

**THE ROLE OF DEPOSIT INSURANCE IN THE BANKING SYSTEM: THE  
CASE OF LESOTHO**

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**Abstract**

Many developing countries have been adversely affected by incidents of economic shocks caused by financial instability which has retarded economic growth. The impact of financial instability explains why the financial sector is regarded as significant tool in the economic development of any country. In an effort to ensure that the stability of the financial system is sustained, many countries have strengthened regulatory and supervisory frameworks to ensure that banks operate within a stable economic environment.

In addition, many countries have set up deposit insurance systems in order to complement the prudential supervision and regulation by the Central Banks as well as the lender-of last-resort function of the central bank. Nonetheless, the introduction of deposit insurance has not only contributed positively in the maintenance of the financial system, but has presented challenges as well. This could be discerned from the negative consequences which deposit insurance systems suffer such as moral hazard and adverse selection. The aforementioned problems have been addressed by making proper considerations in the process of choosing the proper deposit insurance model. However it is pertinent to indicate that there is no model which could be recommended as the best since each model is suitable for the particular circumstances of a given country.

However, an explicit deposit insurance system has been proposed as the model for the best practice deposit insurance systems and has since been endorsed by the International Monetary Fund (IMF) for countries which are in the process of setting up such a system. Explicit deposit insurance system is preferred over other forms since it creates certainty that bank depositors are guaranteed reimbursement in the event of bank failure, has clearly defined

guidelines on the extent to which they are covered against loss occasioned by bank failure as well as saving the government from diverting the national budget to bail out distressed banks for purposes of facilitating reimbursement of depositors and thereby sustaining stability within the financial system and economic system.

It is against this background that the position of Lesotho, in so far as the role played by deposit insurance within the banking system was explored..

### **List of acroynms and abriviations**

**ABSA- Amalgamated Banks of South Africa.** CBL- Central Bank of Lesotho.

CBN – Central Bank of Nigeria.

DICGC – Deposit Insurance and Credit Guarantee Corporation.

DPFB – Deposit Protection Fund Board.

EIFDI – European Fund for Deposit Insurance.

FNB – First National Bank.

FIA – Financial Institutions Act.

FDIC – Federal Deposit Insurance Corporation.

IDI – International Development Ireland.

IMF – International Monetary Fund.

LB – Lesotho Bank (Ltd).

LADB – Lesotho Agricultural Development Bank (Ltd).

LPB – Lesotho Post Bank (Ltd).

NDIC – Nigeria Deposit Insurance. SOB – State-owned Bank.

IADI – International Association of Deposit Insures.

BSBS – Basle Committee on Banking Supervision.

DPB – Deposit protection Board.

FSCS – Financial Services Compensation Scheme.

## Glossary of definitions

The following key concepts shall bear the following meaning for the purposes of this research:

**‘Adverse selection’** – The tendency for high risk banks to opt for participation in a deposit insurance and lower risk banks to opt out when membership is optional.

**‘Bank’** – A bank is an institution that has been licensed to execute banking business by a state or the regulator through a relevant banking legislation.

**‘Bank runs’** – an instant loss of deposits in the banks occasioned by massive withdrawals by depositors triggered by a rumour that particular banks are likely to fail and thereby cause loss on their part.

**‘Blanket guarantee’** – a tendency by the governments to make a commitment that all forms of deposits held by banks will be protected in the event of bank failures.

**‘Bank failure’** means a situation under which a bank reaches a point of being unable to service deposits to all its customers’ simultaneously as a result of insufficient reserves.

**‘Blanket guarantee’** refers to an arrangement where protection is extended to all sorts of depositors, creditors, shareholders and even managers of a failing or a failed bank.

**‘Bank run’** -Means a situation where all or a majority of depositors of a given bank demand their deposits simultaneously and lead to a situation where

bank's ability to meet its obligation to pay out depositors withdrawals is frustrated/limited by insufficient reserves. The reaction of depositors could be induced by either truly anticipated failure of a bank or an incorrect speculation about the solvency status of the bank or other incidental factors occasioned by the channelling of the correct information between depositors and the bank regarding the status the bank.

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**'Conservatorship'** – The legal process provided for in the statute providing guidance in the process by which a temporary management of a failing /failed financial institutions is handled.

**'Deposit insurance'** Means a promise that all or a portion of the principal amount deposited with a particular plus interest accumulated on protected accounts will be reimbursed. Deposit insurance is usually intended to cover small depositors who do not have access to information reflecting the management of financial institutions, to keep maintains the stability of the financial sector. The deposit insurance guarantee however, does not protect institutional investors or those engaged in large financial transactions or security-related financial transactions that are in a better position to access information about financial markets and embark on the proper course of action.

**'Deposit taking institution'** – A bank or specialized institution such as a building society, cooperative, credit union or any friendly society licensed to receive to receive money or deposits from private individuals.

**'Deposit payoff'** – A resolution method for failed an institution that involves the reimbursement of deposits and the transfer of the bank's assets to a receiver to a receiver for liquidation.

**'Differential premiums'** – A levy on a bank assessed on the bases of a risk associated with that bank.

**‘Ex-ante Premiums’** – payment of premiums and accumulation of funds overtime in order to build and maintain a reserve or a fund that can be used in the event of bank failure.

**‘Ex ante deposit insurance fund’** -this is a funding arrangement where all participants to the deposit insurance scheme are required to make a contribution to the fund prior to an incident of failure so that the contributions could be utilized to reimburse depositors of failing failed banks.

**‘Ex-post premiums’** – Levies on members or payment by government only after a failure has occurred.

**‘Ex post deposit insurance funding’** -Under this type of funding, participants to the deposit insurance scheme are mobilized make a contribution or reimbursement of depositor only at the time bank failures are encountered.

**‘Explicit deposit insurance’** – A system of deposit protection where terms and conditions are clearly stated in a statute and the types of deposits that are covered in the event of a bank failure are categorically stated. This type provides legally enforceable guarantee on a portion of deposit insurance plus interest covered.

**‘Financial institution’** – Any institution other than an insurance licensed to take deposits and to carry out financial activities whether bank or non-bank.

**‘Fit-and-proper person’** – One who is financially sound, competent, honest, reputable and reliable.

**‘Financial safety net’** – A system designed to protect the stability of the financial system and consumers. It entails the following elements: Regulation and supervision, lender of last resort, bank insolvency/resolution law, deposit insurance scheme, institutionalized decision-making/cooperation and resolution.

**‘Flat-rate premium’** - A premium assessed at a uniform rate across all insured institutions.

**‘Guarantee fund’** - means a fund established specifically to protect individual depositors against the effects of failing or failed banks. Funds are kept as a contingency for reimbursing depositors when banks fail.

**‘Hybrid premiums’** – type of premiums payment where both ex-post and ex-ante are applied.

**‘Implicit deposit insurance’** – A system of deposit insurance where there are no stated rules but depositors have implied assurance by Government or Mother Company either through precedence or stated intentions that they will be compensated in the event of a bank failure.

**‘Insider deposits’** – Deposits for any senior management and their relatives up to the second degree of kinship (parents, spouses, and children) employees responsible for management of one or more risks, board members and auditors of the affected member financial institutions.

**‘Insured deposit’**- Deposit that fall within the maximum limit covered by the deposit insurance system.

**‘Lender-of-last-resort function’** – an action where the Central Bank as the Regulator provides funds to any licensed bank to maintain its immediate liquidity requirements so that it can meet its obligations to depositors. The lender of last resort function is intended to prevent a bank run and consequently maintains the public confidence in the banking system.

**‘Maximum deposit coverage Limit’** – That amount of money that the deposit insurer would pay in full to the covered depositor in the event of a bank failure.

**‘Market discipline’** – a situation where individual bank depositors or creditors conduct an analysis to determine the level of risk exposure of a bank and this

forms the basis of the decision as to whether they continue to keep their deposits with that bank or withdraw their deposits from that particular bank.

**‘Moral hazard’** – incentive for risk taking that arises as a result of protection from loss.

**‘Open-bank assistance’** – A resolution method in which a failing bank receives assistance in a form of direct financing or a loan, an assisted merger or a purchase of assets.

**‘Purchase and assumption transaction’** – A resolution method in which a healthy bank(s)/ investors acquire all or part of the assets and liabilities of a failed bank and assume all or part of its obligations.

**‘Risk-adjusted differential premium’** – refer to differential premium.

**‘Receivership’** – The legal process undertaken to arrange for a bank which takes charge of a bankrupt/insolvent bank’s property following the winding up of the insolvent institution.

**‘Small uniformed Depositors’** – Small depositors that may not be able to analyse the riskiness of the bank they deposit in because of their level of literacy.

**‘Systemic Risk’** – a risk that has adverse financial implications for the rest of the financial instability and ultimately adverse economic implications.

**‘Too big to fail’** – The decision taken by the government to extend protection to uninsured depositors, creditors, and others against loss in the event that bank failure affects large banks (usually State-Owned) and it is believed that that if they could be left unattended this could lead to a loss of confidence in the financial system by the members of the public.

## CHAPTER ONE: INTRODUCTION

### 1.1 Background

The key roles performed by the financial sector are pivotal in economic development.<sup>1</sup> Whether it is involvement in the payments systems, their role as a link between depositors and borrowers, or the critical role of communicating monetary policy to the members of the public, it is difficult to imagine a 'bankless' business sector.<sup>2</sup> Banks are exposed to liquidity and solvency problems in the process of executing their functions because of the nature of their operations.<sup>3</sup> Banks and governments have an interest in protecting investors from insolvency.

The direction taken by different countries around the world to establish financial safety nets is influenced by the significant contribution made by the banking sector in the promotion of economic development in each particular country. The potential threats of loss of deposits by depositors of a failed or failing bank and the challenge to minimize the risks are the key factors which were taken into consideration in the process of introducing the necessary financial safety nets structures.<sup>4</sup> The whole idea is to counteract the potential economic shocks which are likely to affect banks and subsequently impact on the individual depositors. The need for the establishment of Deposit Insurance Scheme around the globe was emphasized as follows:

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<sup>1</sup> Horn, M ' Discuss the role of a deposit insurance scheme within a system of bank regulation. What is the rationale for deposit insurance, and what are the problems of implementing it?' (October 2, 2008. University of Essex. (Available from [www.essex.ac.uk/economics/eesj/Au/horn248.pdf](http://www.essex.ac.uk/economics/eesj/Au/horn248.pdf)) at 2. Accessed on 06/27/2011.

<sup>2</sup> Nigeria Deposit Insurance Corporation (NDIC) 'Concept, practice, practice and management of Deposit Insurance.' (Available from <http://ndic.org.ng/concept-of-dis.html>.

<sup>3</sup> NDIC (note 2) at 1 of 1.

<sup>4</sup> IDIC (note 2) at 1 of 1.

*In every country, policy makers erect a financial safety net to make systemic banking breakdowns less likely and to limit the fiscal costs generated when they occur. This safety net includes implicit and explicit deposit insurance, lender-of-last resort facilities at the central bank, procedures for regulating and supervising banks and provisions for accessing emergency assistance from multinational institutions such as IMF.<sup>5</sup>*

It was pertinent therefore for the regulators of financial institutions to initiate the establishment of financial safety nets in an effort to combat bank failures. Financial safety net system as a protective measure is normally perceived to be composed of three components. The first component entails the aspect of prudential regulation and supervision. The second component deals with the safety net in the context of lender of last resort which is ordinarily executed by central banks and thirdly, a deposit insurance scheme. This research focuses only on one component of the financial safety net viz, a deposit insurance scheme.

It is therefore imperative to define what the deposit insurance is since it constitutes a key concept on which this research is based. Deposit insurance is a protective measure intended to cover individual bank depositors against loss of their deposits occasioned by bank failure.<sup>6</sup> The whole idea behind deposit insurance is to extend protection to small depositors who do not have access to the information regarding the management of deposit taking financial

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<sup>5</sup> Dermiguc-Kunt,T and Kane E J 'Deposit Insurance. (available from <http://www.worldbank.org/research/bios/asli/revision%20December01.pdf>. At 1.

<sup>6</sup> Central Bank of Kenya 'Deposit Protection Fund.' At 1 (Available from- <http://mhtml:file:///E:/Central Bank of Kenya- Deposit Protection Fund.mht.>). Accessed on 16/05/2011.

institutions.<sup>7</sup> The argument raised here is that small depositors merely deposit their funds relying solely on the trust that financial institution will meet their obligations. The other category of account holders such as investors are not protected since they have access to the information about the profile of a bank they invest with and therefore can make a guided decision as to whether to invest or not.<sup>8</sup>

The purpose of this research is to examine and consider the potential of a deposit insurance system in fulfilling the following roles: Firstly, to ensure the provision of protection to small depositors of a failing or failed bank. Secondly, the contribution to financial stability through promotion of confidence to bank depositors to the Lesotho banking system. And, thirdly, the provision of a formal framework through which problem banks could be handled. The research would be tested by determining the consistency of government intervention to rescue bank depositors in all incidents of bank failure.

The importance of the notion of deposit insurance in the protection of individual depositors in the event of a bank failure occasioned by financial distress will be fully explored.<sup>9</sup> The concept of deposit insurance is also perceived important in counteracting the financial instability which eventually led to the collapse of banks during the times of financial difficulties. According to *some authorities*,<sup>10</sup> the concept of Deposit Insurance is defined as follows:

*Deposit insurance is a measure taken by banks in many countries to protect their clients' savings, either fully or in part, against any possible situation that would prevent the bank from returning said savings.*

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<sup>7</sup> Choi, J 'Structuring a Deposit Insurance System from the Asian Perspective.' at 70 (Available from [http://www.ad.org/oerg/Documents/Books/Rising\\_to\\_the\\_Challenges/Special\\_Issues/3di.pdf](http://www.ad.org/oerg/Documents/Books/Rising_to_the_Challenges/Special_Issues/3di.pdf)).

<sup>8</sup> Choi (note 6) at 70.

<sup>9</sup> History of Bank Deposit Insurance/eHow.com.

<sup>10</sup>Investor Dictionary 'Deposit insurance definition and meaning \_define Deposit insurance.' (Available from [Investor Dictionary.com.deposit\\_insurance.html](http://InvestorDictionary.com.deposit_insurance.html)://E:\. At I of 1.

## **1.2 Justification for the study**

There are a number of benefits which accrued with the inception of the concept of deposit insurance globally. This research is specifically conducted to achieve the following goals:

First, to investigate the proposed deposit insurance legislation for Lesotho;

Second, to recommend an appropriate model of deposit insurance for Lesotho;

Third, to ensure the guaranteed protection of individual depositors during the times of bank failures;

Forth, to investigate whether the existence of a formal deposit insurance in Lesotho would relieve the Government of the burden to shoulder the repercussions of the loss of deposits by customers of a failed bank at the expense of the public funds earmarked for other development priorities and

Lastly, the study is intended to assist in the general reform of the financial sector in Lesotho.

## **1.3 Statement of the problem**

The outstanding problem to Lesotho's financial sector during the economic distress was that there was no formal legal regime establishing the system of deposit insurance to protect individual depositor's accounts during bank failures. The absence of the formal regime on deposit insurance has left the deposits holders unprotected since there was no guarantee provided to them in the event of a bank failure. The anticipation was that the role of the

government was purely discretionary in this regard and was therefore prone to inconsistencies in its intervention to save individual bank depositors.

The absence of an explicit legal regime providing for an institutionalised deposit insurance system in Lesotho can be attributed to the fact that the Government had exercised its discretion to provide financial intervention to rescue depositors in the past two incidents of bank failure.<sup>11</sup>

#### **1.4 Objectives of the research**

The objective of this research is therefore to investigate the reasons underlying the government discretion and decision to bail out individual bank deposits held by the two banks which collapsed.<sup>12</sup> Another objective is to look at the role which could be played by the deposit insurance in the banking system. Lastly the research is intended to explore prospects of establishing a deposit insurance scheme in Lesotho.

#### **1.5 Hypothesis**

I anticipated that the decision of the government to exercise its discretion to bail out depositors following the failure of LADB and LB was not consistently exercised in view of the absence of the legal regime to guide the capricious exercise of the discretion on the part of the government. The paper therefore seeks to undertake research to establish whether the government of Lesotho was consistent in bailing out the insolvent banks.

An assumption on the aspect of the execution of the discretion was that the government of Lesotho did not exercise its discretion in all cases warranting bail out. The study is conducted to determine whether the government of Lesotho exercised its discretion in all cases warranting bail outs.

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<sup>11</sup> The government intervention was enjoyed during the collapse of Lesotho Agricultural Development Bank Ltd and Lesotho Bank Ltd where depositors were reimbursed their deposits.

<sup>12</sup> Ibid.

It was also assumed that the decision of the government of Lesotho to bail out LADB and LB notwithstanding an absence of a clear guaranteed protection of depositors upon bank failure was stimulated by the fact that in both banks 100 per cent shareholding belonged to the government. The research paper conducted to determine whether the decision to bail out the two banks was compelled by the fact that the government was the sole shareholder in these two institutions.

I assumed that the absence of regulation on protection of deposits was encouraged by the existing banking structure in Lesotho where the banking market was small and dominated by foreign financial subsidiaries of South African commercial banks which stand a chance of being relieved by their parent banks to compensate depositors in the event of bank failures. The objective of this research was therefore to verify whether the absence of a legal regime on the protection of deposits was indeed sustained by the dominance of the banking industry by subsidiaries of South African commercial banks which could be relieved by their parent banks to compensate depositors in the event of bank failures and whether that fall-back position existed as a matter of fact.

It was further presumed that that South Africa did not have a deposit insurance facility since it had a stable financial system which did not pose an immediate threat to the banking sector, both in South Africa and Lesotho by reason of operating subsidiaries extra-territorially.

This research was approached from the angle of the globalised banking market which dictates that the operation and regulation of banks should be subjected to the laws and practices which respond to requirements of international standards. The researcher also looked at the research from the context of an environment where smaller economies such as Lesotho are dominated by transnational banking companies.

## 1.6 Organisation of the Study

This research consists of six chapters excluding this introductory chapter which outlines the contextual background of the research as well as providing the rationale for undertaking the research, statement of the problem, objectives and hypotheses. This chapter also reflects the sequence in which chapters have been constructed.

**Chapter two:** The purpose of this chapter is to provide forms of deposit insurance system and the challenges encountered by different jurisdictions during the implementation of various forms deposit insurance schemes and the mitigating tools which could be invoked to counteract those challenges. This chapter would also make a brief analysis intended to indicate why other forms of deposit insurance system are preferred over others.

**Chapter three:** This chapter would make a comparative analysis of different jurisdictions comprising developed, advanced, emerging market and developed countries with a view to explore how different systems feature selected jurisdictions.

**Chapter four:** This chapter would seek to outline the institution of deposit insurance by tapping the relevant literature and theories provided by authorities on deposit insurance. The chapter would be guided by hypotheses formulated by the researcher at the initial stages of undertaking this research.

**Chapter five:** This particular chapter is intended to provide an evolution of the banking system in Lesotho as well as reflecting the structure of the banking sector in Lesotho. The chapter would also revisit the experience of Lesotho's banking system on bank failures. Lastly the chapter would provide the mechanisms which were used to address bank failures.

**Chapter six:** This chapter would make an assessment of the adequacy of mechanisms used to address failures in Lesotho and the incidental reforms

made to strengthen the existing tools. The chapter would also make a case for the establishment of a deposit insurance regime for Lesotho as well as articulating its role in the Lesotho's banking system using the background provided by the previous chapters

**Chapter seven:** The aim of this chapter would be to make an analysis and reflect findings on the hypothesis formulated at the beginning of the research.

**Chapter eight:** This would be the last chapter intended provide a summary of conclusions drawn on the basis of analysis and findings in chapter seven. The chapter would also make recommendations for further the reforms to be made on the subject.

## **CHAPTER TWO: FORMS AND CHALLENGES OF DEPOSIT INSURANCE SYSTEMS**

### **2.1 Deposit Insurance Institution**

Deposit protection arrangements have evolved in various countries with different forms and with the understanding that no single deposit insurance form could best suit circumstances prevailing in every country and this various forms have exposed severe vulnerabilities in some important areas.<sup>13</sup> The concept of Deposit Insurance just like any other concept is not immune from challenges emerging during its implementation during the times of crisis. It has advantages and limitations attached to it. The purpose of this chapter would be to attempt to look at the different forms of deposit insurance and the challenges posed by the introduction of the deposit insurance concept within the financial sector in response to the uncertainties brought about by the financial crisis.

The primary aim of deposit insurance is intended to extend protection to bank depositors in the event that a bank fails<sup>14</sup> since they are placed in the compromised position where their level of understanding does not allow them to make a proper risk analysis on the banks they use to deposit their funds. On the other hand even if the depositors do access the necessary information which needs to be analysed to assess the risk profile of the bank, they do not have capacity to make that analysis themselves.

### **2.2 Ordinary banking crises versus Systemic banking crises**

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<sup>13</sup> Campbell,A and LaBrosse, J R 'etal' 'A new standard for deposit insurance and government guarantee after the crisis.'Vol. 17, No. 3, 2009 210, at 232. *Journal of Financial and Compliance* .(Available [www.emeraldinsight.com/1358-1988.htm](http://www.emeraldinsight.com/1358-1988.htm).Accessed on 26/07/2012).

<sup>14</sup> See Note 67 at 158.

It is necessary to highlight that the deposit insurance system is limited in application to the extent to which the financial crisis has affected the financial sector. In the case where the crisis is of a higher degree and likely to affect a wide spectrum within the financial sector and likely to result in the collapse of the financial system as a whole, that crisis is treated as a systemic crisis and attracts government intervention to invoke a blanket cover to all categories of depositors.<sup>15</sup> Alternatively a crisis could be the routine crisis affecting a particular bank at the particular time and which is addressed by way of a deposit insurance scheme.

### **2.3 Forms of deposit insurance systems**

It is also pertinent to indicate that deposit insurance could take different forms i.e. it could either be publicly established or it could be privately established. Deposit Insurance could be either implicit or explicit depending on the nature of the crisis. In other jurisdictions the scheme operates ex ante funding model whilst in others it operates ex post funding model.

Different jurisdictions differ in the application of deposit insurance scheme for example in some jurisdictions the application of deposit insurance scheme is voluntary, such as in the case of Australia whilst in other jurisdictions it is compulsory. It is also indicated that most countries operate a unitary deposit insurance system whilst others use multiple schemes and a typical example where a multiple deposit insurance is Germany.

The choice of a type of a deposit insurance scheme to be applicable is dependent on the circumstances of each particular country. It is imperative at this point to indicate that a deposit insurance system could either be explicit or implicit depending on the particular circumstances of each jurisdiction.

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<sup>15</sup> Sundararajan, V and Balino T J T *Banking Crises: Cases and Issues*.(1991). International Monetary Fund, Publication Services. Washington. At 3.

### 2.3.1 Funding Models of deposit insurance

Deposit insurance schemes take different forms in different jurisdictions globally and this is dictated by roles, mandate as well as design features of each individual scheme.<sup>16</sup> According to the study conducted on deposit insurance there are four types of deposit insurance scheme classified as follows<sup>17</sup>:

- (a) The pay box model where the role of deposit insurance is restricted to processing payment to claims of depositors acting on the basis of an instruction and information from the bank supervisors without necessarily being involved in the supervisory function.
- (b) The cost reducer model where the scheme is not merely limited to the settlement of depositors claims but is also entitled to intervene and resolve an insured institution for the purpose of protecting depositors;
- (c) The resolution facilitator model where the mandate of an insurer is further extended to permitting it to utilize its capital not only to meet depositors claims but also to turnaround solvent insured institutions from liquidation by using various restructuring options such as mergers and acquisitions, recapitalization as well as splitting up business areas of the bank;
- (d) The supervisor model where the deposit insurance over and above the conventional roles vested on insurers, also acquire the supervisory role on the insured institutions.

### 2.3.2 Public vs Private insurance schemes

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<sup>16</sup> Bernet, B and Walter, S. *Summary of the study 'Design, Structure and Implementation of a modern deposit insurance scheme.'* Presented at the *European Money and Finance Forum, Vienna* (2009) at 7.

<sup>17</sup> Bernet, B (note 35) at 7.

However, deposit insurance schemes in most jurisdictions are publicly established<sup>18</sup>. Although private deposit insurance schemes encourage competition which promotes access to information which could serve as a basis for determining deposit insurance pricing, there are key advantages of public deposit insurance scheme over private deposit insurance reflected as follows: public insurance systems enjoy the support of governments especially during systemic crises, Central Bank interventions through the Lender of Last Resort facility and bank closures since they require public decisions, requirements which are not easily accessible to private insurance systems.<sup>19</sup>

### **2.3.3 Explicit Deposit Insurance System**

Explicit deposit insurance is defined as a system under which the government pledges reimbursement to bank depositors in the event that a bank fails and it outlines the scope of protection such as mandate, powers and governance structure.<sup>20</sup> This type of deposit insurance is characterised by rules and regulations providing a guidance on the extent to which insured institutions could participate, how the system would be funded, the levels of coverage and compensation of participants, a mechanism for the resolution of failing banks, settlement of claims brought up by depositors as well the formula on how the premiums would be determined. Motivations making a case for explicit deposit insurance are as follows: The establishment of explicit deposit insurance system is regarded as an indication of government support for the country's banking system portraying a gesture of caring responsibility on the part of the government to individual depositors and simultaneously fostering stability of the financial system by being prohibitive to eminent bank runs which are likely to ensue in the event that depositors could lose

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<sup>18</sup> Freixas, X and Rochet, J 'Microeconomics of Banking' (2008). 2<sup>nd</sup> ed. MIT Press. England. At 313.

<sup>19</sup> Freixas and Rochet (note 37). At 313

<sup>20</sup> Okeahalam, C and Maxwell, T 'Deposit insurance design and bank regulation in South Africa.' (2001) Vol. 9. No 2, *Journal of Financial Regulation and Compliance*. Political, 136 - at -136.

confidence in the banking system. The creation of a deposit insurance system through legislation or a contractual arrangement is an indication that the government takes cognisance of its initiative to enforce transparency in its activities. This system of protecting depositors is recommended in the sense that it limits discretionary actions on the part government to intervene when banks fail and therefore prohibits possible arbitrary actions by governments which would occur in the event that there was no clarity on the role to be played by the government. The existence of explicit deposit insurance relieves the national budget of the burden of having to bail out distressed banks in order to enable them to reimburse the depositors. The explicit system of protecting depositors also minimises the prospects of systemic risk in the banking sector.

On the other hand explicit deposit insurance is characterised by the following deficiencies: It is said to create a moral hazard in that banks are encouraged to venture into risky transactions banking on the guaranteed compensation in the event that the bank collapses. It is also argued that explicit deposit insurances remove an incentive for depositors to assess the financial soundness of the banks they have deposited their funds to.

#### **2.3.4 Implicit Deposit Insurance System**

Implicit deposit insurance is another system through which depositors are protected in the financial system. It is defined as an arrangement where there is no formal set-up for funding the system, no commitment on the part of the government on the aspect of reimbursing depositors in the event that bank failure occurs. The system also has pros and cons. Implicit deposit is recommended on the basis that it could be flexible in the reimbursement of depositors and could sometimes lead to the reimbursement of depositor's funds up to 100 per cent depending on the availability of funds. Implicit deposit insurance does not maintain a fund and hence spares individual banks of the responsibility to contribute to the fund which they would otherwise have to

maintain. It minimises the threats posed by the theory of moral hazard and induces depositors to critically monitor the financial status of the banks they have kept their deposits with. Banks also calculate risks properly before they could venture into high risk ventures. It is also worth to indicating that highlight that implicit deposit insurance also has disadvantages as well. The unfavourable part of this system of deposit insurance is that it is uncertain since it is premised on the political will of the government to reimburse depositors. It is also criticised for burdening the taxpayer's funds by diverting or derailing the budget from financing the intended projects to unplanned expenditure.

It is also necessary to critically look at the funding models under explicit deposit insurance. Deposit insurance systems are funded in three ways globally. They could either be funded through ex-ante premiums; ex-post levies as well as though the hybrid arrangements combining the two methods.<sup>21</sup>

### **2.3.5 Ex-ante funding model**

Ex-ante system like any other funding arrangement has both advantages and limitations in its application. It is considered credible in the sense that it requires the accumulation and maintenance of a fund to cover deposit insurance claims and other incidental claims prior to the actual event of failure. It could assist to counter the sudden withdrawals which could lead to a bank run. On the other hand ex-ante is criticised since the authority to impose levies on participating banks may be invoked during crises period and sometimes would not be sufficient should there be a general banking crises since this situation could not be redressed by recapitalising failed banks using weak and surviving banks.<sup>22</sup>

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<sup>21</sup> See note 2 at 226.

<sup>22</sup> See note 133 at 215.

### **2.3.5 Ex-post funding model**

This system could induce banks to monitor one another and thereby increase market discipline. The system is on the other hand considered disadvantageous since funds are not collected beforehand and hence there is likely to be delays in deposit repayment caused by the process of re-organising a fund intended to reimburse depositors. It is also argued that funding may prove to be inconsistent since it would be dependent on the availability of resources. It is similarly contested that contributing to repayment of a failed bank, depositors may be financially crippling to surviving bank since banks failures occur in weak financial periods and hence may further exacerbate the problem. The advantage of explicit funding model is that in a highly concentrated banking system it may not be easy to establish a fund of proportional size to make deposit insurance a credible facility and hence the ex-post model could address this problem.

## **2.4 Challenges posed by deposit protection systems**

Although the aim of the deposit protection is to protect the depositors, ensure stability of the financial system and economic stability and national payment systems, it has some negative aspects in the financial system. It is therefore pertinent to explore the challenges posed by the introduction of a deposit insurance system within a financial system in order to weigh the consequences brought about by each aspect and try to strike a balance between the protection of the depositors and the national financial system against the consequences of failure and threats presented by the deposit protection systems. Whereas deposit protection promotes depositors confidence in the national financial system and curbing bank runs which are likely to cause bank failure, it however creates a moral hazard, discourages the depositors incentive to monitor the performance of financial institutions they have

invested in. It also creates adverse selection in the event that it is voluntary in nature.

## **CHAPTER THREE: COMPARATIVE ANALYSIS OF DEPOSIT INSURANCE SYSTEMS IN DIFFERENT JURISDICTIONS**

### **3.1 Rationale for undertaking comparative analysis**

It is worth indicating that a comparative analysis of deposit insurance systems of different jurisdictions would be undertaken with a view to explore how the different jurisdictions have structured their systems. The criteria used would be guided by the level of development of countries so that at least a perspective from developed, advanced, emerging market and developing economies could be compared. Another guideline had been to compare how the systems in big economies and smaller economies compare. Three countries were chosen within the African continent in order to get a broader picture of the trends being followed to set up deposit insurance system under the circumstances which are more or less similar to those prevailing in Lesotho. The jurisdictions which would be revisited for this purpose are the United States of America (US) where the concept of deposit insurance originally emanated, the United Kingdom (UK), India, Nigeria, Kenya and Zimbabwe. .

#### **3.1.1 The United States of America (US)**

The Deposit insurance system originated in the United States (US) in 1933<sup>23</sup> and was launched as a result of the catastrophic collapse of banks. Prior to the establishment of deposit insurance scheme, there had been diverse proposals to handle the bank deposit losses resulting from the collapse of banks. The initial proposal was the establishment of an insurance fund from which

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<sup>23</sup> History of Government Bailouts in the US. 2011.EBSCO Publishing.(Accessed on27/06/2011 – <http>),

disgruntled bank depositors could be paid.<sup>24</sup>The second proposal advocated the guarantee of deposits by the United States government and the last proposal was to the effect that banks should buy surety bonds to serve as protective measure.<sup>25</sup>

A significant development was the establishment of the Federal Deposit Insurance Corporation (FDIC) as it is known today. The United States of America experienced the first bank failure in 1809 when the then notorious Farmers Bank of Gloucester which operated in the Rhode Islands collapsed.<sup>26</sup>Other banks also experienced a similar problem of collapsing in the subsequent years and the New York bank was amongst these banks.<sup>27</sup> It was as a result of this incident that the New York Bank began to offer a form of deposit insurance to its customers. The problem of bank failures was also encountered during 1858 and it affected United States states such as Indiana, Iowa, Michigan, Ohio and Vermont.<sup>28</sup>

The problem of bank collapse in the United States continued to be rampant during the 19<sup>th</sup> Century with the failure of approximately 600 banks annually between the period 1921 and 1929.<sup>29</sup> It was this trend of bank failures which ultimately influenced the enactment of formal Federal Deposit Insurance legislation in 1933.<sup>30</sup>

The emergence of the Deposit Insurance Scheme in the US was occasioned by the financial distress experienced by commercial banks during the 1930's, but which recurred later as well during the 1980's and in 2008 respectively. It was

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<sup>24</sup> See note 5 at p-1 of 2.

<sup>25</sup> Ibid

<sup>26</sup> Mhtml:file:///E:\Define Deposit Insurance eHow\_com.mht at 1 of 2.

<sup>27</sup> Mhtml:file:///E:\ (note 45) at 1 of 2.

<sup>28</sup> Mhtml:file:///E:\ (note 45) at 1 of 2.

<sup>29</sup> IDIC (note 2) at 1 of 2

<sup>30</sup> IDIC (note 2) at 1 of 2.

these incidents of financial difficulties within the financial institutions that highlighted the problem of bank failures globally.<sup>31</sup>

The FDIC was established in terms of section 12B of the Federal Reserve Act of 1933.<sup>32</sup> The Federal Reserve Act was amended by Banking Act of 1935 which brought about a permanent protection of depositors.<sup>33</sup> FDIC operates as an authority.<sup>34</sup> FDIC operates a Fund which derives its sources from participant banks and has an access to Funds from the US government.<sup>35</sup> The founding of the authority is the joint responsibility of the private sector and the Federal Government.<sup>36</sup> FDIC unlike other deposit insurance schemes such as the one operated in the UK, is vested with powers to supervise the insured banks as well as playing a leading role in the actual resolution of distressed banks.<sup>37</sup> The amount of premium paid by contributory banks is determined by the level of risk to which each insured institution is exposed to. This means that in the event that the insured member is exposed to more risk, then the paid premium will be higher than where the risk exposure is less and this is called a differential risk-based premium system.<sup>38</sup> Individual depositors are covered up

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<sup>31</sup> This refers to the situation whereby banks financially affected to a point where they are unable to their obligations to depositors as and when they fall due.

<sup>32</sup> 'History of Bank Deposit Insurance.' (Available from [mhtml:file:///E/History of Bank Deposit Insurance eHow com.mht.](mhtml:file:///E/History%20of%20Bank%20Deposit%20Insurance%20eHow.com.mht)) at 1. Accessed on 13/05/2011.

<sup>33</sup> Eh.

<sup>34</sup> Safali,O & Gurgay, E. *'A Research on Designing an effective Deposit Insurance Scheme for TRNC with particular emphasis on Public Awareness'* (2008) Issue 7. International Research Journal of Finance and Economics at 3. (Available from- <http://www.eurojournals.com/finance.html>). Accessed on 0/10/2011

<sup>35</sup> Safali & Gurgay (note 53) at 3.

<sup>36</sup> Safali & Gurgay (note 53) at 3.

<sup>37</sup> Laeven, L *'Resolution of Failed Banks by Deposit Insurers : Cross Country Evidence.'* (March, 2006) at 2 ( Available from- <http://www.tilburguniversity.edu/webwijs/files/centre/beck/publications/safety/resolution.pdf>). Accessed on 07/10/2011.

<sup>38</sup> Choi (note 6) at 70.

the maximum of USD 100 000 per account.<sup>39</sup> Although FDIC provides a higher deposit coverage it is on rare occasions that it provides compensation to depositors of failed banks.<sup>40</sup> In the contrary, it employs a transaction referred to as Purchase and Assumption (P & A).<sup>41</sup> P & A permits the FDIC to transfer the covered deposits and assets of a failed bank to another bank which is still sound in terms of operations. The fund is used either to bridge the shortfall or to facilitate the receiving bank to make lucrative deals with depositors.<sup>42</sup> The remaining assets and liabilities of a failed bank as well as unprotected deposits are left with the estate of the receiving bank awaiting the usual insolvency proceedings.<sup>43</sup>

The three episodes of financial crisis are as follows: The first episode of the financial crisis is traced as far back as 1929-1933 when the entire world was faced with serious economic difficulties which predominantly affected the US and came to be known as the Great Depression.<sup>44</sup> The repercussions of the Great Depression were so intense that it warranted the US government to establish a Federal Deposit Insurance Corporation (FDIC) through legislation.<sup>45</sup> The FDIC was intended to provide a safety net which would cover individual depositors of commercial banks against possible bank failures.

The second episode of the financial crisis was experienced during the 1980 up to early 1990's. The financial distress in the commercial banks was believed to have been caused by the bailout of savings and loans which negatively affected commercial banks and savings banks.<sup>46</sup> The third episode was classified to be the recent financial crisis which occurred in 2008 and was often referred to as

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<sup>39</sup> Taylor, M '*Sleep more easily.*' (May, 2008) *Financial World*. At 31. (Available from – <http://www.financialworld.co.uk>). Accessed on 07/10/2011

<sup>40</sup> Taylor, M (note 58) at 31.

<sup>41</sup> Taylor, M (note 58) at 31.

<sup>42</sup> Taylor, M (note 58) at 31.

<sup>43</sup> Taylor, M (note 58) at 31.

<sup>44</sup> [Http://en.wikipedia.org/wiki/Federal 'Deposit\\_Insurance\\_Corporation'](http://en.wikipedia.org/wiki/Federal_Deposit_Insurance_Corporation) at p-2 of 10.

<sup>45</sup> Federal Reserve Act, 1933.

<sup>46</sup> [Http://en.wikipedia.org](http://en.wikipedia.org) (note 10)

a Great Recession. The consequences of the global financial crisis in the US were that a significant number of banks became insolvent and were taken over by FIDC. The process of taking over of banks which failed as a result of the crisis triggered bank runs to most of the banks and the magnitude of the crisis was up scaled.<sup>47</sup>

### **3.1.2 United Kingdom (UK)**

In United Kingdom, deposit insurance system was established as a result of the turbulent economic conditions which affected its financial sector during the era of Great Depression. However, the intervention aimed at rescuing the then ailing financial sector could not be operationally sustained due to the voluntary model of deposit insurance system adopted under Policyholders Scheme which was established in 1975.<sup>48</sup> The voluntary nature of a deposit guarantee scheme had a problem of adverse selection.<sup>49</sup> The United Kingdom has had a range of deposit guarantee schemes prior to the current Financial Services Compensation Scheme (FSCS) in a pursuit of a suitable guarantee scheme.<sup>50</sup> The second deposit guarantee scheme was established in 1979 and it was known as Deposit Protection Board (DPB). DPB was succeeded by the Investors Compensation Scheme which was established in 1988 and ultimately the FSCS, which is currently operating was established in 2000. It is relevant to indicate that current deposit protection scheme (FSCS) is operating multifaceted financial guarantee sub-schemes which cover deposits, insurance (life and non-life), investment institutions, mortgage issues as well as general insurance.<sup>51</sup>

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<sup>47</sup> Ibid.

<sup>48</sup> A scheme established through Financial Services and Markets Act 2000 (A Framework for guarantee Schemes in the EU: A discussion paper) at 29.

<sup>49</sup> Adverse selection is a situation when only the worst risks seek to take advantage of protection and this usually results in a nonviable system.

<sup>50</sup> Ibid.

<sup>51</sup> Ibid.

Deposit insurance scheme is structured in such a way that its funding and administration remains the exclusive domain of the private sector.<sup>52</sup> Deposit insurance scheme in UK has ceased to exist as a separate entity since coming into effect of the FSCS.<sup>53</sup> Deposit insurance scheme in UK does not operate a prepaid fund but uses a system whereby an assessment is conducted at the time a particular bank fails to figure out the amount of compensation required for reimbursement of depositors.<sup>54</sup> The amount to be contributed by contributory institutions is subsequently issued all existing banks.<sup>55</sup> The FSCS will then execute its administrative function of paying out claims instituted by depositors.<sup>56</sup> The compensation is normally insufficient so that depositors are responsible to insure the amount of deposits which are not covered under FSCS through the core-insurance concept.<sup>57</sup> The nature of deposit insurance in UK is framed in such a way that failure of a deposit taking institution is treated similar to any other company which could be subjected to the normal winding procedures for purposes of repay its creditors including depositors.<sup>58</sup> Deposit insurance scheme in UK is complemented by co-insurance, a system similar to the one which is prevalent in the Dutch deposit guarantee scheme.<sup>59</sup>

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<sup>52</sup> See note 18 at 3.

<sup>53</sup> See note 22 at 30.

<sup>54</sup> Ibid.

<sup>55</sup> Ibid.

<sup>56</sup> Ibid at 32.

<sup>57</sup> Ibid at 30.

<sup>58</sup> Ibid.

<sup>59</sup> Dijkstra, R J and Faure, M G 'Compensating victims of bankrupted financial institutions: a law and economic analysis.' (2011) Vol.19 No.2 156 at 159. *Journal of Financial Regulation and Compliance.* ( Available from <http://dx.doi.org/10.1108/13581981111123861> through [www.emeraldinsight.com/1358-1988.htm](http://www.emeraldinsight.com/1358-1988.htm)). Accessed on 26/07/2012.

### **3.1.3 India**

The second country to adopt the concept of deposit insurance was India which incorporated it in its banking system in 1962.<sup>60</sup> The idea of establishing deposit insurance in India was influenced by the bank failures which occurred during the 18<sup>th</sup> to early 19<sup>th</sup> century. A classic example of bank failure was experienced by Travancore National and the Quilon Bank shortly after the establishment of the Reserve Bank of India in 1938.<sup>61</sup> A similar incident recurred in during the period 1946 to 1948 as a result of the catastrophic banking crisis in Bengal.<sup>62</sup> The latter incident reiterated a need for the establishment of deposit insurance as a way of redressing the situation which was prevailing in India at the time. The proposed measure was put on hold to enable the promulgation of the legislation facilitating the regulation of banks by the Reserve Bank of India which came into force in 1949.<sup>63</sup> The collapse of Laxmi Bank in 1960 and the Palai shortly thereafter reiterated the decision to bring about the concept of deposit insurance and this led to the enactment of the relevant legislation for deposit insurance.<sup>64</sup>

The Deposit Insurance and Credit Guarantee Corporation (DICGC) is an established public institution which is governed by a board of directors.<sup>65</sup> The chairmanship of the board is taken by the Deputy Governor of the Reserve Bank of India.<sup>66</sup> The authorized share capital of the DICGC is Rs 50 crore[ and it is entirely contributed by the Reserve Bank having secured the approval of the legislature.<sup>67</sup> DICGC is fully owned subsidiary of the Reserve Bank of

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<sup>60</sup> The Reserve Bank of India 'The History of Deposit Insurance in India' (Available from [www.rbi.org.in/scripts/fun\\_deposit.aspx](http://www.rbi.org.in/scripts/fun_deposit.aspx)) at 1 of 2.

<sup>61</sup> Dijkstra and Faure (note 78) at 1 of 2.

<sup>62</sup> Dijkstra and Faure (note 78) at 1 of 2.

<sup>63</sup> Dijkstra and Faure (note 78) at 1 of 2.

<sup>64</sup> Deposit Insurance Corporation Act, 1961.

<sup>65</sup> See note 22 at 80.

<sup>66</sup> Ibid.

<sup>67</sup> Ibid.

India.<sup>68</sup> The board of DICGC is accountable to both the parliament and the Reserve Bank of India. DICGC is not empowered to regulate financial institutions and it is logical to assume that it relies on the supervisory reports from the Reserve Bank of India to execute its functions in respect of financial institutions.<sup>69</sup> DICGC used to maintain two separate funds viz deposit insurance fund and a credit guarantee fund funded by premiums and guarantee fees from contributory members to take care of depositor's claims.<sup>70</sup> There is also an additional fund known as the general fund where the capital of the scheme is held and this fund is responsible for the day to day running of the scheme.<sup>71</sup> It is pertinent to indicate that the credit guarantees were phased out in 1990 as result of financial sector reforms and hence the deposit insurance scheme in India focuses on the core function of deposit insurance.<sup>72</sup>

### **3.1.4 Kenya**

The idea of deposit insurance evolved around 1983 in Kenya.<sup>73</sup> The inception of deposit insurance concept in Kenya came when the banking sector experienced the crisis attributed to a grave solvency and liquidity problem emanating 20 years after attaining independence from the British in 1963.<sup>74</sup> The government of Kenya responded to this crisis by bailing out the banks under distress. However, a similar problem recurred in 1984 and led to the closure of one bank.<sup>75</sup> It was these incidents of bank failure which triggered the discussion on

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<sup>68</sup> Ibid.

<sup>69</sup> Ibid at 82.

<sup>70</sup> Ibid at 83.

<sup>71</sup> Ibid.

<sup>72</sup> The Reserve Bank of India '*Brief History of Deposit Insurance in India*' *First annual report*. At 1. ( Available from [http://www.rbi.org.in/scripts/fun\\_deposit.aspx](http://www.rbi.org.in/scripts/fun_deposit.aspx) Accessed on 27/06/2011

<sup>73</sup> Banking crisis, failures and closures in post-independence Kenya. (June 2009) at 1 of 1.

<sup>74</sup> Ibid.

<sup>75</sup> Ibid.

the need to strengthen the then existing safety nets and resolution mechanisms.<sup>76</sup> The effort of addressing the problem of bank failures eventually precipitated into the amendment of the Banking Act of 1985.<sup>77</sup>

The deposit insurance scheme in Kenya was explicitly established in 1985 through an amendment of the Banking Act which set up Deposit Protection Fund Board (DPFB).<sup>78</sup> DPFB is established as a public institution managed by a board of directors. The board comprise the Governor of the Central Bank of Kenya, the Permanent Secretary of the Treasury and five members drawn from the contributory members.<sup>79</sup> The board members are appointed by the Minister responsible for Finance.<sup>80</sup> Membership is compulsory for all deposit taking institutions. Members are subjected to the same amount of premiums regardless of their risk exposure and this known as the 'flat-rate' premium system. DPFB is vested with powers to revoke membership of any institution whose conduct threatens the interests of the scheme and its participants.<sup>81</sup> DPFB is sponsored by annual premiums contributed by member banks.<sup>82</sup> However, in the event that there is an emergency, a contingency fund could be secured from the Government and the Central Bank of Kenya.<sup>83</sup> DPFB covers bank deposits up to a maximum of Kshs. 100, 000.00 per account.<sup>84</sup> The aspect of supervision of member institutions remains with the Central Bank of Kenya and DPFB works closely with the supervision Department of the Central Bank to oversee the performance of all banks. Although DPFB could execute the

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<sup>76</sup> Ibid.

<sup>77</sup> IADI. Available from [http://www.iadi.org/profiles/DPFB\\_Kenya\\_Profile\\_June\\_2009.pdf](http://www.iadi.org/profiles/DPFB_Kenya_Profile_June_2009.pdf) (retrieved on 01/08/2011)

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid.

<sup>82</sup> Ibid

<sup>83</sup> Ibid

<sup>84</sup> Ibid

functions of a liquidator of a failed bank,<sup>85</sup> it cannot supervise member institutions.

### **3.1.5 Nigeria**

The problem of bank failure in Nigeria emanated prior to 1952 when the notion of free banking was prevalent.<sup>86</sup> The subsequent introduction of the relevant banking legislation<sup>87</sup> was seen as an attempt to formally counteract the problem of bank failure in Nigeria. Despite this significant effort to address the problem of bank collapse, the situation got worse as more banks continued to collapse and reflected a similar situation which occurred in the US during the period 1787 and 1861<sup>88</sup> where a significant number of banks emerged and collapsed within a short space of time. In the Nigerian case, about three banks failed prior to the enactment of Banking Ordinance of 1952.<sup>89</sup> The problem of bank failures extended even to post 1952 regime where about eighteen banks were reported to have collapsed between 1952 and 1954 resulting from mismanagement as well as non-compliance to sound banking practices.<sup>90</sup> It therefore follows that in each incident of bank failure, individual depositors faced the loss since there was no safety net of any form to rescue the situation. It was on the basis of the recurring bank collapse, the liberalization and deregulation banking policies which existed around 1980s and the underlying Basel requirements of liquidity and solvency which necessitated the establishment of Nigerian Deposit Insurance Corporation (NDIC) in 1998 to respond to challenge of bank failure in Nigeria.<sup>91</sup>

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<sup>85</sup> Ibid.

<sup>86</sup> Nwobasi, B.S.N. 'Critical Assessment of the role of Central Bank of Nigeria (CBN) and Nigerian Deposit Insurance Corporation (NDIC) on failed Banks in Nigeria.' (1994-2003) 2004 at 1. (Available from [www.ndic.com](http://www.ndic.com). Accessed on 15/07/2011).

<sup>87</sup> Ibid, banking ordinance, 1952.

<sup>88</sup> Ibid.

<sup>89</sup> Ibid.

<sup>90</sup> Ibid.

<sup>91</sup> Ogunleye, G 'Deposit Insurance Scheme in Nigeria: Problems and prospects.' (May, 2002). BASEL, Switzerland. At 2 (Available

The NDIC is a public entity whose ownership is exclusively vested to the Federal Government of Nigeria through the Central Bank of Nigeria and the Ministry of Finance.<sup>92</sup> Membership of the scheme is compulsory in Nigeria.<sup>93</sup> NDIC is mainly funded from several sources including insurance premiums collected from participating institutions, capital contributions, special fees imposed on viable members during emergency situations and this is done pursuant to Section 21(3) of the NDIC Act 1988 (as amended).<sup>94</sup> Bank deposits are protected up to the maximum of 50, 000.00 Naira and an approval by the board pending formalization through amendment to the NDIC Act<sup>95</sup>. NDIC Act also vests the supervisory function of all insured institutions to the Corporation.<sup>96</sup> The corporation undertakes the supervisory role by way of on-site examination as well as off-site surveillance of participant banks.<sup>97</sup> NDIC can also participate in the resolution of a distressed bank in as much as it could be appointed as a liquidator to pay out proceeds of liquidation to bank depositors.<sup>98</sup> However the power to penalize members for violation of laws administered by the Central Bank of Nigeria remains with the Central Bank.<sup>99</sup>

### **3.1.6 Zimbabwe**

Zimbabwe operated deposit insurance as a separate entity working outside the Reserve Bank but which had been established under the Banking Act 2003. It

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from <http://www.proshareng.com/admin/upload/reports/NDICs%Deposit%Insurance%Scheme%20in%Nigeria%20Problems%20Prospects%20>. Accessed on 07/10/2011

<sup>92</sup> See note 77 at 5.

<sup>93</sup> Ibid.

<sup>94</sup> Ibid. at 6.

<sup>95</sup> Ibid. at 7.

<sup>96</sup> Ibid.

<sup>97</sup> Ibid.

<sup>98</sup> Ibid at 9.

<sup>99</sup> Ibid at 12.

could be inferred from the manner in which the Zimbabwean Deposit Protection Board (DPB) was established that the facility does not exist as an absolutely independent entity since it is established under the Banking Act of 2003 administered by the Reserve Bank of Zimbabwe.<sup>100</sup> Deposit insurance facility (DPB) was established by the Reserve Bank of Zimbabwe in 2003 through section 66 of the Banking Act of 2003.<sup>101</sup> . It utilized funds from the International Monetary Fund (IMF) as seed capital. It is of significance that the financial sector experienced a bank collapse during the first 6 months of existence of DPB. The scheme provides protection of all forms of deposits including savings, current, time deposits, uninvest bankers, manager's cheques, money orders, drafts and travellers cheques.<sup>102</sup> Bank deposits are covered to a ceiling of 90 per cent per account.<sup>103</sup> The membership to the scheme is compulsory and comprises all deposit taking institutions.<sup>104</sup> In Zimbabwe, although DPB operates as a separate entity with its board, it has been established under the Banking Act, 2003 and relies on Department of Supervision for information relating to supervision reports.

This chapter compared different jurisdictions where it was found out that design features in each jurisdiction differ depending on the circumstances prevailing in each country.

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<sup>100</sup> Annual Report '*Deposit Insurance Board of Zimbabwe.*' (2006) at 10.

<sup>101</sup> Zhanje, T '*Deposit Protection Board Explained.*' Zimbabwe Independent. At 1. (Available from <http://allAfrica.com/stories/201106270369.html>.) Accessed on 07/10/2011

<sup>102</sup> Ibid.

<sup>103</sup> Ibid.

<sup>104</sup> See note 88 at 11.

## CHAPTER FOUR: LITERATURE REVIEW

This chapter is intended to explore the literature and theories on the deposit insurance

TheThis chapter would start by looking at the international best practices on deposit insurance. The idea of developing an instrument which could serve as the benchmark for international best practices in as far as deposit insurance is concerned was conceived in July, 2008 by the Basle Committee on Banking Supervision (BCBS) working in collaboration with the International Association of Deposit Insurers (IADI).<sup>105</sup> A working team comprising the representatives from BCBS and IADI commissioned to develop a set of core principles for consideration and adoption by BCBS and IADI. It was as a result of this initiative that a working document titled 'Core Principles for effective Deposit Insurance systems' was formulated and sanctioned by the international community in June 2009.

The core principles of effective deposit insurance systems were highlighted by Garcia<sup>106</sup> with the international best practices as articulated in the core principles for effective deposit insurance systems, argued that an ideal deposit insurance must entail the following features: be explicitly established by a piece of legislation, compulsory and must be supported by comprehensive procedures intended to provide guidance for accounting, loan valuation, regulation as well as supervision. It was also argued that the deposit insurance should have powers and the adequate information to provide resolution to

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<sup>105</sup> IADI was established in 2002 with a mission to contribute to the enhancement of deposit insurance effectiveness by promoting guidance and international guidance and international cooperation. The IADI Core Principles were developed for the benefit of countries considering the adoption of the reform of a deposit insurance system.

<sup>106</sup> Garcia, GG 'Protecting Bank Deposits' (1997) .9 IMF Economic Issues 9, at 4.

ailing banks as well as dealing effectively with insolvent banks. The argument was extended further to require the deposit insurance system to be established under a stable economic environment and should extend equal treatment to large, small, private and state-owned banks as well as putting limited coverage of all types of deposits and lastly to have effective failure resolution mechanism to provide prompt reimbursement upon the failure of a bank.

According to *some authorities*,<sup>107</sup> the history of banking dates back as far as the Renaissance era particularly from Italy where the role of banks was not solely confined to purchasing and selling foreign currencies as they also executed additional function of accepting demand deposits hence the experience of bank failures also existed. As indicated in the introductory chapter deposit insurance had been identified as part and parcel of countries' regulatory safety nets and hence it is important to link it with banking and regulation. In tandem with the latter argument it was argued as follows<sup>108</sup> *'It is widely believed that consumers cannot distinguish a sound bank from an unsound one, and such an information deficiency is the principal reason for government regulation of the operations of the banks.'* Similarly, it was also argued that *'bank failures are not comparable with failure of other enterprises in that failure of latter has an impact largely on owners of the business whereas failure of the bank has adverse effects on depositors.'*<sup>109</sup>

It is also important to point out that the concept of deposit insurance had been found be important in the sense that it serves as a useful instrument to address instability in the banking industry however it required to be complemented by the comprehensive system of regulation to cushion the deposit insurance system from grave losses occasioned by loss of market

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<sup>107</sup> Nwobasi, (note 105) at 9.

<sup>108</sup> Horvitz, P & Ward, R 'Monetary Policy and the Financial System.' (1987). Prentice Hall, inc. USA, at 205.

<sup>109</sup> Horviz & Ward (note 127) at 205.

discipline.<sup>110</sup> A system of regulation may include capital ratio requirements and deposit expansion multiplier as provided by Basel I and Basle II.<sup>111</sup>

I had developed an assumption that the reason underlying the absence of the legal regime for deposit insurance providing a national deposit insurance system was occasioned by previous government intervention measures to reimburse depositors during the past two incidents of bank failures.<sup>112</sup> It was as a consequence of the latter assumption that the researcher conducted investigations to determine the basis upon which the government of Lesotho exercised its discretion to bail out individual depositors of failed banks. There are various authorities written to indicate the role of government in the protection of depositors where there is no formal legal regime establishing a deposit insurance system. According to *other scholars*<sup>113</sup> there is in effect no vacuum in as far as deposit protection issue is concerned since the government in one way or another has got discretion to protect the members of the public during failures and this argument is phrased as follows:

*In this respect it is believed that in every country at least a de facto deposit insurance system exists: This means that implicit form of guarantee is in place, which usually derives from the necessity to manage the effects of a wide systemic crisis.*

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<sup>110</sup> Horviz & Ward (note 127) at 205.

<sup>111</sup> Hsiao, M 'Deposit insurance scheme as the final destination-mapping the financial market.' (2011) Vol. 11. No. 26. *Journal of International Banking Law and Regulation* at 1 (Available from <http://ssrn.com/abstract=1971742>. Accessed on 26/07/2012.

<sup>112</sup> Failure of LADB and LB.

<sup>113</sup> Forum of Deposit Insurers 'Deposit Guarantee Systems: EFDI's First Report.' Rome (October, 2006) Interbank Deposit Protection Fund Research and Data Analysis Department, at 14.

Similarly other authors<sup>114</sup> argue that the deposit taking institutions are crucial to the economic development and that by virtue of their operations they affect all financial sector stakeholders and in particular, members of the public hence government's intervention in an effort to protect depositors against loss of deposits arising from failure of banks. The latter argument as follows:

*Because the operations of financial institutions affect all stakeholders including the general public, there is no government that does not utilize various means, both direct and indirect, to minimize any damage that might be inflicted on the rights and interests of depositors as a result of failure of financial institutions.*

The argument advanced above is reiterated by the same school of thought<sup>115</sup> by providing that 'Without a deposit insurance system, many countries particularly in Africa have extended implicit deposit protection depositors on a discretionary ad hoc basis'

Deposit insurance was said to be categorized into main types namely explicit or implicit. Some authorities<sup>116</sup> explained the forms of deposit insurance as follows:

*Deposit insurance can be explicit or merely implicit. Explicit insurance coverages are contractual obligations; implicit coverages are only conjectural. Implicit insurance exist to the extent that political incentives that influence a government's reaction to large or widespread banking problems make taxpayer bailouts of insolvent banks seem inevitable. Every country offers implicit insurance because during the crises, pressure on government officials to rescue at least some bank stakeholders becomes difficult to resist.*

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<sup>114</sup> Ogunleye, G 'Concept and Relevance of Deposit Insurance in Africa.' Text of paper presented at the 10<sup>th</sup> Meeting of the Committee of Banking Supervision of West and Central Africa in Abuja, Nigeria on 9<sup>th</sup> September, 2004 at 2.

<sup>115</sup> Ogunleye (note 132), at 3.

<sup>116</sup> Demirguc-Kunt, A and Laeven 'Deposit Insurance Design and Implementation: Policy Lessons from Research and Practice.' World Bank Policy Research Working Paper 3969, (July 2006) at 2.

It is also argued that in countries where deposit insurance is explicit, the laws establishing such a facility make it mandatory for the banks to subscribe to it and clearly spell out the obligations of the insurer during and after bank failure.<sup>117</sup> Some authors argue in respect of implicit deposit insurance that it is discretionary in nature and that it exists to as far as there is a political pressure by the members of the public to influence a government intervention to a rescue distressed banks using taxpayer's funds.<sup>118</sup> Other authors,<sup>119</sup> in support of the latter argument provides that:

*The implicit form is a discretionary approach adopted by government to prop up some failing deposit-taking institutions in the absence of an explicit statutory obligation on the part of government to protect depositors. The government is therefore, at liberty to decide whether or not to grant any relief to depositors and the amount of such a relief.*

Notwithstanding the arguments advanced by the proponents of implicit deposit insurance some scholars<sup>120</sup> advocate an explicit instead of implicit deposit insurance system, they however, expressed that in the event that explicit system is not in place, governments have used implicit system to protect depositors of distressed financial institutions. They also went on to make a distinction between explicit and implicit systems by outlining the features of an implicit deposit insurance system and they indicated that:

*The basic features of implicit deposit protection are:*

- *The absence of a written law, such that government is not legally obliged to provide protection, and the extent of such protection is circumscribed by previous practice or the pronouncements of government officials;*

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<sup>117</sup> Ibid at 2.

<sup>118</sup> Ibid.

<sup>119</sup> See note 12 at 2-3.

<sup>120</sup> See note 2 at 72.

- *The absence of explicit rules regarding coverage limits and form of compensation, and discretionary funding by the government in the event of failure, and*
- *Absence of earmarked funds for assistance.*

It is also worth exploring what other scholars have to say about the explicit deposit insurance system. The explicit deposit insurance is understood by other authors as the system which is formally established through a legal regime and a typical example being a legislation which outlines the intended aim of the facility as well as guidelines regarding a number of aspects entailed during the intervention of the facility prior to failures, during the process and post failure. Some scholars<sup>121</sup> describe explicit deposit insurance as follows:

*An explicit DIS is created by a legal instrument. The enabling statute usually states the objectives of the scheme and other operational guidelines relating to such issues as ownership, funding, extent of coverage, membership, supervisory and resolution powers, amongst others. Specifically, an explicit DIS provides a formal framework with clear-cut rules and procedures for providing protection to depositors as well as for assessment and management of failed and failing deposit-taking institutions.*

In order to determine whether the deposit insurance system is explicit or implicit in any particular jurisdiction the formalities surrounding its operations are looked at and in the event that the deposit insurance system is established by a legal instruments then it could be concluded that it is explicit and anything short of this formal arrangement is considered as an implicit deposit insurance system.<sup>122</sup> Other authorities,<sup>123</sup> emphasize the latter distinction in the following words:

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<sup>121</sup> See note 12 at 5.

<sup>122</sup> Demirguc-Kunt, A and Sobaci T 'Deposit Insurance around the World.' (2001). Vol.15.No.3. The World Bank Economic Review. 481 at 482.

<sup>123</sup> Demirguc-Kunt and Sobaci (note 141) at 482.

*...Deposit insurance is explicit if some form of legislation, such as the central bank law, banking, or the constitution, establishes a guarantee scheme for deposits. In the absence of such formal arrangements, we assume that the country has an implicit deposit insurance system.*

I had presumed that the Government of Lesotho did not exercise its discretion consistently when bailing out depositors in incidents of bank failure. I had also had an assumption that the Government of Lesotho did not exercise its discretion in all cases warranting bailout of deposits in distressed financial institutions. It was on the basis of this assumption which called for a need to conduct investigations in order to verify these assumptions. According to *some authors*,<sup>124</sup> those countries with no formally established deposit insurance have offered protection to depositors on a discretionary temporary basis. The absence of a guaranteed protection, it is argued could result into uncertainties in the system particularly the guidelines on the handling of a failing or failed bank. The latter view was also supported by report by *other authorities*<sup>125</sup> as follows:

*Policy makers have many choices regarding how they can protect depositors. Some countries have implicit protection that arises when public, including depositors and perhaps other creditors expect some form of protection in the event of a bank failure. This expectation usually arises because of governments past behaviour or statements made by officials. Implicit protection is, by definition, never formally specified. There are no statutory rules regarding eligibility of bank liabilities, the level of protection provided or the form which reimbursement will take. By its nature, implicit protection creates uncertainty about how depositors, creditors and others will be treated when bank failures occurs. Funding is discretionary and often depends on the government's ability to access public funds.*

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<sup>124</sup> See note 12 at 12.

<sup>125</sup> Financial Stability Forum. 'Guidance for Developing Effective Deposit Insurance Systems.(07 September, 2001) at 12.

On the other hand other writers<sup>126</sup> argued that some scholars have a universal presumption that whether or not a country has an explicit deposit insurance, every country has an implicit deposit insurance system in place to enable governments to undertake their responsibility of protecting the entire financial system and the national economy in the event that a systemic banking crises ensue.

I had also presupposed that the government's decision to reimburse depositors during the failure of the Lesotho Agricultural Development Bank (LADB) and Lesotho Bank (LB) influenced by the fact that it held 100 per cent shareholding in both banks. This study is intended to investigate the factors which influenced the decision of the government to intervene in addressing problems of banks which were distressed. It has been argued that <sup>127</sup>, policy makers have made it a norm to establish a financial safety net in an effort to minimize shocks which are prominent in the banking sector. It is argued that the said disruptions in the financial system are likely to cause fiscal costs. It was also argued that the safety net normally entails implicit and explicit deposit insurance, lender of last resort facilities available at the central banks, guidelines for regulating and supervising banks and statutory provisions for accessing emergency assistance from multi-national institutions such as IMF. In support of a reason why governments protect their banks *it has been argued*<sup>128</sup>

*Long ago economists identified the fact that for a country's economy to prosper and grew it must possess a well-functioning banking sector. The financial function of banks is the locomotive force behind an economic expansion.*

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<sup>126</sup> Dijkstra and Faure (note 67) at 160.

<sup>127</sup> Demirguc.A. and Kane E. 'Deposit Insurance Around the Globe. Where does it work?.' (2002) Vol.16 .No.2 P-175- 195.

<sup>128</sup> Gecchetti and Krause. 'A Research on Designing an effective Deposit Insurance Scheme for TRNC with particular Emphasis on Public Awareness.' (2007) *International Research Journal of Finance and Economics*. Issue No.7. at 202.

*Therefore, governments around the world have sought to regulate and protect their banks.*

It was also of the presumption that the absence of regulation on the deposit insurance is sustained by the current banking structure in Lesotho where the banking sector is dominated by foreign subsidiaries of South African commercial banks which stand a chance of being rescued by parent banks. The objective of the study had been to investigate whether there were any existing arrangements between subsidiaries and their Headquarters in South Africa to compensate depositors of subsidiaries across the border. Some reports provide that<sup>129</sup> in some countries foreign branches are included in the national deposit insurance scheme. It was argued that the wisdom of making it compulsory for foreign branches to be included in the host country deposit insurance scheme was to provide a guarantee protection of all eligible depositors. It was however argued that the approach was not free of risks to the smooth running of host country deposit insurance scheme particularly if foreign branches did not have sufficient supervisory framework. The latter measure could be ensured by requiring foreign banks to pledge assets as a capital substitute as well as conforming to capital adequacy and regulatory requirements spelled out in the legal framework of the host country.

It is also important to indicate that whereas it was not disputable that South Africa has a well-developed banking sector which utilised the Morden systems in technology and information management and that banks had historically reported high profit margins by in the global markets<sup>130</sup>, it is not immune from the effects of bank failure as it had been reflected by the recent failure of South African banks such as Alpha Bank, Cape Investment Bank (CIB), Pretoria

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<sup>129</sup> Htt : //www. EDF \_First Report [1].pdf. At 3 of 8.

<sup>130</sup> Okeahalam,C '*The Political Economy of Bank Failure and Supervision in the Republic of South Africa.*'(1998) Vol.3 No.2, *African Journal of Political Science.* 29-48 at p-31.( Available from- <http://archive.lib.msu.edu/DMC/African%20journals/pdfs>). Accessed on 18/01/2011

Bank, Sechold Bank, Prime Bank, Islamic Bank of South Africa (IBSA) during 1990s.<sup>131</sup> South African financial system appears to be stable regard being had to high liquidity ratios reported by South African banks particularly core banks such as Amalgamated Banks of South Africa Limited (ABSA), Standard Bank Investment Corporation Limited (Stanbic), First National Bank Holdings Limited (FNB) and Nedcor Limited (Nedcor) ,all of which have subsidiaries in Lesotho save ABSA.

It is also argued that where there is a cross-border banking arrangement there is possibility of threat posed by the wholesale transfer of local subsidiaries' funds to the parent banks housed in another country, to back up its liquidity as well as increasing commercial returns<sup>132</sup>

I also had also presupposed that absence of the legal regime establishing deposit insurance in Lesotho was due to the size of the banking sector which was considered to be very small. I had also presumed that the financial system was stable and did not pose an immediate threat to the national economy. The aim of the study is to investigate whether the absence of the legal framework establishing deposit insurance is induced by the size of the banking sector. The research paper was also intended to investigate whether the Lesotho's financial system was stable. Scholars<sup>133</sup> argued that a properly administered bank can nonetheless fail due to factors beyond control of the management. A typical example was identified to be a failure occasioned by factors external to the bank such as financial crisis, political disturbances and threats of war.

I also hypothesized that South Africa does not have deposit insurance facility .The research paper also seeks t to verify the authenticity of the latter assumption. In providing a justification for a lack of clearly defined and explicit

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<sup>131</sup> Ibid at 35 to 38

<sup>132</sup> Morris, P E 'Bank failure and Deposit protection in Offshore Britain: the case of Guernsey.' (2010).Vol.18.No.3: pp272-292 at 276.

<sup>133</sup> See note 12 at 11.

deposit protection scheme for depositors in South Africa, other authors<sup>134</sup> provide that as a result of a clear commitment on the part of the regulatory authorities in South African to offer unconditional support to the major banks, it was possible that the authorities may not wish to be explicit or unconditional since the depositor protection had already been assured by making a commitment. A journalist reporting for City Press <sup>135</sup> reported as follows:

*It emerged at a banking summit ... that the Treasury wanted to introduce the scheme to safeguard depositors in the event that local banks went bankrupt.*

*The journalist*<sup>136</sup> further reported that:

*Implicitly there is already a deposit insurance scheme in South Africa but it is paid by the state and not the banks. When Saambou failed, the government stepped in to guarantee the deposits and bail out the bank.*

*Nearly a decade ago the government had to step in to guarantee the deposits in now defunct lenders Saambou and BoE as it sought to prevent a run by depositors on other smaller local banks.*

According to investigations undertaken previously, report reveal that a total of three major South African commercial banks have clearly supported the idea that South African banking sector needs a deposit insurance scheme.<sup>137</sup>

A similar argument in support of the establishment of explicit deposit insurance for South Africa was reported to have been advanced at the at the second annual banking summit, coordinated by Banking Association of South Africa (BASA) where the National Treasury indicated that efforts were underway

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<sup>134</sup> Okehalam (note 148) at 30.

<sup>135</sup> Ntingi. A. 'Banks not so keen on deposit insurance plan.' August 28 (2011) at 1 of 3 . (Available from <http://.Finn24.com/Companies/Financial-Services/Banks-not-keen-on-deposit-insur>. Accessed on 31/08/2011.

<sup>136</sup> <sup>136</sup> Ntingi. A. (note)at 2 of 3.

<sup>137</sup> Business Live, 'Banks are open to deposit insurance.' At 2 of 4.(Available from [http://businesslive.co.za/southafrica\\_markets/2011/07/16/banks-are-open-to-d...](http://businesslive.co.za/southafrica_markets/2011/07/16/banks-are-open-to-d...) Accessed on 31/08/2011)

for the consideration of issuing a proposal on explicit deposit insurance scheme for the protection of clients deposits.<sup>138</sup> The same journalist<sup>139</sup> reporting on the same article continued as follows:

*Currently in South Africa National Treasury or the taxpayer if you like, bears the risk of deposit insurance should a bank collapse. Close to a decade ago when Saambou Bank was put under curatorship, Treasury had to protect depositors money in the then ailing bank.*

The idea of establishing explicit deposit insurance in South Africa was also highlighted by a reporter for *Mail & Guardian*<sup>140</sup>. The reporter indicated that concerns were raised at the banking summit of BASA held at Johannesburg, where it was indicated that South Africa was on the overall considered to adequately capitalized in terms of BASEL III requirements which have to be implemented by 2013. However the issue of liquidity<sup>141</sup> was seen as an outstanding challenge. It is argued that in terms of BASEL III Banks would be required to have adequate cash readily available to meet their obligations within a period of thirty days. This as was reported might require banks to explore a number of options such as increasing bank charges or establishing an explicit deposit insurance system in an effort to meet its obligations to depositors.

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<sup>138</sup> Nzamela, P ' Treasury mulls pushing banks to pay deposit insurance' (23 August, 2011). Political Economy- Moneyweb Financial Services ( Available from <http://moneyweb.co.za/mw/view/mw/en/page/295025?oid=550406&sn=2009+Detail>. Accessed on 31/08/2011.

<sup>139</sup> Nzamela (note 157).

<sup>140</sup> Steyn, L 'Wake up call for banking sector.' 26 August 2011. *Mail & Guardian* online (Avalble from <http://mq.co.za/article/2011-08-26-wakeup-call-for-banking-sector/>. Accessed on 31/08/11.

<sup>141</sup> Liquidity is explained as the bank's ability to meet its financial obligations to its clients as and when they become due.

It was argued that BASEL III was a reaction to the recent financial crisis which is intended to reform capital and liquidity of banks in an effort to combat the possible occurrence of another financial crisis.<sup>142</sup>

It is further worth closing this chapter by indicating that the issue of creating a special resolution regime intended to facilitate a timely resolution of a failing bank as well as prompt reimbursement of depositors had been underscored by other scholars. According to Singh<sup>143</sup> an effective failure resolution mechanism could take the following forms: 'private sector takes over, the setting up of a bridge bank, temporary nationalisation, bank insolvency procedures or the bank administration procedure'.

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<sup>142</sup> Van Dyk, F '*Basel III: An overview of the safer "safety net"* .' 2011- Official magazine of the SAIFM- the South African Financial Markets Journal (Available from <http://www.financialmarketsjournal.co.za/basel3.htm>. Accessed on 30/08/2011) at 1 of 10.

<sup>143</sup> Singh, D '*The UK Banking Act 2009, Pre-insolvency and early intervention: Policy and Practice.*' Legal Studies Research Paper No.2010-27 at 5.

## CHAPTER FIVE: EVOLUTION OF BANKING SECTOR IN LESOTHO AND EXPERIENCES

### 5.1 Historical context

Lesotho is a small country of about 30,355sq.km in size with a population of about 1.88 million.<sup>144</sup> It became a British protectorate in 1868 and attained independence in 1966. Financial institutions emerged shortly after Lesotho became a British protectorate.<sup>145</sup> They particularly offered banking and insurance services most of which were subsidiaries of foreign banks.<sup>146</sup> The financial sector in Lesotho, like other countries of the world was affected by the circumstances similar to those which existed in the US and perhaps the only distinguishing factor is the extent to which Lesotho was affected by financial crisis throughout the three phases of depression. It is pertinent to indicate that there is no indication that the Great Depression had a direct impact on the Lesotho's financial system and hence there were no reported incidents of failed banks. The researcher anticipated the reason to be that the incident of 'Great Depression' happened at the time when Lesotho still under colonial administration and that arrangements which existed by then could have provided a shock absorber to Lesotho's financial system against the direct impact of the depression. Perhaps the British financial safety net measures developed during the times of economic depression were imported the deposit protection mechanisms which were in existence by then to protect the subsidiaries of British banks such as Barclays Bank Dominion, Colonial and

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<sup>144</sup> Government of Lesotho website,  
<http://www.state.gov/r/pa/ei/bgn/2831.htm#foreign>

<sup>145</sup> Thabane, M ' *Indigenous Entrepreneurial Initiative and attempts to solve Problems of access to Credit in in Lesotho 1868/to/1975.*' At 1. (unpublished).

<sup>146</sup> Thabane (note 163) at 1.

Overseas (DCO), Standard Chartered Bank which started banking operations in 1902 and 1957 respectively.<sup>147</sup>

The second episode of the economic depression manifested itself post-colonial administration and during 1980's to late 1990's. It is apparent that Lesotho encountered a direct impact of the depression since at that time the British government had handed over the administration to Basotho. The post-independence period was characterized by transfer of economic power which was in the hands of foreign companies to indigenous people in Lesotho. There was an effort on the part of the post-independence government to transfer economic activity to Basotho by establishing indigenous banks which were owned by the Government of Lesotho, such as the Lesotho Bank Ltd (LB), which served as a national development and savings bank, the Lesotho Building Finance Corporation and the establishment of Lesotho Agricultural Bank (LADB) during the 1980's. The first experience of bank failures was encountered during the early 1990s and late 1990 have and resulted in the collapse of the two indigenous banks.<sup>148</sup>

It is prudent therefore to reflect the reasons underlying the collapse of both LADB and LB and how the Government of Lesotho responded to these crises:

## **5.2. Lesotho Agricultural Development Bank**

LADB was established in 1976<sup>149</sup> through an Act of parliament and 100 per cent of its shareholding were solely owned by the Government of Lesotho. The

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<sup>147</sup> Matekane, M *'From a banking crisis to restructuring and privatization of state owned banks: The case of Lesotho, 1997-199.'* ( November, 2000) at 1. Unpublished.

<sup>148</sup> Lesotho Agricultural Development Bank and Lesotho Bank in 1998 and 1999 respectively.

<sup>149</sup> Lesotho Agricultural Development Bank, Urgent Actions Report Prepared for the Honourable minister of Finance, Government of Lesotho by International Development Ireland Ltd, August, 1996.

bank was established with the objective of enhancing agricultural development as well as encouraging the promotion of banking and provision of credit services to the rural communities of Lesotho. LADB started its operations as a bank in 1980 and maintained a steady growth from its inception until the mid-1980's when it started making losses.<sup>150</sup> The legislation establishing LADB was revised in 1988 to authorize it to undertake banking operations in addition to its original mandate of operating merely as a development bank in Lesotho. Although the operations of LADB started declining around mid-1980s, serious financial difficulties were experienced by early 1996.<sup>151</sup> The failure of LADB was attributed to the following factors: underestimation of the provision required for bad and doubtful debts, reported frauds, breakdown in basic accounting records, nonperforming loan and investment portfolios, and reliance on high risk lending. The problems of the LADB were found to have exceeded its chances of continuing as an independent bank even if the preliminary proposals to restructure and recapitalize it were implemented since the bank was technically insolvent.<sup>152</sup> In view of the then prevailing circumstances of the bank, the Government of Lesotho appointed the International Development Ireland Ltd (IDI) as provisional administrators of the bank whilst alternative failure resolutions were being explored. According to the KPMG report on the status of the LADB operations at the time, three options were suggested viz, recapitalization of LADB, and merger of LADB with another bank or its liquidation. The Government of Lesotho found the merger option to be the most viable amongst the options however, due to the fast deteriorating conditions of the bank where its assets were reported to be nearing depletion; the

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<sup>150</sup> Ibid.

<sup>151</sup> According to a management audit report compiled by KPMG commissioned by the Ministry of Finance of the Government of the Kingdom of Lesotho following examination reports of the Central Bank of Lesotho outlining problems of LADB.

<sup>152</sup> Ibid.

Government of Lesotho took urgent measures to protect the interests of depositors of LADB and published the following notice:<sup>153</sup>

*In consideration of the severely distressed situation of this Bank (LADB) the intention of the Government is to undertake all such actions as shall safeguard the interests of depositors in the processing of essential restructuring which may include liquidation and transfer of certain rights and obligations to Lesotho Bank or other registered financial institutions.*

Minister of Finance and Development Planning subsequently made a public statement highlighting the possibility that LADB may face an ultimate closure in the event that a suitable partner could not be found. LADB was ultimately closed following a decision of the Government of Lesotho taken on 02 September 1998. The Government of Lesotho Deposited M135 million with Lesotho Bank (LB) to finance the transfer of deposits and the incidental costs of liquidation process. KPMG auditors were appointed as Administrators of LADB to facilitate with the process of closing the bank pending the appointment of liquidators. The liquidation process was duly implemented in 1999.<sup>154</sup>

### **5.3. Lesotho Bank**

Lesotho Bank was a Development and Savings Bank 100 percent owned by the Government of the Kingdom of Lesotho. It was established by the Lesotho government through an Act of parliament known as National and Development and Savings Bank Order 1971.<sup>155</sup> LB commenced its operations in Maseru on 20 October, 1972.<sup>156</sup> Initially the bank operated as a development bank and

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<sup>153</sup> Notice by the Government of Lesotho published in a Gazette on 05 June 1988.

<sup>154</sup> Through the Lesotho Agricultural Development Bank (Liquidation) Act , No. 2 of 199.

<sup>155</sup> Central Bank of Lesotho, Central Bank of Lesotho Board of Directors, Information Paper No: 99/12/M133 at 1.

<sup>156</sup> Ibid.

performed the function of an intermediary through which the donor funds were channelled and disbursed for the national development projects as well as financing parastatals.<sup>157</sup> LB was classified as the largest bank with 16 branches and 9 agencies and in control of 63 per cent of total assets and 67 per cent of total deposits of the banking system.<sup>158</sup> The Bank was placed on provisional administration in December 1997 and the IDI took over following the reshuffle which was made involving 4 employees at the managerial level including the Managing Director. It appears that the problem of liquidity was persistent at the closure of LADB and that the deposit of M135 million by the Government of Lesotho aimed at transferring of deposits somehow delayed the fate of LB. The Bank eventually found Standard Bank of South Africa (SB) as its strategic partner during the restructuring process and purchased 70 per cent of the shares and the remaining 30 per cent was held by the Government of Lesotho.

The third episode of the economic downturn (Great Recession) surfaced in 2008 and its repercussion continues to ravage Lesotho's economy up to this point. A classic example could be discerned from the reduced budgetary provisions to government ministries and a grave decline in the production and exportation of products by the textile and garments factories, loss of jobs occasioned by closure of a number of textile and garments factories when they went out of production, the closure of some of the mining operations, which resulted in the loss of jobs. The impact of the recent financial crisis was not directly visible in the banking sector and perhaps this could be attributed to the fact that the sector comprised of three South African subsidiaries<sup>159</sup> and one indigenous bank.<sup>160</sup> The apparent dominance of South African parent banks might have backed up their subsidiaries to sustain operations in Lesotho during the crisis.

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<sup>157</sup> Draft Cabinet Paper, 'Lesotho Bank Privatisation Scheme' at p1.

<sup>158</sup> This was the position as at the end of October 1998 in terms of the Bank Examination Report prepared by the Central Bank of Lesotho.

<sup>159</sup> Standard Lesotho Bank Ltd, Ned bank Ltd and First National Bank Ltd.

<sup>160</sup> Lesotho Post Bank Ltd.

The sustained operations of the sole indigenous bank<sup>161</sup> were attributed to the fact that its shareholding was 100 per cent owned by government of the Kingdom of Lesotho.

This chapter has provided a background of the banking sector in Lesotho as well as refracting experiences of Lesotho in bank failures as well as the approach of Lesotho government to redress those failures.

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<sup>161</sup> Ibid.

## **CHAPTER SIX: AN ARGUMENT FOR THE LEGAL ESTABLISHMENT OF DEPOSIT INSURANCE IN LESOTHO**

### **6.1 Introduction**

The practice of Deposit insurance takes different forms from one jurisdiction to another. Deposit insurance serves several purposes which are ultimately aimed to balance the interests of depositors who hold deposits with deposit taking financial institutions and deposit-taking institutions themselves. The rationale behind deposit insurance system is to strike a balance between the interests of both depositors and deposit-taking institutions through the protection of small depositors against bank failures as well as maintenance of stability in the banking and financial system of a country. The successful balance of interests of the two parties has the ultimate effect of curbing the likelihood of bank runs by depositors since they will be assured that their deposits are guaranteed by the existence of deposit insurance<sup>162</sup>. The financial institutions are similarly provided with a contingency to meet their obligations to depositors in response to any possible bank run by depositors.

The purpose of this chapter is to explore the prevailing safety net mechanisms for the resolution of insolvent banks in Lesotho as well as determining their adequacy particularly in the protection of small depositors. It is a common cause that Lesotho like any other country is exposed to threats of economic shocks which become more evident on institutions operating within the financial sector. To undertake this assessment, the following outline would be adopted. Firstly, causes attributive to an experience of bank failure in Lesotho would be related and interventions used to address those bank failures. Secondly, the critical issues revolving around the concept of deposit insurance in addressing the problem of bank distress will be critically analysed. Thirdly,

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<sup>162</sup> Gecchetti (note 147) at 8.

issues concerning the aspect of design of deposit insurance will be highlighted. Fourthly, the evaluation of the existing models of deposit insurance around the world and a proposal for the model which could be suitable to Lesotho would be undertaken. Lastly, key factors which are pertinent for the effective operation of deposit insurance will be considered.

## **6.2 Causes of Bank failures in Lesotho**

As it has already been highlighted in chapter one of the research, Lesotho has experienced the problem of bank collapse during the late 1990s resulting from the collapse of the two state owned banks (SOBs) LADB and LB,<sup>163</sup> Factors which led to the collapse of the said SOBs were mainly attributed the bad management and governance, weak legal and regulatory framework for the supervision of banks, inadequate supervisory capacity and bad lending practices.<sup>164</sup> The issue of negligent management of SOBs became visible in a number of areas such as inadequate screening and monitoring of borrowers resulting from weak credit policies and procedures, absence of proper records of transactions executed by the banks as well as weak internal controls to foster compliance to best banking practices.<sup>165</sup> It is reported that the management of the concerned banks did not even take any effort to correct irregularities which were reflected by a number of reports by external auditors and banking supervisors.<sup>166</sup>

The SOBs were also adversely affected by the issue of poor lending practices which included granting of loan to management and members of staff of the involved banks. The system of processing loans was clouded by grave abuses which entailed the practice of increasing loan limits without authority, concealed transactions which involved absence of documents in the files of

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<sup>163</sup> See Chapter five at 48-51.

<sup>164</sup> See note 13, at 23.

<sup>165</sup> Ibid.

<sup>166</sup> Ibid.

staff members reflecting funds advanced and extension of loans to targeted entities related to the banks as well as friends of SOBs managers in which case there were no agreements to that effect.<sup>167</sup>

Another factor which contributed the collapse of SOBs was the deficiencies attributed to the information system (IT) and the overall management information system.<sup>168</sup> The weaknesses in the IT system throttled the efforts of management to calculate and respond appropriately to the challenges posed by the use of modern IT technology in the running of modern banking businesses. IT system is considered to be a very important internal control tool in assessing the risks against business enterprises. The weaknesses in IT system resulted in the failure by the management to successfully implement corporate plans which have been formulated with the assistance of the external consultants.<sup>169</sup>

The problem of weak management was considered to have exacerbated the consequences which led to the collapse of SOBs since it permitted the internal controls of the banks to be manipulated by the staff of the banks for purpose of advancing their personal interests and not those of the deteriorating SOBs.<sup>170</sup> This laxity of controls according to audit reports and banking supervision reports led to the escalation of incidents of frauds, robberies and forgery.<sup>171</sup> The element of looting of assets SOBs occurred but was not major. However, the laxity in the management of SOBs was linked to the creation of moral hazard on the part of borrowers which was manifested in the increase of non-payment of loans by borrowers.<sup>172</sup>

Another major problem which led to the failure of SOBs in Lesotho was identified as the problem of governance.<sup>173</sup> According to both audit and bank

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<sup>167</sup> Ibid.

<sup>168</sup> See note 3 at 24.

<sup>169</sup> Ibid.

<sup>170</sup> Ibid.

<sup>171</sup> Ibid.

<sup>172</sup> Ibid.

<sup>173</sup> Ibid

supervision reports, membership of boards of directors of SOBs comprised of majority of directors which had no background and the relevant experience of the banking industry. This is a direct answer to their reluctance to take appropriate measures on the basis of the gross irregularities reported by external auditors and bank supervisors.<sup>174</sup>

An argument raised with regard to the circumstances which led to the failure of SOBs was that reports of the bank supervisors had reflected on a number of occasions since 1980s that there had been deliberate violations of the legal provisions of the Financial Institutions Act (FIA)<sup>175</sup> which was then administered by the Central Bank of Lesotho (CBL) to supervise financial institutions.<sup>176</sup> A classic example of these violations is the opening of branches which were not licensed by CBL as the regulator of banks, violation of insider lending limits, violation of individual borrowers' exposure limits, failure to maintain the minimum level of reserves required by FIA and other incidental violations of FIA. This therefore means that the SOBs were not operated in line with the banking guidelines.

Another problem was attributed to the organizational framework which was reported to have been heavily overstaffed and could have influenced the extension of branch network to accommodate this heavy structure. This factor was reported to have contributed to the increased running costs against the deteriorating income.

The problems of SOBs did not only emanate from managerial issues but were also aggravated by the deficiencies in the legal and regulatory framework.<sup>177</sup> The repeated incidents of violations of the Financial Institutions Act, 1973(1973 FIA) portray a weak enforcement of the legal and regulatory

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<sup>174</sup> Ibid.

<sup>175</sup> No; of 1973.

<sup>176</sup> See note 3 at 24.

<sup>177</sup> Ibid.

framework.<sup>178</sup> The argument is advanced that failure of CBL to enforce the 1973 FIA is attributed to its compromised independence resulting from the fact that in terms of that FIA, CBL could not take any action without first consulting and securing approval of the Minister of Finance.<sup>179</sup> The manner in which the 1973 FIA was designed leaves one to wonder whether CBL as a regulator could properly manage political influence regarding the regulation of banks. An inference could therefore be drawn that absence of autonomy could explain failure of the 1973 legal regime to provide adequate prudential supervision of banks and hence their collapse during the 1990s. It was also suspected that political influence had played a major role in the mismanagement of the said SOBs and it remains to be seen whether this would be proved to be correct at the later stages of this research.

Another challenge which was posed to the regulatory regime of banks under 1973 FIA during the crisis which ultimately led to the collapse of LADB and LB was the delay by CBL to initiate the revision of the 1973 FIA which was long overdue given the dynamic changes in the banking sector. It is also imperative to highlight that the 1973 FIA was published as the law during the time when the regulation of financial institutions was exclusively under the office of the Registrar of Financial Institutions which was an office under the Ministry of Finance<sup>180</sup>. This arrangement lasted until 1980 when an entity referred to as Lesotho Monetary Authority was established and subsequently transformed into Central Bank of Lesotho in 1982.<sup>181</sup>

The 1973 FIA deficiencies were also blamed from limited scope of prudential guidelines and the preferential treatment of SOBs by way granting unjustifiable exemptions such as the one given to LB from maintaining unimpaired minimum level of paid up capital in respect of local institutions and what was

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<sup>178</sup> Ibid.

<sup>179</sup> Ibid.

<sup>180</sup> See note 3 at 24.

<sup>181</sup> Ibid.

called assigned capital in the case of foreign owned institutions.<sup>182</sup> The financial institutions were also required to maintain a separate Reserve account which should not be tempered with.<sup>183</sup> Perhaps these unwarranted exemptions and preferential treatment of SOBs have contributed to their undercapitalization, and consequently led to the crisis which saw the two SOBs collapsing.

The crisis which led to the failure of LADB and LB was also linked to the incapacitated prudential banking supervision function of CBL during the whole decade of 1980s and a large part of 1990s.<sup>184</sup>

The absence of a strong lending policy exposed the loan portfolios of SOBs vulnerable to the influence by government directed lending to designated sectors like agriculture, manufacturing as well as unhealthy state owned enterprises.<sup>185</sup> The experience of directed lending had been that SOBs did not have a direct interaction with the borrowers since it relied on the efforts undertaken by the supervising ministries to screen borrowers. A typical example is the Ministry of Agriculture which facilitated in the process of screening borrowers who wanted to access loans to establish agricultural projects. This practice was challenged by the fact that loans were granted to borrowers who were not creditworthy since the screening process was executed by people who were not knowledgeable in the banking field. The ultimate result was that borrowers ended up not repaying the loans due to the moral hazard which made them to believe that the loans extended to them were government grants and SOBs could not locate the defaulters because they did not know them since loans were granted having not undertaken the due diligence process.<sup>186</sup>

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<sup>182</sup> Requirements of Section 17(4) of the 1973 FIA. (See note 2 at 25).

<sup>183</sup> See note 2 at 25.

<sup>184</sup> Ibid.

<sup>185</sup> Ibid.

<sup>186</sup> See note 2 at 27 – 28.

The banking crisis in Lesotho reached its pinnacle in 1998 when the already struggling economy coincided with the political disturbances during the same year.<sup>187</sup> The political turbulences resulted into looting and burning of businesses in the capital city Maseru where business and banks were housed and the two other major towns. An inference could also be drawn that banking business was adversely affected by non-performing loans due to loss of jobs and reduction of cash flow resulting from hampered business activities subsequent to that incident. It was under these circumstances that the government of Lesotho intervened by injecting funds to prevent bank panic which could have led to the total collapse of the banking system (bank contagion). The intervention was made using government implicit guarantee of depositors and an inference could further be drawn from this reaction that there was no institutionalised arrangement in place to deal with banking crises.

### **6.3 Government response post-banking crisis**

The Central Bank of Lesotho in an effort to restructure the banking system in Lesotho underwent the following restructuring process: Firstly, the 1973 FIA was revised and replaced by the Financial Institutions Act, 1999 (1999 FIA) which introduced an improved regulatory framework for banking supervision. Among the innovations introduced by the 1999 FIA are as follows:<sup>188</sup>

- The establishment of clear and uniform guidelines for regulating licensed financial institutions comprising of banks and non-banks by the CBL;
- It granted banking supervisors an operational autonomy;

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<sup>187</sup> Ibid.

<sup>188</sup> Central Bank of Lesotho, Supervision Department Annual Report, 1999.

- It provided a basis upon which prudential banking supervision; regulations were formulated and issued for purposes of strengthening the relation and supervision of banks.

The 1999 FIA also empowered CBL to issue the regulations on the following areas of banking industry in an effort to prevent banks panics in the future:

- Licensing requirements;<sup>189</sup>
- Risk-based capital requirements;<sup>190</sup>
- Loan portfolio classification;<sup>191</sup>
- Lending limits;<sup>192</sup>
- Foreign currency exposure limits;<sup>193</sup>
- Branching requirements.<sup>194</sup>

The above –captioned regulations are regarded as an important step intended to minimize the risk of failure of Lesotho’s banking system. The said measures were also aimed to provide a quick corrective action upon any disruption in the banking system. It is imperative to highlight that amongst the innovation brought by 1999 FIA is a requirement for financial institution to disclose its audited balance sheet in the Gazette and at least one local newspaper which enjoys a much wider circulation.<sup>195</sup> This requirement assists in providing the members of the public with the information reflecting the financial status of the concerned bank. This facilitated in the clearing of information asymmetries

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<sup>189</sup> Financial Institutions (Licensing Requirements), 1999.

<sup>190</sup> Financial Institutions (Risk Based Capital Requirements) Regulations, 1999. (Legal Notice No.111)

<sup>191</sup> Financial Institutions ( Loan Portfolio Classification) Regulations,1999 (Legal Notice No.112)

<sup>192</sup> Financial Institutions (Loan Lending Limits) Regulations, 1999 (Legal Notice No.113).

<sup>193</sup> Financial Institutions ( Foreign Currency Exposure Limits) Regulations,2000 (Legal Notice No.19)

<sup>194</sup> Financial Institutions (Branching Requirements) Regulations, 1999 (Legal Notice No.135).

<sup>195</sup> Section 42 of the 1999 FIA.

which on a number of occasions leads to adverse selection and moral hazard.<sup>196</sup>

Consistent with the regulatory framework reform, the CBL also revised the Central Bank of Lesotho Act 1978 (as amended in 1982) and introduced the Central Bank of Lesotho Act 2000. The spirit of the new CBL Act is to give CBL independence in the administration of Monetary and exchange rate policies as well as the regulation of financial institutions. The current CBL Act entitles CBL to make an independent decision without necessarily seeking prior approval from the Minister responsible for finance as it was the case with FIA 1973. The regulatory framework reform enhanced the capacity of prudential banking supervision by establishing a department of supervision which consisted inter alia the division responsible for the supervision and regulation of financial institutions with a view to realizing an integrated approach in the supervision of banks.<sup>197</sup>

It is pertinent to indicate that it is the financial burden of resolving banking crisis which prompted a need to shift from an implicit guarantee schemes to explicit safety net measures to protect depositors in many countries around the world. Perhaps this is why CBL in its progress report on 2003 reforms highlighted the issue of deposit insurance.<sup>198</sup>

As it has already been highlighted in the first chapter, the financial safety net is considered to be balanced when it is comprised of the following key concepts;

- Prudential regulation and supervision;
- Bank access to the bank of last resort; and
- Deposit insurance.

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<sup>196</sup> See note 53.

<sup>197</sup> CBL Supervision Department Annual Report, 1999. At 3-4

<sup>198</sup> CBL Economic Review, January 2004, No.4 at 3.

These measures are designed in such a way that in the event that one fails to prevent a problem of bank failure the other two could provide the necessary back up facility in that sequence.

It has been reflected at the beginning of this chapter that the processes of financial sector reforms in Lesotho have gone as far as strengthening the aspect of prudential regulation and supervision by virtue of enacting 1999 FIA and recently enacting FIA 2012 to the current dynamics in the modern banking industry as well as providing banks with the lender of last resort as a safeguard measure under CBL Act.<sup>199</sup> However, the third measure which is deposit insurance was highlighted briefly in the proposed reforms.<sup>200</sup> but prospects of establishing the facility were not fully explored. It is for this reason that this area is revisited.

#### **6.4 Critical analysis of the role of deposit insurance**

There had been opposing views about the role of deposit insurance in the protection of small depositors as well as maintaining the stability of the financial system in different jurisdictions. It is against this background that it was considered appropriate to reflect the arguments for and against so that the analysis could lead to the determination as whether or not there is a need for deposit insurance in Lesotho.

##### **6.4.1 Arguments for institutionalized deposit insurance**

The motivations advanced for the institutionalized deposit insurance schemes argue that properly-designed deposit insurance is important in the sense that it enables small depositors to recover their deposits within a reasonable time

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<sup>199</sup> Act, 2000.

<sup>200</sup> See note 182 3

after the failure of the bank.<sup>201</sup> The rationale for protecting small depositors is that it is a category of people who cannot make a proper decision on the health of the financial institutions either because they lack the required level of skill to make a proper assessment of the financial position of banks or that they do not have access to the relevant information regarding the management and risk profile of the concerned banks. It is also argued that in the case where there is an established deposit insurance facility, depositors would be paid from the scheme where contributors to the scheme share the cost unlike where there is none in which case the burden of reimbursing depositors is carried by the individual bank in financial distress will await the government intervention to bail out depositors or the Central Bank to exercise its function of lender of last resort.<sup>202</sup>

Deposit insurance encourages banks to adhere to prudential business guidelines in an effort to retain its large customers.<sup>203</sup> This is done through limitation on the scope of depositors to be given protection, which usually focuses on small depositors and excludes sophisticated depositors as well as deposits of bank employees who have sufficient information on financial status of the company.<sup>204</sup>

The existence of a deposit insurance scheme is perceived to be an important tool in the sense that it would enhance confidence of the members of the public as well as foreigners on the stability of the banking system.<sup>205</sup> It is the assurance of ability of banks to reimburse depositors in the event of bank failure which encourages non-banked class of people to be encouraged to keep their funds with banks.<sup>206</sup> Consequently, banks get cash for running its

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<sup>201</sup> See note 30.

<sup>202</sup> Ibid.

<sup>203</sup> Ibid

<sup>204</sup> ibid

<sup>205</sup> Ibid.

<sup>206</sup> E-How.com. 'The Advantages of deposit insurance.' (1999[to]2011) Demand Media, Inc. (Accessed on 13/05/2011- mhtml:file://E:/The Advantages of Deposit Insurance e-How\_com.mht.) at 1.

business since without flow of cash banks would become insolvent and they would collapse.<sup>207</sup>

#### **6.4.2 Arguments against institutionalized deposit insurance**

Although the concept of deposit insurance is believed to bring many benefits in the banking system, it is also criticized for bringing in problems in the banking system. It is argued that a number of problems attributed to deposit insurance system emanate from the problem of asymmetric information<sup>208</sup> which is prominent within the financial sector.<sup>209</sup> One of the main problems posed by a deposit insurance scheme is that it creates a moral hazard<sup>210</sup>. The problem of moral hazard manifests itself in the following forms:

Firstly, it encourages lack of market discipline in the banking industry.<sup>211</sup> The concept of market discipline is about the absence of an incentive on the part of depositors to check the bank's activities or its solvency status.<sup>212</sup> It is argued that in the absence of deposit insurance, depositors particularly the large ones would have a strong basis not to keep their monies with financially unstable banks for fear of personally carrying the risk of the bank's collapse.<sup>213</sup> Banks which are volatile would equally face a risk of paying risk premiums as a reward to its depositors for the increased default risk they have undertaken.<sup>214</sup>

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<sup>207</sup> See note 36.

<sup>208</sup> Asymmetric information refers to the situation where information regarding the financial health of banks is privately held by banks and it is not accessible to both insurers and regulators.

<sup>209</sup> See note 1 at 9 to 10.

<sup>210</sup> Ibid.

<sup>211</sup> See note 39.

<sup>212</sup> See note 39 at 9.

<sup>213</sup> Ibid at 10.

<sup>214</sup> Ibid.

Secondly, the existence of a deposit insurance scheme accelerates the risk appetite of banks.<sup>215</sup> On the basis of the knowledge that there is a deposit insurance scheme to reimburse depositor in the event that a bank fails, a bank can usually embark on the risky ventures with a motive to accumulate more returns and this could pose problems to other participants of the scheme particularly where participant banks pay premiums on a flat-rate scale<sup>216</sup> as opposed to risk-based differential premium system.<sup>217</sup>

Lastly, banks particularly big banks or state-owned banks enjoy government intervention by way of injecting funds to sustain the operations of such a bank. The use of implicit insurance guarantee by the government has encouraged banks to engage in risky ventures and decreases the initiative of large depositors to closely monitor the operations of the bank under the perception that a bank is too big to fail.<sup>218</sup>

The adverse selection is also considered to be one of the main factors which create problems in the implementation of a deposit insurance scheme.<sup>219</sup> Adverse selection is visible in the following forms:

Firstly, risk-taking culture caused by absence of market discipline is promoted and this is caused by the argument that as long as deposit insurance exist the cost of securing funds in the banking market is the same regardless of whether the bank has good risk management profile or not.<sup>220</sup>

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<sup>215</sup> Ibid.

<sup>216</sup> This is an arrangement where all participant banks pay the same amount of premiums to the deposit insurance scheme notwithstanding the difference in their level of risk exposure.

<sup>217</sup> This is the opposite arrangement to that of flat - rate premiums and in this case participants' premiums are calculated and fixed on the basis of the level of their exposure to risks i.e. the higher the level of risk exposure, the higher the premium payable to the deposit insurance scheme and vice versa.

<sup>218</sup> See note 47 at 10.

<sup>219</sup> See note 39 at 10.

<sup>220</sup> Ibid.

Lastly, financially sound banks could be adversely affected by the bad banking practices of unstable banks in the running of their business.<sup>221</sup> This situation could have damaging effects to solvent banks since they could end up losing customers to unstable banks who operate banking business contrary to best practices in banking prescribed by regulators.<sup>222</sup> This laxity in compliance to prudential banking guidelines induced by the existence of deposit insurance could degrade the overall standard in the financial sector.<sup>223</sup> This could eventually lead to a problem of non-performing banks in the scheme, a factor which could deny the banking market of the required role-players to uphold prudent banking practices.<sup>224</sup>

It is also argued that a deposit insurance scheme has potential of influencing escalation of banking costs to clients and thereby reduces profits to shareholders because of the payment of premiums by participating banks.<sup>225</sup>

## **6.5 Issues of design**

The issue of design in deposit insurance is influenced by a number of factors in different countries. A classic example of factors considered in the process of designing a deposit insurance is the manner in which banking sector is structured i.e. whether it comprises state-owned banks or private commercial banks, whether the structure involves foreign branches or subsidiaries, the existing regulatory and supervisory framework and government's approach to previous bank failures.

As it has been highlighted in the introductory chapter the structure of banking in Lesotho is composed of CBL as the regulator of banks, one indigenous

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<sup>221</sup> Ibid.

<sup>222</sup> Ibid.

<sup>223</sup> Ibid.

<sup>224</sup> See note 30.

<sup>225</sup> Ibid.

(state-owned) bank namely, Lesotho Post Bank (LP) and three subsidiaries of foreign-owned banks namely, Lesotho Standard Bank (LSB), Ned bank Lesotho (NBL) and First National Bank (FNB). The total deposits held by these banks (excluding CBL) amounts to M 5.7 Billion as at the end of July, 2011.<sup>226</sup> The regulatory and supervisory regime was improved through the enactment of the 1999 FIA and restructuring of supervisory function of CBL in order to enable compliance to prudential guidelines by the banks. The background to previous bank failures and the government's reaction to such failures have been highlighted earlier in this chapter.

## **6.6 Motivation for setting up deposit insurance in Lesotho**

The need for the establishment of deposit insurance is not a new phenomenon in Lesotho as it has been highlighted in some forums. The reasons underlying the deliberations on the introduction of deposit insurance were that the costs incurred by the government to bailout depositors during the collapse of LADB and LB have raised issues evolving around the adequacy of the existing regime to protect depositors.<sup>227</sup> Consistent with the proposal to establish an explicit deposit insurance Scheme, *CBL Economic Review*<sup>228</sup> provided as follows:

*Participants at the workshop including a keynote speaker from Bank of Uganda and the Central Bank in its proposal highlighted a number of features that would be desirable for a deposit insurance scheme. Firstly, the deposit insurance coverage should be explicit. This uncertainty would undermine the stability of the banking system.*

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<sup>226</sup> Central Bank of Lesotho: Supervision Department Monthly Report as at the end of July, 2011.

<sup>227</sup> See note 2 at 58.

<sup>228</sup> See note 30.

## **6.7 Considerations for setting up deposit insurance in Lesotho**

In the light of the previous incidents of bank failure experienced through the collapse of two SOBs (LADB and LB) during the late 1990s and the recent threats of 2008 financial crisis, the aspirations of setting up a deposit insurance scheme are justified. The desire to set up deposit insurance is based on the following grounds:

- (a) Protection of small depositors. This is a category of bank depositors who are granted protection on the basis that given their low level of skill to analyse the financial health of banks, they cannot tell whether or not it is risky to deposit their funds with a given bank.
- (b) The effort to complement the regulatory and supervisory role as well as lender of last resort role of the CBL aimed at maintaining stability in financial system. Existence of stability assists in instilling confidence individual depositors in the banking system and minimizes the risk of bank runs.

## **6.8 Proposals for an effective deposit insurance system**

### **6.8..1      *A clear deposit insurance legal regime***

Deposit insurance need to be well defined in law. This is reiterated by the Core Principles for an effective deposit insurance scheme<sup>229</sup> which provide for the establishment of a deposit insurance scheme by an Act of parliament. The spirit of proceeding as such is to ensure that the mandate of the scheme is clarified. It is also argued that the existence of explicit deposit insurance relieves the government of the burden of bailing out depositors using tax-payers funds. On the other hand this would also relieve CBL responsibility of simultaneously being the lender of last resort as well resolution of failed banks.

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<sup>229</sup> Report on Core Principles for Effective Deposit Insurance Systems (A proposed methodology for compliance assessment). May 2010. (Accessed on 23/10/211 - <http://www.bis.org/publ/bcbs151.pdf>.) at 8

### **6.8.2 Membership and institutions covered**

Membership to deposit insurance is acquired either voluntarily or compulsorily. It is argued that voluntary membership exposes the banking system to the problem of adverse selection in the sense that weaker banks with high risk profiles would rush to subscribe to the scheme whilst stronger banks with level of risk exposure would shun the scheme with the understanding that joining the scheme would be to indirectly shoulder the risks of weaker banks to their detriment. The mandatory membership to the schemes is therefore regarded as the best option.<sup>230</sup>

### **6.8.3 Coverage level**

The issue of coverage level in the deposit insurance should be considerate of the relationship between coverage level and moral hazard. The argument advanced is that a high level of coverage whilst helpful to cover a large amount of individual depositors, would promote the problem the problem of moral hazard which does not create incentive for depositors to uphold market discipline on banks. On the other hand if the covered low, banks would be discouraged to subscribe to the scheme. Therefore it is imperative that the necessary safeguards measures such limiting the level of coverage,<sup>231</sup> exclusion of certain classes of bank deposits, the introduction of co-insurance principle should be considered. In the proposed Deposit Insurance Scheme for Lesotho it is contemplated that all deposits from the public with the exception of interbank deposits, insider deposits as well as investment deposits. The maximum deposit coverage is based on a percentage of deposits and according to the international best practices over 90 per cent of depositors should be fully covered. In the proposed scheme for Lesotho, a percentage of depositors would be applied. According to the information provided by the Supervision

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<sup>230</sup> See note 69, (Principle 8).

<sup>231</sup> Ibid , (Principle 9).

Department of the Central Bank of Lesotho as of end of July, the total depositors was follows: FNB 71,564, Standard Lesotho Bank 197,333, Lesotho Post Bank 78,287 and Ned bank 38,428 and the depositors with deposits of M10,000 and less is 68,272, 183,405, 72,428 and 34,630 respectively. It follows from the latter information that 95 per cent of FNB depositors, 93 per cent of Standard Lesotho Bank depositors, 93 per cent of Lesotho Post Bank depositors, 90 per cent of Ned bank depositors would be fully covered.

This level is above the recommended minimum by three per cent and therefore needs to be reduced in order to instil market discipline and discourage moral hazard. The maximum cover would therefore be set at M7000.00.<sup>232</sup>

#### **6.8.4 Funding**

It is argued that for a deposit insurance to be able effective, it needs to have sufficient funds to settle claims of depositors in the event of bank failure.<sup>233</sup> In order for the deposit insurance to successfully fulfil this mandate, it needs to have a pool of funds kept in a fund established by law where participant banks could make contributions. This fund is normally used as a contingency in times of crises. The importance of a well-funded fund was emphasized in the CBL Economic<sup>234</sup> Review where it was provided that:

*An under-capitalized scheme would compromise the effectiveness of the deposit insurance scheme, as it means that the scheme will not be able to honour claims from depositors if a bank fails and that the government may have to pay depositors despite the existence of the scheme.*

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<sup>232</sup> This implies that a depositor with M7, 000.00 or less would be compensated a full amount while a depositor with more than M7, 000.00 will get only M7.000.00.

<sup>233</sup> Ibid,(Principle 11).

<sup>234</sup> See note 30.

A classic example of the incident where deposit insurance failed to perform by reason of insufficient funds in the fund was Uganda during the period between 1998 and 1999 where the government had to take over and settle depositors' claims after the failure of four banks.<sup>235</sup> In the light of the foregoing information it was pertinent to indicate that as a starting point the initial capital needed to set up the scheme is M30 million. According to the simple calculations made, 80 per cent of the initial capital which would be equivalent to M24 million would be expected to come from the Government of Lesotho whilst 20 per cent equivalent to M6 million would be contributions from the participating members institutions.

#### **6.8.5 Premiums**

It is pertinent to indicate that premiums charged to members constitute the large portion of funds for the deposit insurer.<sup>236</sup> It is therefore imperative for the premiums to be calculated on the basis of the total deposits instead of the level of insured deposits since it is easier to determine the premium base on which premium could be assessed and fixed. As highlighted earlier in this chapter, there are two ways in which premiums could be charged viz, a flat-rate premium system and a risk-based differential premium system. Analysis made previously reflected the flat-rate as the most preferable on account of being easy to administer and to use in the calculation of premiums to be charged. The risk-based differential system although it is equitable in its calculation of premiums, it is considered to be complex and difficult to administer and hence not recommended at an initial stages of setting up a deposit insurance. However it is worth indicating that the major weakness of the flat-rate system of calculating premiums is that stable banks with low level of risk exposure subsidize unstable banks with high level of risks.

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<sup>235</sup> Ibid.

<sup>236</sup> See note 69, (Principle 11).

## CHAPTER SEVEN: ANALYSIS AND FINDINGS

This thesis was set to determine whether the deposit insurance scheme can competently complement the already existing safety nets within the Lesotho's banking system in the protection of small bank depositors as well as maintaining the stability of the financial system. It is therefore material to make a proper analysis on the assumptions which were raised prior to the undertaking of the research.

### 7.1 Analysis

The first assumption was that the absence of the legal regime establishing the national deposit insurance system is caused by the previous efforts by the government to bail out depositors in incidents of bank failures. It was therefore in view of the said assumption that investigations were instituted in order to determine the basis upon which the government of Lesotho intervened to bail out individual depositors during the incidents of bank failure.

According to *other scholars*,<sup>237</sup> the deposit insurance is either implicit or explicit in nature. The two authors argue that Deposit insurance is regarded as explicit if the guarantee extended to depositors it is established by a statutory instrument such as the Central Bank legislation, banking legislation or the constitution provision. On the other hand they argue that in the case where there are no formal mechanisms providing for the establishment of the national deposit insurance an assumption is made that a country is operating an implicit deposit insurance.

Consistent with the above distinction between implicit and explicit form of deposit insurance system, *some authorities*,<sup>238</sup> provides that a distinction could be drawn between the two main forms of deposit insurance namely, implicit deposit insurance and explicit deposit insurance. According to him implicit

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<sup>237</sup> Dermirguc-Kunt, A and Sobaci, A "Deposit Insurance around the World.(2001) Vol.15.No.3. *The World Bank Economic Review*.481 at 482.

<sup>238</sup> See note 1 at 9.

deposit insurance is the one in which depositors funds are insured by the government without necessarily communicating this arrangement formally. This type of insurance is normally not guided by any piece of legislation nor rules outlining how the process of compensating depositors would be handled in the event of a bank failure.

An inference could therefore be drawn from the above analysis that there cannot be a vacuum in as far as protection of depositors is concerned. It is not in dispute therefore that the assumption made in this regard has turned out not to be fully consistent with the findings of the research in the sense that the government of Lesotho was executing its mandate to bail out depositors during failure of both LADB and LB on the basis of an implicit form of deposit insurance scheme. However, the findings of the research support part of the assumption that there is no legal regime establishing deposit insurance system in Lesotho.

The second and third presumptions which the had were to the effect that the government was not consistent in exercising its discretion to bail out depositors and that it did not exercise its discretion in all cases warranting bailouts. Investigations were therefore instituted to verify this assumption. As it was highlighted in the review of literature,<sup>239</sup> where an argument was advanced that implicit deposit insurance is discretionary in nature. It was also contended that the government intervention in this case is determined by the availability of resources in as much as there is no fund designated specifically for such emergencies. The practice had always been for the government to mobilize financial resources as and when the emergency arises. Another argument is that the absence of clear guidelines indicating how cases of compensating depositors in bank failures should be handled. The latter argument was further reiterated by indicating that policymakers have a number of options available to them on how they can extend protection

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<sup>239</sup> See note 22 on Chapter two.

measures to depositors.<sup>240</sup> Authorities argued that in some jurisdictions an explicit form of deposit insurance system was responsible for the provision of safety net to depositors and that it usually arose where the members of the public expect a protection of some kind in case a particular bank collapses.<sup>241</sup> It was argued that the expectation to secure protection was based on the previous cases of government intervention on similar incidents or statements made by officials on this issue.<sup>242</sup> It was argued that there were no legal rules prescribing the types of bank liabilities which qualify for protection, the magnitude as well as the form which the expected protection will take.<sup>243</sup> This form of guarantee is surrounded by a lot of uncertainty as to how various customers of the failing banks will be handled when banks collapse. It is argued that funding is optional and in most instances relies on the ability of the government to secure public funds to relief depositors.<sup>244</sup>

The fourth hypothesis was that the government of Lesotho took a decision to bailout depositors of LADB and LB mainly because they were state-owned banks. Investigations instituted critically looked at the reasons which led to the formation of public financial institutions and the findings as depicted from various authors were that that financial institutions were regarded an important drivers of the country's economic development. According to other scholars<sup>245</sup> the significance of the role played by the financial institutions in the economy is manifested by its participation in the national payment system, the intermediary function between depositors and borrowers as well as their role as agents in transmitting monetary policy. Consistent with the latter view

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<sup>240</sup> Financial Services Forum, 'Guidance for Developing Effective Deposit Insurance Systems .' ( September, 2001) at 8.

<sup>241</sup> Ibid.

<sup>242</sup> Ibid.

<sup>243</sup> Ibid.

<sup>244</sup> Ibid.

<sup>245</sup> See note 4.

certain authors<sup>246</sup> support it by indicating that the banks were important in the country's economy in the sense that they play a pivotal role in the exchange of money within the entire economy, they collect savings from small and large depositors, administer the payment system as well as regulating financial transactions. The assumption that the government of Lesotho intervened to bailout depositors of the two state-owned banks was found not to be true in view of the above analysis. I also hypothesized that the absence of a formally established protection of depositors against bank failures was maintained by the structure of Lesotho's banking system which is largely dominated by foreign financial subsidiaries of South African commercial banks. I assumed that due to affiliation of the said subsidiaries with foreign banks, they stood a benefit of financial support in the event that they experienced bank failure. The investigations instituted to determine whether the absence of deposit insurance in Lesotho could be attributed to dominance of Lesotho's banking system by foreign subsidiaries raised a number of questions; firstly whether there was any possible cross-border arrangement for parent banks in South Africa to address the problem of failing banks in a foreign country such as Lesotho. According to the literature reviewed the following findings were made: Firstly, that a branch of foreign company desiring to conduct banking in Lesotho is required to be incorporated under the relevant laws in Lesotho. The South African subsidiaries operating in Lesotho had been duly incorporated as public company in terms of Section 4(2) of the Act.<sup>247</sup> Secondly, that parent banks can make an internal arrangement with their subsidiaries for the provision of financial assistance subject to the requirements relating to the maintenance of statutory reserves equivalent to 5 per cent of the profits in the particular year. It is relevant to indicate that in the case of Lesotho Section 20(5) of the Act,<sup>248</sup> requires all financial institutions to maintain reserves at 5 per cent. The hypothesis that the reasons underlying a delay to set up an

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<sup>246</sup> Garcia,G,G, 'Protecting Bank Deposits.' (1997) *Economic Issues* 9. *International Monetary Fund. Washington.*

<sup>247</sup> Financial Institutions Act, No.6 OF 1999.

<sup>248</sup> Ibid.

explicit deposit insurance could have possibly been influenced by the way the banking system is structured, thus it consists mainly of foreign subsidiaries of South African based banks which could receive a financial backup from their headquarters in the event of bank collapse has been proved to be correct. I had also presumed that the absence of the legal regime establishing as well as administering the deposit insurance in Lesotho could be attributed to the size of the banking sector which is relatively small since it comprises of one indigenous bank whilst the other three banks are subsidiaries of South African banks. The assumption of the researcher was therefore that the size of the banking sector does not pose a serious threat to the national economy. The investigations conducted reveal that the issue of establishing deposit insurance in any country is not dictated by the size of the banking sector but the spirit is to ensure that the stability of the financial system through protection of bank depositors. Efforts to extend protection to depositors contribute significantly in the prevention of bank runs and thereby maintain confidence of depositors in the banking system.

It was found out that the hypothesis that the delay to set up a deposit insurance scheme in Lesotho revolved around the size of the market which was considered to be very small and hence did not pose any major threat to the national economy was proved to be incorrect. I had also hypothesized that South Africa just like Lesotho does not have a formal deposit insurance scheme. It was further presumed that notwithstanding the assumption that South Africa does not have an established deposit insurance scheme; the depositors were not exposed to any serious threat since South Africa had stable financial system. The investigations made looked at the historical background of the South African banking system to check whether there had been previous incidents of bankruptcy reported within the banking sector and the extent to which the South African Government has intervened to protect depositors. The literature reviewed reveal that South Africa has previously experienced bank failures. The following banks are typical examples of some of the banks which

collapsed: Saambou Bank which collapsed in 2001, BoE Bank which acquired by Nedcor Bank in 2002,<sup>249</sup> <sup>250</sup>

It was found out that the assumption that South Africa was not prone to the threat of the banking crises was proved to be incorrect in the sense that the investigations conducted have proved that there had been a number of bank failures in South Africa in the past. I had also hypothesized that Lesotho's financial system is currently enjoying stability and hence not susceptible to any threat of banking crises and conducive to set up deposit insurance scheme since it was still stable as is recommended the core principles of the deposit insurance that it is ideal to undertake the establishment of a deposit insurance when there appears to be a stability in a country's financial system.<sup>251</sup> The reason provided for the latter argument is that this could allow those responsible for setting up a deposit insurance facility to thoroughly work on the design of the facility and consequently come up with the ideal model which is country specific. It has also been argued that there are external causes of bank failure which are sometimes beyond our control.

The hypothesis that the Lesotho's financial system is currently stable and not threatened by any bank failure has been found to be correct. Another presumption which the researcher had was that the existing regulatory legislation which is administered by the Central Bank of Lesotho ensures strict compliance in the regulation and supervision of financial institutions and the existence of the legal instrument of this nature assists in ensuring stability in the Lesotho's financial system. The latter assumption was based on the fact that the Central bank of Lesotho has already been mandated to protect the

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<sup>249</sup> U.Nqauke '*Promoting Depositors and Financial Stability in South Africa: Is there a case for introduction of deposit insurance?*' (2003), a thesis submitted in partial fulfilment of the Master of Commerce- University of Rhodes (accessed at [www.http://eprints.ru.ac.za/90/2/Ngauke\\_Thesis.pdf](http://eprints.ru.ac.za/90/2/Ngauke_Thesis.pdf).) at 88.

<sup>250</sup> Ibid

<sup>251</sup> See note 207

financial system and this has been clearly articulated under Section 6 (a) of Central Bank Lesotho Act. It is also pertinent to state that it is on the basis of the provisions of the latter Act that the Bank undertook some restructuring process which inter alia included the revision of the 1973 FIA and the promulgation of the 1999 FIA to fill the gaps identified under the 1973 FIA subsequent to the failure of the two state-owned banks. The restructuring process included the strengthening of the supervision component of the Central Bank as the watchdog to detect the financial status of the banks and advise properly before a bank could collapse.

The hypothesis that the Central Bank is administering a legislation which fosters strict compliance in the regulation and supervision of financial institutions and hence ensuring stability in the Lesotho's financial system has been found to be true. However, the supervisory measures are only effective to the extent that the banks are viable.

I had also hypothesized that Lesotho's banking industry has not experienced a bank run before and therefore there had not been any pressing issues to establish a deposit insurance system of any form. The overview of Lesotho's banking system which was highlighted in chapter five portray that there had been previous bank failures in the history of Lesotho's banking system.

The hypothesis that the absence of the a deposit insurance scheme in Lesotho could be attributed the fact that the Lesotho's banking industry has not experienced any bank failure has been found to be incorrect since there is a clear evidence indicating that Lesotho had previously experienced bank failures through the collapse of two state-owned banks viz, LADB and LB during the 1990s.

## **CHAPTER EIGHT: CONCLUSIONS AND RECOMMENDATIONS**

As a way forward and pursuant to the findings of the research, the following recommendations are made:

### **8.1 Conclusions**

This research was mainly intended to determine prospects of establishing formal deposit insurance in Lesotho as well as exploring the role which could be played by deposit insurance within the context of Lesotho's banking sector. In view of the aforementioned objectives of the research and the analysis conducted in the previous chapter the following conclusions could be drawn:

- It could be concluded that the absence of a legal regime establishing deposit insurance does not necessarily mean that there is no deposit insurance in Lesotho but that there is one which is of implicit nature;
- It could be concluded from the above analysis that although there was no evidence of inconsistency or failure to extend protection to depositors at any incident of bank failure, the aspect of uniform treatment to depositors under implicit deposit insurance was not practical due to the following grounds: Firstly, there was no legal instruments or legislation imposing obligations on the part of the government to protect depositors in the event of bank failure; and, secondly, the government's intervention was dependent on the availability of financial resources which was usually sourced from the public coffers. It was also argued that in all cases where the banking sector in Lesotho experienced an occurrence of bank failure such as in the case of LADB and LB, the government reacted and provided a blanket guarantee to all types of depositors. It therefore follows that the researcher's assumption that there has not been consistency in the intervention of government during incidents of bank failure has been proved incorrect by the findings of the research. Similarly the hypothesis that the government of Lesotho did

not act in all cases warranting intervention was not supported by the findings in this research.

- A conclusion was therefore drawn that the fact that only state-owned banks were involved in bank failure and given recognition by the government was merely a coincidence;
- A conclusion could therefore be drawn that Standard Lesotho Bank, Ned bank as well as First National Bank (FNB) all of which are subsidiaries of South African banks continue to enjoy all forms support, including financial support from parent banks from South Africa besides the support they could enjoy from Central Bank of Lesotho through reserves kept with it in accordance with Sections 20(5) and 24(1) of FIA read with Section 5(2) of the Financial Institutions (Liquidity Requirements) Regulations 2000 (in the exercise of its lender- of- last-resort function as mandated by Section 6(a) of the Central Bank of Lesotho Act 2000. A typical example is the case where they lend initial capital whenever subsidiaries want to increase their lending exposure. The parent banks are induced to give subsidiaries support since in their integrated supervision reports they furnish full account of the performance of the banks including foreign branches as well as foreign subsidiaries but within the South African jurisdiction;
- The investigations conducted point to the contrary since banking crises and failure have affected both small economies as well as big economies in the same way. The argument that the banking in Lesotho was structured in such a way that there was less likely to be bank failures in view of the fact that Lesotho Post Bank was a state-owned bank and would enjoy financial support from the government should there be signs of financial distress on its part. It was also argued that the rest of the banks comprise of Standard Lesotho Bank, Ned bank and FNB which are subsidiaries of foreign banks i.e. their parent's banks based in Johannesburg South Africa. It was therefore anticipated that they would enjoy support in the case where there were financial problems on their

part which may lead to their failure. It was argued that in as much as subsidiaries may enjoy support from parent banks, which support was not guaranteed since it was discretionary.

- It could therefore be concluded that South Africa did not have established deposit insurance. It could therefore be concluded that there was no formalized deposit insurance in South Africa but implicit one based on the fact that in the past, the government of South Africa through the Reserve Bank of South Africa had responded to all cases of bank failure by taking the responsibility to compensate depositors in all cases of bank failure. South Africa is therefore in the same position as Lesotho in so far as deposit insurance is concerned. It was only recently (in mid-2011) that that South African Treasury had triggered debates with the banks by holding consultative sessions gearing deliberations on this issue to determine whether there is a need to establish to establish a formal deposit insurance scheme in the light of the continuing trend of bank failures. It was apparent therefore that the banking sector in South Africa was still encountering the same challenges as Lesotho insofar as bank failures and the protection of depositors were concerned.
- It could also be concluded that current status of the banking system in Lesotho is suitable for the setting up of an explicit deposit insurance facility in Lesotho.
- It could also be concluded that the supervisory measures are complementary in nature in the sense that they assist to prevent the occurrence of a bank failure whereas the deposit insurance handles the issue of compensating the depositors. The bank has played this role using various legal instruments regulating the 1999 FIA such as *Financial Institutions (Liquidity Requirements) Regulations 2000* to ensure that there is sufficient liquidity to service the demands of the depositors as and when a need arises. The maintenance of sufficient liquidity enables financial institutions to meet the obligations of depositors and

hence curbs the possible bank runs which could lead to bank failures. The Central Bank has also been established a Lender of Last Resort to assist the banks to meet their obligations. The Lender of Last Resort function of the Central Bank has been statutorily established under Section 6 (a) of The Central Bank Act, 2000 which provides that:

- *The functions of the Bank shall be- (a) to foster the liquidity, solvency and proper functioning of a stable-based financial system.*
- It is in this sense that that a conclusion could be drawn that there has in fact been bank runs which preceded bank failures which were recorded. Perhaps one could draw an inference that the urgency of establishing explicit deposit insurance has been delayed by the previous government intervention to bail out depositors while at the same time restoring depositor's confidence in the banking system.
- Lastly it could be concluded that there is no formal deposit insurance in Lesotho.

## **8.2 Recommendations**

- That there is a need for the establishment of an explicit deposit insurance system in Lesotho. This recommendation was based on the findings that the protection of depositors in Lesotho was implied from the previous intervention of government to bail out depositors during the failure of LADB and LB during 1990s. The advantage of having explicit deposit insurance would be that CBL would be relieved of its current double duties of lender-of –last resort and resolution of failed banks, since deposit insurer, would handle the latter. The government would also be spared of diverting taxpayers funds supposed to finance national projects on issues such as deposit insurance which come as emergencies. The idea of establishing explicit deposit insurance now was found to be ideal in that the environment would be conducive since there is no imminent threat of bank failure in the Lesotho's banking sector at the present moment.

- That a deposit insurance was an effective way of protecting depositors and consequently the financial system although there may be other protective measures which may appear under the supervisory and regulatory regime and hence necessary to explicitly establish it since it would assist to clarify mandate and obligations and procedures to be followed to pay depositors claims of depositors. This would remove the element of discretion on the part of the scheme whilst it boost confidence of depositors that they would receive their funds should banks fail and this has a stabilizing effect on the financial system as it prevents bank runs.
- That the system of deposit insurance recommended for Lesotho should be designed in such a way that it would operate a hybrid system of deposit insurance where premiums would be levied 'ex-ante' in order to build and maintain a fund that could take care of unforeseen future banks failures whilst in addition, participants may be called to make additional contribution especially where the established fund did not have sufficient funds to meet depositors requirements during a bank failure.
- That a flat-rate method of assessing premiums should, as a starting point be used since it is easy to apply. However, the deposit insurance once established, should consider the introduction of a risk-based differential premium system as a method of determining premiums as long-term strategy. The underlying reason was the that although flat-rate was found to be easy to determine as opposed to risk-based differential premium which involved complex steps to determine premiums, it was found to be more equitable in the sense that the premiums imposed on each bank is proportional to the level of risk that a particular bank poses to the financial system.
- That membership of banks to the deposit insurance should be made compulsory by the legislative framework establishing an explicit deposit insurance system. The benefit of doing so were that the findings in this

research have revealed that where deposit insurance was voluntary there was always a problem of adverse selection on the part of banks whereas the compulsory nature of the membership to the deposit insurance scheme prevents the problem of adverse selection. The compulsory nature of membership to deposit insurance was found to be suitable for Lesotho given the way in the banking sector is structured viz, that is comprised of three subsidiaries of foreign banks which would not bother to join the proposed deposit insurance scheme if membership were to be voluntary since they would assume that they would get financial back up from their headquarters in South Africa. Another bank is LPB which would similarly presume a financial support from the government during banking crisis since it is 100 per cent owned by the government of Lesotho. The proposed facility could end up being a white elephant if membership to it could not be made compulsory. Again an issue of adverse selection would surface.

- That there is a need to have a strong fund compliant to Principle 11 of the Core Principles for effective deposit insurance system.<sup>252</sup> This is intended to enable the scheme to respond promptly to depositors claims as this would increase the depositor's confidence in the financial system.
- That the system of coinsurance system to amounts which are above M7, 000.00, the maximum amount to which a depositor could receive 100 per cent cover.
- The proposed deposit protection scheme for Lesotho should be strengthened with the establishment of an effective failure resolution mechanism which would facilitate the prompt reimbursement of depositor subsequent to bank failure occurrence.

Finally, it is recommended that as a starting point, the proposed facility be established as a division within the Central Bank of Lesotho for at least a period not exceeding five years to allow it to be properly organised. This would

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<sup>252</sup> See note 207.

enable the facility to tap from both financial as well as human resources of the Bank. The second phase would deal with the setting up of the facility as an independent entity outside the CBL where it would administer its affairs through a board as the highest authority and the secretariat handling the day to day issues of the scheme. However, it is pertinent to amend Section 9 (5) of the CBL Act to accommodate the participation of the Governor of CBL to participate in the Board of the Deposit Insurance Scheme. This is because the latter provision prohibits the Governor from serving from any other board apart from that of CBL.

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