supervision. However, for some time the Finnish regulatory framework mirrored that of Norway, Denmark and Sweden until the late 1980s. A number of institutional changes were introduced to the Finnish system and these focused mainly on enhancing the link between banking supervisors and the Bank of Finland. It is against this background that the Finnish Financial Supervision Authority was established. Although administratively connected to the Bank of Finland, the Finnish FSA is independent in its decision making. Drawing comparisons between the model for integrated financial supervision adopted in many Scandinavian countries and that found in the UK, Taylor and Fleming conclude:

For different reasons, the UK’s adoption of unified regulation stands out as something of an exception among northern European countries. Unlike the Scandinavian countries, the UK is home to an international financial centre and its domestic financial services industry is much larger, more diverse and less concentrated than in Scandinavia. Furthermore, the UK’s Financial Services Authority is responsible for both prudential and conduct of business regulation, unlike its counterparts in Scandinavia which have focused on prudential regulation only ... Finally, the formation of the UK Financial Services Authority has been undertaken as a radical, ‘Big Bang’ measure, bringing together nine existing regulatory bodies. By contrast, the Scandinavian integrated regulators were the product of a long process of agency consolidation, and were formed primarily from the merger of banking and insurance inspectorates ... the growth of bancassurance business – that is, financial conglomerate groups combining both banking and insurance

74 Op cit, Taylor and Fleming, fn 4, p 7. See, also, generally, Drees and Pazarbasioglu, 1998, where it is argued that, although the banking crises in Norway, Sweden and Finland in the early 1990s followed a similar pattern and appear to have had similar causes, their impact on the structure of regulation differed significantly between Norway and Sweden, on the one hand, and Finland, on the other.
75 See op cit, Taylor and Fleming, fn 4, p 7.
76 See op cit, Taylor and Fleming, fn 4, p 7.
77 See op cit, Taylor and Fleming, fn 4, p 7.
activities – was regarded as a powerful reason for adopting an integrated approach to supervision (that is, in most Scandinavian countries) ... None of the three Scandinavian integrated regulatory bodies (that is, the Swedish, Norwegian and Danish bodies) was created by removing the banking supervision function from the central bank: in each case the regulation of commercial banks had long been conducted by a specialist banking supervisory body.80

Regulatory constraints and related developments

In resolving banking crises not only do structures of a regulatory framework present limitations to institutional and structural changes. Other constraints are seen in cultural rigidities against institutional change. Such obstacles are particularly predominant in banking systems that are dominated by State banks. In reforming such systems – that is, those systems that exist under a ‘commandist’ economy – into systems under a free market economy, particular attention must be paid to the normative and concrete structures underpinning the existing legal, socio-political and economic order. Taking the 1998 financial crisis of Russia as an example, the aftermath of the crisis was met with major policy changes that pointed towards privatisation and commercialisation of State owned banks as the panacea for some of the economic ills. This policy shift prompted the revision of several banking laws in Russia. Proposals for new bank insolvency laws were floated. The problem, however, seems to be more than one of enacting new pieces of legislation. Law does not, and has never, existed in a vacuum. Its overall importance must relate to a people’s way of life. In this regard, and only this way, will law serve its function as an effective tool for social change and economic re-engineering. Thus, the cultural rigidities that are seen in certain segments of a ‘commandist’ economy are dialectical reactions to hastily introduced market forces. In situations of this sort, the mechanism of law enforcement is often weak, and this can have a profound effect on the efficacy of the legal framework. It is submitted, therefore, that the problem is not one for a quick fix solution of simply introducing modern business concepts such as international accounting standards. There is also need to manage cultural and political change in a pragmatic manner. Some institutions will respond promptly to change, while others will take time to adapt. This disparity and

80 See *op cit*, Taylor and Fleming, fn 4, pp 9, 17.
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dichotomy explains why Chapter 2 of this work argued in favour of applying systems thinking to systemic bank restructuring.81

In implementing effective banking reforms, there is a need to go beyond the mere adoption of anecdotal conjecture in accounting and financial economics. For example, relying heavily on information presented in the balance sheet of a bank is unlikely to provide a holistic picture of problems leading to banking crises. Honohan advances a narrow thesis which assumes that estimating the likely fiscal costs of future banking crises requires information about the size and composition of balance sheets of banks and expert assessments about the accuracy of the accounting data and about certain short term risks.82 But, accounting standards alone, or even legislation on its own, is not enough. The two are processes. The main issues, therefore, include the following: what are the attitudes of the people managing cultural-political change and the related processes like? And how can we influence their value systems in the shift towards a more open and transparent economic system? To capture a broader picture here, there is a need to adopt a holistic perspective which takes into account other dimensions of the problem.

Although the management of cultural and political change presents itself as an imperative, it is often overlooked and trivialised by many analysts. The net result is the transplant of economic and legal models from one jurisdiction to another with the hope that the models will work in the same manner that they have done in the previous settings. But, ought there not to be an understanding of the institutional framework required to implement the law, and also whether the law is likely to induce the same behaviours in the new environment?83 As Gower puts it, not everything in the legal garden in the advanced countries represents the perfection of human reason.84 Indeed, experience has shown that legislative reform that does not take into account the particular circumstances of the country in question stands a high chance of failing even in the banking and commercial law areas.85 There is a need, therefore, to engage local expertise in banking reforms, for often the locals have valuable information on the nitty-gritty and peculiar issues pertaining to a particular environment. A trade-off is necessary in order to achieve optimal efficiency; that is, should foreign consultants and experts be seen as the sole stewards of best practices and wisdom on banking reforms, or should there be

81 Cf Hoelscher, 1998: http://www.imf.org/external/pubs/cat/doctype.cfm?docno=WP/98/96-EA: ‘Kazakhstan began restructuring its financial system immediately following independence in 1992. The government’s first concern was to restructure the large State banks and tighten entry requirements for new banks. Once a degree of stability was achieved, the government sought to modernise banking operations and the legal and regulatory environment. Between 1995 and 1997, wide ranging regulatory and accounting changes were introduced ...’
82 See World Bank, Reports Nos 2197–261, 1999, p 14; see, also, generally, Honohan, 1999.
84 Ibid, p 57.
85 Ibid, p 19.
a reasonable blend of foreign expertise and local participation? In Africa, for example, a number of so-called ‘experts’ have emerged from the use of foreign consultants. Most of these consultants have dubious professional backgrounds and their career record is virtually unknown. The unfortunate bit, though, is that Africa remains a testing ground for inferior knowledge from the West. We have seen how some inexperienced foreign consultants have become big sharks on Africa and how they now claim to possess divine knowledge on matters pertaining to the continent. However, although some foreign consultants may possess the requisite expertise, they, too, must re-educate and acquaint themselves with the host country-specific conditions. To do so, they must work jointly with the local experts and be ready to learn about matters that are peculiarly tied to the context of the host environment. Indeed, this underpins the importance of having both foreign and local consultants participate on legal reform projects. In the same vein, the balancing of management skills and technical competencies among team members is vital.

Changing attitudes and the way forward in choosing consultants

In responding to the question of how the attitudes of local stakeholders in banking reforms can be influenced, it is important to appreciate the role that value judgments play. Apart from helping to identify a number of issues that are specific to the local environment, the participation of local experts can also restore public confidence. The public is likely to accept the view that the model adopted or introduced is not a mere transplant of foreign machinations if the local experts are consulted. Particularly useful, as local experts, highly skilled and well-specialised academics and government technocrats can prove to be less costly to hire.86 Indeed, they possess highly valuable skills and provide a financially ‘cheap’ source of professional services. Ofosu-Amaah, however, argues that local legal practitioners are a good source of knowledge in legal reform.87 This view raises a number of difficulties. A notable shortcoming here is that in a number of developing countries (including emerging economies), legal practitioners hardly specialise in any particular area of the law. Indeed, they end up as generalists and hardly ever engage in serious and specialised intellectual work which would require, say, publication of a journal article or some form of substantial contribution to a field of knowledge. Perhaps unfair to legal practitioners? Let us take a more reasoned look.

86 Being poorly paid, university professors in many developing countries and emerging economies often forgo – by default and rarely by design – the real value (or market value) of their valuable professional skills. Indeed, some of them, engaged in part-time consultancies, sell their highly valuable skills to the market at rates far below the real value. To them, that is good enough, since the earnings from, say, one consultancy project represents an income far above their monthly salaries.

87 See op cit, Ofosu-Amaah, fn 83, p 53.
Legal reform, by its very nature, is not suited for legal practitioners. Legal reform requires a rigorous intellectual mind that stands at the cutting edge of knowledge. To be able to analyse and reform law critically and appropriately, a thorough and well grounded schooling in substantive and jurisprudential issues affecting the law is needed. It is this characteristic that many legal practitioners lack. Immersed in their own small world of drafting non-innovative and standard legal documents such as affidavits, summonses, writs, loan agreements, and amendments to loan agreements, legal practitioners are best suited as proofreaders of statutory provisions to ensure that these provisions fall in line with what has been agreed upon by policy makers and specialists. Here, the category of specialists includes reputable and renowned academics. That said, the downside of adopting academics as local experts is not as gloomy as that of using legal practitioners. Commenting on how to choose consultants, Professor Flood, a renowned academician and business consultant, argues:

Academic based groups (providing consultancy services) offer an alternative to the parasitic, money-hungry, commercial companies (for example, law firms, in this case). They are more likely to be committed to their ideas. The trouble is that many of them believe in their ideas but do not have the experience to believe themselves able to pull off those ideas in practice. Every job won is daunting to the academic, although it is valuable propaganda within their peer group. Relief of getting out of the job intact is followed by the true worth of the job to the academic. It provides the opportunity to talk and write for years about how his/her ideas were actually used (once?) in practice ... The confident academic can be worse. They are committed to their ideas and certain that they are right. They have published extensively telling everyone just this. In action they can be dogmatic and patronising and are capable of turning people off at a rapid pace.88

Countering the above shortcoming, it is submitted that there is nothing as practical as a good theory. Indeed, all good theory is derived from systematically observed practice; from experience; and from empirically observed data. Practice, however, is not always a reflection of good theory. It is this dichotomy which leaves the academic better placed than the legal practitioner.

The limitations to heavy reliance on ‘capital adequacy requirements’

Writing on restoration of banking stability, Caprio and Honohan observe:

Hard on the heels of the 1994 Mexican crisis, the new wave of financial crises sweeping across emerging economies since early 1997 – starting in the miracle

88 Flood, 1995, pp 78–79.
economies of East Asia, then hitting Russia and later Brazil – has brought the fragility of banking and finance into unprecedented focus. Yet, just a few years ago, financial liberalisation and financial deepening were seen as a key prerequisite for economic development (King and Levine 1993; Levine, Loayza, and Beck 1998). What has gone wrong?89

Caprio and Honohan argue that, although denied by some ideologues, the liberalisation of financial markets in general has not been supported by adequate prudential regulation of intermediaries.90 They contend that prudential regulation is important since finance is prone to acute information asymmetries, because of economies of scale in monitoring, and because of the severe negative externalities that can be entailed in intermediary failure.91 In their study, Caprio and Honohan examine why emerging markets, in particular, are susceptible to and affected by financial difficulties. They argue that these difficulties have a richer, more complex structure than they are sometimes believed to have – with marked information asymmetries and substantial volatility.92 According to Caprio and Honohan, the sources of heightened regulatory failure in emerging markets in recent years include the volatility of real and normal shocks, the difficulty of operating in uncharted territory after financial liberalisation and other changes in regime, and the political pressures that can constrain the enforcement of prudential regulation.93 Commenting on the collapse of the Asian markets, Caprio and Honohan observe:

The debate over whether it was fundamentals or panic that brought down the Asian financial systems should thus not be confused with the question of whether underlying banking sector policy weaknesses contributed. Although the domestic banking system cannot easily be blamed for actually causing a panic, it had assumed increased vulnerability. Not only the weakened capital position of banks, but above all their unhedged direct and indirect94 exposure to foreign exchange risk and to the risk of property and equity market collapses, opened the door to a self-fulfilling panic. Liquidity risk from the substantial dependence on short term funding from foreign wholesale sources also increased fragility; and the risk that any initial reverse would be catastrophically amplified, was exacerbated by the high leverage of the corporate sector, especially in Korea. Finally, the lack of reliable financial information and trustworthy mechanisms for enforcing contracts (including bankruptcy procedures) made for severe information asymmetries with the result that these countries became very vulnerable to a sudden change in

89 Caprio Jr and Honohan, 1999, p 1.
90 Ibid.
91 Ibid.
92 See op cit, World Bank, fn 82, p 17.
93 See op cit, World Bank, fn 82, p 17.
94 On-lending in foreign exchange to a corporation which itself is uncovered is almost as risky for a bank as being uncovered itself.
sentiment ... Volatile capital flows are always a risk factor for banks; but the Asian crisis forces us to recognise how much bad banking can contribute to capital flow volatility (in and out). Far from providing a buffer against external volatility (in this instance coming from a reversal in capital flows) the banking system in the affected Asian countries not only exposed the economies to a self-fulfilling panic, but meant that the outflows would cause acute macroeconomic consequences.95

Caprio and Honohan are, however, mindful of what stronger regulation can and cannot achieve, as well as options to improve the incentive structure for bankers, regulators, and other market participants.96 They examine the shortcomings of a regulatory paradigm that relies heavily on supervised capital adequacy and discuss the possible intermittent application of supplementary ‘blunt instruments’ as an interim solution while longer term reforms are being put in place.97 Caprio and Honohan conclude that there would be fewer problems in banking if there was: more diversification; more balanced financial structures (for example, as between debt and equity); more foreign banks in emerging markets’ financial systems; and better enforcement of both contracts and regulations.98

Other views have been expressed by different scholars on the collapse of the financial markets in East Asia. These arguments include proximate and short run causes of the crisis, such as the current account deficit, exchange rate misalignment and disproportionate short run external debt relative to foreign exchange reserves.99 It could be argued, however, that these constraints are themselves endogenous outcomes of deeper institutional problems. Using Malaysia as a case study, Ghani and Suri provide an insightful study on how the East Asian miracle turned into one of the worst financial crises of the century.100 The learned authors argue that some long term features of the development strategy that helped sustain high growth in the first place also contributed to the economy’s increasing vulnerability.101 They put it more succinctly as follows:

High output growth was driven by rapid growth in capital stock, for example. The banking sector played a critical role in transforming (and accelerating the transformation of) large savings into capital accumulation. But the banking sector may not have been allocating capital effectively ... Malaysia’s exceptional growth record over the past quarter century was driven largely by the growth...

96 See op cit, World Bank, fn 82, p 17.
97 See op cit, World Bank, fn 82, p 17.
98 See op cit, World Bank, fn 82, p 17.
99 See op cit, World Bank, fn 82, p 24.
100 See, generally, Ghani and Suri, 1999.
101 Ibid; summary findings quoted on the inside of the cover page.
in physical capital stock. Total factor productivity growth may have slowed in the late 1990s, and sustaining high output growth will require greater emphasis on productivity improvements ... Policies that encouraged the flow of foreign direct investment and better access to imported capital goods contributed to productivity growth. But rapid growth in bank lending relative to GDP may have slowed it.102

So, how can policy makers go about slowing the growth of credit? In a World Bank study on risk and efficiency in East Asian banks, Laeven argues that banks restructured after the crisis of 1997 – most of them family owned and almost never foreign owned – tended to be heavy risk takers and thus had excessive credit growth.103 What, then, could be the way forward? This remains an interesting question for financial economists to explore. In a 1998 IMF Working Paper, Daniel and Pazarbasioglu examine some of the notable causes of banking distress in 38 countries.104 They argue that banking distress is associated with a largely contemporaneous fall in real GDP growth; boom–bust cycles in inflation, credit expansion, and capital inflows; rising real interest rates and a declining incremental capital output ratio; a sharp decline in the real exchange rate; and an adverse trade shock. Further, country-specific and regional circumstances are identified as some of the contributing factors to banking crises. In the case of primary-product exporting countries, it is argued that banking distress is likely to be triggered by a different set of leading indicators. According to Daniel and Pazarbasioglu, certain factors seem to have been especially pronounced in the Asian crises: the real appreciation followed by a very sharp depreciation, and the build-up followed by the collapse of banks. The authors further contend that banking sector difficulties may be severe without reaching the level of a crisis. Their analysis leads them to conclude, first, that severe banking problems are more domestic in origin and effect than full-blown crises, and that different leading indicators are relevant. Secondly, they submit that credit expansion funded mainly by capital inflows and leading to over-investment, and movements in the real effective exchange rate, were often critical in the lead-up to the Asian crisis. In the case of significant distress, Daniel and Pazarbasioglu observe that credit expansion fuelling consumption, and movements in the real interest rate on (domestic) deposits, are usually better indicators.

102 See, generally, op cit, Ghani and Suri, fn 100.
The limitations to heavy reliance on ‘deposit insurance’

In a study undertaken by the World Bank on 61 countries, and based on evidence collected from these countries between 1980 and 1997, it is argued that explicit deposit insurance tends to be detrimental to bank stability, the more so where bank interest rates are deregulated and the institutional environment is weak. Demirguic-Kunt and Detragiache observe that the first formal system of national bank deposit insurance was established in the US in 1934 with the purpose of preventing the extensive bank runs that contributed to the Great Depression. Tracing the origins of the concept of deposit insurance, they argue that it was not until the postwar period that deposit insurance began to spread outside the USA, and that the 1980s witnessed an acceleration in the diffusion of deposit insurance, with most OECD countries and an increasing number of developing countries adopting some form of explicit depositor protection. Indeed:

In 1994, deposit insurance became the standard for the newly created single banking market of the European Union. More recently, the IMF has endorsed a limited form of deposit insurance in its code of best practices ... Despite its increased favour among policy makers, the desirability of deposit insurance remains a matter of some controversy among economists.

The World Bank report notes that the adverse effect of deposit insurance on bank stability tends to be stronger the more extensive is the coverage offered to depositors, and where the scheme is funded and run by the government rather than the private sector. Demirguic-Kunt and Detragiache acknowledge that these findings raise a number of interesting questions and they inquire thus: ‘what is the channel that leads from explicit deposit insurance to increased bank fragility, given that depositors tend to bail out anyway when systemic problems arise?’ In resolving this dilemma, Demirguic-Kunt and Detragiache offer two possible interpretations:

The first is that without an explicit legal commitment by the government, there remains a degree of uncertainty on the part of depositors as to what extent and how quickly their losses will be covered in case of a crisis. This margin of uncertainty, then, is sufficient to restore significant incentives for depositors to monitor bank behaviour. A possible objection to this interpretation (and, more generally, to the view that deposit insurance is an important source of moral hazard) is that it is very costly (and perhaps impossible) for depositors,
especially small ones, to be effective monitors of banks. Acquiring and evaluating information about the quality of bank assets is a complex and costly activity which is likely to be subject to a substantial collective action problem, as each individual depositor can free-ride on the monitoring activities of others... There is, however, an alternative explanation of why deposit insurance may increase bank fragility, that does not rely on the ability of depositors to monitor banks: with deposits already covered by the funds set aside through the insurance fund, in the event of a crisis, other bank creditors and perhaps even bank shareholders may be in a better position to pressure policy makers to extend protection to their own claims. Conversely, if it must scramble to find the budgetary resources to pay off depositors, then the government may find it easier to say no to the other claimants. If this is true, then *ex ante* deposit insurance would lead to weaker incentives to monitor bank management not only for depositors, but also for other bank creditors and bank shareholders.\footnote{111}

That said, it would be interesting to find out if deposit insurance can lead to stability of a banking system in countries not explored even though, on average, such insurance has adverse effects. In a recent study on Argentina, de la Torre examined the institutional changes introduced in 1995 to handle bank failures more effectively, particularly the creation of the deposit guarantee scheme and the procedural framework for resolving bank failures, embedded in Art 35 of the Financial Institutions Law.\footnote{112} The framework provided for in Art 35 enables the Central Bank of Argentina to set aside the assets and ‘privileged’ liabilities of the failing bank and transfer them to sound banks, thereby sending only a ‘residual’ balance sheet to judicial liquidation.\footnote{113} As noted in a recent World Bank report:\footnote{114}

The author (de la Torre) assesses a number of issues that arise from the Argentina model of bank failure resolution, taking into account both country-specific circumstances and more general concepts and concerns. He emphasises the potential trade-offs between reducing contagion risk, limiting moral hazard, and avoiding unnecessary destruction of asset value; the implications of priority-of-claims rules and least-cost criteria; the pros and cons of alternative organisational and institutional arrangements; and the need for legal security. Finally, he outlines two prototypical approaches to striking a balance between rules and discretion, an issue underlying much of the ongoing policy discussion on alternative bank exit frameworks.\footnote{115}

\footnote{111} See *op cit*, Demirgüç-Kunt and Detragiache, fn 106, pp 22–24.  
\footnote{112} Taylor and Fleming, 2000, summary findings quoted on the inside of the cover page. See also, Garcia-Herrero, 1997, where it is argued that the banking crises in Argentina, Paraguay and Venezuela suggest that the macroeconomic impact was influenced by the causes of the crisis, the exchange rate regime, the degree of dollarisation and the structure of the banking system.  
\footnote{113} See, generally, *ibid.*, Taylor and Fleming.  
\footnote{114} See *op cit*, World Bank, fn 82, p 14.  
\footnote{115} de la Torre, 2000, summary findings quoted on the inside of the cover page.
By contrast, Demirguc-Kunt and Detragiache conclude that, in countries with a very good institutional environment, deposit insurance may not lead to additional instability, perhaps because in those countries regulators can more effectively offset moral hazard.\textsuperscript{116}

**Lack of transparency as a regulatory constraint**

A recent World Bank study investigating how transparency affects the probability of a financial crisis looks at empirical evidence in 56 countries.\textsuperscript{117} This study, based on evidence gathered between 1977 and 1997, is underscored by the view that lack of transparency increases the probability of a crisis following financial liberalisation.\textsuperscript{118} Mehrez and Kaufmann construct a model in which banks cannot distinguish between aggregate shocks and government policy, on the one hand, and firms’ quality, on the other.\textsuperscript{119} They argue that under such a model, \textit{ceteris paribus}, banks may therefore overestimate firms’ returns and increase credit above the level that would be optimal given the firms’ returns.\textsuperscript{120} The learned authors conclude that once banks discover their large exposure, they are likely to roll over loans rather than declare their losses.\textsuperscript{121} This would then delay the crisis, although increasing its magnitude. According to Mehrez and Kaufmann, ‘countries should focus on increasing transparency of economic activity and government policy, as well as increasing transparency in the financial sector, particularly during a period of transition such as financial liberalisation’.\textsuperscript{122}

**Conclusion**

This chapter has examined important lessons of experience in banking supervision and systemic bank restructuring. The chapter was underscored by the view that reforming banking systems requires a good appreciation of interdisciplinary and meta-paradigmatic perspectives. Arguments were advanced on the advantages and disadvantages of introducing an integrated model for financial supervision. The various factors that seemed to influence the setting up of integrated models in Scandinavian countries, for example, were seen to be different from those obtaining in the UK.

\textsuperscript{116} See \textit{op cit}, Demirguc-Kunt and Detragiache, fn 106, p 24.
\textsuperscript{117} See, generally, Mehrez and Kaufmann, 2000.
\textsuperscript{118} \textit{Ibid}; summary findings quoted on the inside of the cover page. See, also, \textit{op cit}, World Bank, fn 82, p 10.
\textsuperscript{119} \textit{Ibid}; summary findings quoted on the inside of the cover page.
\textsuperscript{120} See, generally, \textit{ibid}.
\textsuperscript{121} \textit{Ibid}.
\textsuperscript{122} \textit{Ibid}.
The concept of central bank independence was explored and a number of lessons of experience were analysed. All in all, the chapter provided an economic analysis of the pertinent legal issues affecting the regulatory framework for banking supervision. Regulatory constraints were identified and an argument was made on the need to utilise expertise of both local and foreign consultants in legal reform. The chapter espoused a systemic and holistic approach to systemic bank restructuring. Limitations on heavy reliance on capital adequacy requirements and deposit insurance were noted. In arguing for efficiency of a regulatory framework, the chapter postulated that regulation must provide for increased transparency of economic activity and government policy, as well as transparency of activities in the financial sector.
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