

Resolving Bank Failures in Uganda: Policy Lessons from Recent Bank Failures

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In 1998/99 four insolvent commercial banks were intervened and closed by the central bank in Uganda. One bank was closed promptly while the other three were all subject to some form of attempted open bank resolution before eventual closure. This article examines the lessons from this experience and concludes that, in general, prompt closure is preferable to open resolution. This is because the losses incurred by distressed banks are likely to be much greater than the estimates made by regulators or auditors prior to closure, while the prospects for recapitalisation by private sector shareholders are likely to be very limited at best. Open resolution entails serious dangers of moral hazard, which increase the eventual cost to depositors and taxpayers.

In 1998 and 1999, four insolvent banks, which together held 12.1% of the Ugandan banking system's deposits, were closed by the central bank – the Bank of Uganda (BoU). This article examines the lessons for bank intervention policy, which can be learned from these bank failures. Intervention in distressed banks is often the most difficult aspect of regulatory policy for the bank regulator to implement, as it has potentially serious economic, budgetary and political implications.

There were some important differences in the way the BoU intervened in the failed banks. These are highlighted in the following section of this article, which describes the interventions by the central bank and also provides a typology of the options for intervention available to a bank regulator. The third section provides estimates of the losses incurred by the failed banks and the fiscal costs of the failures; the next section then examines the lessons from these failures for intervention policy. Because bank failures like those which occurred in Uganda – involving private sector banks with a relatively small share of the market – have become fairly commonplace in several sub-Saharan African countries since financial markets were liberalised in the 1980s and early 1990s, the lessons to be drawn from the Ugandan experience should have relevance for other countries in the region.

The bank failures, which occurred in Uganda did not reflect a systemic banking crisis, the intervention policy implications of which are very different from a situation of non-systemic bank failure. The policy response to a systemic banking crisis has been addressed by Andrews and Josefsson (2000), Frydl and Quintyn (2000) and Lindgren et al. (1999).

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Intervention in distressed banks

The four banks which were closed in 1998 and 1999 comprised two which were owned by local private sector investors (International Credit Bank (ICB) and Greenland Bank), one which was owned by the Co-operative movement (the Co-operative Bank) and one which was a subsidiary of a Kenyan bank (Trust Bank).

Greenland Bank and the ICB had been the subject of special audits by international accounting firms commissioned by the BoU in July/August 1998, prompted by the realisation that they were suffering financial distress. The ICB was found to be massively insolvent and was closed in September 1998, with minimal delay. Greenland Bank was also found to be insolvent (although at a much lower estimated level of insolvency than the ICB) and was also in violation of the insider lending and single loan exposure limits in the banking laws. Greenland Bank was not closed but had to sign an agreement with the BoU in September 1998 to take corrective measures. However, its financial condition worsened markedly, and by late November 1998 it was illiquid and requested liquidity support from the BoU. The BoU intervened in early December, replacing the Managing Director, but allowed Greenland Bank to remain open and extended liquidity support to it amounting to about half the bank's deposits. Upon intervention, the BoU discovered that Greenland Bank had substantial assets and liabilities which had not been disclosed on its balance sheet. In January 1999, the BoU placed Greenland Bank under statutory management, but it remained open, requiring further liquidity support, until April 1999, when it was finally closed.

The Co-operative Bank had a long history of financial distress, including insolvency, going back to the 1980s, and had been recapitalised by foreign donor agencies. It was discovered to be insolvent by a BoU on-site examination in September 1998, but remained open in the hope that it could be recapitalised by further financial support from donors. It was eventually closed in May 1999 after it became evident that further donor support was unlikely and that it had serious management and governance problems.

Trust Bank, the smallest of the four banks which were closed, had closed temporarily on its own initiative in September 1998 because it was illiquid. It was allowed by the BoU to reopen in January 1999 but was closed because of insolvency in November 1999.

The BoU intervened directly in one other bank during this period. Soon after closing Greenland Bank, the BoU placed Uganda Commercial Bank Ltd (UCBL) under statutory management. UCBL was also insolvent and, with 22.8% of the banking system's total deposits, was much larger than the other failed banks. UCBL was a state-owned bank, which had been partially privatised with the sale of a 49% equity stake to a Malaysian company, Westmont Land Bhd, in 1998. Its failure was linked to that of Greenland Bank. Greenland Bank had lent money to Westmont to purchase its equity stake in UCBL, in return for which Westmont had secretly assigned its shares in UCBL to Greenland Bank. UCBL then lent money to Greenland Bank and its related companies. UCBL remained open after the BoU intervention. Its closure was never considered an option because the government was committed to maintaining the bank's nationwide branch network. Because of its size and importance in the banking market, the policy implications for regulatory intervention in UCBL were very different from

those of intervention in the other, much smaller banks which failed in Uganda. Consequently, the resolution of UCBL's problems is not considered here.

Three other very small private sector banks also suffered financial distress during this period and were subject to regulatory directives from the BoU, although there was no direct intervention. Each had to sign a Memorandum of Understanding (MoU) with the central bank to recapitalise and rectify managerial deficiencies. Two of these banks were eventually able to recapitalise, while the third was sold to new investors (which already owned a development bank in Uganda).

Deposits up to a maximum of US\$ 3 million (about \$2,000 in 1999) were protected under the deposit insurance fund (DIF) in Uganda. However, after the closure of Greenland Bank, the government announced that it would repay all of its deposits, including those that were uninsured, and subsequently repaid all of the private sector customer deposits in the ICB, Greenland Bank and the Co-operative Bank. Some of the Cooperative Bank's deposits were transferred through a purchase of assets and assumption of liabilities (P&A) transaction to two private sector banks, with the remainder of the deposits transferred to UCBL. All of Greenland Bank's private sector deposits were transferred to UCBL, with the exception of very small deposits which were repaid in cash. UCBL received BoU securities to back the deposit liabilities it had assumed, while the two private sector banks which had taken over deposits from the Co-operative Bank received a mixture of BoU securities and liquid assets from the Co-operative Bank. The administrative complexities involved meant that depositors had to wait for several months after the bank closures before their deposits were transferred to the receiving banks. The ICB had only a small amount of private sector deposits, which were mostly repaid directly by the BoU.

In the June 1999 budget speech (which was just after the closure of the Co-operative Bank), the Minister of Finance announced that, in the event of any further bank closures, only the deposits protected under the DIF would be fully repaid. Thus when Trust Bank was closed later that year, only the protected deposits were repaid in full, whereas the unprotected deposits were transferred to another bank at a discount reflecting an adjustment to take account of the losses incurred by Trust Bank.

Table 1 sets out the different methods of intervention in a distressed bank available to the regulator. The first decision which has to be made by the regulator, on detecting that a bank is insolvent or close to insolvency,¹ is whether or not to close the bank: in other words, the regulator must choose between columns 1 and 2 in the table. If the bank is not closed, the regulator chooses a form of open bank resolution with the objective of rehabilitating the bank while it remains open for business, although it may be closed at a later date if rehabilitation is unsuccessful.

Under open bank resolution the bank may remain under the control of the existing owners (column 1A) or be placed under the statutory management of the regulator (column 1B). Allowing an insolvent bank to remain open under the control of its existing owners involves serious moral hazard; the regulator is therefore likely to take steps to ensure that the owners carry out remedial actions, such as raising new capital, recovering non-performing loans, hiring new managers, etc. This may involve them in

1. The detection of insolvency would not normally come as a surprise to the bank regulator if the early warning system of bank distress is effective.

Table 1: Methods of intervention by the bank regulators

1. Open Resolution		2. Closure
1.A Remains under management of existing owners	1.B Placed under statutory management by the regulator	Followed by:
With or without MoU		Sale; P&A; liquidation
With or without liquidity support	With or without liquidity support	
With or without capital injection from public funds	With or without capital injection from public funds	

signing an MoU with the regulator, which sets out the remedial measures to be carried out and a timetable for their implementation. Open bank resolution, whether the bank remains under the control of its existing owners or is placed under statutory management, may involve the provision of liquidity support by the central bank. However, providing liquidity support to an insolvent bank also increases moral hazard, and could provide the owners with the opportunity to loot the bank.

Open bank resolution may also involve the provision of public funds for recapitalisation, such as a low-interest rate loan to the distressed bank. Public subsidy could also involve hiving off bad debts to an asset recovery agency and replacing them with government securities. In some countries, governments have, in effect, nationalised insolvent banks by injecting new capital from public funds. Because it is essential to avoid bailing out the shareholders of failed banks at taxpayers' expense, there should be some arrangement for eliminating or reducing in value the equity holdings of the existing owners of banks, which have been recapitalised with public funds.

If the bank is closed, the options for the regulator may include: selling it as a going concern to new owners; undertaking a P&A transaction, in which some or all of the assets and liabilities are transferred to new owners; or liquidating its assets. A sale and a P&A are also possible options under open resolution.

The resolution options set out in Table 1 are not exhaustive. Sheng (1996) provides a detailed discussion of the various methods of resolving distressed banks.

The typology of resolution options in Table 1 can be used to categorise the interventions by the BoU, which took place in 1998/99. The ICB was closed as soon as its insolvency became known, and was eventually liquidated. The three other banks which were closed all underwent some form of open bank resolution first. Greenland Bank initially remained under the control of its owners, but was then taken into statutory management: i.e., it passed from column 1A to 1B and then to column 2 in Table 1. The Co-operative Bank and Trust Bank both underwent open bank resolution without being placed under statutory management (column 1A) before being closed.

Following closure, the ICB and Greenland Bank were liquidated, whereas the Co-operative Bank was subject to a P&A transaction which enabled about two-thirds of its deposits and a small share of its assets to be transferred to two private sector banks, with the remainder of its assets placed in liquidation. Unlike the other banks which were closed, the Co-operative Bank had some franchise value because it had a countrywide branch network with branches in locations where most other banks were not present; hence a P & A was a more attractive option for potential bank investors than was the case for Greenland or the ICB. Some of the deposits and assets of the closed Trust Bank were taken over by a private sector bank in a P & A transaction.

Of the banks which had been subject to open bank resolution prior to closure, only one (Greenland Bank) received substantial liquidity support from the BoU, and no bank received subsidised funds from the BoU or the government. This was in contrast to the open bank resolution interventions in two insolvent banks in 1995, in which both banks were taken into statutory management and received long-term loans from the BoU at interest rates far below market rates, which they were allowed to treat as core capital. The loans from the BoU were thus used to recapitalise these two insolvent banks.

The size and cost of the bank failures

Table 2 provides data on the magnitude of the estimated insolvency of the closed banks and the fiscal costs of their failures, based on data from the banks' liquidators as of 31 December 2001. The actual losses are not yet certain, as this will depend upon the value of assets eventually recovered by the liquidator, a process that is still ongoing. The estimated insolvency of each bank is computed as its total liabilities, including all contingent liabilities crystallised, minus the actual assets recovered and what is estimated as the remaining realisable assets. The estimated insolvency does not include the liquidators' costs. A striking feature of Table 2 is the level of insolvency compared with total assets, especially of Greenland Bank and the ICB, which is indicative of the massive scale of the losses in these banks. In the case of the ICB, the estimated

Table 2: Assets, deposits, liquidity support and estimate insolvency of closed banks (Shs bn)

Bank	Total assets	Deposits	Liquidity support from BoU	Estimated insolvency	Cost
ICB	30.9	17.7	1.9	49.3	18.1
Greenland	105.6	48.3	24.2	82.3	79.5
Co-operative	72.8	55.0	0	28.1	46.7
Trust	10.8	4.5	0	1.0	0
Total	220.1	125.5	26.0	158.7	144.3

Notes: The deposits exclude interbank deposits. The average exchange rate in 1998/9 was \$1 = Shs 1363.

Source: Bank of Uganda.

insolvency exceeds the bank's assets because it had huge off-balance-sheet contingent liabilities.

The bank failures had substantial fiscal costs for five reasons. First, the value of deposits protected under the DIF, at Shs 41 billion, exceeded the funds in the DIF and the liquid assets of the closed banks by Shs 27 billion. Secondly, the government repaid uninsured private sector deposits in the ICB, Greenland Bank and the Co-operative Bank, amounting to Shs 59 billion. Thirdly, there was Shs 14.5 billion of government deposits in the closed banks. Fourthly, the closed banks had liabilities to the BoU totalling Shs 27.2 billion. Fifthly, Greenland Bank held Shs 16.9 billion of deposits from UCBL, a bank partly owned by the government. The total fiscal cost of repaying private sector deposits, plus the losses of government deposits, UCBL deposits and central bank loans, amounted to Shs 144 billion (about \$106 million at the exchange rates prevailing in 1998/9),² which was about 1.9% of GDP.³ The fiscal cost will be reduced to the extent that the liquidators recover some of the assets of the closed banks, but is unlikely to be much less than Shs 100 billion.⁴ Most of the fiscal cost was met by issuing securities, bearing a market interest rate, to banks which took over the deposits of the closed banks.

The aggregate losses of the closed banks can be interpreted in two ways. First, they represent a transfer of resources from the banks' creditors and shareholders to bad debtors. Because the government is a major direct creditor and repaid almost all of the private sector customer deposits, most of the losses involve a transfer from taxpayers to bad debtors, many of whom were connected to the banks' owners. Such a transfer is highly regressive, because bank owners and borrowers are among the richest people in society, whereas the majority of taxpayers in Uganda are poor.

Secondly, the bank losses represent a welfare loss to the economy because scarce resources have been misallocated, with credit extended to borrowers who could not generate sufficient rates of return from their investments to service their loans. Had these resources been allocated to projects which were profitable and capable of repaying their loans, total output and income in the economy would have been higher.

Lessons for bank intervention policy

Intervention in distressed banks is a particularly difficult area of regulatory policy for several reasons. First, the regulators usually face uncertainty about the true financial condition of a distressed bank, because of the difficulty of valuing its assets, which are likely to be highly impaired, and sometimes because of deliberate misreporting of the bank's financial condition by the bank itself.

2. This figure does not include the interest costs of the securities issued to the banks which assumed the deposit liabilities of the closed banks.

3. This is small by the standards of banking crises in some other developing countries: for example, the estimated losses in Korea, Indonesia and Thailand are 26%, 50-55% and 33% of GDP respectively (Caprio and Klingebiel, 1999). The small size of the losses in Uganda as a percentage of GDP reflects the shallowness of the banking system. Broad money is the equivalent of only 12% of GDP in Uganda, compared with 57% in Indonesia, 58% in Korea and 90% in Thailand.

4. As of March 2002, Shs 51 billion has been recovered by the liquidators, while a further Shs 10 billion is estimated as being realisable. The liquidators' costs were Shs 11.8 billion.

Secondly, intervention may have an adverse impact on wider financial markets, i.e. on systemic stability. Systemic effects could occur either because the distressed bank has liabilities to other banks or because the closure of a distressed bank may trigger deposit runs in other banks perceived by depositors to be also at risk of closure.

Thirdly, there is an inevitable tension between the desire to give a distressed bank time to remedy its problems and the need to stem losses to depositors and taxpayers and to avoid moral hazard. Allowing a distressed bank to remain open inevitably increases moral hazard, because the bank's owners, with little or none of their capital left to protect, have strong incentives to take excessive risks with depositors' money in the hope of restoring the value of their capital ('gambling for resurrection'), or simply to loot what is left of the bank's assets (Akerlof and Romer, 1993). Hence allowing a distressed bank to remain open risks an escalation of the losses to its creditors. Fourthly, intervention is usually politically sensitive, because bank closures entail costs for bank customers and staff, and for their owners and debtors who are often politically well connected.

In this section, we examine the lessons of the bank failures in Uganda in 1998 and 1999 for intervention policy. We begin by looking at the key decision which the regulator must take upon detecting that a bank is insolvent or close to insolvency, namely, whether to close the bank or attempt some form of open bank resolution.

Closure versus open bank resolution

With the exception of the ICB, which was closed very soon after its insolvency was discovered, the BoU at first adopted a strategy of open bank resolution for the other distressed banks, allowing them to remain open for business while efforts were made to rectify their problems. The hope of the regulators was that the closure of these banks could be avoided if the owners were given time to raise new capital, recover loans and correct managerial weaknesses. There were several reasons why the BoU favoured open resolution rather than closure of insolvent banks, notably inadequate information on the true scale of the bank's insolvency and concern about the potential systemic effects of closures.

Assessing the scale of insolvency Although it was known that the banks were insolvent, the magnitude of their insolvency was seriously underestimated on the basis of the balance-sheet information, which was available to the banks' auditors and to the bank regulators through off-site returns and on-site inspections. For example, the special audit of Greenland Bank, which was conducted by one of the big five international accounting firms, estimated that its net worth was negative Shs 197 million as of June 1998 (which was less than 0.3% of its total assets), whereas the audit and investigation conducted after its closure in April 1999 estimated its net worth to be negative Shs 62.4 billion (60% of its assets). As it is very unlikely that Greenland Bank lost Shs 62 billion in the nine months leading up to its closure, the special audit must have underestimated the scale of its insolvency in June 1998 by a considerable margin. Although the auditors underestimated the actual level of losses in the distressed banks, their estimates of the losses were nevertheless much larger than those reported by the banks' managers, who in most cases were providing financial statements to the BoU which showed their bank to be solvent.

The balance-sheet data produced while the distressed banks were still operating underestimated the scale of their insolvency for several reasons. Substantial volumes of assets and liabilities were deliberately concealed from auditors and bank regulators by the managements of two of the closed banks (Greenland Bank and the ICB). Accounting procedures were very poor, with no uniformity in the treatment of non-performing assets. Documentation of loans, loan securities, guarantees, etc. was inadequate or missing entirely in some cases, and loan securities often proved to be of little value. Overall, the Ugandan experience bears out that of many other countries which have experienced bank failures and where the final losses on liquidation have turned out to be a multiple of the losses estimated by bank inspectors and external auditors, which in turn were a multiple of the losses estimated by the banks' managers (Sheng, 1996: 54).

Prospects for successful recapitalisation and rehabilitation Partly because their insolvency had been underestimated, the regulators were overoptimistic about the prospects for resolving the problems of the distressed banks through recapitalisation and loan recovery. In fact, for the banks which were closed, no new capital was injected, either by their owners or by new shareholders, and loan recovery was minimal.

Any benefits for financial intermediation, which are derived from providing time for banks to be recapitalised, need to be set against the inevitable risks to depositors of allowing insolvent banks to continue trading and the damage that this does to the credibility of bank regulation. Moreover, recapitalisation is only one of the remedial actions required to restore an insolvent bank to commercial viability. Any bank which has a large portfolio of non-performing loans, a small portfolio of viable borrowers and little franchise value is a poor prospect for successful resolution, even if it is recapitalised by its owners, because it does not have a strong customer base on which to rebuild its profitability (Andrews and Josefsson, 2000: 20).

Systemic effects The regulators feared that bank closures would lead to a loss of the public's confidence in other banks, which could trigger systemic failures in the banking system. These fears were unfounded. The interventions did not lead to runs on sound banks, and deposit growth in the banking system remained strong throughout the period of the bank closures. Between June 1998 and March 1999, bank deposits grew by 7% (9.1% on an annualised basis). This was a period in which the ICB was closed, two other banks voluntarily suspended operations because of illiquidity, and Greenland Bank was taken into statutory management. There was a fall in deposits between March and June 2000, but this is entirely attributable to the removal from the data of the deposits of Greenland Bank and the Co-operative Bank (amounting to Shs 94 billion), both of which were closed in this period. In the following 12 months deposits grew by 33%, of which only one-third was attributable to the transfer of the deposits in closed banks to other banks. During the two years from June 1998 to June 2000, which covered all of the regulatory interventions and bank closures, bank deposits expanded by almost 40%. As the domestic consumer price level rose by only 7.3% during this period, deposit growth in real terms was 30%. Hence there is very little evidence of a flight by depositors from the banking system as a whole.

Table 3: Bank deposits, June 1998 - June 2000 (Shs bn)

	June 1998	March 1999	June 1999	June 2000
International banks	312	409	472	641
Domestic banks ^a	200	186	179	221
All banks ^b	843	900	884	1179

Notes: a) Excluding the deposits of the closed banks and UCBL. b) Including the deposits of all of the banks which were open on that date. The data for June 1998 are not strictly comparable with those for the other dates because of changes in the bank reporting format.

Source: Bank of Uganda.

There was some evidence of a ‘flight to quality’, in that the subsidiaries of international banks experienced much stronger deposit growth than domestically owned private sector banks. The former more than doubled their deposits between June 1998 and June 2000. The domestically owned private sector banks (excluding those which were closed), which were most at risk from contagion, lost about 10% of their deposits between June 1998 and June 1999, but their deposits recovered in the following 12 months with growth of 24%. The only major run on a sound deposit-taking financial institution occurred in May 1999, when the Housing Finance Company of Uganda (HFCU) – a non-bank financial institution (NBFi) partly owned by the government – suffered a run which was quickly brought under control by a public announcement by the government that HFCU was safe.

Moreover, BoU liquidity support to solvent banks was negligible. Excluding Greenland Bank, the commercial banks’ borrowing from the BoU increased by only Shs 2.1 billion (0.2% of total bank deposits) in the six months following the first intervention in Greenland Bank in December 1998, and this increase was accounted for by only one bank which was already suffering from lack of liquidity before the intervention in Greenland Bank.

The absence of ‘bank runs’ on sound banks cannot be attributed to any blanket government deposit guarantee. Until Greenland Bank was closed in April 1999, the official position was that only insured deposits (up to a maximum of Shs 3 million) would be protected. After the closures of Greenland Bank and the Co-operative Bank, the public was told that the uninsured as well as the insured deposits of these banks would be reimbursed, but the government also announced that in future it would revert to its policy of only reimbursing insured deposits, which was the policy followed when Trust Bank was closed in November 1999. It appears that most depositors were able to understand why the closed banks had failed and did not automatically assume that other banks, which were still open, were suffering similar problems. Public confidence in the overall soundness of the banking system is likely to have been bolstered by the press statements issued by the Minister of Finance and the BoU immediately after the closures of Greenland Bank and the Co-operative Bank, which made clear that the closures were caused by problems specific to these banks and were necessary to protect their deposits.

Because of the structure of the Ugandan banking system, a systemic banking crisis triggered by the closure of one or more banks is unlikely. Prior to the bank closures,

40% of all the deposit liabilities of the commercial banks were held by subsidiaries of international banks, which are subject to consolidated supervision in their home countries and are generally soundly managed. These banks have very little exposure to potentially weak banks through the interbank market, while they are unlikely, because of their international reputation, to suffer any loss of depositor confidence resulting from bank failures elsewhere in the system.

As was the case in Uganda, bank failures are likely to induce a shift in deposits towards the international banks, rather than to lead to disintermediation from the banking system as a whole. Whether such a shift is desirable is another issue. It is likely to reduce the scale of losses to deposits arising from bank failures in the future, because a larger share of the banking system's deposits are held by banks which are least likely to fail. But it may also restrict access to credit and other banking services from sections of the economy such as small and medium-scale enterprises which are not usually well served by the international banks.

Costs of open bank resolution The decision to attempt open bank resolution for insolvent banks, rather than closing them once their insolvency was detected, entailed fiscal costs, because the banks which were eventually closed incurred further losses during the period of open bank resolution. It is impossible to estimate how large the additional losses incurred during this interim period were, because, while there are now estimates of the total losses incurred by the time the banks were eventually closed, the extent of their losses at the time when open bank resolution efforts were first initiated is not known with any degree of certainty, given the gross inaccuracies in their financial reporting. A very rough proxy for the minimum fiscal costs of open bank resolution is provided by the liquidity support extended to a bank during open bank resolution, in that, had the regulator closed the bank instead of attempting open bank resolution, the loss of liquidity support could have been avoided. For Greenland Bank, about 30% of the fiscal cost was accounted for by the liquidity support extended by the BoU after it had intervened.

Statutory management of distressed banks

If the regulators decide to pursue an open bank resolution option for a distressed bank, a critical decision is whether they should leave it under the management of the existing owners, albeit with conditions set out in an MoU, or directly intervene and replace the management, which may involve placing the bank under the statutory management of the regulator. Although leaving an insolvent bank under the control of its existing owners and managers, who have been responsible for its failure, involves serious problems of moral hazard, it is also very problematic for the regulator to assume responsibility for the management, as was demonstrated by the experience with Greenland Bank.

The attempted open bank resolution of Greenland Bank placed the banking regulators in a particularly difficult situation, because once the BoU had intervened and replaced the Managing Director and the Board of Directors, it effectively assumed responsibility for the bank's management, and then did so formally when the bank was placed under statutory management a few weeks later. Greenland Bank was already both illiquid and insolvent when the BoU first intervened in December 1998 and was

losing deposits as public confidence in the bank drained away. Once it had assumed responsibility for the management, the BoU also had to ensure that the bank had the liquidity to honour its liabilities. This meant that the BoU had to reassure large depositors and other creditors that their money would be safe, which was not possible in the absence of a government guarantee of those liabilities falling outside the coverage of the DIF, and to provide the bank with open-ended liquidity support. After receiving an initial Shs 19.1 billion of liquidity support in December 1998, Greenland Bank required a further Shs 5 billion of liquidity in the four months before it was closed in April 1999.

Greenland Bank was also soliciting deposits from the public after the BoU intervened, even though it was insolvent and, therefore, technically incapable of meeting all of its liabilities. As the BoU was responsible for the bank's management, it was also effectively assuming responsibility for its deposits, thereby effectively socialising Greenland Bank's huge losses. This could only have been avoided if the bank had been closed as soon as the BoU intervened in early December. Non-intervention, which would have involved leaving the bank under the control of its owners and managers, was clearly no longer an option at that point because of the scale of its mismanagement, the violations of the banking laws and the deliberate concealment of assets and liabilities from the regulators.

Greenland Bank was not the first case of open resolution under statutory management attempted in Uganda. Two insolvent banks had been taken into statutory management by the BoU in 1995. Although they were eventually turned round, this was only possible because the BoU provided them with large subsidised long-term loans.

In general, statutory management by the regulator of an insolvent bank which remains open for business should be avoided. The insolvent bank's uninsured depositors and other creditors will withdraw their funds, forcing the regulator either to provide them with some form of implicit guarantee or to provide liquidity support as a substitute for the funds which they withdraw. The exception where statutory management might be appropriate would involve banks where an implicit government guarantee of all the deposits already exists, as with a government-owned bank such as UCBL, or where closure would threaten very real systemic dangers, such as when a bank is deemed too big to be allowed to fail (in which case there is also an implicit government guarantee of deposits). Once an insolvent private sector bank is taken into statutory management, the onus is placed on the regulator to rehabilitate it. This inevitably increases the pressure on the regulator to bail the bank out with some form of financial assistance if only to avoid its statutory management being perceived as a failure if the bank is eventually closed. In addition, the ability of bank regulators in developing countries to manage distressed banks successfully back into solvency is likely to be impeded because the managerial resources at their disposal are very limited.

Conclusions

Several lessons for intervention policy can be drawn from the experience of dealing with failed banks in Uganda.

First, although the danger of bank closures triggering runs on sound banks cannot be ignored, the systemic risks of closing small banks should also not be exaggerated. The bank closures in Uganda had no systemic effects on the banking system and no sound banks, and only one NBFI, suffered serious bank runs. Depositors appear to be

able to discriminate between banks and understand that some are more risky than others. Moreover, there is little danger of closures of small banks triggering a systemic crisis in a banking system with very limited interbank lending and where international banks have a large share of the deposits.

Secondly, the regulators should be sceptical about the prospects for successfully rehabilitating distressed banks. The true financial condition of a distressed bank is likely to be much worse than that reported in financial statements and returns submitted to the regulator, given that distressed banks have every incentive to misreport the true state of their financial condition to the regulators. It may even be worse than the position revealed by on-site inspections or special audits, as the banks may conceal assets and liabilities from inspectors and auditors. Furthermore, the expectation that the owners, or new shareholders, will recapitalise a bank which is already massively insolvent is unlikely to be realised. Neither the existing shareholders nor new shareholders have much incentive to inject new capital into an insolvent bank, or even to pay back insider loans, as they will simply be making good losses which stand to be borne by someone else.

Thirdly, open bank resolution should only be attempted when the distressed bank has some value left, and not when a bank is already insolvent: in other words, only when a bank is undercapitalised but not yet insolvent, and/or has some franchise value which might attract new investors. Allowing an insolvent bank to remain open, under the control of its owners, allows the owners who are responsible for the bank's failure more time to gamble with its remaining assets, or simply to loot these assets, while the staff have incentives to commit frauds. As the shareholder value is negative, any further losses that the bank suffers must be borne by its creditors or taxpayers.

Fourthly, the period of open resolution should be strictly limited to a few months at most. The regulators should impose meaningful penalties on banks which fail to implement the remedial measures stipulated in MoUs and should not allow them to miss deadlines for recapitalisation. Allowing distressed banks to remain open for extended periods, in violation of statutory minimum capital requirements, undermines the credibility of bank regulation and risks fostering the expectation that regulators will extend forbearance in cases of bank distress.

Fifthly, the regulators should avoid attempting open bank resolution under statutory management except in circumstances where a *de facto* government guarantee of deposits already exists. In managing a distressed bank, the regulator faces the choice of reassuring non-insured creditors that their funds are safe or, alternatively, providing liquidity support to the bank in the event that creditors withdraw their funds. Statutory management of a distressed bank is likely to protect the uninsured creditors at public expense, and is likely to increase pressure on the regulator to bail out the bank with public funds.

Sixthly, open bank resolution should be avoided unless there is a strong probability that the insolvent bank can be both recapitalised and restructured into a viable bank within a short period of time. For heavily insolvent banks with a large non-performing loan portfolio, the prospects for successful recapitalisation and rehabilitation must inevitably be poor.

Seventhly, it could be argued that open bank resolution of an insolvent bank is preferable to closure because the latter involves disruption to banking services. However, if open bank resolution is unlikely to be successful for the reasons outlined

above, attempting it merely postpones the disruption to the bank's customers rather than avoiding it. Moreover, the disruption to services from bank closure can be reduced by means of measures such as a purchase of assets and assumption of liabilities transaction or a transfer of deposits to sound banks (Andrews and Josefsson, 2000).

Finally, the lessons of the bank failures in Uganda indicate that, in most cases of bank distress, the regulators should intervene and promptly close the bank once its capital has fallen to some critical threshold rather than attempting any form of open bank resolution. Because of the inevitable pressures that regulators face to exercise forbearance to distressed banks, it is desirable to set out clearly defined and publicly announced intervention and closure rules (Glaessner and Mas, 1995). After the Savings and Loan debacle of the 1980s, the US introduced 'Prompt Corrective Action' (PCA) rules, which stipulate mandatory regulatory interventions triggered by falls in a bank's regulatory capital, including closure after a bank becomes 'severely undercapitalised'. The Ugandan Government has submitted new banking legislation to Parliament, which includes PCA rules.

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