UNIVERSITY OF ALBERTA

THE LEGISLATIVE FRAMEWORK FOR REGULATING BANKING BUSINESS IN CANADA AND NIGERIA: A CRITICAL APPRAISAL

by

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A thesis submitted to the Faculty of Graduate Studies and Research in partial fulfilment of the requirements for the degree of Master of Laws.

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ABSTRACT

The thesis examines the current legislative framework for regulating banking business in both Canada and Nigeria with a view to determining their adequacy to contain the incidence of bank insolvencies. It reviews the historical justification for introducing specific statutes to regulate the banking sector in both countries and highlights parallels between the concerns then and the challenges now. Furthermore, the thesis identifies some of the factors responsible for the bank failures in both countries and critically appraises the legislative response to them.

The thesis recommends the enactment of a *Bank Regulators (Accountability) Act* which allows depositors of a failed bank to bring action against bank regulators where the circumstances indicate inexcusable regulatory lapses or oversight as the principal factor that led to the bank's insolvency.

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INTRODUCTION

The practice of regulating and directing human conduct by a legitimate authority[1] towards a desirable end is as old as human existence. According to a learned writer, "[r]egulation of individual behaviour by higher authority is as ancient as the Garden of Eden .... Adam and Eve chaffed against the iron-clad specification standard they confronted, accepted the advice of an independent counsellor, engaged in non-compliance activities, and suffered the consequences"[2].

Hence, the idea of having a legal framework[3] setting the parameters of desirable practices for individuals within a polity is not new, and has come to be generally accepted as critical to the well-being and survival of the polity itself.[4] This consensus of views on the necessity of law to regulate individual behaviour becomes polarised as soon as the subject of regulation relates to how an individual exercises his free-will to direct his business affairs or conduct his economic transactions with others.

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1 The phrase "legitimate authority" is used loosely to denote any Being, person, body or institution generally recognized and accepted by all within a given Society as the *de facto* or *de jure* law-giver.

2 Y. Bruce, "Bootleggers and Baptists in the Market for Regulation" in F. Jason, ed., *The Political Economy of Government Regulation* (New York, Kluwer, 1989) 29.

3 But see Ehrlich, a German jurist of sociology orientation, who argues that it is not only the legislative framework, which posits positive law - or legal propositions as he calls it -that operates as the prescriptive order within a society There is, according to him, in addition, a normative structure embodying what he calls "the living law" which governs society in all its aspects: For more on this, see Dennis Lloyd, *The Idea of Law* (England: Penguin, 1976) at 209[*Lloyd*].

4 See generally C. Morris, *The Justification of the Law* (Philadelphia: University of Pennsylvania Press, 1971).

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Over the years, the issue of the desirability or otherwise of government intervention[5] in the ordinary workings of a market economy by way of regulatory[6] measures has drawn, and perhaps will continue to draw, comments from a wide and diverse group of persons – scholars, politicians, economists, *etc.* The various arguments are diverse, but can be narrowed down, for the purpose of this thesis, into two broad categories, *viz* those who favour government intervention and those who oppose it.

The former group argue that government intervention is necessary to check the incidence of market failures[7], as the market on its own, they contend, is incapable of correcting economic imbalances and market fluctuations or other fallouts of an unregulated market[8]. Their view is premised, essentially, on the belief that " government can and will carry out the strategies necessary to correct market failures"[9]. Those who oppose government

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5 Many of the studies have also examined the effects and motives for government intervention in the operations of the markets: See for example the pioneering work of Stigler in, George Stigler & Friedland C, "What can Regulators Regulate? The Case of Electricity" (1962) 5 J.L & Econ.1 [*Stigler*]

6 The word "regulatory" is used generically to cover all legislation, subsidiary instruments, guidelines, directives, circulars *etc.* enacted or issued by a competent government authority.

7 MARKET FAILURE is the modern justification for government action. And that justification has been used ... to produce broad -ranging programs, rules and agencies to control and influence economic choices.... Rent control, pollution regulation, safety rules, import restrictions ... and thousands of other controls have been enacted to overcome the perceived imperfections in the market" : See C. Mitchell and R. Simmons , *Beyond Politics - Market , Welfare and the Failure of Bureaucracy* (San Francisco: Westview ,1994) 1[*Beyond*].

8 *Ibid.* at 3-20.

9 *Ibid.* at 19. According to Bruyn, "When corporations exploit labor, the government creates labor departments and labor legislation. When business produces hazards in the workplace, the government sets rules for safety and health on the job. When business harms or lies to customers, the government establishes consumer agencies and legislation to regulate product safety, truth in lending...as well as hundreds of other regulations to protect buyers. When big business destroys its weaker competitors by underpricing and making monopolistic mergers, governments create agencies and laws to establish fair competition. When markets widen the gap between the rich and poor, governments raise wage standards nationwide and establish a progressive tax system. When

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intervention, on the other hand, generally question the wisdom in, and basis for the belief in the ability of government to correct market failures. According to this group, "[t]he vision underlying this ... is that government succeeds where market fails . It is a vision we do not share. We have more faith in markets than in governments"[10].

There is, in fact, a vast amount of economic literature dealing generally with the question of government regulation of economic activity, and in most cases, questioning popular beliefs about government's true motives for regulating businesses or the efficacy of particular regulatory approaches to bring about desired outcomes[11]. Starting largely with the pioneering works of Stigler[12], mainstream economic theorists on regulation have

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business destroys the environment, governments create environmental protection agencies to stop the devastation. And so on, ad infinitum", Bruyn S, "How to Transform Capitalist Markets to Civil Markets" online: <http://www2.bc.edu/~bruyn/Newton.htm>

10 *Beyond supra* note 7 at 1. For a full articulation of the various arguments of the two sides, see *Beyond, supra note 7* at 1-100; see also, T. Cowen, ed., *The Theory of Market Failure: A Critical Examination* (New York: George Mason University Press, 1988).

11 In banking for instance, differences in views among researchers are more pronounced when the issue is on the ideal model of regulation as opposed to when the question is on the desirability of regulation. More will be said on this in the course of the thesis. The issues discussed in the context of banking are multifarious and include: *Is there too much or too little regulation? Do we have the right type of regulation - that is, is it effective in achieving the goals set for it? Are the goals of regulation the right ones? Are the procedures of regulation effective, fair and democratic? What criteria should be used to assess regulatory effectiveness? Are the regulators being excessively meddlesome? Is regulation effectively immune from political interference? Do we have the right mix of regulatory measures or is there a mismatch? Does the regulatory framework stifle innovation and competition in the industry? Are there justifiable reasons why banks are subjected to more regulation than other financial intermediaries carrying on similar activities? Has the regulatory framework significantly reduced the likelihood of bank insolvencies? Are there adequate measures in place to promote depositor confidence in the banking industry? Would competition in the banking industry be enhanced if the regulatory framework places domestic banks at a competitive advantage over foreign banks? Should greater regulatory role be given to the market? Has regulation placed an undue burden on the banks? Are banks inherently fragile so as to require constant monitoring by government? Who regulates the regulators*

12 Stigler, *supra* note 5; Stigler, G. "The Theory of Economic Regulation" (1971) 2 Bell J. E & Man. Sci.3; Peltzman S., "Toward A More General Theory of Regulation" (1976) 19 J.L.Econ 211; Peltzman S, Levine M & Noll R, "The Economic Theory of Regulation After A Decade of Deregulation" *Brooking Papers on Economic Activity,* 1989 at 1.

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devised means of conducting systematic empirical analysis to study the actual effects of regulation on particular industries, including banking[13]. Their findings – though not necessarily infallible – provide a rich source of information for legal scholars to make constructive proposals for legislative reforms. According to Lloyd[14],

> [I]t is far from being the case, as some lawyers fondly imagine, that legal training and experience alone are sure guides to the real character of the social and economic problems with which the law has to make contact and for which it has to afford solutions....In such matters then, there is a large field for impartial and scientifically conducted inquiry into the basic facts and true nature of the problems with which the law is attempting to wrestle....[S]ufficient advances have already been made to show that certain fields of study can make important contributions to the understanding and workings of the legal system and to its improvement for the future

It is beyond the scope, and indeed jurisdiction, of this thesis to go into an analysis of many of these economic arguments or to question the findings or the assumptions on which they are based. Nevertheless, some of the relevant arguments will be considered in the second chapter of this thesis when examining different views on the desirability of government regulation of banking business. This insight will give a better understanding of some of the theoretical arguments and issues surrounding bank regulation

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[13] See for instance, Gerard Caprio Jr., "Bank Regulation: The Case of the Missing Model" online: World Bank Policy Research Paper 1574<http://econ.worldbank.org/files/408_wps1574.pdf>; Karenken J & Wallace N, "Deposit Insurance and Bank Regulation: A Partial Equilibrium Exposition"(1978) 51 J. Bus, No.3 413; Jordan J, "A Market Approach to Bank Regulation" online: <http://www.cato.org/pubs/jounral/cj13n3/cj13n3-1.pdf>; Herring R and Santomero, "What is Optimal Financial Regulation" online: Wharton School Center for Financial Institutions Working Papers < http://fic.wharton.upenn.edu/fic/papers/00/0034.pdf>.

[14] *Lloyd*, *supra* note 3 at 331- 332.

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Regulating Banks

There is a general acknowledgement of the crucial role played by banks in the overall economic growth and development of a country[15]. Apart from their principal function of financial intermediation which, in simple terms, means the channelling of funds from the surplus sector of the economy to the deficit sector, they act as a sort of "conduit pipe" through which government implements most of its monetary policies.

Though the contemporary activities of banks in countries all over the world, including Canada and Nigeria, are regulated to achieve several objectives such as protection of depositors' funds, promoting monetary stability, encouraging an efficient and competitive financial system[16], ensuring the safety and soundness of the banking system is still the paramount consideration[17] and this basically means: preventing them from failing. Amongst the issues to be discussed in this thesis are: *To what extent are the current banking laws in both Canada and Nigeria able effectively to contain the incidence of bank insolvencies? How adequate are they in containing those ills that have been identified as potentially destructive to the banking industry?* The primary objective of many countries in designing their banking regulatory model is: the development of the 'ideal regulatory structure' that would be able to prevent, or reduce to the barest minimum, the incidence of bank insolvencies.

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[15] Smith R and Walter I, *Global Banking* (New York: Oxford University Press, 2003) at 335.

[16] See J. Ebhodaghe, *Safe & Sound Banking Practices in Nigeria: Selected Essays* (Lagos: Page, 1997) at 80 [*Ebhodaghe*].

[17] Without a safe and stable banking system, none of the other objectives can be realised.

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In spite of efforts by various governments, however, the elixir for bank failures remains elusive, and the threat still looms, arguably, as large as it has always been. Historical facts reveal that no country is immune from bank failures. In Canada, for instance, memories of the crash of the Canadian Commercial Bank and the Northland Bank in the 1980s is still fresh in the minds of many. In Nigeria too, the banking system, recently described as "ramshackle" by the British Broadcasting Corporation[18], has had its share of bank insolvencies. The effects of a bank failure on the overall economy can be catastrophic. According to Kaufman and Seelig ,

> Bank failures are widely viewed in all countries as more damaging to the economy than failures of other types of firms similar size for a number of reasons. The failures may produce losses to depositors and other creditors, break long-standing bank-customer loan relationships, disrupt the payments system, and spill over in domino fashion to other banks, financial institutions and markets, and even to the macro economy[19].

Bank failures are, therefore, "almost universally regarded as special calamities" that must be prevented, and it is against this backdrop that the topic of this thesis, *The Legislative Framework for Regulating Banking Business in Canada and Nigeria: A Critical Appraisal*, was conceived.

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[18] "Nigeria Mulls Bank Fines" BBC News,(7 March 2002) online: <http://news.bbc.co.uk/1/hi/business/1861050.stm>.

[19] Kaufman and Seelig, *" Post Resolution Treatment of Depositors at Failed Banks: Implications for the Severity of Banking Crises, Systemic Risk, and Too Big to Fail"*, (2002) 26 E.P.5

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Objective of Study

It should be noted that contemporary banking legislation[20] typically addresses issues of market conduct and prudential regulation[21] by making provisions for, *inter alia,* entry requirements, capital and reserve requirements, corporate governance, activity restrictions, auditing, loan classifications and permissible loan concentration.[22] The thesis will not examine each of these heads in relation to both Canada and Nigeria but rather evaluate both countries' current regulatory framework in the light of the factors identified as responsible for the most recent cases of bank insolvencies in both countries.[23] *Are the regulatory measures capable of promoting stability in the banking sector and promoting depositor confidence?*

Also, it seems to be the case in many jurisdictions that much attention is given to "the regulated" and not as much to " the regulators". Developing and maintaining a healthy banking system, however, does not stop at having a regulatory framework which focuses almost exclusively on the nature and scope of banking business, how it is to be conducted, proper and ethical banking practices, responsibilities of bank management *etc.* In my view, there should be specific provisions aimed at ensuring the efficiency and

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[20] The word "legislation" is used here broadly to include rules, regulations, guidelines, directives *etc.*

[21] Canada, *Report of Task Force on the Future of Canadian Financial Services Sector,* (Ottawa: Department of Finance, 1998) at 8-9.

[22] See generally, Barth J, Caprio G & Levine R, "Bank Regulation and Supervision: What works Best?" online: World Bank Research Papers, <http://www.bis.org/bcbs/events/b2ealev.pdf>.

[23] The common underlying causes of bank insolvencies have been identified to be, insider lending, moral hazards, undercapitalisation, large portfolio of non-performing loans, illiquidity, over-exposure and mismanagement. See generally, Benton Gup, *Bank Failures in the Major Trading Countries of the World: Causes and Remedies,* (Westport: Quorum Books, 1998)

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accountability of the regulatory bodies[24]. Bank management and officers alone cannot be singled out for persecution or prosecution in the event of a bank failure. The truth of the matter is that every bank failure is, in a way, an indictment on the regulatory institutions, and an objective inquiry into the circumstances surrounding a bank failure might reveal evidence of, excesses, overzealousness, laxity, or other improprieties on the part of the regulatory bureaucrats which make them equally culpable.[25] In many cases, it is typically possible to "point towards specific failures of the regulatory system that permitted the mistakes or malfeasance that were the proximate cause" [26] of bank failures.

Some have argued that the remedies available under public law (*mandamus*, *certiorari etc.*) should suffice, and, consequently, persons aggrieved by the actions or inactions of the regulatory institutions should avail themselves of any of these remedies. The thesis argues that these so-called remedies are grossly inadequate – and indeed inapt – for anyone seeking remedies from the regulatory institutions for loss suffered by that person as a result of a bank failure. In many instances, " the aggrieved citizen... wishes monetary compensation for the loss suffered," [27] and the likelihood of the court making an award against a regulatory institution in the event of a bank failure is a stronger "incentive" for those institutions to be more diligent in carrying out their duties.

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24 Kane, E, "Ethical Foundations of Financial Regulation", online: Working Paper 6020, National Bureau of Economic Research, 1997 <http://www.nber.org/papers/w6020.pdf>. In this article, the author argues that regulators owe a duty of care to tax payers and by reason of this should be made accountable for incompetent or corrupt behavior which leads to insolvency. *Ibid*, at 17-18.

25 An Austrian case discussed in the last chapter of this thesis clearly illustrates this point.

26 Gavin Michael and Ricardo Hausman, "The Roots of Banking Crises: the Macroeconomic Context", Inter-American Development Bank, Working Paper 318, January 1996 at 2.

27 J. Law and F. Laux eds., *Administrative Law : Supplemental Materials* (Edmonton :Faculty of Law, University of Alberta , 1998) p.433.

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In the light of this, a case will be made for the accountability of the regulators – principally to the persons sought to be protected by bank legislation: the depositors. On this point, the remedies that may be available under private law will be considered and, to this end, the following questions will be examined: *Is the concept of a private duty cognisable in a typically public law context? Do the regulatory authorities owe any legal duty to existing or prospective depositors? Could a depositor or other creditor of a failed bank assert a claim against the authorities for negligence in granting an authorization, which ought not to have been granted, or in failing to exercise due care and diligence in the discharge of their statutory duties?* This thesis argues that the common law torts of negligence, breach of statutory duty and misfeasance in public office – all of which, arguably, may be invoked by a depositor of a failed bank to seek compensation from the regulatory institutions – operate alongside a statutory scheme of remedies. The fiduciary obligation remedy under Canadian law will also be examined. This study does not contemplate an extensive examination of these legal actions and neither does the focus of the thesis require a critical analysis of the court decisions. However, the objective will be to determine the extent to which they may provide remedies for bank depositors against the regulators in the event of a bank failure.

Incidentally, there is scant legal literature on this proposal for the creation of a statutory scheme of remedies for bank depositors and, to that extent, it is somewhat of a novelty. Making a case along these lines is perhaps long overdue and this is evident in the fact that some depositors of failed banks have fought their claims for compensation against bank regulators to the highest courts in some common law jurisdictions. *Would they have expended more financial resources - in form of legal fees - if they did not believe that*

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bank regulators should be accountable where failure is due to inexcusable regulatory lapses?

It is my conviction that if the proposed scheme of statutory cause of action is adopted in the legislative framework for banking business in both Canada and Nigeria, the depositors will feel better protected and more reassured that the regulators now have every reason to take their work more seriously. As a consequence, their confidence in the banking system will grow and the banks will be the better for it: they depend on people's continued confidence to survive. The thesis is organized as follows:

CHAPTER ONE will briefly consider the origin and evolution of banking in the world and trace that development up to the Middle Ages, highlighting events of importance particularly those of regulatory significance. The meaning of "banking business" will be ascertained prior to the historical survey. The origin and development of the modern banking institution in both Canada and Nigeria will also be examined, with particular emphasis on the development of the statutory framework. Specifically, the reasons which were historically viewed as justifying government regulation of banks will be considered, and on this, relevant portions of parliamentary debates preceding the enactment of the first banking legislation for both countries will be examined.

CHAPTER TWO will consider some theoretical arguments on why governments, generally, intervene in the operation of markets and why banks should or should not be regulated. It will be examined if, and how, these conceptual arguments can be used to rationalise the regulatory models adopted by both Canada and Nigeria. The latter portion

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of this chapter will examine the incidence of bank failures in both countries, and on this, emphasis will be placed on the latest cases of bank failures experienced in both jurisdictions. The aim will be to identify those factors found as the immediate and remote causes of the bank failures and this will form the basis for the appraisal of the relevant provisions of the statutory framework.

CHAPTER THREE will critically consider those provisions in the regulatory framework aimed at addressing those factors already identified in the preceding chapter as the major causes of insolvency, the aim being to determine their effectiveness to contain this malady. As this is the concluding chapter, some of the relevant findings made and conclusions reached in the preceding sections of the thesis will be articulated and used to form the basis of proposals for reforms. Also, the common law torts of negligence, misfeasance in public office and the Canadian concept of the fiduciary obligation will be examined to determine the degree of remedy, if any, they afford to a depositor of a failed bank against the regulatory authorities .The thesis will not delve extensively into these common law remedies as the principles appear to be fairly established; hence, only the decisions that are considered to be of most relevance to the direction of arguments in the thesis will be examined .Furthermore , only the decisions of the highest courts , where available, will be used. Among the proposals to be made in the concluding chapter is the introduction of a statutory scheme of remedies for the benefit of depositors. Arguments will be proffered for the enactment of a *Bank Regulators (Accountability) Act* to serve as a better and more viable alternative remedy for depositors of a failed bank against the regulators.

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CHAPTER ONE

Introduction

The economic activity of deposit-taking and advancement of credit – the core activities of banks – is undeniably one of the oldest forms of business undertaking in the world, with its origin going as far back as Biblical times. This chapter, *inter alia,* traces the origin and evolution of banking business, emphasising, however, only the areas which are of regulatory significance or which may otherwise have relevance to the constitutive structure of the arguments in subsequent chapters.

The chapter begins with an examination of what constitutes "banking business" at common law and traces its development from ancient times up till modern times. The chapter further considers the historical development of banking business in both Canada and Nigeria, tracing the development of the regulatory framework. A chronological examination of the banking statutes is, however, not contemplated here; rather, the circumstances surrounding the enactment of the first major banking statutes in both countries [hereafter jointly called the *First Acts* for the purpose of this introduction] will be considered. A question to be considered is, *what, historically speaking, were the reasons viewed as necessitating the establishment of a regulatory framework for monitoring the affairs of banks in both countries?* A proper understanding of the current

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regulatory framework of both countries requires an appreciation of how the regulatory regime emerged.

In examining the reasons underpinning the introduction of the regulatory framework, relevant portions of the reports of legislative debates[1] preceding the passage of the *First Acts*, in addition to other relevant literature documenting the prevailing economic and social milieu, will be considered as they provide invaluable evidence of the context and factual matrix in which the *First Acts* were made, and should, therefore, give an insight into the underlying reasons that informed, not only the passage of these statutes, but also why the particular model of regulation was adopted. As some provisions in the current banking statutes of both countries are relics of the *First Acts*, understanding the underlying reasons for the enactment of the *First Acts* will be helpful in questioning, where relevant, the rationale for the continued existence of certain provisions of the banking statutes if the circumstances that informed their inclusion have ceased to exist or to be relevant. The final part of this chapter will give a very brief overview of the regulatory structure of both countries highlighting the principal regulatory institutions.

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[1] At common law, the courts reserve the right to consult legislative documents to determine legislative intent: See generally, F. Bennion, *Statutory Interpretation* (London: Butterworths, 1997) at 451, 485, and 535-536.

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What is Banking Business?

The definitional problems often associated with "banking" are perhaps too well known to be repeated here[2], and it would indeed " be a bold man who would undertake to state categorically which business activities legally appertain, and which do not appertain to the business of banking"[3]. According to a commentator "banking, like other forms of business, continues to develop and expand its activities to meet its competitors and provide wider services for *[sic]* the public"[4]. It is interesting to note that, quite apart from the difficulties associated with defining banking in adequate terms, its etymology is also a source of disagreement amongst scholars of ancient banking,[5] and this perhaps may have been the root cause of – or contributed in part to – the definitional problems.

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2 See generally B. Crawford, *Crawford and Falconbridge Banking and Bills of Exchange*, vol. 1 (Toronto: Canada Law Book Inc., 1986) at 11 [*Crawford*]; M.H. Ogilvie, *Canadian Banking Law* (Toronto: Carswell, 1991) at 5 –23 [*Oglivie*]; C.C. Johnson, "Judicial Comment on the Concept of "Banking Business"" (1961-1962) 2 O.H.L.J at.347 [*Judicial Comments*]; Lord Chorley, *Law of Banking* (London: Sweet & Maxwell, 1974) at 30 -34; Hapgood, *Paget's Law of Banking* (London: Butterworths, 1989) at 121-126; E.P. Ellinger, E. Lomnicka & R.J.A. Hooley, *Modern Banking Law* (Oxford: Oxford University Press, 2002) at 65-70.

3 Baxter, *The Law of Banking and the Canadian Bank Act* (Toronto: Carswell, 1968) at 5; See also the judgement of Beetz J in *Canadian Pioneer Management Ltd.* v. *Labour Relations Board of Saskatchewan* and others, [1980] 1 S.C.R. 433 at 449 [*Canadian Pioneer cited* to S.C.R.]

4 *Judicial Comment, supra* note 2 at 347; See also *Canadian Pioneer, ibid.* at 449-450. Both were talking in the context of the difficulty associated with defining banking business in adequate terms.

5 Whilst some authors (notably, P. Usher, *The Early History of Deposit Banking in Mediterranean Europe* (Massachusetts: Harvard University, 1943) at 12 [*Usher*]; R. Lopez, *The Dawn of Modern Banking*, (Yale: Yale University Press, 1979) at 1 [*Lopez*]; J. Gilbart, *History, Principles and Practice of Banking*, vol.2 (New York: Greenwood, 1968) at 9 [*Gilbart*] contend that the word "bank" evolved from the Latin or Italian word *"banco"* (literally meaning "bench" to represent the platform used by primeval bankers to conduct their business) another eminent scholar argues that the word "banco" actually has two meanings , "bench" and "heap" or "mound" and it is from the

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Some of the more important judicial decisions will now be considered with a view to identifying those core activities that have generally and traditionally been considered essential to and characteristic of banking business.

The Cases

In Canada, judicial efforts to formulate a definition for "banking business" are complicated by constitutional law issues, as most of the cases in which that question arose were in the context of the extent of the legislative powers of the Federal Government *viz-a-viz* the Provinces regarding banking and related activities.[6] Nonetheless, two of the very important ones are considered below.

One of the most important decisions on this point in Canada is the Supreme Court decision in *Canadian Pioneer*[7], where his Lordship, Beetz J, examined the various approaches adopted by the courts to define banking and proposed three different ways of addressing the issue[8], *viz* (1) the nature of the relationship between the institution and its customers; (2) the functions of the institution considered from both the economic and legal point of view; and (3) the formal or institutional character of banks.

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second meaning that the word "bank" evolved, see W. Sumner ,ed., *A History of Banking in all the Leading Nations* vol.2 (New York : Augustus M. Kelly ,1971) at 195-196 [*Leading Nations*]

6 See generally, Ogilvie, *supra* note 2 *at* 5.

7 *Ibid*

8 *Canadian Pioneer, supra* note 3 at 450-468.

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His Lordship rejected the first two approaches and decided the case on the basis of the third. In particular, Beetz J, disapproved of the functional definition of banking on the grounds that, "it does not follow that these activities are exclusive to the business of banking". His Lordship adopted the formulation of "banking" given by one of the interveners in this case to the effect that," "[b]anking" involves a set of interrelated financial activities carried out by an institution that operates under the nomenclature and terms of incorporation which clearly identify it as having the distinctive institutional character of a bank"[9].

This judicial definition, though sufficient to dispose of the case in question, is not suitable for present purposes. The decision is to the effect that "banking is what Parliament says it is"[10], and the purpose here is to establish those activities that have traditionally been regarded as characteristic of banking.

Another decision which is of interest here is the case of *Re Bergethaler Waisenamt*[11] , where Richards JA enumerated a number of transactions that could qualify as banking business. These include, receiving money from its customers, paying a customer's cheques or drafts drawn on it to the amount on deposit by such customers, dealing in exchange and in gold and silver coin and bullion, arranging credits for itself with banks, and lending money to its customers by way of overdraft. In this case, the Court was of the

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9 See, *Canadian Pioneer, ibid* at 465.

10 *Oglivie*, *supra* note 2 at 23

11 [1949] 1 DLR 769[*Bergethaler* cited to D.LR.]

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view that paying a customer's cheques or drafts drawn on it to the amount on deposit by such customer is a distinguishing characteristic of banking.

An important English case in point is the Court of Appeal's decision in *United Dominions Trust v. Kirkwood*[12]. In that case, the Court identified some activities which, according to their Lordships, are characteristic of and essential to banking business. According to the Court,

> (i) they accept money from , and collect cheques for , their customers and place them to their credit ; (ii) they honour cheques or orders drawn on them by their customers when presented for payment and debit their customers accordingly . These two characteristics carry with them also a third, namely, (iii) they keep current accounts, or something of that nature, in their books in which the credits and debits are entered.

The Court also opined that the perception of the institution by "ordinary intelligent commercial men"[13] may be important in adjudging an institution a bank. On this, the Court held that,"[i]f they recognised it as carrying on the business of banking, that should turn the scale"[14]. This case, as well as the case of *Re Bergethaler*, conceives of banking business in terms of what is regarded, in modern times, as essential to banking business, *i.e.*, operation of chequing accounts.

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12 [1966] 1 All E.R. 968 at 975[*Kirkwood*]; See also the case of *Re Roes Legal Charge Park Street Securities Limited* v. *Albert William Roe* [1982] 2 Lloyds Rep. 370.

13 *Kirkwood* ibid at 979.

14 *Ibid*

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What can be gleaned from the above decisions, and the many other cases[15] that describe banking business in functional terms, is that certain core activities are regarded as characteristic of banking; hence, an institution engaged in such would, in all probability, be held to be carrying on banking business. The case of *Re Begerthaler* is very instructive on this point as some of the activities outlined by the court *did* have very close parallels in primeval banking.[16]

In the light of the above cases, therefore, the acceptance of deposits and the advancement of loans have historically been regarded as the core activities of a banking enterprise. Hence, banking business essentially involves the function of credit creation, in which savings are mobilised for on-lending to "needy" persons.[17] In modern parlance, this is called financial intermediation. This activity, from available historical accounts, appears to be the earliest form of distinctive business transaction engaged in by persons who were then recognised as bankers.[18] The origin and progress of banking shall be briefly examined hereunder, and to this end, the subject will be discussed under two periods of time, *viz, Primeval Banking Era and Medieval /Post Medieval Banking Era* to reflect the categorization of banking business into ancient and modern banking.

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15 For a detailed analysis of many of these cases, see *Crawford supra*, note 2 at 11-20; *Ellinger, supra* note 2 at 65-71; *Oglivie, supra* note 2 at 5-23

16 Lopez *supra* note 5 at 2.

17 See generally, *Usher*, *supra* note 5 at 3; J. Kross and W. Blyn, *A History of Financial Intermediaries* (Toronto: Random House Inc. 1971).

18 It is perhaps significant to note that early banking also included a semblance of foreign exchange transactions - which was necessary at any rate to facilitate cross border commerce amongst the caravan roving merchants: See, *Gilbart, supra* note 5 at 2; G.Davies , *The History of Money from Ancient Times to the Present Day,* (London : Cromwell , 1994) at 53 , 54 , 152-154[*Davies*]

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Primeval Banking

The banking industry has, through the Ages, undergone many phases of evolution and development to the extent that hardly can one draw much parallel between the form and practice of banking today and what obtained in ancient period[19]. There is, however, a dearth of information on the time in history that the business of banking actually began. There seems to be convincing evidence, nonetheless, that some form of banking business existed as far back as Biblical times, and was in fact carried on in the ancient cities of Mesopotamia, Athens, and Babylon.[20] Some Biblical passages prohibiting usury lend credence to these assertions.[21]

Quite apart from the lack of sufficient historical information on the time banking business actually began, it would appear that no single country or geographical location can be positively credited as the "founder" or "originator" of banking business. According to one scholar[22],

> As a natural consequence of the simplicity of the operations involved in lending and in receiving deposits, it is probable that they have been

19 The phrase "ancient period" is used to denote the period of time before the Middle Ages which is considered the dawn of modern banking: See *Lopez, supra* note 5 at 1. More will be said on Medieval banking in the course of this chapter.

20 See generally,.D. Astle, *The Babylonian Woe* (Toronto: Astle, 1975) at 11-26, 94-101 [*Astle*] ; *Lopez ,supra* note 5 at 1-3 ; Usher , *supra* note 5 at 1 .

21 See Deuteronomy Chapter 23: 19-20, Exodus 22:25.

22 Charles Dunbar, *Theory and History of Banking* (London: G.P. Putnam's sons, 1929) at 4 [*Dunbar*].

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> undertaken and carried on in every old country by individuals long in advance of any public establishments, and long before the chroniclers of history thought it worthwhile to notice phenomena of such a humble order.

Consequently, there is the possibility that banking may have evolved simultaneously in every region of the world[23] that had a form of currency or specie as a medium of exchange.[24]

In the ancient cities mentioned above, the caravan roving merchants, who engaged in both domestic and cross-border trade, were largely instrumental to the development of banking business. These early merchants were shrewd entrepreneurs who quickly recognised the ease and convenience of making money from other people's money. They accepted deposits from people for safe-keeping[25] and lent these funds to borrowers, charging interests. Their own personal funds were never put at risk. As will be shown later, merchants also played an important role in the development of banks in both Canada and Nigeria.

Another important aspect of ancient banking practice is foreign exchange transactions. Cross border trade would have been greatly hampered without the development of ways to ascribe values to the different currencies of trading countries. The community of

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23 See also, *Gilbart, supra* note 5 at 2-12; *Usher, supra* note 5 at 3-20; W. Sumner, ed., *A History of Banking in All the Leading Nations* vol.3 (New York: Augustus M. Kelly, 1971) at 6 [Leading Nations vol. 3].

24 For a historical account of the development of money in different parts of the world, see generally *Davies, supra* note 18.

25 It was easy for them to attract people to make deposits with them since they were the ones who usually owned vaults for keeping their money and other valuable.

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merchants from various regions who were trading partners had to devise a generally acceptable mechanism for determining the value of one legal tender relative to another.[26] As time went on, the merchants gradually developed their own body of rules to regulate their business dealings and the courts have taken judicial notice of these rules and customs, *lex mercatoria,* as evidence of the manner in which the merchants conducted their business dealings.[27]

The law merchant is of particular importance to the history of banking business as it largely helped the courts in setting the parameters of what constituted banking business at common law[28] long before the legislatures of various countries developed their regulatory framework delimiting the transactions that constitute banking business. It should be noted that the law merchant, though became more prominent in the Middle Ages, is believed to have existed prior to that time[29] and it found its roots in diffuse codes that evolved in different locations[30].

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26 *Astle, supra* note 20 at 2-7.

27 *Kirkwood, supra* note 12 at 980.

28 See the Canadian Supreme Court decision in *Leduc* v. *La Banque D'Hochelaga* [1926] SCR 76 at 87 where the court - quoting another decision - held that "The nature of the business of bankers is a part of the law merchant and is to be judicially noticed by the court"

29 See Bradlee H., *History of the Law Merchant,* online:<http://szabo.best.vwh.net/lex.html>; See also, Trakman Leon, "From the Medieval Law Merchant to E-Merchant Law", (2003) 53 U.T.L.J. 265 [*Trakman*] Sachs Edwards, *The Law Merchant and the Fair Court of St.Ives, 1270-1324,* (B.A. History), Harvard University, (2002) [unpublished]

30 Trakman, *ibid* 268.

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As would be expected, the business methods of the ancient banker were very primitive. He conducted his business on a bench, usually placed in a market place[31]. It was there that customers came to meet him to transact business. An interesting phenomenon then was the negative public reaction to a banker that became insolvent. According to accounts, whenever a banker failed, his bench was broken by the populace signifying public displeasure at the turn of events.[32] Thus, he was always usually considered guilty.

Medieval and Post-Medieval Era

The Middle Ages is generally regarded as the dawn of modern banking.[33] This period, particularly in Europe[34], witnessed rapid progress in the development of banking, possibly due to the fast pace of industrial development coupled with advancement and notable achievements recorded in many spheres of human endeavours. Commercial and financial transactions also assumed more sophistication with the development of

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31 Gilbart, *supra* note 5 at 9.

32 *Ibid.*

33 It is so regarded because the form and character of banking business assumed more sophistication, largely due to the increased pace of industrial development. It was during this period that the use of bills as instruments for fulfilling debt obligations developed and gained wider acceptance.

34 Europe will be used as our focus in this part given that many of the modern banks originated from here.

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negotiable instruments to aid easier and more convenient modes of payment or transfer of rights to payment[35]. All these, naturally, created a greater demand for banking services.

This period also witnessed the development of improved methods of maintaining accounts or records of business transactions due to the evolution of advanced bookkeeping practices. With this development, bankers were able to keep proper records of their transactions and accounts. This marked a significant milestone in the development of modern banking system. The issue of proper documentation of banking transactions had always created problems, and quite often, the banker and his customers disagreed on the details of their transactions and the accuracy of the banker's books.[36]

Another important point to note here is that it was during the Medieval Era that the practice of ascribing special status[37] to the books of a banker in judicial proceedings developed. Prior to that time, bank credit transactions were required to be entered concurrently by the creditor and the debtor in their respective books of account. Where any question arose regarding the existence or terms of the transaction between the banker

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35 See *Leading Nations, vol. 3 supra* note 23 at 2, where an instance of what is believed to be the first use of the bill of exchange was mentioned. This transaction was credited to Pope Innocent IV in 1246. See also the case of *Goodwin* v. *Robarts* (1875) L.R. 10 Ex.at 346-358 [*Robarts*], where Lord Cockburn traced the history and development of bills.

36 *Usher, supra* note 5 at 11 - 20.

37 The phrase "special status" is used here not to suggest that the banker's books have any superior value relative to other documents in court proceedings but rather to emphasise that it is treated differently. More will be said on this later on in the text.

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and his customer, both were required to tender their respective books of account to prove the fact of the transaction[38]. According to Usher[39],

> The earliest medieval laws on banking make one addition to the legal doctrine of the Corpus Juris. The books of the banker were given a special status through the requirement of an oath. Throughout Mediterranean Europe, the banker was required at stated intervals to swear that his journal was a true record of all the transactions of his business. By reason of this oath, his journal acquired the status of a public register of contracts comparable in everyway to the registers of the public notaries.

With this therefore, it was no longer necessary for both the debtor and the bank to produce their respective books of account to prove facts or the existence of the transaction. Once a banker publicly declared, under oath, that his books of account was a true and accurate reflection of his business dealings, the need for any corroborative evidence from the customer was obviated. The declaration was treated, for all intent and purposes, as having the same status as one made by a public notary[40].

There seems to be somewhat of a parallel between this "oath of verification" required of a banker in Medieval times regarding his book of account and the "oath of attestation" required of the modern banker in respect of his books of account in judicial proceedings. In Nigeria, parties wishing to assert the truth of the contents of their documents in judicial proceedings must, as a general rule, tender the original of the document itself. This is

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38 *Usher, supra* note 5 at 10. This worked great injustice on the banker. All a fraudulent debtor need do is simply claim that he had misplaced his own records of the transaction thereby making proof difficult and almost impossible for the banker/creditor.

39 *Ibid.*

40 *Ibid.*

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known as the *best evidence rule*[41]. Copies may only be tendered in special circumstances upon fulfilment of certain conditions[42]. Where the copies sought to be tendered in evidence are copies of a banker's book, then either a manager or an accountant of the bank – in the case of Alberta, or an officer of the bank, in the case of Nigeria is required to attest to certain facts with respect to the copies sought to be produced.[43] . First, he must attest that the book or record from which the copy was made was at the time of making the entry, one of the ordinary books or records of the bank, and that the entry was made in the usual and ordinary course of business of the bank. He must further confirm that the book or record is in the control of the bank and that the copy is a true copy thereof[44]. It should be noted that under the *Alberta Evidence Act* and the Nigerian *Evidence Act,* the only corporate entities required to adopt this procedure when seeking to tender secondary evidence of their account books or other documents are banks. Perhaps, this is meant to underscore public expectations of high probity in the management of the affairs of a bank.

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41 Ss.91, 93 and 96, *Evidence Act*, L.F.N. 1990, c.112, s.97 (2)(e).

42 ss.95 and 97, *Evidence Act.*

43 See *Alberta Evidence Act, R.S.A.2000*, c. A-18, s.41 (1)(2) and (3); *Evidence Act*, L.F.N. 1990 ,c.112 , s.97(2)(e).

44 *Ibid.*

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During this period also, the attitude of the Church towards the charging of interests on loans, *i.e.,* usury[45], was unchanged. The Church believed that he who has would not borrow in the first place, and it would be unconscionable for those who have to exploit the unfortunate circumstances of those who lack. This, naturally, did not go down well with the shrewd merchants and goldsmiths[46] who found loaning money, not only lucrative, but also very convenient, since the loans they advanced were other people's deposits: their own personal capital was hardly at risk. It was not surprising, therefore, that strategies[47] were quickly devised to circumvent the Church's precepts, without appearing to do so, since it would have been considered blasphemous openly to defy the Church's religious injunctions.

The Medici family, regarded as one of the wealthiest and most influential families in Europe established the Medici Bank in Florence, Italy in 1397[48]. The bank established branches in many European cities and had representatives in each of them to carry on the fledgling business of modern banking.[49] The use of bills of exchange, another legacy of

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45 *Leading Nations, vol. 3 supra* note 23 at 1; Chown, *A History of Money From AD 800* (London, Routledge: 1994) at 120[*Chown*].

46 The goldsmiths were very much involved in the development of modern banking in England in the early 17th century, largely due to the sudden lack of interest of the merchants in accepting peoples deposit. For more on the immediate circumstances that discouraged the merchants from accepting public deposits see, *Leading Nations supra* note 5 at 1-3.

47 For how this was done, see *Chown* , *supra* note 45 at 121-122.

48 See, online:<http:/www.rbs.co.uk/Group_Information/memory_bank/our_history/a_history_of_banking/11_14_history.htm, accessed on 2 February, 2004 [*History Website*]

49 *Ibid*; For more on the Medici Bank, see De Roover Raymond, *The Rise and Decline of the Medici Bank, 1397-1494* (Cambridge: Harvard University Press, 1962).

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this period, became more popular as a means of payment for both domestic and international commercial transactions[50].

By the middle of the 17th century, the London goldsmiths were becoming active in playing the role of financial intermediaries, accepting valuables and cash from their customers for safekeeping, carrying out their payment instructions and extending credit facilities to them[51]. It may be interesting to note here that goldsmiths, as opposed to merchants, were the ones who played the more active role in the development of modern banking in London.

The success of the Bank of Amsterdam – established in 1609 and generally reagarded as the first real bank in the modern sense of the word[52] – encouraged the British government to mull the idea of establishing a similar institution in London. For instance, the bank aided in the development of the Dutch economy by lending to both the City of Amsterdam and the State in the form of the Province of Holland[53]. It also helped to facilitate both domestic and international trade[54] as well as being responsible for coinage and exchange[55]. The Bank of England was eventually established in 1694 through public

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50 *Ibid*;

51 *History Website, supra* note 48.

52 *Chown , supra* note 45 at 130.

53 See Bank of England, online:< http://www.bankofengland.co.uk/Links/setframe.html>.

54 It was realized that successful credit- based trading could benefit a nation in many ways and help to enlarge its sphere of influence, *ibid.*

55 *Ibid.*

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subscription for its stock[56]. It should be noted, however, that the main reason why the government authorized the establishment the bank was to fill a revenue gap. The government needed the money obtained though the stock subscription to finance its wars[57]. It is interesting to note that the Bank of England on its formation acted as a private bank and a public institution, catering for the banking needs of both the government and its (i.e. the bank's) customers[58].

The banking industry in Europe continued its steady development refining its processes and gradually expanding the scope of its services in the light of changing circumstances and demands. By the 17th Century, more banking institutions had been established in many European cities particularly in Italy and France[59]. As time went by, modern banking spread to other parts of the world.

HISTORICAL DEVELOPMENT OF BANKING IN CANADA

As this is intended to be merely an overview of the historical development of the banking institution in Canada, no detailed outline is contemplated. The whole length of the thesis is, indeed, insufficient to deal with that issue. In consequence, a sketch will need to

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56 *Ibid*

57 *Ibid.*

58 *Ibid.*

59 For more on the development of the European Banks see, Dunbar, *supra* note 22 at 4.

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suffice.[60] The important developments in its evolution will be highlighted, particularly those events that are considered to be of regulatory significance and that have a bearing on the general direction of arguments in the thesis.

The territory now known as Canada did not start out as a single political unit, but rather individual colonies[61] administered separately by the British Government. By reason of this and to make for easier understanding, the subject here shall be discussed under two broad heads, *Pre- Confederation Period and Post Confederation Period.*

Pre-Confederation Period

The period prior to the establishment of the first banks in Canada has been described as "the most obscure in the history of the country"[62] from an economic standpoint, and this presents great difficulties to efforts aimed at tracing the history of banking in the country.[63] Historical evidence indicates that, in addition to domestic commerce, there was a fair amount of cross border trading between the inhabitants of Canada and those of the

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60 For detailed historical accounts of the banking industry in Canada, see B. Breckenridge, *History of Banking in Canada* (Washington: Government Printing Office, 1910) [*Breckenridge*]; B. Breckenridge, *The Canadian Banking System 1817-1890* (London: Macmillan, 1895)[*1817-1890*] ; Denison, *A History of the Bank of Montreal*(Toronto :McClelland & Stewardt ,1967)[*Denison*] ; *Leading Nations ,vol. 3 supra* note 23 at 415-459 ;Beckhart, ed., *Banking Systems*,(New York : Columbia University Press, !956) at 119-182.

61 Prior to confederation in 1867, Canada was divided in to about six provinces, see *1817-1890, ibid.* at 14

62 Adam Shortt, "The Early History of Canadian Banking", vol. IV No.2 January, 1897, in *Adam Shortt's History of Canadian currency and Banking 1600 – 1880* (Toronto: Canadian Bankers' Association, 1986) 30 [*Shortt*]

63 *Ibid.*

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United States towards the latter part of the 18th century, and since banking business is "so wholly dependent upon the commercial habits and ideas of the people"[64], it is plausible to state that banking had existed in Canada as far back as the 18th century or even prior to that.[65] According to Shortt[66],

> Banking facilities do not burst upon the business community as a quite new and developed service; they simply afford an easier, more effective and generally less costly manner of rendering services which are already performed in more or less primitive fashion

The role of merchants in the early stages of banking was noted in the earlier portion of this chapter and it is interesting to note that they also played a pivotal role in the evolution of modern banking in Canada[67]. They provided services[68] typically offered by bankers and it was only natural that the promoters of the first corporate bank were the merchants.

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64 *Ibid* at 9.

65 The successful operations of the Bank of United States, established in 1791 and certain domestic issues such as scant supply of currency, lack of adequate capital to handle the colonies' trade or to develop their farms, fisheries and forests all prompted much discussions about the possibility of establishing a bank during this period; See Breckenridge, *supra* note 60 at 5

66 Shortt, *supra* note 62 at 29.

67 Both the Scottish and the American model of banking are believed to have greatly influenced the shape of the early Canadian banks; see, Shortt, *supra* note 62 at 10-25; *Breckenridge supra* note 60 at 5.

68 "They received deposits of money and bills, made payments to order and advanced loans or credit" among other things, see Shortt and Doughty, eds., *"Canada and its Provinces, vol.* 4 (Toronto: Glasgow Brook and Co., 1914-1917) at 605.

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The provinces of Lower Canada (Quebec), Upper Canada (Ontario), Nova Scotia and New Brunswick appeared to have played prominent roles in the establishment of the first banks in Canada. The idea of establishing a bank in Canada is believed to have been first mooted by a group of merchants from Montreal in association with some English businessmen in 1792. They proposed to form the *"Canada Banking Company"* in Lower Canada.[69] The intention of the promoters was to establish a bank "to receive deposits in cash, to issue notes for circulation, and to discount bills"[70]. Their application to the legislative house of Lower Canada for a charter was, however, unsuccessful[71], and hence the bank formed could only function as a private bank that accepted just deposits: it had no power to issue notes.[72]

Some Montreal and Quebec merchants made another attempt in 1808 to establish a chartered bank, the *Bank of Lower Canada* and to this end, a bill to obtain legislative charter for the proposed bank was introduced in the legislature of Lower Canada. The

69 See *Breckenridge supra* note 60 at 3; the successful operation of the Bank of the United States coupled with the difficulty of raising capital to finance trade expansion in the colonies of both Lower and Upper Canada were some of the principal reasons that prompted discussions about the possibility of forming a bank around this period.

70 H. Binhammer and P. Sephton, *Money, Banking and the Canadian Financial System*,(Ontario : Nelson Thomson Learning ,2001) at 273[*Binhammer and Sephton*]; *1817-1890* , *supra* note 60 at 22 .

71 Incorporation of banks then was by a Charter or a special Act of the colonial legislature. It should be noted that historical accounts did not give reasons for the refusal of the application for charter. However, domestic politics have been suggested as the common reason for the legislature to grant bank charters during this period; see, *Breckenridge*, *supra* note 60 at 6 and 16.

72 *Binhammer and Sephton*, *supra* note 70 at 273; *Breckenridge, ibid* at 3. There appears to be divergent opinions on whether or not the Canadian Banking Company *did* issue notes. On this see C.S. Howard, "Canadian Banks and Bank Notes: A Record", Canadian Banker, LVII (1950) at 30, 32-33.

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bill, however, failed to pass and accounts seem to suggest that the failure was largely due to domestic politics.[73] The charter of the proposed bank was a carbon copy of that of the Bank of United States,[74] and the subsequent history of Canadian banking showed that emerging banks in both Lower and Upper Canada largely adopted the provisions of this charter.[75]

By 1815, agitations for a chartered bank was reaching a feverish pitch due to scarcity of specie and its adverse consequences on trade and the agricultural industry[76]. On 8 February, 1815, a motion to consider the expediency of establishing a bank was introduced in the legislature of Lower Canada[77]. The motion was discussed but nothing concrete came out of the discussion and in the following year, several merchants in Montreal jointly petitioned the legislature highlighting the problems facing the local economy and the fact that the establishment of a chartered bank will greatly facilitate commerce and act as a catalyst for the economic development of the region[78]. A committee was set up to look into the matter and it recommended the establishment of a chartered bank[79]. A bill would have been passed that year to give effect to the

[73] *Breckenridge, ibid* at 6; however, *Shortt* prefers not to give any reason for the failure of the bill to pass, see *Shortt, supra* note 62 at 25.

[74] For the full text and comparison of both charters, see *Shortt, ibid* at 18-25.

[75] *Shortt, ibid* 26.

[76] *Shortt, ibid* at 69.

[77] *Ibid.*

[78] *Ibid.*

[79] For more on the recommendations of this committee, see *Shortt, supra* note 60 at 69 – 71.

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recommendations of the committee but the legislature was abruptly prorogued because of a contentious motion[80]. The following year, 1817, the bill was re-introduced in the legislative house but yet again, the legislature was dissolved for the same reason as the previous year[81]. The bank promoters thus gave up their efforts to secure a charter and proceeded to establish a private banking corporation, Bank of Montreal, without provincial charter[82].

Eventually in 1821, charters were granted to the first three banks in Lower Canada – Bank of Montreal, Quebec Bank, and Bank of Canada – in 1821[83]. What seems to be of significance here are some of the provisions of these charters which appear to have found their way into the early *Bank Acts* [84], and successive ones, with minor adjustments to adapt to changing circumstances. For instance, the charters authorised them to "receive deposits, deal in bills of exchange, discount notes", but prohibited them from engaging in any other business but banking[85]. The charters were to be operational for ten years, and also empowered the government to "require at any time, *for the protection of the public*

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80 There were attempts by some members of the legislature to impeach two judges, see *Shortt, ibid* at 71.

81 *Shortt, ibid* at 73.

82 The Articles of Association was signed in 1817, but the bank operated without a charter until 1822 when the charter was granted by royal assent.

83 Royal assent was however not given until 1822.

84 *Leading Nations, supra* note 5 at 428

85 *Leading Nations*, *ibid* at 428

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[emphasis added], a statement, under oath, of the position of the bank"[86]. This latter provision is of great significance in two respects. First, it underscores government's desire to ensure prudent and well managed banks, and secondly, it suggests that the protection of the public is the motivational factor for government regulation of banks in Canada. Government's concerns stemmed out of the need to maintain the stability and integrity of the payment system and not from any particular incidence of a bank failure.[87]

As was the case with Lower Canada, merchants from Upper Canada were also the first promoters of a banking corporation in this region.[88] In 1817, a petition to this effect, similar to the one drawn up in Lower Canada, was made to the legislature.[89] The petition was well received in the legislative house and a bill[90] to give effect to it was introduced and duly passed in the same year. However, royal assent was not obtained before 1 January 1819 by reason of which the bill was forfeited but the bank however commenced operation as an unchartered banking corporation.[91] It was eventually granted charter in 1821[92] but royal assent was not received until 1822. This effectively makes the Bank of

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86 *Ibid.* As mentioned earlier in the text, a similar practice obtained in the Medieval Period.

87 More will be said on this in the course of the thesis.

88 The Kingston merchants began working towards the establishment of a bank in their colony around 1810 and there was also similar initiatives in Halifax in 1811; see, *Breckenridge, supra* note 60 at 5; see also, *Shortt, supra* note 62 at 83.

89 For the full text of this petition, see *Shortt, ibid* 84.

90 The bill was for the incorporation of the Bank of Upper Canada; see *Shortt, ibid* at 85.

91 *Ibid* at 86 – 90.

92 *Ibid*; For more on the development of early banks in Canada, see generally *Breckenridge supra* note 60 chapters 1, 2 and 3.

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New Brunswick the first chartered bank in British North America, as it received royal assent the same year its Act of incorporation was passed by the New Brunswick legislature, 1820.[93]

In 1840, the Act of the Union was passed by the British Parliament uniting both colonies of Lower and Upper Canada into a single entity, the Province of Canada[94]. One consequence of this was that all the existing 10 banks in the two former colonies automatically came under the jurisdiction of a single legislature[95].

In 1850, following the steps of the State of New York[96], the Canadian government introduced a regime of "free banking" through the enactment of the *Free Banking Act*[97]. This new regime was different from the former one in that it allowed entry into the banking industry without the necessity for a charter "provided that the new bank would purchase a specific amount of state bonds, which, in turn, served as an upper limit on the bank's note issue" [98]. In other words, total value of issued notes for each bank will be

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[93] *Binhammer and Sephton, supra* note 70 at 274: For more on the development of banks in the other provinces earlier mentioned see, *Leading Nations, supra* note 5 at 429-433; *Binhammer and Sephton, ibid* at 274-275.

[94] See:< http://www.thecanadianencyclopedia.com/index.cfm?PgNm=TCE&ArticleId=A0000029,> *Breckenridge, supra* note 60 at . The Act took effect the following year.

[95] *Breckenridge, ibid* at 42 – 43.

[96] *Ibid* at 58.

[97] It may indeed be a misnomer to call the statute *Freedom of Banking Act,* as there were many provisions in it restricting the activities that banks constituted under it can engage in, and there are also many provisions there designed to protect note holders.

[98] *Binhammer and Sephton, supra* note 70 at 277; *Shortt, supra* note 62 at 464-465.

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equal to the value of the government bond purchased by the bank. This was a form of security for the note holders as it ensured that each bank note they held was secured to its full amount by government bond[99]. Also, the new law allowed individuals and partnerships, as opposed to only joint stock corporations, to form banks if they were able to meet the requirements of the new Act.[100] Banks organized under this enactment were, generally, treated differently from those organized though royal charters or established by an Act of incorporation, and, in particular, they were not allowed to open branches.[101]

Post Confederation Period

By virtue of the *British North America Act* (BNA), the new Dominion government of Canada was given exclusive legislative powers over *"[b]anking, incorporation of banks, and the issue of paper money"*[102]. The interpretation and scope of this provision has been the subject of many cases and scholarly publications.[103] What is worth noting here is the fact that the BNA established the foundation for federal regulation of banks in Canada.

A number of important statutes were passed around this period, largely dealing with currency matters. The government was particularly intent on ultimately prohibiting banks

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99 *Breckenridge, supra* note 60 at 58*; Shortt, supra* note 62 at 464-465.

100 *Ibid*

101 *Ibid*

102 Section 91(15); see also the Privy Council's decision in *Tennat v. Union Bank* [1894] A.C. 31, which is the *locus classicus* on the interpretation of this provision.

103 See *Ogilvie supra* note 2 at 5-23.

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from issuing notes and making itself the sole issuer of notes as a way of ensuring the integrity of the payment system and government control of the process.[104] As the chartered banks were key institutions in the issuance of notes, they were naturally the primary "targets" of the statutes, which they thought was an unjustified intrusion by government into their operations[105].

The most important of all the laws passed during this period was the *Bank Act* of 1871[106] (hereinafter the *Bank Act*) – the first Bank Act – which essentially consolidated all the charters of the individual banks granted prior to confederation. The *Bank Act* formed the blueprint for all subsequent *Bank Acts*. The pertinent question here is: *Why was the Bank Act introduced at this time?*

Unlike the situation in Nigeria, as will be shown later, Canadian banks also started out as note issuers, and this gave them considerable economic leverage particularly as regards the payment system. As has already been shown, banking business had traditionally been defined in the light of the role of banks as financial intermediaries. The early Canadian banks, however, were also allowed to issue notes for circulation. This essentially made them very critical to the economic well-being of the country and the need to make them stable became more important.

104 *Breckenridge, supra* note 60 at 89-95.

105 The effect of some of these statutes was to place restrictions on banks' power to issue and distribute notes. It has been suggested that the aim of government then was to ultimately assume direct and sole control of note issuance. For more on this, see *Binhammer and Sephton, supra* note 70 at 280; see also, *Breckenridge, supra* note 60 at 95-98.

106 *An Act Relating to Banks and Banking*, S.C.1871, c.5.

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It is on record that there were two major bank failures[107] around this period – the collapse of the Bank of Upper Canada in 1866 and that of Commercial Bank of Canada in 1867[108] largely due to imprudent lending practices.[109] This, however, created a loss of confidence in chartered bank notes amongst the public, as holders of the notes of failed banks were unable to redeem or use them.[110] This situation was largely unacceptable to the Government of Canada which was becoming increasingly concerned about the safety of the banks and their ability to continue to meet the claims of their note holders. On 14 May 1869, the Minister for Finance, Hon. John Rose, made it clear that the government intended to prevent the occurrence of a payment crisis and put the entire paper issue on a sound footing.[111] And with this was the need to further regulate the operations of banks through the enactment of a special banking legislation. According to the Minister, there was the need to prevent "[t]he extreme inconvenience, not to say disaster, which resulted from the promiscuous circulation of the notes of Banks, established in various localities all over the Union, each of which had a different degree of security to give its note-

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107 *Shortt, supra* note 62 at 583; It should be noted that prior to this period, around 1859, four banks (Colonial, International, Bank of Clifton and Bank of Western Canada) had failed creating a currency crisis as their notes already in circulation were worthless. For more on this see, Bank of Canada online:< http://www.bankofcanada.ca/en/ dollar_book/full_text-e.htm>

108 *Breckenridge, supra* note 60 at 79 –82 and 86.

109 *Ibid.* For a list of banks that collapsed (or went into voluntary liquidation) between 1867 and 1908, see *Breckenridge, ibid* at 219.

110 *Shortt, supra* note 62 at 609.

111 *Breckenridge, supra* note 60 at 96.

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holders"[112]. Also, during the legislative debates on the proposals of government on bank reforms, the Minister for Finance, Hon. John Rose, trying to dispel negative notions about government's motives[113] said,

> The Government had no special object of its own to obtain in this matter. They were not urged by any pressing wants, but they were actuated only by a single-minded desire to place the banking institutions of the country on the soundest and most wholesome basis that could be reached. All that the Government had to consider in this matter was the relation in which the banks stood towards the public in reference to their circulation. The business of banking proper, the affording of facilities for the commercial transactions of the country, was a matter for private enterprise and private capital, which it would be beyond the province of the Government to control; but it was their duty to see that the circulation which the public was bound to take, was on a secure basis[114]

From the above, it is clear that the stated intention of the government was not, primarily, to protect the depositors, but to ensure that the banks continued to be liquid and sound so as to be able to meet their debt obligations to note-holders. However, there were strong oppositions to the proposals of the Minister from many bankers and other members of the public including many legislators, the main reason being the general perception that government intended to monopolise the power to issue and circulate currency a situation which would have greatly reduced the privileges of banks[115]. On June 15 1869, the

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112 See online: < http://www.upei.ca/~rneil/webpapers/1871/notes.html>.

113 *Ibid.* It was suggested here that the principal focus of the *Bank Act* was "on macro economic control over prices and the general level of economic activity"

114 Ottawa, Parliamentary Debates on "Banking and Currency" (14 May 1869) at 313-314 [*Debates*]; see also, *Breckenridge, supra* note 60 at 95-98.

115 *Ibid.*

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Minister announced government's intention to temporarily withdraw the proposals. He later resigned his appointment before the next parliamentary session commenced.[116]

His successor, Sir Francis Hincks, engaged in extensive consultations with different interest groups, particularly the bankers whose main concern was government's "proposed interference with the notes issue of the banks"[117]. The Minister was able to formulate a generally acceptable general banking policy and this formed the basis of the banking bill that was eventually sent to Parliament.[118] The *Bank Act* became law in 1871 and contained provisions meant to unify banking practices in Canada, protect the stability of the banks and promote the integrity of the payment system.[119] For instance, it prescribed minimum prudential practices for banks to comply with and required them also to file monthly returns stating their assets and liabilities. Also, it made provisions for minimum share subscription and placed restrictions on the amount of notes a bank could issue for circulation relative to its paid up capital.[120] Furthermore, banks were prohibited from issuing notes below $4 which were the ones that had the widest circulation. This

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116 *Breckenridge, ibid* at 98.

117 *Shortt, supra* note 62 at 610-611.

118 *Ibid.*

119 For details of the provisions see, *Breckenridge, supra* note 60 at 99-104.

120 *Ibid*

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ensured government's monopoly of the circulation of those notes, a move meant to lay the foundation for government's ultimate control of paper money.[121]

The *Bank Act* did not contain any provision restricting the use of the appellation "bank" to only federally incorporated institutions carrying on banking business. This restriction was introduced by virtue of an amendment in 1880, which made it an offence for any person or corporation to use the words "bank", "banker" or "banking" without authorization by a federal statute.[122] This provision has survived to the present day, and it, in fact, formed the basis of the Supreme Court's decision in *Canadian Pioneer*.

Revisions were made to the *Bank Act*, notably in 1880 and 1890, partly in response to a couple of bank failures[123] and partly for the benefit of bank note holders. The latter revision made provision for the establishment of a Bank Circulation Redemption Fund – the precursor to the Canadian Deposit Insurance Corporation[124] – into which banks were

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121 *Ibid* at 105.

122 *Bank Act,* 1880 S.C. c.22, s. 10.

123 For a list of the banks that failed during this period, see Canada, *Report of the Inquiry into the Collapse of the CCB and Northland Bank,* (Ottawa: Supply and Services Canada, 1986) at 359 [*CCB and Northland Report*].

124 More will be said about this institution in the course of the thesis.

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required to place a percentage of their annual circulation of notes to protect note holders in the event of insolvency.[125]

HISTORICAL DEVELOPMENT OF BANKING IN NIGERIA

There was practically no banking business in Nigeria – at least in the modern sense – until about the end of the 19th century when British colonialists arrived the country, and this was almost a century after the emergence of modern banks in Canada. Strictly speaking, there was no entity called Nigeria at this time.[126] Many of the various indigenous tribes within the country, however, practised their own form of pristine banking largely in the nature of deposit taking, advancement of loans, and safekeeping of valuables. According to a commentator,"[i]n the pre-banking era, traditional financial institutions served Nigerian communities relatively well and performed some of the functions of modern banks though in an unrefined and limited manner"[127]. What happened then was that the various fragmented tribes practised a semblance of banking, though in a primitive sense, to satisfy the banking needs of their immediate locality. Local institutions such as village courts, elders' council, traditional institutions, etc,

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125 For a chronological outline of the various regulatory measures introduced by subsequent Bank Acts, see: P.Siklos, *Money Banking and Financial Institutions: Canada in the Global Environment* (Toronto: McGraw-Hill, 2001) at 347.

126 It was not until 1914 that the Northern and Southern Protectorate were merged that the country called Nigeria came into being.

127 J.K. Onoh,, *The Foundations of Nigeria's Financial Infrastructure* ,(London: Croom Helm,1980) at 11. [*Onoh*]

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administered justice, and helped in settlement of disputes arising from commercial transactions within their domain.

The origin and development of modern banking in Nigeria can be examined under two broad heads – *Free Banking Era* and *Pre/Post Banking Ordinance Era* to reflect the periods of non-regulation and introduction of regulation. One of the issues to be considered, as mentioned at the beginning of the chapter, is to discover the reasons historically viewed as necessitating the introduction of a specialised legislation to regulate banking business. In other words, what were the circumstances that informed the adoption of the particular model[128] of regulation introduced by the first *Banking Ordinance?*

Free Banking Era (1891-1951)

The simple nature of commercial transactions in Nigeria, and the means through which payment was effected did not immediately create any need for modern banking institutions There was no uniform legal tender, and payment for goods and services was made through commodity currency. According to a learned author "[t]he need for banks cannot arise in an environment of trade by barter or of predominantly commodity

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[128] This model - stipulation of minimum prudential practices and information disclosure-has largely been maintained in all subsequent banking legislation: See See J. Ebhodaghe, *Safe & Sound Banking Practices in Nigeria: Selected Essays* (Lagos: Page, 1997) at 52 [*Ebhodaghe*].

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currencies . It was not, therefore, until coins were regularly used that banking became feasible"[129].

The advent of colonial rule in the mid-19th century marked a new dawn in the history of the country. With this development, many European merchants who had hitherto been trading with indigenes of the coastal states were encouraged to set up more permanent business ventures in the hinterland. This upsurge in business activities created a need for banking institutions and, in August 1891, the *African Banking Corporation*, then operating in South Africa, opened a branch in Lagos[130] to offer its services to the fledgling community of foreign companies in the colony of Lagos. There was no requirement for any prior licence to commence its operations and in January 1892, the colonial administration granted it the right to import silver coins for use in Nigeria.[131] With the introduction of silver coins, commercial transactions assumed more sophistication, and it was not surprising that two years later, another bank, the Bank of British West Africa was established.[132]

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129 P.N.C. Okigbo, *Nigeria's Financial System* (Essex: Longman, 1981) at 75 [*Okigbo*].

130 *Okigbo, ibid.* at 78 ; R. Fry , *Bankers in West Africa ,The Story of the Bank of British West Africa Limited* (London : Hutchinson ,1976) at 19.

131 *Ibid.*

132 For more on the history and development of these first generation banks, see *Okigbo ,supra* note 129 at 79-82.

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It is significant to note that between the years 1891 to 1951, there was no specific legislation in place governing the establishment and operations of banks in Nigeria, [133] though in 1912, the first *Company Act* – the first formal legislation to monitor the activities of registered companies in Nigeria – was enacted by the British colonial administration to operate, however, only within the colony of Lagos. In 1917, after the unification of the country, its application was extended to the whole country[134]. What may pass as a regulatory institution then was a corporate registry formed basically to keep a record of registered companies operating in Nigeria and to accept the statutory returns registered companies were required to file under the *Company Act*. A point was, in fact, made during the debate preceding the passage of the first *Banking Ordinance*[135] in the country that the corporate registry was a sufficient institution to monitor the affairs of banks and that empowering the Financial Secretary to look into the books of banks – as the proposed *Banking Ordinance* allowed – would constitute an invasion of a bank customer's privacy.[136]

All the banks operating in Nigeria around the first three decades of the 19th century were foreign banks and were owned by expatriates accused of treating the local businessmen unfairly with regard to loans facilities. As a consequence, numerous petitions were sent to

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133 See. *Ebhodaghe, supra* note 128 at 56.

134 See Ezejiofor, Okonkwo and Ilegbune, *Nigerian Business Law* (London: Sweet & Maxwell, 1982) at 258.

135 More will be said about this statute in the course of this chapter.

136 See Lagos, House of Representatives, Debates on the Banking Ordinance, (8 April 1952) at 1115. [*House Debates*].

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the Colonial Office in London by Nigerian merchants complaining about the discriminatory practices of the foreign banks and the preferential treatment given foreign companies in loan applications. This led to a campaign for the establishment of an indigenous bank that would meet the credit needs of Nigerians. Eventually, the first indigenous bank, the Industrial and Commercial Bank Limited, was formed in 1929, to, principally, do what the British banks had been reluctant to do: "offer credit liberally to Nigerians"[137]. The folly of this decision was soon realised as the bank went under within a year of its formation due to imprudent lending practices and mismanagement.[138]

The failure of this bank appeared to have triggered the collapse of other local banks[139], all resulting in substantial losses to depositors who had, naively, been swayed by nationalistic sentiments into patronising the local banks on the belief that they represented "a bank of the people by the people and for the people", and as such would serve them better and protect their interests.[140] In order to stem this trend, government introduced the first banking bill to the legislative house.

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137 *Okigbo, supra* note 129 at 86.

138 This was however blamed on "unfair" competition from the British Banks; For more on the indigenous banks, see *Okigbo*, *ibid* at 86-92.

139 For more on this, see *Okigbo, ibid.* at 86: *Ebhodhage* , *supra* note 128 at 117. According to historical accounts "there was a rapid growth in the number of indigenous banks between 1947 and 1952" but unfortunately "these banks also collapsed with the same rapidity with which they were established. By 1954, twenty-one (21) out of the twenty-five (25) indigenous banks failed": *Ebhodage,* ibid. at 7.

140 Nationalistic sentiments was very high in Nigeria between 1930 and 1950, and as such gaining public support or sympathy on any issue of public importance is premised on your ability to effectively play on these sentiments.

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An interesting contrast may be drawn here between what, largely, motivated the enactment of the first principal banking legislation in both Canada and Nigeria. Though both statutes were – historically speaking – designed to protect the public against the consequences of a bank insolvency, the lawmakers of each country were driven by different underlying considerations. In Canada, the chartered banks were authorised to issue notes for circulation and these notes were legal tender in the whole country used in payment for goods and services. The paramount consideration, therefore, was that the banks should always have enough assets to back these liabilities so that each time a note holder presents his note for redemption, they, *i.e., the banks* would be able to honour it. The inability of the chartered banks to continue to do this may precipitate a payment crisis, and lead to catastrophic consequences for the economy as a whole; hence, the imperative need to ensure their continued liquidity. In Nigeria, on the other hand, the main underlying reason for the enactment of the legislation was to curtail the excesses and unscrupulous propensities of the bank directors and shareholders.

Whilst presently, circumstances are largely different in both countries, the need to continue to ensure the safety and soundness of the banks remains a priority and this has, largely, guided the design of the regulatory framework in both countries. They both prescribe minimum prudential practices that banks are required to comply with in addition to the existence of specialised institutions to monitor the affairs of banks operating in their respective countries. More will be said on this in the course of the thesis.

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Pre and Post Banking Ordinance

The need for a special banking legislation was felt by the government after the spate of failures of the indigenous banks. To this end, a special commission headed by a Mr. Paton, was set up in 1948, *inter alia*, to carry out a comprehensive examination of the institutional structure of the Nigerian banking system. The Commission submitted its report and included a draft banking bill[141], which, among other things, introduced the requirements of a banking licence to authorise an entity to carry on banking business, stipulation of a minimum paid-up capital and cash reserves, the publication of financial statements[142], and restrictions on loans to directors. Speaking on the need to include this latter provision while introducing the bill to the legislative house, the Financial Secretary gave an example of a bank director who obtained unsecured overdraft facility from the bank in which he was a director to the tune of £70, 000 to finance his trading company. According to him,

> The money used for that loan was the depositors' money, and when the company took it, it had favourable facilities with which to expand its business, and try to make a profit. In this case, I believe it did not make a loss. But let us suppose it made a loss. Who would have got the loss? Not the directors, but the depositors.... All the profits go to the borrowing company all the losses go to the depositors in the bank[143].

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141 See *House Debates supra* note 136 at 1112.

142 It came to light as part of the findings of the Paton Commission that many banks do not even have financial statements, much less publish it: See *House Debates, ibid.*

143 *Ibid.*

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The Financial Secretary argued that it was unconscionable for a person to put others' financial assets at risks in order to make a profit. Speaking also on the need to insert provisions precluding certain classes of persons from becoming directors, he said "...[i]f a man is going to look after other people's money or if people are going to have confidence in him looking their money *[sic]*, he is to be a man of the highest moral integrity"[144].These statements clearly give an insight into the reasons why government not only decided to introduce a regulatory framework for banking, but also why it adopted that particular model . The objective was, primarily, to protect depositors' funds and ensure that the affairs of banks are conducted in a safe and prudent manner by persons of integrity.

As would be expected in any case of impending regulation of an activity which had previously been conducted freely, there was strong opposition from various groups and vocal individuals. Some legislators – mostly the business men – argued vehemently against it, using, yet again, the nationalist appeal. They contended that the banking bill was another attempt by the colonial masters to repress and impoverish Nigerians, and they accused the Financial Secretary – in rather robust language – of executing a hidden agenda.[145] In the midst of all these claims and counter-claims came a very instructive comment from one of the legislators regarding what he believed to be the proper purpose of banking legislation. Though he opposed the bill, his concerns were premised on the

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144 *Ibid.*

145 *Ibid.* at 1115.

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need for a local banking regulatory framework to advance the interests of its domestic banks. According to him,

> [T]his bill is too negative . It seeks to protect depositors but it does not embody any positive measure to encourage development of our local banks.... Thou shall not" is the spirit underlying it. The bill only tends to prevent local banks from being a nuisance, but it does not seek to make them socially useful.... I do not say that all African banks are good but quite a number of them have assisted Africans which European banks failed to do.[146]

He continued, "African banks sprang up as a protest against discrimination which the bigger British Banks have been practising in this country" [147] and in consequence, in his view, the desire to encourage and protect domestic banks must permeate any banking legislation. Though parochial interests might have motivated this comment, the legislator spoke what he believed should be an important policy consideration that should be taken into account in designing banking regulatory structures.

CURRENT REGULATORY FRAMEWORK IN CANADA AND NIGERIA - OVERVIEW

The banking systems of both countries have gone through a lot of development over the years. Both countries, from time to time, make adjustments to the regulatory framework to deal with the challenges of modern banking and promote the safety and soundness of banks operating within their respective jurisdictions. It is important to note, however, that "institutional arrangements and supervisory systems that eliminate the risk of bank failure

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146 *Ibid.*

147 *Ibid.* There is in fact a local saying in Nigeria to back up this proposition: *Charity begins at Home.*

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and financial system do not exist"[148] and the key objective should be the promotion of practices which are generally associated with bank stability and safety[149].

Canada

The power to make laws regulating the business of banking in Canada is under the exclusive jurisdiction of the Federal Government[150] and the principal statute regulating the affairs and operations of banks describe what constitutes banking business. Section 409 (1) of the *Bank Act*[151] provides that"[a] bank shall not engage in or carry on any business other than the business of banking and such business generally as appertains thereto". Some of the businesses banks are allowed to engage in pursuant to Section 409(2) include "(a) providing financial service; (b) acting as a financial agent; (c) providing investment counselling services and portfolio management services".

Gelfand, while speaking on the scope of the above provision, opines that it is wider than the traditional definition of banking business[152]. This perhaps is in keeping with global trends which is to allow banks engage in wider businesses outside those traditionally associated with banking. In the case of Canada, such business must, however, "appertain

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148 Gavin Michael & Ricardo Hausman, "The Roots of Banking Crises: The Macroeconomic Context", *Inter-American Development Bank, Working Paper 318, January 1996* at 2.

149 More will be said about this in the course of the thesis.

150 *Constitutional Act, 1867* (U.K.), 30 & 31 Vict., c. 3, s. 91(15).

151 R.S.C. 1991, c.46.

152 B.Z. Gelfand, *Regulation of Financial Institutions* (Toronto: Carswell, 1999) at 1-32.2

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to banking business", and must not come under those expressly prohibited by the *Bank Act*[153].

The principal regulatory institution[154] of banks in Canada is the Office of the Superintendent of Financial Institutions (OSFI)[155], which is responsible to the Minister of Finance. There is also the Canada Deposit Insurance Corporation (CDIC) which insures the deposit liabilities of, not only banks, but also other financial institutions that elect to be part of the federally operated insurance scheme[156]. Another regulatory institution, which was set up to protect the interests of consumers of financial services, is the Financial Consumer Agency. This body was set up in 2001[157] to, *inter alia,* ensure compliance by financial institutions, including banks, with the consumer provisions[158] applicable to them.

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153 The *Bank Act* places restrictions on banks regarding certain transactions, *e.g.* s. 412 prohibits banks from acting in certain fiduciary capacity; others include, s. 414 (restriction on powers of banks to act as guarantors, s. 415 (restrictions on securities' dealings – see also, *Securities Dealing Restrictions (Banks) Regulations,* S.O.R./92-279), s.417 (restriction on leasing).

154 More will be said about the relevant institutions in the course of the thesis.

155 For the objectives, powers and duties of this body, see generally *Office of the Superintendent of Financial Institution Act,* R.S.C. 1985, (3rd Supp.) c.18 [*OSFI Act*].

156 For more on the objectives, powers and duties of this body, see *Canada Deposit Insurance Corporation Act,* R.S.C. 1985, c.C-3.

157 See, *Financial Consumer Agency of Canada Act,* 2001 c.9. [*FCAC Act*]

158 *Section 2* of the *FCAC Act* outlines the "consumer provisions" sections contained in the *Bank Act.* An example of one of them is s. 157(2)(e) of the *Bank Act* which requires directors of a bank to "establish procedures to provide disclosure of information to customers of the bank that is required to be disclosed" under the *Bank Act.*

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Eliminating the risk of bank failures is an objective many regulatory authorities cannot realistically commit to and neither will any government[159], given the vulnerability of banks to macroeconomic shocks[160] – something largely extrinsic to the banking system. The regulatory framework in Canada, however, requires timely intervention on the part of the regulatory authorities where a bank is engaged in unsafe or unsound practices or is not complying with regulatory stipulations[161]. To this end, OSFI has developed a number of guidelines that will enable it effectively assess the safety and soundness of regulated institutions using criteria such as, the institution's risk profile, risk management processes and financial condition[162].

There is also the "Guide"[163] which outlines standard regulatory procedures/responses to be taken by OSFI and CDIC in dealing with different regulated institutions showing varying degrees of crisis. The document helps "promote awareness and enhance transparency of the system of intervention for federal deposit-taking financial institutions"[164] and "summarizes the circumstances under which certain intervention

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159 *Section 4(4)* of the *OSFI Act* expressly provides that, "[n]otwithstanding that the regulation and supervision of financial institutions by the Office and the Superintendent can reduce the risk that financial institutions will fail, regulation and supervision must be carried out having regard to the fact that boards of directors are responsible for the management of financial institutions, financial institutions carry on business in a competitive environment that necessitates the management of risk and financial institutions can experience financial difficulties that can lead to their failure".

160 *Gavin, supra* note 148 at 2.

161 *Section 4(1)(b)* of the *OSFI Act.*

162 See generally, *Supervisory Framework Guideline,* online:<http://www.osfi-bsif.gc.ca/eng/documents/practices/docs/framew_e.pdf>

163 See, *The Guide,* online:<http://www.osfi-bsif.gc.ca/eng/documents/practices/pages/index.asp?id=1995>.

164 *Ibid.*

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measures may be expected, and it describes the coordination mechanisms in place between OSFI and CDIC when dealing with federally regulated deposit-taking institutions".[165]

Nigeria

In the case of Nigeria, section 61 of the *Banks and Other Financial Institutions Act*[166] *No 25 1991,* as amended by the *Universal Banking Guidelines of 1999*[167], defines banking business as:

> "[t]he business of receiving deposits on current account , savings account or similar account , paying or collecting cheques drawn by or paid in by customers , providing finance, consultancy and advisory services relating to corporate and investment matters; making or managing investment on behalf of any person; and providing insurance marketing services and capital market business or such other services as the Governor of the Central Bank of Nigeria, may, by order published in the *Gazette,* designate as banking business."

This amendment – made by the Governor of Central Bank – introduced the concept of Universal Banking into the Nigerian financial system. The original section defined banking business in a narrower sense as "the business of receiving deposits, on current, savings or other accounts; paying or collecting cheques drawn or paid in by customers;

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165 *Ibid.*

166 *Act No. 25 of 1991* [BOFIA].

167 The Guidelines were made in December 1999 by the Governor of Central Bank acting pursuant to powers conferred on him by Section 61 of *BOFIA* [*Guidelines'*].

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provision of financial or such other services as the Governor of the Central Bank of Nigeria, may, by order published in the *Gazette*, designate as banking business"[168].

The Central Bank of Nigeria (CBN) is the principal regulatory institution for banks in the country and it shares this responsibility with the Nigeria Deposit Insurance Corporation formed in 1988[169](NDIC), and to an extent, the Corporate Affairs Commission.[170] More will be said about both the CBN and the NDIC in the course of the thesis.

Comments

Though the banking regulatory framework for both countries share a number of similarities – as will be shown later –, there are a number of significant differences in both schemes, some of which will be highlighted below. The Canadian banking regulatory framework is much better than what presently obtains in Nigeria as it shows a clearer and deeper appreciation of many of the issues involved in bank regulation. In addition, the fact that the framework was developed and nurtured through a democratic and open process ensured that a wide variety of issues, interests and considerations were taken into account. In Nigeria, on the other hand, the major banking statutes made in 1969 and 1991, were enacted by military governments who, putting it mildly, were not equipped for a legislative job of that nature. The current legislation, BOFIA, is barely up

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168 *Section 61* of *BOFIA.*

169 See the *Nigerian Deposit Insurance Corporation Act, Cap.301 Laws of the Federation of Nigeria 1990.*

170 This body was set up pursuant to s. 1 of the *Companies and Allied Matters Act, Cap.59 Laws of the Federation of Nigeria 1990* and is responsible for monitoring the affairs of all registered companies..

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to sixty-five sections, dealing only with what the military rulers believed to be the bare essentials. No general public consultations were solicited and it is not ascertainable what policy considerations underpinned their approach to bank regulation.

However, there appears to be a genuine desire on the part of the Nigerian bank regulators to ensure that they keep track of global developments in the area of bank regulation and the management of financial distress. For instance, the CBN and the NDIC are in the process of adopting the Toronto Leadership Forum's Framework on Contingency Planning For Banking System Distress and Crises and, to this end, a joint committee of both the CBN and the NDIC has been set up to look into the issue.[171]

The Canadian banking regulatory framework uses a comprehensive statute, the *Bank Act*, as the common charter[172] for all banks doing business in Canada[173]. The duration of the banks' authority to carry on business has been defined in successive *Bank Acts* as being for about ten years, subject to renewal[174]. This ten-year practice began in 1871 as a way of maintaining control over the banks and it has since become a distinctive component of the Canadian banking regulatory framework. In Nigeria, persons desirous of engaging in banking business must first of all incorporate as a company under the *Companies and Allied Matters Act* before making the application for licence to CBN as required by

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171 See "Savannah Bank: The Hammer Falls", *This Day,* (25 February 2002).

172 See section 13, *Bank Act.*

173 *Ogilvie, supra* note 2 at 27.

174 *Ibid.*

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BOFIA. Usually, the application for licence is to be made and approval obtained in principle before the bank is subsequently incorporated[175].

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175 See O. Ajayi, *The Regulation of Banks and Financial Institutions*,(Lagos: Greyhouse, 1991) at 12-13.

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CHAPTER TWO

"Deregulation has put the proponents of business regulation on the defensive. Today, economic regulation must be justified by reference to convincing evidence of dysfunction in unregulated markets; otherwise, its interference with competitive market forces is considered unnecessary and even counterproductive. Yet, when regulation has dominated an industry for a long period of time, the case for or against regulation may be difficult to make. Defenders of regulation can point to the hazards that the original regulatory program was designed to address, but, years later, the regulated business may have changed so completely that stories of past abuses by an unregulated industry take on a legendary quality. On the other hand, the consequences of sudden deregulation of an industry that has grown up with and has been shaped by regulation are so unpredictable, and potentially so destabilising, as to discourage total demolition of existing regulatory structures. The result often is a compromise, involving refurbishing regulatory controls, which is unsatisfactory both to proponents and to opponents of deregulation."[1]

Introduction

The public regulation of the banking industry today is seen as almost given in nearly all the countries of the world[2]. Smith and Walker[3] give one possible rationale for this,

> [b]anks cannot be allowed to impose politically unacceptable costs on society, either by failing those people deemed worthy of protection in financial matters or by permitting bank failure to contaminate other financial institutions and, ultimately, the economic system as a whole.

It may, perhaps, be too late in the day to proffer arguments that would be taken as compelling enough for government to "hands-off" banks[4]. Nonetheless, researchers, particularly economists – as indicated in the introductory portion of this study – have

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1 Helen. A. Garten, "Subtle Hazards, Financial Risks, And Diversified Banks: An Essay on the Perils of Regulatory Reform", (1990) 49 Md. L. Rev No.2 at 314-315.

2 Smith C, & Walter I, *Global Banking 2nd ed,*(Oxford: Oxford University Press, 2003) at 335 [*Smith & Walker*] ; James Birth, Gerard Caprio and Ross Levine, "The Regulation and Supervision of Banks Around the World", *World Bank Papers,* online: <www.worldbank.org/research/interest/intrstweb.htm> [*Birth, Caprio and Levine*]

3 *Smith & Walker, ibid.*

4 Sheila Dow, *Why the Banking System Should Be Regulated,* (1996) 106 Economic Journal 698-707[*Dow*]

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conducted several studies to examine many issues related to bank regulation prime among which are: Why does government subject banks to a special kind of regulation given that there are other financial institutions that also deal in assets and liabilities? What are the effects of regulation – or a mix of regulatory practices – on the banking industry?

The first part of this chapter examines, *albeit* briefly, the underlying rationale for government intervention in the workings of the markets generally with a view to establishing the broad basis for government involvement in the affairs of banks. The second part of the chapter considers some of the arguments that have been suggested to justify or oppose government regulation of banks. In addition, some arguments projecting the promotion of market discipline as an alternative to government regulation will be considered. Does this provide a feasible alternative? These discussions, it is believed, will aid better understanding of the regulatory structure in place in both Canada and Nigeria and thus, provide the necessary background for the appraisal and evaluation of the relevant legislation in the next chapter.

The final portion of this chapter examines the incidence of bank failures in both Canada and Nigeria in order to identify the principal factors these insolvencies. For our purpose, emphasis will be on the most recent cases of bank failures in both countries.

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Government Intervention in Markets - Why?

The issue of the desirability of government regulation of the banking industry can broadly be examined in the larger context of government intervention in the ordinary workings of a market economy, and on this, economic experts are sharply divided into two broad camps. On the one hand are those who argue that government intervention in the operations of the market is antithetical to the ideal notion of capitalism[5] and would not lead to optimal allocation of resources[6]. On the other hand are the economists who contend, in the main, that an unregulated market brings about unsatisfactory results such as monopoly, undersupplied goods, exorbitant and ubiquitous social costs of private actions, unprotected consumers and unfairly distributed wealth and income[7]. To this latter group, all these unpleasant outcomes are clear manifestations of market failure for which government intervention is not only justified but also imperative in order to bring about, amongst other things, efficient resource allocation and fair distribution of wealth[8]. This is

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5 The underlying philosophy of the capitalist economic system, largely practised- to a lesser or greater degree - in the Western States, is the promotion and encouragement of individualism in the pursuit of personal economic goals, with each individual being "regulated", principally, by his conscience and directed by Adam Smith's concept of the invisible hand to further the common good whilst pursuing their respective self-interest.

6 It is generally contended by this school of thought that given certain assumptions, an "unregulated system of enterprise tends to achieve an optimal allocation of resources": See, G.Benston & G.Kaufman, "The Appropriate Role of Bank Regulation", in M. Hall ed., *The Regulation and Supervision of Banks* vol. 1: The Case for and Against Bank Regulation, (Massachusetts: Edward Elgar, 2001) at 60. [*Benston & Kaufman*]

7 On this, see generally Arthur Cecil Pigou, *The Economics of Welfare,* (New Brunswick: Transaction, 2002).

8 *Ibid*; For more discussions of these polemical arguments, see W. Mitchell & R.Simmons, *Beyond Politics: Markets, Welfare and the Failure of Bureaucracy*, (San Francisco: Westview, 1994), Parts 1 and 3; See also C. Baggaley, *The Emergence of the Regulatory State in Canada, 1867 – 1939,* Economic Council of Canada, Technical Report Series, No. 15 1981 at 1 – 24, where, among other things, the various theoretical models for explaining the role of the Canadian State in

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viewed as the *helping hand* theory of government regulation[9] and applying this in the context of banking, such common regulatory practices as "official supervision of banks, limits on bank activities, restrictions on bank entry, and a deposit insurance scheme"[10] are seen as "appropriate policies that alleviate market failures and improve resource allocation"[11].

Posner, while supporting the views of the economists who contend that "[m]onopoly, pollution, fraud, mistake, mismanagement and other unhappy by-products of the market are …failures of the market's self-regulatory mechanisms and therefore appropriate occasions for public regulation"[12] argues further that the failure alluded to is not just the failure of the market, but also the failure of the rules prescribed by the common law. He further contends, using pollution as an example,

> 'Pollution ...would not be considered a serious problem if the common law remedies, such as nuisance and trespass were efficient methods of minimizing the costs of pollution. The choice is rarely between a free market and public regulation. It is between two methods of public control – the common law system of privately enforced rights and the administrative system of direct public control"[13].

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economic affairs was examined in addition to the rationale for government intervention to alter the economic behaviour of private enterprise.

9 James Barth, Gerard Caprio and Ross Levine, "Bank Regulation and Supervision: What Works Best?", *World Bank Papers Series*, online:< http://www.bis.org/bcbs/events/b2ealev.pdf> [*What Works Best*]

10 *Ibid.*

11 *Ibid.*

12 Posner R, *Economic Analysis of Law* (New York: Aspen Law and Business, 1998) at 401[*Posner*]

13 *Ibid*

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Thus, the legal scholar believes that government intervention in the market can be rationalised on grounds other than that widely suggested by the above group of economists. He argues that the inability of the common law rules to effectively deal with some of the fallouts of market failures is the principal reason for direct government control. A deficiency he identifies in common law rules is that "incentives to obey are created by the threat of having to compensate victims for the harm done them"[14]. Direct government regulation, on the other hand, he contends, "tries to prevent injuries from occurring in the first place rather than to compensate victims of injuries"[15].

Quite apart from the literature arguing for or against government intervention in the workings of the market, there is a vast amount of academic work which examines the (potential) motives for and effects of government regulation.[16] It is beyond the scope of this thesis to go into an analysis of these studies. However, whatever may be regarded as the rationale or motive for government intervention in economic affairs, the fact remains that it appears to be the prevailing political preference, particularly as far as banking is concerned. In many jurisdictions of the world today, heavy regulation of the banking industry is the norm rather than the exception and arguments proffering contrary options are, at best, only of academic interests. The question however is: *why are banks treated*

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14 *Ibid.*

15 *Ibid*; For more on this, see *Posner*, *ibid* at 401-403.

16 Stigler, G. "The Theory of Economic Regulation" (1971) 2 Bell J. E & Man. Sci.3; Peltzman S., "Toward A More General Theory of Regulation" (1976) 19 J.L.Econ 211; Richard Posner, *Theories of Economic Regulation*, (1974) 5 Bell J.E & Man. Sci. 335-358;

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differently as far as regulation is concerned when compared with other financial intermediaries?

Why Regulate Banks?

A substantial amount of academic literature documents that a well-functioning and stable banking industry accelerates economic growth[17] and this is one of the reasons why States pay more than a cursory attention to the operations of banks[18]. Banks are subject to government regulation in nearly all the countries in the world. The regulatory framework commonly encompasses Market Conduct Regulation and Prudential Regulation[19]. The former is designed to protect customers engaged in specific transactions while the latter is meant to maintain the soundness and stability of the banks[20]. The emphasis in the thesis is on the latter[21]. The issue here is: *Why are banks treated differently as far as regulation is concerned?*

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17 See generally, *Barth, Caprio & Levine, supra* note 2.

18 For an economic analysis of why banks are needed, see Sudipto Bhattacharya, Arnoud Boot, Anjan Thakor, "The Economics of Bank Regulation", (1998) 30 *Journal of Money, Credit and Banking, No.4.*

19 H. Binhammer & P. Sephton, *Money, Banking and the Canadian Financial System*,(Ontario : Nelson Thomson Learning ,2001) at 247[*Binhammer and Sephton*]; See also, Canada, Task Force on the Future of the Canadian Financial Services Sector, *Improving the Regulatory Framework, Background Paper #5*,(Ottawa: Department of Finance, 1998) at 7-8.

20 *Ibid.*

21 Additional reasons have been given for regulation and these include the need to enhance competition, achievement of some social goals, prevention of excessive concentration of power and to achieve the monetary control policies of the government: See generally, *Binhammer and Sephton supra* note 19 at 247 – 250.

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There is a large amount of academic literature dealing with diverse aspects of bank regulation. First, there are those who argue for continued government regulation.[22] Second, there are those who argue against any form of government intervention and contend that promotion of market regulation offers a better alternative.[23] Also, some address specific aspects of government regulatory practices[24] and argue for the removal of certain regulatory measures on the grounds that they are actually inimical to the well-being of banks or the efficiency of the market. A good example of this is the deposit insurance scheme which some have argued reduces the incentive for depositors to monitor their banks[25]. This part examines some of the conceptual arguments proffered to support or oppose State regulation of the banking industry. It will also examine some of the views advocating the promotion of market discipline as a better alternative to government regulation.

The Arguments

According to the Canadian House of Commons Standing Committee on Finance ("the Committee"), capturing the views of many commentators who support government

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22 For example, see *Dow, supra* note 4.

23 Jerry Jordan, "A Market Approach to Banking Regulation", (1994) 13 Cato Journal No.3 at 321

24 A case has, however, been made that given the fact that the salient issues in bank regulation and supervision are so interrelated, one must examine an extensive array of factors simultaneously to identify those combinations of regulatory and supervisory policies that produce successful banking systems. On this see, *Barth, Caprio & Levine*, *supra* note 2.

25 See for example, Brownbridge Martin, "Financial Distress in Local Banks in Kenya, Nigeria, Uganda and Zambia: Causes and Implications for Regulatory Policy", (1998) 16 Development Policy Review, No. 2 at 173.

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regulation, there is need for prudential regulation in order to minimize systemic risk[26]. Systemic risk[27] has generally been described as the "likelihood of a sudden, usually unexpected, collapse of confidence in a significant portion of the banking or financial system with potentially large real economic effects"[28]. The Committee, explaining further the rationale for government regulation, also posits the existence of information asymmetry[29] as a legitimate basis for government regulation of banks. According to it, "most consumers cannot adequately assess the solvency of the financial institutions with which they deal. Thus government plays a vital role as collective overseer of financial institutions and the financial system"[30]. The public perception of the safety and soundness of banks is critical to maintaining confidence in the sector, but getting adequate information about the risk behavior of a bank is "usually costly and not readily available to most depositors"[31]. Government's regulation of banks' risk behavior, thus,

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26 See Canada, Parliament, Standing Committee on Finance, "The Future Starts Now: A Study on the Financial Services Sector in Canada" December 1998, chapter 5 online: <http://www.parl.gc.ca/InfoComDoc/36/1/FINA/Studies/Reports/finarp12-e.htm>[House Report].

27 This phrase became a buzz work in bank regulation literature around the 80s. See generally, Philip F Bartholomew, "Bank Consolidation and Systemic Risks", *Brookings – Wharton Paper on Financial Services,* 1998 at 373-404.

28 Philip F Bartholomew and Gary W Whalen, *"Fundamentals of Systemic Risk"* in *Research in Financial Services Private and Public Policy* (Greenwich: JAI Press, 1995) at 3.

29 This generally refers to a situation where information is known to one participant in a transaction and not to all, thus giving that party unfair advantage over others: On this see generally, *Binhammer and Sephton, supra* note 19 at 248.

30 House Report, *ibid;*

31 *Binhammer and Sephton, supra* note 19 at 248.

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"serves as a substitute for information and, as such, supports the public's confidence in the safety of their deposits"[32].

Feldstein posits a public interest rationale as the basis for government regulation of banks. According to him,[33]

> The public interest in avoiding the failure of banks...argues strongly for government regulation and supervision of these institutions. Even Adam Smith explicitly advocated the regulation of banks because he recognized that their failure would have damaging effects on the economy more generally.... The banking system as a whole is a "public good" that benefits the nation over and above the profits it earns for the banks' shareholders. Systemic risks for the banking system are risks for the nation as a whole.... Banks left to themselves will accept more risk than is optimal from a systemic point of view. That is the basic case for government regulation of banking activity...

Dow's argument on the need for government regulation is premised on the central role played by money in the economic process and the "uncertainty associated with it"[34]. She contends that this uncertainty in turn renders free banking unworkable "since the proposal requires the non-bank public to assess the expected value of the portfolios"[35] of banks. Dow emphasizes the role of money as a "means of payment and a store of value"[36], and contends that money is more useful when its value is more predictable. She argues that

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32 *Ibid.*

33 Feldstein Martin, "The Risk of Economic Crisis: Introduction" in Martin Feldstein ed., *The Risk of Economic Crisis* (Chicago: University of Chicago Press, 1991) at 2 and 15.

34 Dow, *supra* note 4 at 698;

35 *Ibid*; part of Dow's arguments supports the information asymmetry rationale for bank regulation.

36 Ibid

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government prudential regulation is necessary to reduce uncertainties about the value of bank produced money by ensuring that banks continue to remain solvent in order to honor cheques drawn on them[37].

There is also the argument that the existence of a government run deposit insurance scheme and the status of one of its institution as the lender of last resort make a strong case for government regulation of banks since the State will need to monitor the activities of banks to ensure they are not taking unnecessary risks.[38] It is however doubtful if this argument provides a principal rationale for government regulation of banks in Canada and Nigeria since bank regulation in both countries predates the introduction of their respective deposit insurance scheme[39] and the establishment of both Bank of Canada[40] and the Central Bank of Nigeria[41] – the lender of last resort in both countries.

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[37] *Cf. Benston & Kaufman, supra* note 6 at 60-69.

[38] For more on this and a critique of this view, see generally, Angela Redish, "The Government's Role in Payment Systems: Lessons from the Canadian Experience", in Catherine England ed., *Governing Banking's Future: Market vs. Regulation,*(Boston: Kluwer, 1991) at 161-180; see also, Jerry Jordan, "A Market Approach to Banking Regulation", (1994) 13 Cato Journal No.3 at 321.

[39] This was introduced in Canada in 1967, while it came into existence in Nigeria in 198...It should be noted here however, that some have argued that prior to the formal introduction of the deposit insurance scheme in Canada, the government had a form of arrangement to assist banks in distress through "whole bank purchase or bailouts", and assisted depositors to minimize loss arising from the collapse of their banks. For more on this, see Marie Hélène Noiseux, *Canadian Bank Mergers Rescues and Failures,* (Ph.D Thesis, John Molson School of Business, Concordia University 2002) at 78 –79. [*Noiseux*]

[40] This was established in 1935

[41] This was established in 1958.

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Some arguments emphasise that given the somewhat "precarious" nature of what constitutes the bulk of a bank's assets – *i.e. loans*, there is the need to have a regulatory framework which stipulates an adequate capital -to -asset ratio for banks to adhere to so as to absorb losses that may arise as a result of debtor default[42]. In other words, the fact that banks are highly leveraged institutions is a major reason why government should intervene to stipulate minimum standards of desirable practices to ensure the safety of depositors' funds.[43]

Speaking along similar lines, Hall opines that

> [C]ommercial banks are susceptible to deposit runs because of the risk and maturity transformation roles which they perform, leading them to operate with a high proportion of illiquid, non-marketable loans on the assets side of the balance sheet backed, in large degree by very short –term deposit liabilities. If deposit runs start, individual banks can soon suffer from illiquidity which, in turn, can readily degenerate into insolvency[44].

The issue of bank runs[45] has been a major source of concern to many governments given its potential to spread throughout the banking industry, creating problems for otherwise

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42 *Binhammer and Sephton, supra* note 19 at 234-235. It is by reason of this that the regulatory authorities in both Canada and Nigeria prescribe the ratios in which a bank's asset should stand relative to its capital.

43 There is a voluminous amount of economic literature on the operational stability of banks given the nature of what forms the bulk of their assets and the conclusion is that this has made the banking system fragile. For more on this see generally, G.Benston and G.Kaufman, "Is the Banking and Payment System Fragile", in M. Hall ed., *The Regulation and Supervision of Banks vol. 1: The Case for and Against Bank Regulation*, (Massachusetts : Edward Elgar ,2001) at 28-56 and G. Kaufman, "Bank Failures, Systemic Risks, and Bank Regulation", online: <http ://www.cato.org/pubs/journsl/cj16n1-2.html>[*Kaufman*].

44 See M. Hall, "Introduction to Volume 1" in M. Hall ed., *The Regulation and Supervision of Banks vol. 1: The Case for and Against Bank Regulation,* (Massachusetts: Edward Elgar, 2001) at *xiv* [*'M.Hall'*]

45 Bank runs describes "large and persistent cash withdrawals" by depositors arising from concerns about the continued safety of their banks: *Binhammer and Sephton, supra* note 19 at 224; See also, Benton Gup, *Bank Failures in the Major Trading Countries of the World: Causes and Remedies*, (Westport: Quorum Books, 1998) at 12 [*Gup*]

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healthy banks – the contagion effect[46] thereby disrupting the payment system and, in consequence, the whole economy[47]. Though some have argued that there is no empirical evidence to support this so-called contagion effect, and, hence contend that panic withdrawals cannot spread throughout the banking industry if only one bank has problems[48], the majority of academic opinions seem to conclude that the contagion effect *is* indeed a real possibility capable of having catastrophic effects on the whole economy[49].

Other arguments focus on the risks inherent in banking business to support or justify government intervention. According to some legal scholars[50],

> The business of banking is fraught with dangers ...and....Banks face many pitfalls in their daily operations. The better – known examples are unwise investments in questionable industrial projects, lending to countries with unstable economies, hazardous dealings in foreign currencies, and the investment of money received on short-term deposits in long-term transactions. This last dangerous practice has achieved notoriety. When, contrary to expectations, short-term deposits are not renewed, a bank that has lent funds involved on a long-term basis faces a liquidity crisis.

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46 For more on the contagion effects, see P.Siklos, *Money Banking and Financial Institutions: Canada in the Global Environment* (Toronto: McGraw-Hill, 2001) at 310 [*Siklos*]

47 It seems that as things are, the courts will not prevent a depositor from demanding his money from his bank as he wishes, no matter how detrimental this may be to the liquidity position of the bank. The law is settled that the nature of the relationship between the banker and his customer is contractual and hence, the bank must fulfil its own side of the bargain by allowing a customer access to his funds: See the cases of *Foley v. Hill* (1848) 2 HL Cas.28; *Thermo King v. Provincial Bank* 34 OR (2d) 369.

48 *Kaufman, supra* note 43.

49 For more on these various arguments see, *M. Hall, supra* note 44 at xiv, 5-13 and 595-601.

50 E. Ellinger, E. Lomnicka & R. Hooley, *Modern Banking Law,* (Oxford: Oxford Univerity Press, 2002) at 27.

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A number of risks faced by banks have been identified and they include solvency risks, foreign exchange risks, credit risks, interest rate risks and operating risks[51]. This latter risk arises from a number of factors such as human error, sabotage, fraud, process or systems failure[52]. All these risks pose grave danger to the banks hence the need to have a regulatory framework that provides prudential guidelines on how these risks should be handled and contained within manageable limits, not only for the sake of the individual bank but also for the protection of the whole banking industry.

On the other side of the spectrum are those who oppose government regulation of banking and Dowd seems to have captured the gist of the arguments of this school of thought. Dowd, in advocating his case for financial *laissez-faire*, argues that those who oppose free banking[53] do so "more or less instinctively as if its failings are obvious"[54]. Dowd points out what he sees as a contradiction in many economists who, for the most

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51 See generally, E.Cade, *Managing Banking Risks* (Chicago: Glenlake, 1999) 16 [*Managing Risks*].

52 *Ibid* at 16; *Binhammer and Sephton*, *supra* note 19 at 234.

53 Note that the concept of free banking also includes allowing banks to issue their own currencies: See *Siklos, supra* note 46 at 532.

54 Kevin Dowd, "The Case for Financial *Laissez-Faire*", (1996) 106 Economic Journal at 679[*Dowd*].

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part, "accept the general principle of free trade"[55], but "deny that it applies to financial services"[56].

Dowd's view is premised on three essential points. First, he contends that if free trade is good, as generally accepted, then "there must be at least a *prima facie* case in favour of free banking"[57]. Secondly, he states that concerns about the notion of free banking largely "reflects the way we have been conditioned to think"[58] about the need for government regulation. He also maintains that empirical evidence in fact supports the view that unregulated banks are stable[59]. Dowd, in particular, attacks the argument that state-run deposit insurance scheme and the lender of last resort concept promote confidence in the banking system and hence ensure bank stability[60]. Without these two, he argues, individual depositors would be "acutely aware that they stood to lose their deposits if their bank failed"[61]. This will encourage them to monitor their banks and seek reassurance about its safety. Bank managers, he contends, will be more circumspect in conducting the affairs of their banks as they would be aware that "their long-term

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55 *Ibid.*

56 *Ibid*; It should be noted here that though Dowd uses the word "financial" as if his study relates to the whole financial services institution, his work is actually dedicated to the banking industry.

57 *Dowd, supra* note 54 at 679.

58 *Ibid*

59 *Ibid.*

60 *Dowd, ibid* at 681.

61 *Ibid.*

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survival depended on their ability to retain their depositors' confidence"[62]. He asserts that market forces will force banks to regularly adjust their capital base to a degree sufficient enough to absorb potential losses and still be able to repay depositors[63].

On the contagion effect as a justifiable basis for government intervention, Dowd argues that the difficulties of one bank will not necessarily induce the public to withdraw money *en masse* from healthy banks[64]. He asserts that "good banks have a stronger incentive to distance themselves from bad ones"[65] and if the good banks felt there was any danger of contagion, "they would strengthen themselves and curtail credit to weak banks"[66]. They will also position themselves to "offer the customers of weak banks a safe haven when their own banks run into difficulties"[67]. To the extent that Dowd's argument predicts that in a banking crisis, good banks will distance themselves from bad banks, it is not truly reflective of the situation in Canada – at least historically speaking. Historical evidence indicates that rather than distance themselves from an ailing bank, and increase the

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62 *Ibid.*

63 *Ibid*

64 *Dowd, supra* note 54 at 682.

65 *Ibid*

66 *Ibid*

67 *Ibid;* see however, Goodhart C, "Why Do Banks Need A Central Bank?", *Oxford Economic Papers* 39 (1987), 75-89; For arguments in favour of free banking based on an economic analysis of the role of banks in the payment and monetary system, see generally, George Selgin, *The Theory of Free Banking: Money Supply Under Competitive Note Issue,*(New Jersey: Rowman and Littlefield, 1988) [*Selgin*].

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possibility of the contagion effect, healthy Canadian banks have always absorbed the ailing banks, wherever this is possible[68].

Jordan advocates less government supervision and promotion of market discipline as a way of reducing the cost of compliance[69]. According to him, "[t]he cost of compliance with regulatory requirements includes both the explicit cost of meeting regulatory requirements and the implicit costs imposed by regulatory prohibitions. Both costs are large, but are often overlooked in the heat of concern for bank safety"[70]. He proposes that well managed and well capitalized banks should not be subject to the same degree of government regulation as troubled banks thereby lowering their costs of compliance and creating an incentive for other banks to aspire to be members of this "quality club"[71]. He suggests, among other things, that regulatory agencies should rate banks using Capital adequacy, Asset quality, Management, Earnings and Liquidity (CAMEL) and release the information to the public. Such information will enable the market to properly assess the risk profile of a bank and also enable bank customers determine where to do their banking business[72].

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68 See *Noiseux supra* note 39 at 130 -150.

69 Jerry Jordan, "A Market Approach to Banking Regulation", (1994) 13 Cato Journal No.3 at 315-332 online:<http://www.cato.org/pubs/journal/cj13n3/cj13n3-1.pdf>[*Jordan*].

70 *Jordan, ibid* at 319.

71 *Jordan, ibid* at 316.

72 *Jordan, ibid* at 323-324.

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Benston and Kaufman argue, in the main, that apart from the provision of a well-structured deposit insurance scheme[73], banks should not be regulated for purposes of achieving objectives such as "efficiency, safety, and monetary control"[74] as regulation does not necessarily assure the attainment of these goals, and if anything, it increases the cost of bank services. They contend, *inter alia,* that banks are regulated to provide "revenue and power for government officials"[75].

Paradigm Shift?

The above arguments reflect the salient points of mainstream views supporting or opposing government regulation of banking. That there is a need for some form of regulation, however, is hardly in much contention from all the arguments, the critical issue is: which regulatory model works best?[76] According to a learned writer, "[i]dentification of the need for intervention is the easy bit; construction of an 'optimal' framework is far more demanding"[77].

While some make a case for more involvement of the market in the regulatory process, others contend that government's role is critical and indispensable. To be sure,

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73 They take this as given because "it is unrealistic to assume that government deposit guarantees will be removed entirely" *Benston & Kaufman, supra* note 6 at 68.

74 *Benston & Kaufman, supra* note 6 at 66.

75 *Ibid.*

76 See also, Caprio Gerard, "Bank Regulation: The Case of The Missing Model", *World Bank Research Papers,* online: < http://econ.worldbank.org/files/408_wps1574.pdf>

77 *M. Hall supra* note 44 at xv.

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economists have for a long time projected the benefits of a free market. In relation to banking however, many of the proponents of market regulation have not argued that markets should substitute government regulation[78]. Their argument is that both should be complementary. One issue here, however, is that certain government regulatory measures, for instance the deposit insurance scheme, are largely incompatible with the idea of market-based regulatory regime[79] as insured depositors lack the necessary incentive to monitor the soundness of their banks[80].

It is seen from the above that many of the arguments are based on economic analysis of the roles of banks in the economic system and the conclusions reached are largely based on economic principles. However, as has been rightly pointed out, whether or not banks should continue to be subject to government regulation is now largely a political question having little or nothing to do with economic analysis.[81] The potentially adverse ripple effects of a bank failure and the associated costs[82] make government regulation a more

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78 Ursel Baumann and Erlend Nier, "Market Discipline and Financial Stability: Some Empirical Evidence",(2003) Financial Stability Review, online:< http://www.bankofengland.co.uk/fsr/fsr14art7.pdf >[*Baumann*]; See also, Eduardo Yeyati, *et al,* "Market Discipline in Emerging Economies: Beyond Bank Fundamentals", online:< http://www.utdt.edu/~ely/Market_Discipline.pdf>[*Eduardo*].

79 *Ibid.*

80 For more on this and the conditions-precedent necessary for promoting market discipline, see *Baumann, ibid* and *Eduardo, ibid.*

81 J. Wadsley, G. Penn, *The Law Relating to Domestic Banking, Vol 1* (London: Sweet & Maxwell 2000) at 3;*Selgin, supra* note 67 at 145; For similar arguments in relation to deposit insurance scheme, see generally, J.L. Carr, G.F. Mathewson and N.C.Quigley , *Ensuring Failure: Financial System Stability and Deposit Insurance in Canada*,(Toronto: C.D.Howe Institute, 1994);

82 For a discussion of losses incurred by different stakeholders by reason of bank failure in Canada see, *Noseriux, supra* note 39 at 78-101.

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preferable option as it gives a measure of assurance that government is making the effort to protect not only the depositors' funds but also promote the safety and soundness of the banking system.

BANK FAILURES

The incidence of bank failure is an unfortunate malaise that has, regrettably, plagued financial systems all over the world[83] since the evolution of banking business and has left in its trail, in many instances, monumental financial losses to various classes of persons – shareholders, depositors and creditors –, not to mention the resultant catastrophic consequences on the domestic economy of the concerned country. In some instances, the effects transcend national boundaries causing – in extreme cases – severe dislocations in the economies of other countries. It was indeed in recognition of this likely spillover effect that moves were made at the international level about three decades ago for the harmonization of regulatory standards and encouragement of greater co-operation amongst bank regulators to ensure uniformity in supervision of banks. These international initiatives led to the establishment of the Committee on Banking Regulations and Supervisory Practices – otherwise called the *Basle Committee* – in 1974[84], and the

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[83] For a list of countries that have experienced distress between 1981 and 1994, see James Barth *et al*, "Cross-Country Evidence on Banking Crises: Do Financial Structure and Bank Regulation Matter" in George Kaufman ed., *Bank Fragility and Regulation: Evidence from Different Countries,* (New York: Elsevier, 2000) at 3.

[84] J.B. Hall, *Handbook of Banking Regulation and Supervision in the United Kingdom* (Cheltenham: Edward Elgar, 1999) 9[*Hall*]. The crash of the *Bankhaus Herstatt*, a major German bank, resulting in serious disruptions to foreign exchange transactions in the world economy is regarded as the catalyst for the establishment of the Basle Committee on Banking Supervision, an international initiative formed to promote convergence of regulatory practices.

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subsequent adoption of the *Basle Concordat* which, *inter alia,* prescribes minimum standards of best practices aimed at promoting global bank stability.

Though what constitutes a bank failure, and hence when a bank is deemed insolvent, can hardly occasion any polemical academic debate, it is thought nonetheless apt to explain, *albeit* briefly, when a bank is considered – technically speaking – insolvent, as this will be helpful for purposes of the analysis contemplated in the next chapter. According to George Kaufman, "[a] bank fails economically when the market value of its assets declines below the market value of its liabilities, so that the market value of its capital (net worth) becomes negative. At such times, the bank cannot expect to pay all of its depositors in full and on time"[85]. It may perhaps be pointed out here that the inability of a bank to honour its debt obligations to depositors when demanded may not necessarily mean insolvency, but rather illiquidity. The significance of this distinction is critical as it should inform the type of regulatory response that is most appropriate to deal with the situation. A misapprehension of the true state of affairs of an ailing bank by the regulators may result in the adoption of ill-advised – or perhaps more aptly, incongruous – remedial actions, or in some cases controversial decisions. An example of this is the recent banking licence incident in Nigeria where the Central Bank of Nigeria withdrew the licence of one of the leading banks in the country on the grounds that it had become insolvent. The bank disputed this contending that at the worst it was passing through a

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[85] G. Kaufman, "Bank Failures, Systemic Risk and Bank Regulation", online: <http://www.cato.org/pubs/journal/cj16n1-2.html>; See also, *Binhammer and Sephton, supra* note 19 at 234 and J. Ebhodaghe , *Safe & Sound Banking Practices in Nigeria : Selected Essays*(Lagos : Page,1997) at 22 [*Ebhodaghe*].

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mere temporary liquidity crisis, which was in no way peculiar to it. The matter is still pending in the Federal Courts.

Bank Failures in Canada

The Canadian banking system, which is one of the most stable in the world, has also had its own experience of bank insolvencies. One of the major concerns of the Canadian Parliament before the enactment of the *Bank Act 1871* was the issue of the safety and stability of the banks. The principal reason for this was to ensure that the banks were and continued to be, solvent to enable them redeem their notes whenever presented by their note holders. The available records show that the bank failures actually started before Confederation in 1867 and the last major ones occurred around the mid 1980s[86]. The attempt here is to examine the main factors responsible for these failures, and in doing this, the latest bank insolvency incidents shall be used as the case study namely, the collapse of Canadian Commercial Bank (CCB) and Northland Bank[87]. For our purpose, the events that led to the failure of both banks will be described to enable easy identification of some of the factors that led to their collapse.

86 For a chronological table of the different bank failures that has occurred in the country, see Canada, *Report of the Inquiry into the Collapse of the CCB and Northland Bank,* (Ottawa: Supply and Services Canada, 1986) at 359 – 363 [*CCB and Northland Report*]

87 For a full and detailed report of the incident, see generally *CCB and Northland Report.*

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CCB

This was a bank[88] that intended to become a national bank but eventually concentrated its operations in Western Canada, Alberta and British Columbia taking advantage of the real estate and energy boom during the late 70s and early 80s in those regions[89]. The bank concentrated the bulk of its loan portfolio in these two sectors: this turned out to be its major undoing. The economic downturn in Western Canada in the early 1980s greatly affected both the energy and the real estate sector occasioning massive loan default[90]. The bank management's decision to acquire a minority interest in Westlands Bank, a California bank also heavily involved in the real estate, was described as "poorly investigated and ill-advised"[91]. That bank had very poorly managed loan portfolio and CCB was eventually required, *inter alia,* by Federal Deposit Insurance Corporation (the US Bank Regulator) to inject new funds into it. The opening of a lending office by CCB in California resulted in a write-off of $85 million in loans[92].

The bank management, in collusion with their auditors, adopted questionable accounting practices in the valuation of the bank's loan portfolio, the end objective being to misrepresent the financial position of the bank and create the picture of a financially

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[88] Formerly known as Canadian Commercial Industrial Bank and was established in 1975, see *CCB and Northland Report, supra* note 86 at 363.

[89] *CCB and Northland Inquiry, ibid* at 10

[90] *Ibid.*

[91] *CCB and Northland Report, ibid* at 11.

[92] *CCB and Northland Report, ibid* at *12.*

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healthy bank[93]. The *CCB and Northland Report* blamed the Board of Directors of the bank for not seeing through management's smokescreen. It was suggested that the Board should have done more in the circumstances and insisted upon "simple and straightforward information from management" regarding the true state of affairs of the bank[94]. It was a finding in the CCB and Northland Report that the regulatory agency – then known as the Office of the Inspector General of Banks (OIGB) – was tardy and did not effectively perform its statutory duties and hence should "bear much ...of the blame for...what transpired"[95]. The bank eventually collapsed in spite of a rescue program that was put in place[96].

Northland Bank

This bank, also a regional bank collapsed shortly after the failure of CCB. One of its main problems right from inception was the quality of its management team. They were largely inexperienced and lacked the necessary expertise to effectively run the affairs of the bank, resulting in poor handling of the bank's loan portfolio[97]. In order to give a picture of a healthy bank, the bank's management devised accounting techniques that essentially obfuscated the true financial condition of the bank on the balance sheet. The directors

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93 *CCB and Northland Report, ibid* at 12-16.

94 *CCB and Northland Report, ibid* at 16.

95 *CCB and Northland Report, ibid* at 17.

96 The rescue program was arranged without adequate information on the true state of the bank: see *CCB and Northland Report, ibid* at 16-18.

97 *CCB and Northland Report, ibid* at 3.

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were active borrowers from the bank and failed to provide the necessary leadership and direction for it[98]. Too much reliance was placed on management and there was hardly any "challenge to management's actions"[99].

The problems of the bank were exacerbated by the recession and the collapse of the CCB. Though the Bank of Canada offered liquidity assistance, it was discontinued when it was realised that the bank was beyond redemption. It was found that the OIGB, largely aware of the situation, failed to take timely action to address the drift[100].

Bank Failures in Nigeria

Nigeria, like many other countries – developed and developing – has had its own share of bank insolvencies[101]. The advent of indigenous banks in the country's financial system about the third decade of the 20th century marked the dawn of bank failures in her economic history. Interestingly, many of the factors that caused the collapse of the indigenous banks then were also identified as responsible for the many bank insolvencies that occurred in the 1990s, when more than half of the country's banks collapsed. If nothing else, the most recent string of bank failures in Nigeria calls into question the

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98 *CCB and Northland Report, ibid* at 10.

99 *Ibid*

100 *CCB and Northland Report, ibid at* 11-12.

101 *Ebhodaghe, supra* note 85at 7 and 24.

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adequacy of the existing regulatory framework, and in particular the dedication and seriousness of the regulators in the performance of their duties.

An eminent Nigerian scholar on banking identified two main eras of banking crisis in the history of the country. According to him, there was the banking crisis of the 1950s and that of the early 1990s[102]. The period between 1969 and 1990 was relatively stable – that is, as far as the banks were concerned[103]. For the purposes here however, only the events leading up to the latest failure of two banks in Nigeria will be described below[104].

Savannah Bank

Between 1995 and 1996, major differences amongst members of the board of this bank, one of the oldest in the country, forced the Central Bank of Nigeria (CBN) to temporarily take over the control of the bank and assist in the reconstitution of a new Board and management[105]. Despite this however, the CBN was still not satisfied with the way the bank was being run, and in particular, the handling of its large loan portfolio[106]. For the three years preceding its closure in 2002, the bank did not issue any financial

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102 J. Anifalaje, "Causes, Effects and Remedies of Bank Failures in Nigeria", in I. Sagay and O.Oliyide eds., *Current Developments in Nigerian Commercial Law: Essays in Honour of Chief Samuel Igbayiola Adegbite,*(Lagos: Throne of Grace, 1998) at 1-2[*Anifalaje*].

103 *Ibid at 2.*

104 More will be said on the general factors that have contributed to the several bank insolvencies in the history of the country in the next chapter.

105 See online:< http://english.cri.com.cn/english/2002/Feb/48923.htm >.

106 *Ibid;* see also online:< http://nigeriannet.com/newsline2/archives/00000004.shtml>.

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statement[107]. It remains to be seen if this is the sort of conduct the regulatory authorities should have condoned. The management of the bank accused the CBN of a double standard contending that the decision to close it down was political and was done to cover up the indebtedness of many powerful politicians[108]. CBN stated that the decision to close the bank down was due to its poor health, mismanagement and giving misleading information to the regulatory authorities[109]. The bank is currently challenging its closure on the grounds that CBN did not follow the stipulated statutory procedure in revoking its license.

Peak Merchant Bank

This bank was granted a licence to commence banking business on 15 February, 1991. As a result of petitions received by CBN from depositors regarding their inability to retrieve their deposits in 2001, CBN conducted an examination of the bank's operations and it came to light that it was experiencing a serious liquidity crisis and that its assets had greatly depreciated[110]. The immediate cause of this problem was management's decision to venture into a rice importation deal in which the bank lost N1 billion (approx. CAD$10 million). The bank was advised to recapitalise and aggressively seek to recover outstanding debts owed to it. It came up in the course of investigation that the bank had a

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107 *Ibid.*

108 *Ibid*; For comments on the huge losses to depositors see online: <http://www.thisdayonline.com/archive/2002/08/03/20020803plu05.html>.

109 For more on this see online:< http://www.africatoday.co.uk/mar02/mar02businesspg.htm>.

110 See Nigeria, *CBN Press Release on the Revocation of the License of Peak Merchant Bank, 28 February 2003.*

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large portfolio of insider related credits[111]. Attempts by new investors to inject fresh capital were deadlocked because the Chairman of the bank feared that his equity interest would be diluted. Though there seemed to have been a degree of regulatory forbearance on the part of CBN, it was forced to withdraw the bank's license because of the "lack of sincerity and seriousness of purpose on the part of the Board and management of the bank"[112] to comply with regulatory suggestions on how to turn the bank around. The bank's problems were compounded by a weak and incompetent board, an overbearing chairman who was also a major shareholder, lack of corporate governance culture and a significant degree of insider related credits[113].

Concluding Remarks

From the above, the circumstances leading to the collapse of all the banking institutions discussed are quite evident. In the case of the Canadian banks, the principal factors identified were, size of the non-performing loans, the non-diversification of the loan portfolio and lack of competent corporate leadership[114]. One other contributory factor identified in the *CCB and Northland Report* was regulatory oversight. It was thought that even when the regulators saw all the tell-tale signs of an impending disaster, they still did

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111 *Ibid.*

112 *Ibid.*

113 *Ibid.*

114 Though the economic recession had its own impact on the fortunes of these banks, it was the finding in the *CCB and Northland Report* that the stated factors were the critical and immediate causative elements of the collapse of the banks.

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not act in a timely fashion to avert the crisis or at least minimize the loss[115]. Similarly, a point was made in the *CCB and Northland Report* about the regulatory structure and its organisational weakness in relation to the sudden rise in number of banks around that time. It was stated that "the adoption of a policy of expansion of the population of banks was not accompanied by a study of the complementary changes required in the supervisory system"[116] and this, naturally, put a strain on the system thus impairing effective supervision.

In relation to Nigeria, the first era of banking crisis involved only the indigenous banks that were incorporated by Nigerians to, basically, meet local credit needs. A number of factors were identified as responsible for their collapse, and these are "inadequate capitalisation, over-trading, lack of technically skilled personnel and...poor management"[117]. The second era was between 1990 and 1995, a period which witnessed "the most excruciating socio-economic turbulence" in the entire history of the country[118].

While the bank distress of the first half of the 20th century could largely be attributed to the absence of a legislative framework delimiting the ambit of banking business and prescribing minimum standards of prudential practices, the banking crisis of the 1990s was caused by a number of factors – some of which were actually extrinsic to the banking

115 *CCB and Northland Report supra* note 86 at 19.

116 *CCB and Northland Report, ibid* at 3.

117 *Ebodhage, supra* note 85 at 7; See also, *Anifalaje, supra* note 102 at 2.

118 *Anifalaje, ibid* at 2.

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industry[119]. According to Ebhodage, the banking crisis of the 1990s was actually precipitated by a number of ill-advised directives issued by the government to the banks[120]. In particular, in 1989, the Federal Government directed the banks to transfer all public funds in their accounts – which in fact formed a large chunk of the banks' deposit base – to the Central Bank of Nigeria. These directives "exposed the precarious liquidity position of some banks and the distress they had subterraneously harboured. What was then thought to be a temporary liquidity problem for a few banks soon caught up with a lot more banks"[121]. The resultant effect was that between 1990 and 1995, sixty of the country's total banks of about one hundred and twenty were in dire liquidity crisis and had in fact failed or moved beyond the point of redemption, representing an average of about one out of every two banks operating in the country[122]. This scenario brings into question the capability, will or competence of the regulatory authorities to cope with the situation. As will be argued later in the thesis, there is no way the regulatory authorities could be exonerated from culpability in this situation. There have been reports that a large number of the regulatory officials were suborned by the management of troubled banks, and hence ignored the excesses of many of them in spite of telling signs of impending doom. Also, there have been allegations that bank reports and statements that should have put any reasonably prudent regulator on notice were deliberately ignored.

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119 For a detailed explanation of how the erratic monetary policies introduced by the then military government adversely affected Nigerian banks, see George Ayitteh, "Nigeria: The High Cost of Erratic Financial Policies" online:<*http://www.cipe.org/publications/fs/ert/e15/nigeri.htm*>.

120 *Ebhodage, supra* note 85 at 24.

121 *Ibid.*

122 *Ibid.*

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Other factors that have been responsible for the unprecedented bank failures in the country include, mismanagement[123], frequent boardroom rancour and personality clashes and large exposures to single individuals, corporations or related entities[124], insider related credits[125], and ownership structure

Having identified the principal causes of bank failures in both countries, the purpose of the next chapter is a consideration of the regulatory framework of both jurisdictions with a view to determining their adequacy to forestall or contain bank insolvencies after which, recommendations will be made on the basis of the analysis.

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123 *Ibid* at 28 – 29.

124 On large exposures, see generally, O. Ajayi, *The Regulation of Banks and Financial Institutions,* (Lagos: Greyhouse, 1991) at 54-55.

125 *Ebhodage, supra* note 85 at 29; In many instances, top executives of banks set up phony corporations to obtain credit facilities from the banks they run beyond allowable limits. Thereafter, these debts are eventually written off by them or their cronies as bad debts after feeble attempts

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CHAPTER THREE

> *It is now generally accepted that a mechanism for ensuring adherence to appropriate prudential standards is a necessary component of a developed banking sector. Not only do banks play a key role in distributing financial resources to the rest of the economy, but in doing so they act as repositories for the public savings. Their stability is a matter of considerable political concern; yet banks are peculiarly susceptible to instability and collapse. The nature of their business necessitates relatively high financial gearing....The imposition of a regime of prudential supervision aims to foster an environment of bank safety and soundness....This is done by establishing procedures to ensure that risk is properly recognized and measured and that the institutions concerned have adequate capital in place to support the level of business and risks which they run. It is also necessary to ensure that financial institutions maintain adequate liquidity to meet prospective net cash requirements*[1]

Introduction

The above statement succinctly encapsulates the *leitmotif* of banking regulation and the need for, and rules relating to, the operational efficiency of banks. In many jurisdictions, statutes and regulations prescribe capital[2] and reserve requirements, limits on loan exposures to individual entities and related parties, a regime of on-site or/and off-site monitoring of bank records and other prudential stipulations to ensure financial discipline, best practices and sound management by banks[3]. It should be noted here that there are many facets to bank regulation with each, essentially, meant to attain a specific or complementary objective. The attempt here is not to examine all the issues relating to bank regulation, but rather to look at specific statutory provisions that are meant to contain the incidence of bank insolvencies.

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1 J. Wadsley, G. Penn, *The Law Relating to Domestic Banking, Vol 1* (London: Sweet & Maxwell 2000) at 3.

2 This is commonly based on the Basle Capital Accord, as revised from time to time.

3 Regular, formal or informal, consultations with management of banks is also another usual component of the regulatory framework operating in many jurisdictions: See the address given by Dr. Donald Brash, Governor of the Reserve Bank of New Zealand to the IMF Conference on Bank Soundness and Monetary Policy in a World of Global Capital Markets, on 30th January, 1997, online: < http://www.rbnz.govt.nz/speeches/0042879.html>

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The previous chapter, amongst other things, identified some of the factors responsible for the most recent bank insolvencies in both Canada and Nigeria. The principal purpose here is to critically examine the current regulatory framework in both jurisdictions to determine the extent to which they respectively address these factors and the possibilities for change. Among some of the issues to be considered are the following: *Are these statutory provisions adequate? Has the current regulatory framework significantly reduced the likelihood of bank insolvencies? Who regulates the regulators? Should the depositors be placed at the mercy of the regulators, so to speak? Should depositors of failed institutions be allowed to have direct recourse to the regulators for remedies?*

The first part of this chapter will critically examine various regulatory provisions on entry, management and ownership, loan exposure and insider loans with a view to determining their effectiveness in containing the incidence of bank insolvencies. It will be argued, particularly in the case of Nigeria, that while some of them appear to be well suited to meet the problems of distress in the banks, there are still a number of loopholes which could be exploited by unscrupulous elements. The thesis will argue that these should be addressed in order to make the regulatory framework, on the whole, better placed to contain the issue of bank insolvencies.

The issue of accountability of regulators of financial services to consumers of those services is increasingly gaining momentum worldwide[4]. Whilst there is as yet no case in

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[4] The recent legislative overhaul of the British financial services sector through the restructuring of the Financial Services Authority is an indication of this. On this, see, A. Page, "Regulating the

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common law jurisdictions where bank regulators have been held liable under private law to depositors of a failed bank, the recent decision of the House of Lords in the case of *Three Rivers District Council and others v. Bank of England (No 3)*[5], suggests that it may only be a matter of time before the regulators are made liable under a head of tort. The next portion of this chapter, therefore, examines some relevant tort cases dealing with heads of torts that depositors may use to found an action against bank regulators. The issue to be considered here is the propriety of allowing depositors of a failed bank to have recourse to the regulators for remedies where the circumstances clearly indicate regulatory lapses[6]. It will be contended that this is a necessary measure to improve the effectiveness of the statutory framework, as it is capable of not only impelling the regulators to do their duties more diligently but also to be more mindful of the nature of their responsibilities to the public. To this end, the thesis examines the common law torts of negligence, misfeasance in public office and the Canadian concept of fiduciary obligation to determine the remedy, if any, they afford to depositors of a failed bank against the regulatory authorities. The thesis will not delve extensively into these common law remedies as the principles appear to be fairly established, hence only decisions that are considered to be of most relevance to the direction of arguments will be examined. Furthermore, only the decisions of the highest courts, where available, will be used.

Regulator –A Lawyer's Perspective on Accountability and Control", in E. Ferran & C. Goodhart eds., *Regulating Financial Services and Markets in the 21st Century*, (Oxford: Hart, 2001) at 127[Page].

5 [2001] 2 All ER 513[*Three Rivers*].

6 More will be said on this in the course of the chapter.

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Among the proposals to be made in the concluding part is the introduction of a statutory scheme of remedies for the benefit of depositors. Arguments will be proffered for the enactment of a *Bank Regulators (Accountability) Act* to serve as a better and more viable alternative remedy for depositors of a failed bank against the regulators where the circumstances leading to the banks' insolvency indicate serious regulatory lapses[7].

ENTRY REQUIREMENTS

What perhaps is one of the hallmarks of a good banking regulatory framework is its effectiveness in keeping undesirable elements[8] out of the banking system. Given the devastating social and economic consequences of money laundering[9] or bank failure, for instance, nobody will doubt the need to ensure that those granted approval to operate banks are screened properly before they are 'let loose' on society. The BCCI incident, mentioned below, is a good example of the dangers inherent in not effectively monitoring or screening persons who conduct banking business or gain control of its affairs and operations.

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7 More will be said on the degree of lapses that will be sufficient to found an action.

8 The phrase 'undesirable element' is used to categorize persons who are into the banking business for motives other than a legitimate desire to engage in the banking enterprise. For example, people who float banks in order to have easy access to much needed credit for their other business interests.

9 This is one of the crimes that can be perpetrated where banks are controlled by shady characters. For more on the catastrophic effects of money laundering, see generally, online: <http://www.state.gov/www/global/narcotics_law/1997_narc_report/money.html>.

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The general consensus appears to be that the regulatory institutions bear the burden of ensuring that adequate filters, as opposed to barriers[10], are in place to sift out genuine applications from the pool of interested bank promoters[11]. In the English case of *Three Rivers*, one of the contentions made before the House of Lords against the regulatory authority, the Bank of England, was that it failed to exercise reasonable diligence in processing applications for bank licences, a situation which led to the granting of licence to the promoters of the now infamous Bank of Credit and Commerce International. The question here then is: *to what extent do the legislative framework of both Canada and Nigeria safeguard the integrity of the banking system by preventing undesirable elements or other entrepreneurs with ulterior motives from floating banks?*

Canada.

Entry into the Canadian banking industry, unlike the Nigerian system, basically depends on whether the bank is being floated by local investors or by a foreign bank. The concern here is not to examine the modes through which foreign enterprise commence banking business in Canada but rather to look at those matters which the regulatory authorities must take into account before approval is given for incorporation of banks and the commencement of banking business.

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10 The regulatory framework will also need to take into account the need to make the financial industry competitive.

11 See, F.Mishkin, "Prudential Supervision: Why Is It Important and What Are the Issues", in F. Mishkin ed., *Prudential supervision: What Works and What Doesn't?* (Chicago: University of Chicago Press, 2001) 12; see also Canada, Report of the Inquiry into the Collapse of the CCB and Northland Bank, (Ottawa: Supply and Services Canada, 1986) at 2 where the Commission said that '[t]he keeper of the gate of entry into the banking business is the Government of Canada'[*CCB and Northland Report*].

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Part III of the *Bank Act*[12] deals with the formalities of incorporation. Section 25(1) of the *Bank Act* provides that an application for letters patent to incorporate a bank, setting out the names of the first directors of the bank, shall be filed with the Superintendent, together with such other information, material and evidence as the Superintendent may require. It is noteworthy to mention that the *Bank Act* requires (a) prospective applicant(s) for letters patent to publish a notice of his/their intention to do so in the *Canada Gazette* and in a newspaper in general circulation at or near the place where the head office of the bank is to be situated[13]. This is to be done at least once a week for four consecutive weeks and persons who have objections to such incorporation are expected to make this known to the Superintendent within the specified time of thirty days[14].

The legislative intent for this requirement is ostensibly to notify the community of the intended establishment of the bank. However, the *Bank Act* does not expressly specify those things that are required to be included in the public notice. The only requirement is that it should be 'in a form satisfactory to the Superintendent'[15]. It is believed that the *Bank Act* should expressly require the notice to contain the names of all the bank promoters, including the management team so that members of the public would be able to 'scrutinize' those they would be entrusting their money to.

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12 1991, c.46. [*Bank Act*]

13 See s. 25(2) of the *Bank Act;* This procedure is not required in the case of Nigeria for any form of incorporation, except in the case of incorporated trustees: s. 677 *Companies and Allied Matters Act, Laws of the Federation of Nigeria c.59, 1990* [*CAMA*]

14 See s. 26(1) of the *Bank Act.*

15 See s. 25(2) of the *Bank Act.*

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Section 27 of the *Bank Act* provides a very comprehensive, though not exhaustive, statutory checklist of considerations the Minister for Finance should take into account in deciding whether or not to grant letters patent[16] for the incorporation of a bank. It provides,

> Before issuing letters patent to incorporate a bank, the Minister shall take into account all matters that the Minister considers relevant to the application, including
>
> (*a*) the nature and sufficiency of the financial resources of the applicant or applicants as a source of continuing financial support for the bank;
>
> (*b*) the soundness and feasibility of the plans of the applicant or applicants for the future conduct and development of the business of the bank;
>
> (*c*) the business record and experience of the applicant or applicants;
>
> (*d*) the character and integrity of the applicant or applicants or, if the applicant or any of the applicants is a body corporate, its reputation for being operated in a manner that is consistent with the standards of good character and integrity;
>
> (*e*) whether the bank will be operated responsibly by persons with the competence and experience suitable for involvement in the operation of a financial institution;
>
> (*f*) the impact of any integration of the businesses and operations of the applicant or applicants with those of the bank on the conduct of those businesses and operations;
>
> (*g*) the opinion of the Superintendent regarding the extent to which the proposed corporate structure of the applicant or applicants and their affiliates may affect the supervision and regulation of the bank, having regard to
>
> (i) the nature and extent of the proposed financial services activities to be carried out by the bank and its affiliates, and

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16 For items that will be on the letters patent, see s.28 of the *Bank Act*.

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(ii) the nature and degree of supervision and regulation applying to the proposed financial services activities to be carried out by the affiliates of the bank; and

(*h*) the best interests of the financial system in Canada.

The provisions are most reassuring and underscore the importance the Canadian government – and rightly in my view – attach to maintaining a stable and sound banking industry as many of the above requirements are meant to ensure that the proposed bank has the necessary human and financial resources to successfully operate a bank. Though the bank comes into existence on the day indicated on its letters patent[17], it is not authorized to commence business until the Superintendent has, by order, approved the commencement and carrying on of business by that bank.[18] One of the conditions for the grant of the order is that the bank must have complied with all the relevant requirements of the *Bank Act.*[19] Once the Superintendent satisfies himself that the necessary conditions for the grant of the order have been satisfied[20], he will issue an order. It has been held that once approval is granted, it is assumed that all of the conditions required to be satisfied have been, and such approval could only subsequently be questioned in proper legal proceedings.[21]

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17 See s. 32 of the *Bank Act.*

18 See s.48 (1) of the *Bank Act*

19 On this see generally s. 52(1) of the *Bank Act.*

20 By virtue of s.53 of the *Bank Act* however, the Superintendent is allowed to impose 'such conditions or limitations that are consistent with this Act and relate to the business of the bank as the Superintendent deems expedient and necessary.

21 See *Re Home Bank, Gillespie's Case* [1927] 1 D.L.R. 871; See also, M.H. Ogilvie, *Canadian Banking Law* (Toronto: Carswell, 1991) at 45[*Ogilvie*].

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Nigeria

The Nigerian government also stipulates some stringent requirements for prospective entrepreneurs who desire to float banks[22]. They are required to provide a feasibility report, a draft copy of the memorandum and articles of association of the proposed bank, a list of the shareholders, directors and principal officers and the prescribed application fee[23]. Furthermore, the promoters are expected to provide "such other information, documents and reports" as the CBN may from time to time specify[24]. These usually include information about the profile of the management team, evidence of funds availability and evidence as to the source of funds. These last two requirements are the two most cumbersome for bank promoters to fulfill, and the reason why they are required is to forestall the injection of illicit money into the banking system.[25] In addition, the shareholders of the bank are also required to deposit a sum equal to the minimum paid up share capital applicable at the time of the application.[26]

That the regulatory framework prescribes some stringent conditions for obtaining a banking license is not so much in doubt and neither is the rationale for such debatable.

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22 See, *The Guardian*, February 12 2002 where the Governor of Central Bank of Nigeria outlined the minimum expectations required of bank promoters; see also, *This Day*, 26 August 2002.

23 Section 3 (1) of *Bank and Other Financial Institutions Act, No. 25* 1991[*BOFIA*].

24 *Ibid.*

25 *This Day, supra* note 22.; *The Guardian, supra* note 22.

26 ss. 3(2) and 9 of BOFIA; this sum has continuously grown from N40 million in the 1980s to the current N2 billion required for new banks. Existing banks are required to raise theirs to N1 billion. The two main factors responsible for the steady increase is the progressive decline of the national currency and the rising level of inflation: See Central Bank of Nigeria, Monetary, Credit, Foreign Trade and Exchange Policy Guidelines for Fiscal 2002/2003, Monetary Policy Circular No. 36, para. 3.2.11(d).

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The critical question, however, is: to what extent has it succeeded in adequately screening new entrants into the banking industry? It is sad to note that prospective investors who would otherwise have failed the screening process circumvent the regulatory stipulations and work their way into bank boards through the back door. According to Ogbuile,

> Among all these requirements, intending bank owners have found it difficult to meet some of the criteria such as evidence of source of funds, evidence of important funds availability and the records of the promoters. This is because CBN always want to make sure that those who are intending to acquire a new banking license must be above board and would not have such records which are capable of undermining the interests of depositors and customers. This is why the acquisition of license takes much longer time because a rigorous investigation is always carried out on the records of promoters. But to avert this, promoters have been known to have hidden under proxy investors, most of the time pushing their registration through credible personalities only to emerge few years after the bank has fully granted the license to operate[27]

Another means through which people acquire ownership of banks without passing through the CBN is through stock purchase in the capital market. Given that the Nigerian Stock Exchange is a largely anonymous market, share acquisition and disposition is done freely without any major issue about the identity of a selling shareholder or an acquiring investor. The shares are sold and bought through brokers. According to Ogbuile, speaking further on this point,

> [M]ost bank owners today have been able to sneak into boards of big banks through acquisition of existing shares ... Most major share holders in banks today did not achieve that position through new banking licenses. They had gradually cornered the stock market and gradually began to mop up shares of their target banks until they earned as much shares that offered them the impetus to become relevant so as to be directly accorded the much desired ownership status".[28]

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[27] See Nik Ogbuile," How to Own A Bank", *This Day* (26 August 2002) [*Ogbuile*].

[28] *Ibid.*

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This is indeed a gaping lacuna in the current regulatory framework as it is capable of allowing wealthy but shady individuals, either directly through fronts, or nominees to gain control of a bank without passing through the rigorous screening exercise of the CBN. The situation is made worse by the fact that the current regulatory framework does not place a cap on the amount of equity a single individual may hold either directly or indirectly – or both- in the total share capital of a bank. The rationale for the inclusion of section 10 of BOFIA is still hard to tell. It provides that " the voting rights of every shareholder in a bank shall be proportional to his contribution to the paid-up share capital of the bank". This section creates a situation where the destiny of a bank may be subject to the whims of a single individual. More will be said on this in the course of the thesis.

The provisions of section 44(1) of BOFIA require banks to seek the prior approval of the CBN "before appointing any director or chief executive". But, is this a sufficient check to prevent shady individuals or money launderers from gaining control of a bank? Whilst it may be plausible to contend that the CBN may reject a director under the above provision where he is considered "not fit and proper", there is absolutely no legal duty that the CBN should investigate the source of the funds with which the prospective director purchased the shares and there is also no indication that such is done in practice. At any rate, it is believed that reading section 44 as a whole, the apparent legislative intent is not directed at persons who intend to inject illicit funds into the banking system.

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The Board and Management

One of the observations made in the *CCB and Northland Report* was that 'experienced and competent management are essential to the success of a bank and constitute the first line of defence against bank problems'[29]. Speaking in a similar vein Ebhodaghe noted[30],

> [T]he continued survival and viability of the banking system rests within the Board of Directors and the top management of the banks on the one hand and the regulatory authorities on the other. While regulation can help, it cannot be a substitute for purposeful leadership expected to *(sic)* board of directors

Also, in its circular of August 6 2002[31], the CBN indicted bank boards for the banking crises that have occurred in the country. According to it,

> It is on record that the various financial crises experienced in Nigeria between 1930 and 1999 which led to the demise of a number of banks, can be traced to several factors, including most notably the role of the personalities who were at the helm of affairs of the affected banks. This was as a result of the lack of a clear-cut regulatory policy, which left the banks with weak corporate governance structures to adopt arrangements that were inherently inadequate and risky.

Speaking also on this point, the *CCB and Northland Report* indicted the Board of the two Canadian banks for their timidity in relation to the affairs of the banks,

> The Board of Directors must share some responsibility as well for the failure of the bank. They were susceptible to being mesmerized by the management, and realization of the true state of affairs came too late. The key is their failure to insist upon simple and straightforward information from management"[32].

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29 *CCB and Northland Report, supra* note 11 at 292.

30 J. Ebhodaghe , *Safe & Sound Banking Practices in Nigeria : Selected Essays*(Lagos: Page,1997) at 110 [*Ebhodaghe*].

31 See Circular BSD/7/2002. For more on the activities of the CBN, see online: <http//www. cenbank.org.>

32 See *CCB and Northland Report, supra* note 11 at 16.

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The question here is: *to what extent do the regulatory framework of both Canada and Nigeria contain provisions that promote or enhance the quality of bank boards? Are there minimum qualifications required as criteria for directorship? If not, is this desirable in the light of contemporary corporate realities?*

Canada

The provisions of s.27(1)(c)(d)(e) and (f) of the *Bank Act* clearly demonstrate that a high premium is placed on the quality of the management and the boards of banks operating in Canada. The Minister, in considering an application for letters patent, is required to take into consideration, *inter alia,* whether the bank will be operated by persons with the competence and experience suitable for involvement in the operation of a financial institution. Though there is no doubt that the management team of a bank is required to be constituted by well-qualified personnel, there is no corresponding requirement in the *Bank Act* that membership of the board requires a particular qualification threshold. This was, in fact, one of the issues considered in the *CCB and Northland Report*t. The Commission, however, concluded that 'it would be impossible to legislate a uniform standard of board composition' and that the evidence did not indicate 'a need for any specific statutory qualifications for bank directors other than the usual requirement that board members have the capacity to discharge their duty'[33], 'be over eighteen, be of sound mind, be natural persons and not have the status of a bankrupt'[34].

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33 *CCB and Northland Report, supra* note 11 at 286.

34 *CCB and Northland* Report, *supra* note 11at 284. See generally s. 160 of the *Bank Act.*

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Given the increasing need to ensure proper corporate governance practices in corporations and promote better supervision by the board of the management team, it is believed that the board of banks should be required to be largely constituted by members who are well qualified to understand the intricacies and complexities of modern day banking. Section 157(1) of the *Bank Act* imposes an express duty on the board to 'manage or supervise the management of the business and affairs of the bank'. It is doubtful how these duties can be effectively carried out without at least a basic understanding of the issues involved in operating a banking enterprise. Also, it is interesting to note that the *Bank Act* makes express provisions on what are considered to be some of the specific duties of the board[35] and one of these is the duty to establish investment and lending policies[36]. The directors will need to possess a measure of relevant skills to be able to perform this particular duty. More will be said on this point later on in the course of this chapter under the heading *"Analysis"*.

It has been contended that the statutory scheme for constituting bank boards under the *Bank Act* is largely aimed at not only promoting Canadian economic nationalism and the independence of the banks from other financial institutions, but also to prevent undue government interference and market concentration[37]. The importance of having an independent board cannot be over-emphasized and this seems to be the essence of s.164 of the *Bank Act*. It provides,

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35 Section 157 (2) of the *Bank Act.*

36 See s.157 (2)(g) of the *Bank Act.*

37 *Oglivie, supra* note 21 at 47. On this, see ss. 160 and 183 of the *Bank Act.*

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> No more than 15 per cent of the directors of a bank may, at each director's election or appointment, be employees of the bank or a subsidiary of the bank, except that up to four persons who are employees of the bank or a subsidiary of the bank may be directors of the bank if those directors constitute not more than one half of the directors of the bank.

It has been stated that"[d]emonstrable board independence is at the core of effective corporate governance"[38]. The above provisions promotes the independence of the board and an independent board will be better placed to perform its oversight duties free from management interference[39].

Nigeria

The twin issue of board composition and quality management are a major concern of the regulatory authorities in Nigeria. According to Ajayi,

> It is essential to note that only fit and proper persons must be allowed to partake in the management, and serve as employees, of banks. A person should only be regarded as fit and proper or suitable for banking if he is of high professional probity, competence and if his holding office as a director, manager or employee of the bank will not result in, or jeopardise, or likely threaten, the interests of depositors. The CBN must also ensure that it monitors those holding office in banks by applying the test of suitability or being fit and proper before and after licensing[40].

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38 See para. VIII *Corporate Governance Guideline, Office of the Superintendent of Financial Institution, January 2003* [*OSFI Guideline on Corporate Governance]*

39 *Ibid.*

40 See O. Ajayi, *The Regulation of Banks and Financial Institutions,*(Lagos: Greyhouse, 1991) at 77 [*Ajayi*].

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In order to ensure the quality of a bank's board and its management, the CBN puts prospective directors and management through a 'fit and proper' person's test. According to CBN's bank supervision report for 2001[41],

> To ensure that only fit and proper persons own and manage financial institutions, the CBN takes prospective shareholders, directors and top management staff of these institutions through the "fit and proper persons test" which involves, among others, obtaining status reports from financial institutions, financial sector regulators and past employers, security screening as well as the use of market information[42].

It is necessary at this point to make a distinction between the qualifications required for membership of the board of a bank and those required as a condition for holding management positions. The CBN, in one of its circulars, declared its intention to "ensure that only sound management teams are installed in banks for a sound financial system"[43]. To this end, minimum qualifications were prescribed for holding management positions. In the case of the Managing Director (CEO), he must possess,

> [A] minimum of first degree in disciplines like Economics, Accountancy, Banking, Finance or in any other field backed by a Masters in Business Administration (MBA) or an acceptable professional qualification in Banking or Accountancy. The candidate must also have a minimum of 20 years post qualification experience 15 of which at least must have been in the banking industry and at least 10 at top/senior management level. In

41 Nigeria, Central Bank of Nigeria, Banking Supervision Annual Report, 2001 at page 16 [*Report 2001*].

42 This 'fit and proper test' is flawed in one major respect. The fact that a prospective director is a person of character and integrity does not necessarily mean that he is well equipped to perform the duties associated with the office of a bank director.

43 Circular BSD/DO/CIR/VOL.I/01/2001 issued on 4 January 2001 [*Circular 2001*].

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> addition, the candidate must demonstrate evidence of experience in several areas of banking operation[44].

Minimum academic qualifications are also prescribed for other top management positions. This, undoubtedly, is a most welcome initiative from the Nigerian regulatory authorities, though it is most unlikely that any bank would, in the first place, allow unskilled persons to occupy sensitive and top posts in the corporate hierarchy. The only issue here, then, is the qualification required for membership of the board as a non-executive director. On this, there appears to have been a regulatory capitulation. Circular 2001, rather than stipulate definite qualifications as a requisite, only enjoins banks to take into account "candidates with first degrees or their equivalents and appreciable experience/exposure or candidates with lower qualifications but with evidence of efficient management/directorship in well run organizations supported by the organizations' audited/published accounts"[45]. Given the importance of the board in the corporate structure[46]– a fact which was acknowledged by the CBN[47] –, it is believed that there should be specific skill related minimum qualification requirements as a requisite for eligibility as a non-executive director of a bank. This, it is believed, will better place them to perform their management oversight duties more effectively. In fact, CBN requires non-executive directors to be able to "interpret and appreciate reports and make

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44 See para. 1(a) *Circular 2001*.

45 See *Circular 2001*, para. 1(f).

46 Under Nigerian law, the board is the organ invested with the powers to manage the business of the company to the exclusion of the shareholders: see generally, ss. 63 and 64 of CAMA.

47 *Circular 2001*, para. 1(f).

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meaningful contributions *[emphasis added]* to board deliberations"[48]. How can they do this without possessing relevant qualifications?

Analysis

Since the arguments to be made in relation to board composition for both Canada and Nigeria are similar, the thesis will examine the issues together to avoid duplication of arguments.

The regulatory framework for Canada does not require the possession of any minimum qualification directors. Suggestions along this line were roundly rejected in the *CCB and Northland Report*.[49]The growing sophistication and complexities of banking business, however, requires a board largely composed of persons that are literate in banking and related disciplines.[50] For instance, one of the specific duties imposed on the board, under the *Bank Act*, is the responsibility to establish "investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return"[51]. Though members of the management team who are also on the board would usually provide input, outside directors too, who are required to be in the majority, will need to have relevant skills to enable them do a proper job and make meaningful contributions.

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48 *Ibid.*

49 See *CCB and Northland Report*, *supra* note 11 at 286 – 287.

50 For details of some of these, see generally *OSFI Guideline on Corporate Governance.*

51 s.465 of the *Bank Act.*

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The *Enron* and *WorldCom* saga have brought to the fore the need for the board to more effectively monitor management and perform their oversight duties more diligently. It is believed that for the board to be best equipped to take on this enormous responsibility, it should have a majority of members with financial literacy, banking experience, proven business acumen, accounting knowledge, or business related skills[52]. The importance of having skilled personnel on the board has been noted by *Buckley et al.* According to them "[b]ankers , underwriters , accountants and lawyers may ... be useful to have as board members, both for their professional skills and for their role as conduit of information between the firm and its relational contractors"[53].

Thus, for the board to effectively function and perform its duties very well, it should largely be made up of persons having most or all of the skills[54] outlined above as this would position it well to challenge, where necessary, the principal officers on issues affecting the bank. It should not be a mere rubber stamp of management. It should not be a 'yes board'. Baggallay Q.C[as he then was] in an argument before the English Court of Appeal contended that "[i]f the directors are to rely entirely on the manager or secretary

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52 Arguably, the law appears to require directors of corporations to have a degree of business acumen, without expressly saying so. s 44 of BOFIA , for instance, bars from being directors, without the express authority of CBN, persons who have been "directly or indirectly concerned in the management of a bank which has been wound up". It would seem implicit in this provision that there is an expectation of good managerial skills in prospective directors.

53 See H.Buckley, M.Gillen &R.Yalden," *Corporations: Principles and Policies*(Toronto: Emond Montgomery ,1995) at 588 [*Buckley*]. *Quaere* "...what about consumer spokespersons and community leaders whose presence on the board is sometimes championed by advocates of corporate social responsibility": see *Buckley, ibid* at 588.

54 The question which appears to follow then is: what threshold should be used to determine if a prospective director meets any of these criteria?

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what is the use of directors?"[55] It is believed that the time has come to dispel the notion of the board as a 'prosaic body' with little or nothing to offer with respect to management of an undertaking[56] and one way of achieving this is to have a board largely constituted by persons who match or nearly match the principal officers in terms of skills and knowledge.

The necessity for this appears to be underscored by the research findings of Prof. Mace, an American scholar on corporate governance, which indicated that many board members preferred to keep quiet rather than look stupid during management presentations. According to him,"[m]any board members cited their lack of understanding of the problems and implications of topics that are presented to the board by the president , and to avoid "looking like idiots" they refrain from questions or comments"[57].

Whilst no specific qualification requirement is contained in the *Bank Act*, it is submitted that this is desirable for reasons already given. The *Bank Act* should make it mandatory that possession of any of a number of skills is a prerequisite for outside directorship in banks, as this would largely remove the 'ego problem' alluded to in Prof. Mace's article. One way of making this practical, it is believed, is for the law to outline the major skills already mentioned above, in addition to other relevant ones, but without making the list

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[55] See *Land Credit Company of Ireland v. Lord Fermoy* [1870] LR.5 Ch. App 763 at 770. The court agreed with this part of his argument, and opined further that "where there was anything unreasonable or unusual about the transactions one should expect them to make inquiries" ibid.

[56] Board members are expected to provide effective leadership, see *OSFI Guidelines on Corporate Governance.*

[57] M. Mace, *Directors: Myth and Reality*, (1971) Harvard B. J. 185.

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exhaustive to allow for flexibility. Also, it should be indicated that formal education, professional qualification or proven practical experience in any of the outlined skills would suffice. Where persons or the banks are in doubt, the regulatory authorities should be consulted for clarifications. At any rate, this may not even necessarily be a problem if the board is already constituted by a majority of skilful people[58] since the proposal here is not for all the directors to be skilful but only for a majority of them, and chances are that the board of banks will always have a majority of professionally qualified members.[59]

In relation to Nigeria, there has not been any legislative response specifically aimed at enhancing the quality of bank boards, in spite of the growing complexities and sophistication of bank transactions. The arguments made above in relation to Canada apply with equal force to the situation in Nigeria. There is every need, in the light of the realities of the times, to ensure that bank boards are constituted, in the majority, by persons who, either through academic qualifications or professional experience, are well qualified to understand and fully appreciate the risks involved in contemporary banking business and how to effectively deal with them[60]. It is believed that a viable way of achieving this objective is to stipulate that boards of banks should be constituted in the majority by persons with qualifications that are very relevant to banking business. According to Ebhodaghe, bank boards should normally be constituted by persons "knowledgeable about the economic situation of the country, competent in business and

[58] Excluding the management and executive directors.

[59] *Quaere* , should the presence of the professionally skilful directors be critical to forming a quorum for board meetings?

[60] The changing face of banking business and the challenges it has created for the regulators was discussed in Nigeria, *Central Bank of Nigeria Banking Supervision Annual Report,* 2000.

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skilled in financial management"[61]. He argues further that outside directors "must be skilled in the knowledge of finance and economics"[62].

Sadly, the reality of the situation in Nigeria is that bank directors are usually appointed by the shareholders on the basis of considerations other than the possession of skills or any degree of competence in banking business. According to Ebhodaghe[63],

> [S]hareholders appoint a person as director because of the extent of the person's equity interest in the bank. The belief is that major shareholders will have vested interests in the performance of the bank....Also, in order to enhance a bank's image, prominent and respected citizens are often appointed as directors. This is particularly true of outside directors, as it is believed that such prominent persons will help to bring business to the bank. In the same vein, an ability to be able to bring business to a bank can qualify a person to be a bank director.

The above shows that, in practice, skills or competence is not usually a critical consideration for shareholders in appointing outside directors to a bank. BOFIA should be amended along the lines already suggested above in order to enhance the quality of the board and make it provide the much-needed corporate leadership.

Another issue here is: What standard should be required of directors in the performance of their duties? The current position under Nigerian law is that a director of a bank, just like that of any company in Nigeria[64], is expected to conduct the affairs of the company

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61 *Ebhodaghe, supra note* 30 at 178.

62 *Ibid.*

63 *Ibid.*

64 Only *CAMA* prescribes the duties of directors. No other special provision is made in the *BOFIA* regarding directors' duties.

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"in such manner as a faithful, diligent, careful and ordinarily skilful director would act in the circumstances"[65]. It is believed that this threshold is too low and directors should be required to measure up to a higher standard of care and diligence in the discharge of their duties[66]. Ebhodaghe observes that many of the directors "rarely get involved in debates on such important issues as operating costs, manpower development policies, strategic planning or performance evaluation"[67]. What they are more concerned about are their entitlements at the expense of their responsibilities and they "devote more time pursuing what they regarded as their rights and often forgot their duties"[68]. In view of this, upgrading the standard these directors should measure up to in the performance of their duties will go a long way in 'impelling' them to be more alive to their responsibilities. They should be required to measure up to the standard of "an experienced business person qualified to be the director of a regulated financial institution"[69].

With respect to Canada, the above proposed standard should also be adopted. The current position is that a director is required to exercise the "care, diligence and skill that a reasonably prudent person will exercise in comparable circumstances"[70]while performing his duties as a director. Though in the *CCB and Northland Report*, the Commission

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65 Section 279(3) of the *CAMA*.

66 Currently, the standard is that of a reasonable prudent person in comparable circumstances.

67 *Ebhodage, supra* note 30 at 189.

68 *Ibid.*

69 See *CCB and Northland Report, supra* note 11 at 287.This was one of the issues considered by the Commission but it concluded, taking into account a number of factors, that the standard should remain as it was.

70 Section 158(1)(b) of the *Bank Act.*

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rejected arguments that the standard of care should be elevated stating, *inter alia,* that "if the burden upon a director is too high, either in criminal or civil law, then the likelihood of electing responsible, competent citizens to the board of directors diminishes"[71].

While it may not be a viable proposition in the Canadian banking context given the extensive corporate governance guidelines issued by OSFI[72], the situation in Nigeria requires a measure as drastic as that being proposed. The most recent banking crisis the country experienced in the 1990s revealed a lot of improprieties on the part of the directors of failed banks. One of these was the lackadaisical approach many of them adopted in relation to the affairs of the banks under their control[73]. Upgrading the standard to which they should measure up to in the performance of their duties, therefore, should act as the much needed impetus to stimulate them to perform their duties more diligently.

Some of the concerns raised in the *CCB and Northland Report*, particularly that relating to the possibility of excluding competent and responsible people to the board where they may be open to more liability, should not be a major issue in the Nigerian context. For instance, in spite of the very stringent criminal sanctions contained in the *Failed Banks (Recovery of Debts) and Financial Malpractices Act,* people still scramble to become

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71 *CCB and Northland Report, supra* note 11 at 288.

72 OSFI also encourages banks to develop their own corporate governance guidelines and internal control policies and many Canadian banks do have their own governance rules. For instance *see TD Financial Group Annual Report 2003* which outlines the corporate governance practices of the bank and measures that have been taken to enhance the board quality and performance.

73 It was around this period in 1994 that the government promulgated the *Failed Banks (Recovery of Debts) and Financial Malpractices Act.*

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directors of banks. So, upgrading the standard of care, on its own, would not act as a disincentive to intending bank directors in Nigeria.

INSIDER LOANS

Though this factor was not one of those identified as chiefly responsible for the failure of the two Canadian banks discussed in the last chapter, it is one of those that has arisen in the context of bank failures in many jurisdictions.[74] In Nigeria, it has been a major causative factor of all the bank failures that has occurred in the country, hence the applicable provisions under the Nigerian regulatory framework will be examined more extensively.

Canada

The *Bank Act* has created a very comprehensive regime for addressing related party transactions.[75] Section 486(1) of the *Bank Act* provides that a person is a related party of a bank where the person,

> *(a)* is a person who has a significant interest in a class of shares of the bank;
> *(b)* is a director or senior officer of the bank or of a body corporate that controls the bank or is acting in a similar capacity in respect of an unincorporated entity that controls the bank;
> *(c)* is the spouse or common-law partner, or a child who is less than eighteen years of age, of a person described in paragraph (*a*) or (*b*);
> *(d)* is an entity that is controlled by a person referred to in any of paragraphs (*a*) to (*c*);
> *(e)* is an entity in which a person who controls the bank has a substantial investment;

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74 B.Z. Gelfand, *Regulation of Financial Institutions* (Toronto: Carswell, 1999) at 1-22 [*Gelfand*]; See also, Benton Gup, *Bank Failures in the Major Trading Countries of the World: Causes and Remedies,* (Westport: Quorum Books, 1998)

75 See generally on this Part XI of the *Bank Act.*

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(*f*) is an entity in which the spouse or common-law partner, or a child who is less than eighteen years of age, of a person who controls the bank has a substantial investment; or

(*g*) is a person, or a member of a class of persons, designated under subsection (3) or (4) as, or deemed under subsection (5) to be, a related party of the bank[76].

The *Bank Act* further prescribes that related parties may not transact business with the bank except those transactions that are specifically authorized in the *Bank Act*[77]. Even at that, such permitted transactions[78] are still required to be approved by a bank's Conduct Review Committee[79]. In certain instances, the board approval may be required where, for instance, the bank is making a loan or incurring any obligation with respect to the related party where the outstanding indebtedness of that related party to the bank will, in aggregate, exceed a particular threshold[80].

The provisions of *Part XI* of the *Bank Act* deal with a wide variety of issues on related party transactions, including insider loans and conflicts of interests situations[81]. The main focus here however is on insider loans and the aim is to use some of the provisions as a

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76 See further s.486 (3)(4) and (5).

77 ss. 489(1) and 496 of the *Bank Act* ; see also, *Gelfand, supra* note 74 at 1-151.

78 The *Bank Act* provides in s. 490 that '[n]otwithstanding anything in this Part, a bank may enter into a transaction with a related party of the bank if the value of the transaction is nominal or immaterial to the bank when measured by criteria that have been established by the conduct review committee of the bank and approved in writing by the Superintendent'. It should be noted here that this provision only relates to the less substantial loans.

79 This is one of the committees that the *Bank Act* places a specific duty on the board to establish: see s.157 (2)(b). In order to ensure it's independence, majority of its members are not to be persons affiliated with the bank and none of them may also be its officers or employees. For the definition of an 'affiliated person' see Canada, *Affiliated Persons (Bank) Regulations (SOR/92-325).* For the duties of this committee see, s.195 (3) of the *Bank Act.*

80 i.e. two percent of its regulatory capital: see, s.497(1) of the *Bank Act; cf. s.497(2) of the Bank Act.*

81 See s. 18 of *BOFIA* for rules relating to conflict of interests situations and how it has been dealt with under the Nigerian regulatory framework.

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model for improving the Nigerian regulatory framework. Section 491 of the *Bank Act* requires banks to make only secured loans to related parties. It provides,

> A bank may make a loan to or a guarantee on behalf of a related party of the bank or take an assignment of or otherwise acquire a loan to a related party of the bank if
>
> *(a)* the loan or guarantee is fully secured by securities of or guaranteed by the Government of Canada or the government of a province; or
> *(b)* the loan is a loan permitted by section 418 made to a related party who is a natural person on the security of a mortgage of the principal residence of that related party.

This is a marked difference between the *Bank Act* and *BOFIA* (the equivalent banking legislation in Nigeria) as the latter allows banks to grant unsecured credit facilities to its directors and officers[82] who ordinarily come under one of the categories of persons designated as related parties in the Canadian *Bank Act*[83]. However, the *Bank Act* allows banks to grant loans to its senior officers on preferred terms relative to that offered the public[84] with the prior approval of the conduct review committee of the board. It is doubtful if grant of unsecured facilities by a bank to related parties can come under these 'preferred terms'.

The provisions of the *Bank Act*, it is believed, offer detailed and adequate provisions to address the issue of insider loans. In particular, the establishment of the conduct review committee with specific statutory mandate to handle issues related to self-dealings is an

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[82] This will be addressed later in the chapter.

[83] Note that in certain instances a special majority of the board may be required in respect of a loan to a related party where the aggregate of the specified obligations owed by that party to the bank will exceed two percent of its regulatory capital, see s. 497(1) of the *Bank Act*.

[84] s.496(4) ; For the definition of who qualifies as 'senior officer' see.s.485.1 of the *Bank Act*.

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apt regulatory response to this problem and it is one of the key recommendations that would be made to improve the current regulatory framework in Nigeria.

It seems somewhat of a paradox, when considered in relation to Nigeria, that Canada where the issue of insider loan abuse is not a major problem[85] only allows the grant of secured loans to related parties whereas Nigeria, which has had this cankerworm ever since indigenous banks sprang up, still allows the grant of unsecured credit to its directors and officers. This restriction under Canadian law could arguably be the reason why the regulatory framework in Canada has largely been successful in containing the incidence of bank failures or eliminating the question of insider loans a major cause of bank collapse in the country. The question which would be addressed below is whether Nigerian banks should still be allowed to extend unsecured facilities to their directors and officers.

Nigeria

The issue of insider related credit facilities was a major causative factor of all the bank insolvencies that have happened in the history of the country. Bank promoters in Nigeria, unfortunately, have the misconception that the banks are created purposely to finance their other business interests and provide an avenue for a steady line of credit. Sadly, this misconception, which dates back from the time indigenous banks evolved about the third decade of the 20th century, still persists and it has been the focus of banking legislation

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[85] Going by the findings in the *CCB and Northland Report.*

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and regulatory instruments over the years. The CBN recently noted this in one of its circulars where it said,

> One of the endogenous factors that caused the last generalized distress in the financial system was the magnitude of non-performing facilities granted to key shareholders and directors of banks and their related interests....[T]he reports of routine examination of banks by both the Central Bank of Nigeria (CBN) and the Nigerian Deposit Insurance Corporation (NDIC), have indicated that many banks have continued to record huge amounts of insider-related credit facilities, many of which have been classified as either doubtful or lost[86]

This is one problem that is endemic in the country's financial system and indications are that the regulatory response is not achieving the desired results. For instance, it came out in the course of investigations into the affairs of one of the Nigerian banks that had its licence recently revoked by CBN that over twenty five percent of part of its loans classified as bad and doubtful debts were advances made to its owners and directors[87].

The relevant provision of BOFIA meant to deal with the issue is section 20(2) which provides,

> A bank shall not, without the prior approval in writing of [CBN]: -
> (a) permit to be outstanding, unsecured advances, loans
> or unsecured credit facilities, or an aggregate amount
> in excess of N50,000.00
> (i) to its directors[88] or any of them whether such advances, loans or credit facilities are obtained by its directors jointly or severally;

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86 See CBN Circular BSD/DO/CIR/VOL.1/01/18 issued on 13 November 2001 [*Circular 13*]

87 See CBN Press Release issued on 28 February 2003 regarding the revocation of the licence of Peak Merchant Bank [*CBN Press Release*]

88 The definition of 'director' for the purposes of this section is very wide and it includes 'director's wife, husband, father, mother, brother, sister, son, daughter and their spouses: see s. 20(5)

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> (ii) to any firm, partnership or private company in which it or any one or more of its directors is interested as director, partner, manager or agent or any individual firm, partnership or private company of which any of its director is a guarantor;
> (iii)to any public company or private company in which it or any one or more of its directors jointly or severally maintains shareholding of not less than five per cent either directly or indirectly;
> (b)permit to be outstanding to its officers and employees, unsecured advances, loans or unsecured credit facilities, which in the aggregate for anyone officer or employee, is an amount which exceeds one year's emolument to such officer or employee;

Directors of banks are jointly and severally liable to indemnify their banks against any loss arising from the grant of credit facilities in contravention of the above provision[89]. In addition, criminal sanctions attach against directors for non-compliance with the provisions. BOFIA provides that "any director, manager or officer who fails to comply with the requirements of this section is guilty of an offence and liable on conviction to a fine not exceeding ₦100,000.00 or to imprisonment for a term of 3 years and shall in addition be required to repay the loan or forfeit his known assets in lieu of the unpaid loan"[90]. The question here is: how effective has this provision been as a deterrent against indiscriminate grant of insider credit facilities contrary to BOFIA? Has there been any significant reduction in the occurrence of this abuse?

A couple of loopholes[91] are evident in BOFIA and may be taken advantage of by an unscrupulous person. The one that is most relevant for our purpose here is section 20(2)(a)(ii). The provision requires that CBN's prior approval is needed where the bank

89 See s. 20(6) of *BOFIA*.

90 See s. 20(7)

91 The presence of obvious gaps in BOFIA should actually not come as a surprise given that it was enacted by a military regime.

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proposes to extend credit facilities above the statutory threshold to *"any firm, partnership or private company in which it or any one or more of its directors is interested as **director, partner, manager or agent** [emphasis added]..."*. It is clear from this provision that the nature of interests a bank director is supposed to have in a private company seeking a loan from the bank before the statutory requirement for CBN's prior approval becomes applicable is that of a director or manager. What about when the director of the bank is merely a shareholder in the private company seeking the loan? Would CBN's prior approval be required? It is submitted that in that scenario, CBN's approval is not required. The rule is *expressio unius est exclusio alterius*[92]. The list should be taken as exclusive of those not mentioned, more so when there are no reasons why the drafter could have excluded such an obvious member (shareholders) of the corporate structure. It should therefore be taken that the exclusion was intended[93]. In order to cover this gap, it is suggested that the definition of 'related party' in the *Bank Act*[94] should be adopted as it is very comprehensive and covers nearly all conceivable situations.

While there are no readily available empirical statistics to verify the precise number of banks that have violated or violate these provisions or the frequency with which this is done,[95] it is common knowledge in Nigeria that this abuse takes place with impunity and

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92 On the application of this principle, see, generally, F. Bennion, *Statutory Interpretation* (London : Butterworths ,1997) at 969-975.[*Bennion*]

93 *Bennion*, *ibid* at 970.

94 See s.486 particularly subsection 3.

95 CBN requires banks to file on a quarterly basis all insider related loans.

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it was in response to this that CBN had to specifically issue a circular aimed at stemming "the incidence of uncollectible, delinquent loans arising from the unsecured credit facilities granted to directors and key shareholders of the banks, and the attendant negative impact on the financial health of such banks"[96]. In many instances, directors and top executives of banks set up phony corporations to obtain credit facilities beyond the allowable limits from the banks they run. Thereafter, these debts are eventually written off by them or their cronies as bad debts after feeble attempts are made at recovery[97].

The issuance of the Circular 13 by CBN is a clear indication of the failure of the existing statutory provisions to prevent this abuse. The circular prescribes blacklisting for the 'recalcitrant director', in addition to the compulsory sale of his shares to defray his indebtedness to the bank.[98] To this end, all banks are to obtain from a director blank share transfer forms duly signed by the director transferring his shareholding interest to the bank prior to the grant of any credit facility.[99] It remains to be seen what happens where such director does not hold shares in the bank since Nigerian law does not require any share qualification for directorship, except where the articles of the bank otherwise provide.[100]

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[96] See *Circular 13.*

[97] For more on this, see Ebhodage, *supra* note 30 at 29 – 30.

[98] See para. 1(b) of *Circular 13.*

[99] *Ibid.*

[100] Section 251(1) of *CAMA.*

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While no one will argue against the need for some decisive action on the part of the regulators to contain the abuse of insider related credits, the efficacy or indeed validity of the approach adopted by CBN in issuing the Circular 13 is very doubtful. First, a couple of legal absurdities might result from the concurrent application of both Circular 13 and the provisions of BOFIA. For instance, where a director signs a share transfer form relinquishing his shareholding interests to the bank prior to obtaining a loan as required by the circular, that may, invariably, amount to the creation of a security for the loan[101], particularly since the bank is empowered to use this to defray the debt in the event that the director defaults. If this is correct, it follows that the loan in question has ceased to be 'unsecured loan' which is the primary focus of Section 20(2) of BOFIA and the circular, and once it ceases to be 'unsecured loan' it becomes doubtful if the board, management or the director involved can be subject to the sanctions imposed by BOFIA or the circular for granting 'unsecured' loans contrary to the provisions of the law. To clearly illustrate the point and show the absurdity in the concurrent application of both the provisions of BOFIA and Circular 13, I will present the following scenario:

> *Director AB of Bank of Nigeria requests a loan of N100,000 from the bank without intending to provide any security for the loan. BOFIA prohibits the granting of unsecured loan above N50,000 to directors* ***except prior written consent of CBN is obtained*** *[emphasis added]. Circular 13 stipulates that any director*

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[101] The deposit of a blank transfer form to a creditor is capable of creating, at least, an equitable charge over those shares without the need to transfer a share certificate which is merely prima facie evidence of title: on this see generally, E.P. Ellinger ,E. Lomnicka & R.J.A. Hooley , *Modern Banking Law*(Oxford : Oxford University Press,2002) at 813-815. On creation of security interests in Nigeria see, O.Ajayi, "Bull in the China Shop: A Commonwealth Charge & the Common Law", (1998) 2 MPJFIL, No. 1. *Quaere: Is it plausible to argue that to the extent that the parties could be said not to have intended to create a security interest, then they would not be held to have created one?* It is believed not. The law is that the appellation parties give their transaction or dealings is not conclusive in all instances and the question is usually this: what, in fact or law, does the transaction amount to regardless of what the parties label it or might have intended?

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applying for a loan from a bank in which he serves as director must sign a blank share transfer form transferring all his shares to the bank prior to the grant of ***any***[102] *[emphasis added] credit facility. Bank of Nigeria grants the loan of N100,000 to the director without obtaining CBN's prior approval, but the director executed the share transfer form as required under Circular 13.*

The issue here is whether CBN can sanction the bank for not obtaining its prior written consent to the loan transaction since it was in excess of N50,000 and 'no security was given' *per se*.. It is submitted that CBN cannot sanction Bank of Nigeria for failure to obtain its prior consent. The execution of the blank share transfer form, as argued earlier, creates a security for the loan and once the security is created the loan of N100,000 to Director AB ceases to be 'unsecured'. Consequently, CBN cannot insist on compliance with Section 20(2) which only deals with unsecured loans.

One thing appears clear from the above arguments. Circular 13, to the extent that it requires all credit facilities to directors to be secured,[103] is clearly inconsistent with the provisions of Section 20(2) of BOFIA which still allows the grant of unsecured credit facility. Under Nigerian law, a subsidiary legislation – such as Circular 13 made by CBN – is not to be inconsistent with the provisions of the enabling Act.[104] Also, a subordinate legislation cannot amend its enabling statute except when the statute so provides[105]. There is no provision of BOFIA which grants such powers of amendment to CBN. On

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102 Regardless of the amount.

103 It requires directors to execute a blank share transfer form for every loan.

104 *Ewate v. Gyang* [1997] 3NWLR (Pt 496) 728; see also, *Waddel v. Schreyer* 5 D.L.R. (4th) 254.

105 *Phoenix Motors Ltd v. NPFMB* [1993] 1NWLR (Pt272) 718.

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this basis, it is submitted that Circular 13 is null and void to the extent of its inconsistencies with section 20(2) of BOFIA.

Furthermore, if it is correct, as contended above, that the execution of the transfer form amounts to the creation of a security, then it would also be in conflict with the provisions of section 20(1)(b) of BOFIA which precludes a bank from granting any loan or advance against the security of its own shares. For this reason also and in the light of the above argument, Circular 13 is null and void to the extent of its inconsistency with section 20(1)(b) of BOFIA.

The regulators might not have directed their minds to these absurdities, but, as shown above, the issues raise important questions of law which are not just of academic interest. It is recommended here that BOFIA should be amended to mandate that Nigerian banks set up a conduct review committee fashioned along the lines of the one required under the *Bank Act*, both in terms of composition and functions. Also, it is high time that the grant of unsecured loans is done away with in the Nigerian regulatory framework. Whatever might have informed its incorporation[106] in BOFIA, it is clear that it has been abused and consequently should be expunged. For reasons already given, Circular 13 cannot validly do this. What is required is an amendment of the principal legislation, BOFIA.

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[106] Some have argued that there is the need to reduce the encumbrance on corporate assets, as this would make obtaining refinancing a big hurdle.

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Share Ownership

The issue of share ownership of a bank is a critical one in any regulatory framework and usually a number of considerations are taken into account in determining the extent to which individual or related party shareholding should be accommodated in the regulatory scheme.

Canada

The *Bank Act* contains extensive and very detailed provisions on control[107] of a banking enterprise. The applicable rules on this are largely determined by the bank's equity capital, the Schedule of the *Bank Act* the bank belongs and Ministerial discretion[108]. The attempt here is not to examine these provisions but rather to make a point of the fact that such restrictions do exist in Canada. It is clearly evident from the provisions that there is a conscious effort on the part of the Canadian government to prevent a single person or group of associated persons from having a significant interest in any class of shares of banks in Canada except to the extent permitted under the *Bank Act.*[109]

Nigeria

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107 For the statutory definition of 'control' see s. 3 of the *Bank Act.*

108 On this see generally Part VII of the *Bank Act* and in particular, ss. 372, 374, 375 and 377; see also, *Gelfand, supra* note 74 at 1-22 to 1-32.

109 *Gelfand, supra* note 74 at 1-22 to 1-23.

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Unfortunately, no provision restricting share ownership currently exists in Nigeria[110]. As things presently stand, a single individual can practically 'own' a bank by acquiring the majority of its shares. There is no cap on the percentage of shares a single person or related parties can own in the total share capital of a bank. Needless to say, a majority shareholder can always find a way of influencing corporate acts to suit his interests, more so when the provisions of BOFIA expressly states that the voting rights of every shareholder in a bank shall be proportional to his contribution to the paid- up share capital of the bank.[111]

A pathetic instance of how majority equity holding power can be selfishly wielded played out recently in the case of Peak Merchant bank which had its license revoked in February 2003. As part of the 'rescue' proposals made by CBN to the bank prior to the revocation of its license was the need for it to recapitalize through the injection of new capital into the business. This would have enabled it to meet its immediate obligations.

When the bank could not get the much-needed funds from the capital market or through inter-bank lending, it entered into negotiations with a group of three different foreign investors who showed interests in investing. However, the transactions were deadlocked in all the instances because of the Chairman's unwillingness to accept the proposed terms

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110 Perhaps, given the level of economic development in the country and government's desire to attract foreign investment, the government lacks the economic leverage to place restrictions on share ownership in relation to foreign investors since many of them will prefer to control the enterprise in which they have invested their money.

111 s. 10 BOFIA.

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on the grounds that it would dilute his interests in 'his' bank.[112] In this instance, the Chairman preferred that the bank be liquidated rather than lose control[113]. The CBN deprecated the 'overbearing nature' of this Chairman who was also a major shareholder in the bank.[114] Should this be allowed under the law? Should a single individual be empowered to run aground a bank because of his selfish desire to maintain control at any cost?[115]

That the banking institution cannot be subjected to the whims of a single individual is underscored by the important nature of the services provided by banks, and for this reason they are considered *sui generis*. According to *OSFI Guideline on Corporate Governance,*[116]

> [T]he effectiveness of any economy depends significantly on how well its financial services sector functions. Relative to non-financial businesses, the failure of a financial institution can have a greater impact on members of the public who may have placed a substantial portion of their life savings with the institution and who may be relying on that institution for day-to-day financial needs.

A related problem in relation to the Nigerian banking environment is the ever-present boardroom squabbles and personality clashes which, though not a new phenomena in the

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112 See *CBN Press Release, supra* note 87 at para. 6.5.

113 It remains to be seen whether a majority shareholder, who is also a director, can validly exercise his votes to block a transaction which would, ostensibly, have been in the best interests of the bank

114 See *CBN Press Release, supra* note 87 para.8.1.

115 There may be a problem here regarding foreign investors who may wish to invest in an existing bank rather than seek a new banking licence. They would definitely wish to control the operations of the bank

116 *OSFI Guidelines on Corporate Governance, supra* note 38 at 4

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context of corporate governance, has become increasingly disruptive of the operations of Nigerian banks.[117] A major factor responsible for this is the presence of an all-powerful director/shareholder who will always want to call the shots and push his wishes through[118]. In a way, the law allows him to, and most times he makes use of his equity leverage to secure the 'approval' of the bank for his or her associates' loan applications.

In the light of the above, it is believed that for the regulatory framework to achieve the desired results of containing the incident of insider abuse, the statutes and the CBN circulars should be complementary, and in particular, the BOFIA should be amended to reflect all the recommendations made above.

LARGE EXPOSURE

It is clearly indisputable that large exposures by banks to one customer, a group of customers, related parties or indeed an economic sector is imprudent banking practice and can easily lead to the insolvency of the bank where things go awry for the group to which it is exposed[119]. It is for this reason that large or excessive exposures are considered to be a sign of poor prudential banking. Regulatory authorities, in consequence, are generally empowered to monitor and regulate this[120].

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117 See generally *Ebhodaghe, supra* note 30 at 190, 196-201.

118 *Ibid.*

119 This is regarded as a *credit risk exposure*. For more on this see, Canada, *Guidelines on Large Exposures Limits, Office of the Superintendent of Financial Institutions, No. B2 December, 1994.*[*Large Exposure Guidelines*].

120 Ajayi, *supra* note 40 at 54-55.

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Canada

Under Canadian law, the *Bank Act* expressly places a duty on the board of directors to establish "investment and lending policies, standards and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return"[121]and the banks are required to adhere to these policies[122]. Here, the law mandates the board to formulate the lending policies of the bank and requires them to ensure that procedures are in place to ensure proper implementation[123].

Both the *Large Exposure Guidelines* and the *Prudent Person Guidelines* provide minimum standards to which banks must comply regarding the management of their loan portfolios but enjoins banks to adopt policies and procedures which more truly reflect their individual risk profiles using the guidelines as a guide regarding what is minimally expected.[124]. As regards exposure[125] limits, the aggregate exposure limit of a bank[126] to

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121 Section 465 of the *Bank Act*

122 See Canada, *Prudent Person Approach Guideline, Office of the Superintendent of Financial Institutions, No. B1 January 1993.* [*Prudent Person Guideline*]

123 See *Prudent Person Guideline, supra* note 122 at 2.

124 See *Large Exposure Guidelines, supra* note 119 at 2; *Prudent Person Guideline supra note*....at 1-3.

125 For the definition of "exposure" and what is excluded from it, see *Large Exposure Guidelines, ibid* at 3-5.

126 It should be noted that the guidelines require that where the debtor is exposed to both a bank and its subsidiary, the exposure limits will be calculated as if both represent one entity, ie. on a consolidated basis: See *Large Exposure Limits, ibid at* 2.

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any entity[127] or connection[128] shall not exceed 25 percent of total capital[129]. It should be noted that banks are enjoined to use a lower threshold and resort to the 25 percent only in exceptional circumstances[130].

The regulatory approach in Canada regarding exposure limits is to encourage individual banks, through their respective board of directors, develop their own policies and procedures which will take into account their peculiar circumstances – in particular their respective capital bases and its ability to absorb losses – subject, however, to the minimum requirements stipulated by the guidelines.[131] The lending policy for individual banks is required to establish limits on aggregate outstanding loans by type of loan broken down by major category (e.g., commercial, consumer).[132]

As seen in the last chapter, one of the reasons for the collapse of the two Canadian banks was due to their over-exposure to the energy and real estate markets. The *Prudential Person Guideline* requires banks to make policies which will set limits on the exposure not only to industries but also to geographical locations and the volatile currency

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127 An *entity* is a natural person, a body corporate, trust, partnership, fund, unincorporated association or organization, an agency of the Crown in right of Canada or of a province, and any agency of a foreign government: See *Large Exposure Guidelines, ibid* at 5.

128 A *connection* exists where two or more entities are a common risk. The exposures to the entities comprising a connection shall be aggregated for the purpose of applying limits on a company's large exposures: *Large Exposure Guidelines, ibid at* 6.

129 *Large Exposure Guidelines, ibid at* 2.; *total capital* is the consolidated total capital of a company as defined for the purpose of calculating its risk-based capital adequacy ratio, *ibid* at 3.

130 *Ibid.*

131 See *Prudent Person Guideline, supra* note 122 at 2.

132 *Prudential Person Guideline, ibid* at 3.

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markets[133]. The board of each bank is required to monitor compliance with these policies and review it, at least once a year.[134]

In line with OSFI's desire to allow banks to individually manage their exposure risks, it does not require them to file these policies with the office but rather ensure that they are available upon request.[135]

Nigeria

The operative provision is Section 20(1)(a) of BOFIA which provides that, a bank shall not, without the prior approval in writing of CBN, grant: -

> [T]o any person any advance, loan or credit facility or give any financial guarantee or incur any other liability on behalf of any person so that the total value of the advance, loan, credit facility, financial guarantee or any other shareholders fund unimpaired by losses or in the case of a merchant bank not more than fifty per cent of its shareholders fund unimpaired by losses; and for the purpose of this paragraph all advances, loans or credit facilities extended to any person shall be aggregated and shall include all advances, loans or credit facilities extended to any subsidiaries or associates of a body corporate;

With the adoption of the universal banking system, there is no longer any characterisation of banks into merchant and commercial banks, and as a result, there is currently only one uniform figure of thirty five percent for all banks.[136]

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133 *Ibid.*

134 *Ibid.*

135 *Ibid.*

136 Nigeria, *Universal Banking Guidelines*, December 1999. [*Guidelines*]

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It has been suggested that in order to further promote the soundness of the banking industry, the exposure requirements should be amended so as to include, in the calculation of any one bank's exposures, exposure taken by a bank's subsidiaries and associates where such are not themselves banks.[137] The necessity for this is even more evident now that Nigerian banks, by reason of the adoption of universal banking in the country, are now allowed to form subsidiaries that offer other types of financial services outside core banking. The bank and its subsidiaries should be treated as a unit for purposes of calculating the exposure requirements. This will ensure that the maximum exposure of the group to a person or company does not exceed thirty five percent as opposed to the seventy percent it would have been if the exposure threshold had been computed separately for both the bank and its subsidiaries.

The objective of the above cited provision is, clearly, to control a bank's exposure to a single person, corporate body or its subsidiaries. The CBN, however, is permitted to allow a bank to exceed this statutory threshold. A gaping omission in the provision is the non-specification of those factors CBN should take into account where it seeks to grant a bank the permission to exceed the threshold. It is believed that in order to prevent arbitrariness and ensure a uniform standard, BOFIA should expressly indicate those factors that should be taken into account by CBN while considering a bank's application to go beyond the thirty five percent exposure limits. Such factors should include, the bank's current liquidity position and contingent liabilities, the creditworthiness of the

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[137] *Ajayi, supra* note 40 at 54-56.

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debtor company or individual, the banks off-balance sheet items and other risk bearing factors.[138]

Another lacuna in this provision is that it adopts a somewhat narrow approach to the issue of over exposure in that it is directed only at individuals and companies, leaving out particular sectors of the economy. One of the factors identified in *CCB and Northland Report* as responsible for the collapse of the two Western Canadian banks was that the banks did not diversify their loan portfolios. The banks were found to have concentrated their loans in the hands of the real estate and energy markets, and in consequence, exposed themselves to the vagaries of these two markets[139]. In Nigeria too, the introduction of the Global Systems for Mobile Telecommunications (GSM) saw many banks go into a financing frenzy. They made huge loans to the promoters of the short listed operators to enable them bid for the available GSM licences. A crash of the telecoms market in Nigeria will definitely adversely affect the financial conditions of these banks and may lead to another distress in the banking industry. In fact, the bankers to the unsuccessful bidders are currently having problems making the debtors meet their payment obligations.

Accordingly, BOFIA should be amended to reflect that over exposure also covers exposure to particular markets. On this also, the government would need to ensure that its

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138 *Ajayi, supra* note 40 at 56.

139 *CCB and Northland Report*, *supra* note 11at 69-74.

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policies of directing banks to make preferential credit allocation to certain sectors of the economy is well thought out.

REGULATORY OVERSIGHT

In many instances where a bank fails, the focus of public attention and odium, at least in the first instance, is the bank management and board. The possibility of lapses on the part of the regulators is hardly considered. In the *CCB and Northland Report,* the failure of the regulatory institution to 'respond to the signals as received' was blamed as part of the causes of the failure of the two Western Canadian banks[140]. In view of this, the Commission extensively considered the role of the regulatory institution, then known as the Office of the Inspector General of Banks, and it was its conclusion that the regulators did not act in a timely fashion to avert the collapse. The pertinent question then, according to the Commission, is: "How can one build into the present system the **incentive and the will to intervene in a timely fashion** *[emphasis added]* so as to reduce to a minimum the risks to depositors and investors, and the cost to the community associated with the liquidation of a bank"[141]? A good example of when the regulators failed to intervene on time was the case of *Savannah Bank of Nigeria* discussed in the last chapter. The bank did not publish its financial statements[142] for three consecutive years,

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140 *CCB and Northland Report, supra* note 11 at 273. The Commission was of the view that the regulatory institution lacked the will to respond when the signals of trouble in a bank come to the regulator.

141 *Ibid*

142 Accounts suggest that none was in fact prepared for public dissemination. More will be said about this in the course of the chapter.

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[143]yet the regulators did not deem it fit to deal decisively with the situation[144]. It is believed that making bank regulators more accountable through the creation of a statutory cause of action is one way of making them more alive to their responsibilities.

It is clear that the legislatures of both Canada and Nigeria have anticipated that there is, at least, a possibility of civil claims in this area – bank regulation. This explains why immunity is conferred on public officials involved in the regulatory process. Section 39 of the *Office of the Superintendent of Financial Institutions Act*[145] provides that,

> No action lies against Her Majesty, the Minister, the Superintendent, any Deputy Superintendent, any officer or employee of the Office or any person acting under the direction of the Superintendent for anything done or omitted to be done in good faith in the administration or discharge of any powers or duties that under any Act of Parliament are intended or authorized to be executed or performed

It is evident from the above provision that, subject only to the *proviso* on acting in good faith, the law takes away any right of action that may exist in favour of anyone, even where the facts clearly establish a reasonable cause of action. The question of whether or not private law actions should be cognizable in a largely public law context with its own parallel remedies has been a subject of debate and judicial pronouncements. Within the context of bank regulation, the issue has been litigated upon in some cases in the UK and indications are that the courts are gradually leaning towards adopting a more favourable

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143 By law, every bank is required to prepare and publicly publish their financial statements on an annual basis and non-compliance is a criminal offence: s. 27 of *BOFIA*.

144 Is this a case of regulatory forbearance or sheer recklessness on the part of the regulators?

145 R.S.1985, c.18; see, also s. 49 of BOFIA which is drafted in identical language; on this too, see s.41 *Canada Deposit Insurance Act*, R.S. 1985, c.3.

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disposition to the plight of depositors of a failed bank. In the latest House of Lords decision on the issue, *Three Rivers,*[146] (this case involved the depositors of the infamous BCCI) the court, by a majority, refused to summarily strike out the claims of the depositors as having 'no real prospect of success' but allowed the plaintiffs to proceed with their claims for misfeasance in public office[147] against the Bank of England – the official regulator[148]. Whilst the cases as yet have not finally established the extent, if any, of any possible regulatory responsibility on the part of bank regulators in the event of a bank collapse, the *Three Rivers* case established that bank regulators could potentially incur liability to the depositors if certain factual and evidential criteria are met.[149] According to a commentator,

> [T]he decision of the House of Lords allowing the case to proceed to full trial was made on a bare majority basis – two members of the House of Lords would have barred the claim outright, on the basis that it has no realistic prospect of success. The depositors' claim has therefore already provoked significant judicial disagreement at the highest level. Although they are of a preliminary nature, the decisions of the House of Lords do establish an important general principle – a banking regulator may potentially incur legal liability to a depositor if an institution under its supervision becomes insolvent[150].

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146 *Three Rivers, supra* note 5.

147 The Plaintiffs argued that senior officials of the Bank of England acted in bad faith by licensing BCCI in the first place, by shutting their eyes to what was happening in the bank and by failing to take steps to close the bank earlier when there was clear evidence of the unscrupulous practices of the officers of the bank.

148 It should be noted that the Bank of England, since 2000 has ceased to be the official regulator. Its regulatory functions have been transferred to the Financial Services Authority: See s. 21 *Bank of England Act1998* (U.K), c. 11 and the *Financial Services and Markets Act 2000* (U.K.), c.8.

149 For a full analysis of these decisions and their likely impact on bank regulation, see online: <http://www.titeandlewis.com/articles/article4.pdf>

150 *Ibid.*

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It should be noted here that the last has not been heard of the *Three Rivers* case. Recently declassified portions of the *Bingham Report*[151] indicated that, prior to the collapse of BCCI in 1991, many[152] – including the security services – had actually expressed misgivings to the Bank of England about the operations of the bank[153]. Another suit by the creditors and liquidators of BCCI against the Bank of England commenced before the English High Court in January 2004, and one of the issues for determination relates to the tardiness of the Bank of England in intervening promptly in the affairs of the bank in view of the "unsavoury allegations" leveled against it[154]. The thesis in the following section examines the possibility of using common law remedies to establish a private claim for damages against bank regulators in both Canada and Nigeria.

Common Law Causes of Action

The immunity provisions outlined earlier have clearly removed any right of action even if the facts and circumstances could have established a reasonable cause of action, hence any extensive consideration of the likely causes of action will be to no end. Nonetheless, the torts of negligence and misfeasance in public office will be considered as they have been used to found civil actions in the context of bank regulation. The main objective of

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151 The Bingham Commission of Inquiry was set up on 19 July, 1991, about 2 weeks after the collapse of BCCI to basically consider whether the regulatory authorities acted promptly.

152 The depositors and liquidators of the bank recently sued the Bank of England regarding the release of some documents presented to the Bingham Commission of Inquiry. The judge of first instance gave judgement in their favour and an appeal by the Bank of England challenging the procedure and interpretation of the relevant rules by the trial judge was dismissed: *Three Rivers District Council and others v. Bank of England (No.4)* [2002] 4 All E.R. 881.

153 See, "What Spooks told Old Lady about BCCI", *The Observer* (18 January, 2004) online: <http://politics.guardian.co.uk/economics/story/0,11268,1125478,00.html>.

154 *Ibid.*

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this is to identify those concerns that were raised in the cases as militating against imposing liability in this area[155]. The Canadian concept of fiduciary obligations will also be considered. It should be noted, however, that what seems to be the thrust of the government regulation arguments is that the court is not the proper forum for imposing liability on bank regulators and that if such is thought desirable, the legislature is the best organ of State to introduce it.

Negligence[156]

The vexed question of whether bank regulators owe a duty of care in the discharge of their duties was considered by the Privy Council in the case of *Yuen Kun Yeu v. Attorney General of Hong Kong*[157]. In that case, the Commissioner of Deposit-taking Companies in Hong Kong (the "Commissioner") was charged under the *Deposit-taking Companies Ordinance* 1976 with various regulatory functions in relation to deposit-taking businesses in Hong Kong. Under that law, companies intending to carry on a deposit-taking business must register and receive prior authorization from the Commissioner who had discretionary powers to refuse to register, or to revoke the registration of, a company which he considered not to be a fit and proper body to take deposits. The appellants had substantial deposits with a registered deposit-taking institution which subsequently went into liquidation, causing them to lose their money. They sued the Attorney General –

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155 These issues will be taken into account in proposing the enactment of *Bank Regulators (Accountability) Act*.

156 The issue in relation to the duty of care of public authorities is usually "should unreasonable conduct in the face of foreseeable injury necessarily result in a private cause of action or do overriding policy concerns prevent the imposition of a duty of care"? L. Klar, *Tort Law,* (Ontario: Carswell, 1996) at 222[*Klar*].

157 [1988] A.C. 175[*Yuen's case*]

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representing the Commissioner – contending that the Commissioner failed to take any action to protect depositors despite his knowledge that the company had been run fraudulently, speculatively and to the detriment of depositors. They further argued that they had relied on the fact of registration as indicating that the company was a fit and proper body and was under the prudential supervision of the Commissioner, that the commissioner knew or ought to have known that the affairs of the company were being conducted fraudulently, speculatively and to the detriment of depositors, and that he should either never have registered the company or should have revoked its registration before they deposited their money[158]. The lower courts struck out their claim as disclosing no cause of action[159] and on appeal to the Privy Council, the main issue that arose for determination was whether there existed between the Commissioner and would-be depositors such a close and direct relationship as to place the Commissioner, in the exercise of his powers under the Ordinance, under a duty of care towards would-be depositors.

The Attorney General argued[160] strongly against the imposition of a duty of care in the context of bank regulation and raised a number of reasons why such was undesirable. First, he argued that the Commissioner was involved in a number of complex and conflicting relationships with different groups in the society and the appellants were just one of a section of that public. Secondly, he contended that given the novelty of the claim

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158 *Ibid.*

159 See *Yuen Kun Yeu v. Attorney General* [1986] HKLR 783.

160 For the full text of the Attorney General's arguments, see *Yuen's case, supra* note 157at 182 – 185.

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and the potential implications for different regulatory bodies, policy considerations should be a major factor the courts should take into account in deciding whether or not to impose a duty of care. Furthermore, he argued, the immunity conferred by the legislature suggests a deliberate policy not to impose liability: such liability should only be imposed by the legislature after due consideration had been given to competing interests. Also, he argued that placing a duty of skill and care on the regulators will unduly impede the smooth performance of their duties, which in many cases required the exercise of personal judgment and discretion. He concluded his arguments by contending that finding liability in this case will open a floodgate of cases whenever a bank collapses.

The arguments of the Attorney-General raised a lot of issues on the dangers inherent in imposing a common law duty of care on bank regulators in the discharge of their statutory duties. In order to have a balanced view of the whole matter, the counter arguments[161] of the appellants should also be considered. The appellants argued, in the main, that a careful Commissioner would have realised that the affairs of the bank were being improperly conducted to the detriment of the depositors and it was inconsistent with his statutory duties to have allowed the bank to continue to operate. Furthermore, they contended that the Commissioner had extensive powers under the Ordinance to monitor deposit-taking institutions and such powers were meant, primarily, to safeguard the interest of depositors and prevent deposit-taking companies from causing loss to them. They argued that the fact that the Commissioner had to balance competing interests in the performance of his duties is no reason why he should fall short of reasonable

[161] For a full text of the arguments of the appellants, see *Yuen's case, ibid* at 178-182.

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standards and, at any rate, this factor may establish that he had not been negligent in particular instances. They lastly contended that a function of the law of negligence by making parties liable was to help them improve their standards and the legislature could not have intended the Commissioner to exercise his duties other than with due care and attention.

The Privy Council did not agree with the arguments of the appellants and the case was, accordingly, dismissed. The Court refused to impose a duty of care in this context holding that no intention in that regard was discernible from the statutory scheme and it "would be strange that a common law duty of care should be superimposed on such a statutory framework"[162]. Mere foreseeability of harm[163] did not of itself create sufficient proximity between the Commissioner and would-be depositors for a duty of care to arise, since the Commissioner had no control over the day-to-day management of deposit-taking companies and also had to consider the position of existing depositors in deciding whether to deregister a company. Accordingly, there was no special relationship between the Commissioner and the company or between the Commissioner and would-be depositors capable of giving rise to a duty of care owed by the Commissioner to the appellants.

However, the court made it clear that the action was denied on the grounds that it disclosed no reasonable cause of action. The question of disallowing the appellant's case

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162 *Yuen's case, ibid* at 195.

163 The harm in question is the one likely to occur to depositors where an uncreditworthy bank is allowed to remain on the register.

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on public policy grounds as contended was not countenanced by the court. According to the court,

> The final matter for consideration is the argument for the Attorney General that it would be contrary to public policy to admit the appellants' claim.... It was maintained that, if the commissioner were to be held to owe actual or potential depositors a duty of care in negligence, there would be reason to apprehend that the prospect of claims would have a seriously inhibiting effect on the work of his department. A sound judgment would be less likely to be exercised if the commissioner were to be constantly looking over his shoulder at the prospect of claims against him, and his activities would be likely to be conducted in a detrimentally defensive frame of mind. In the result, the effectiveness of his functions would be at risk of diminution. Consciousness of potential liability could lead to distortions of judgment. In addition, the principles leading to his liability would surely be equally applicable to a wide range of regulatory agencies, not only in the financial field, but also, for example, to the factory inspectorate and social workers, to name only a few. If such liability were to be desirable on any policy grounds, it would be much better that the liability were to be introduced by the legislature, which is better suited than the judiciary to weigh up competing policy considerations....Their Lordships are of opinion that there is much force in these arguments, but as they are satisfied that the appellants' statement of claim does not disclose a cause of action against the commissioner in negligence **they prefer to rest their decision on that rather than on the public policy argument**[164]. *[*Emphasis added*]*

In spite of the fact that their Lordships dismissed the claims of the appellants in this case as disclosing no reasonable cause of action, it did not deter the Plaintiffs in *Davis v. Radcliffe*[165] – which for all practical purposes is indistinguishable from *Yuen's case* – from bringing their claims before the Privy Council about three years' later. In that case, Savings and Investment Bank Ltd. ("SIB") was incorporated in the Isle of Man on 18th December 1965 and following the coming into force, on 20th May 1975, of the *Banking*

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164 Lord Keith, *Yuen's case supra* note 157 at 198

165 [1990] 2 All ER 536. [*Radcliffe's case*]

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Act 1975 of the Isle of Man ("the Banking Act") which established a system of licensing banks in the Island, a banking licence was issued to SIB on 24th November 1975. Thereafter, SIB carried on business internationally from the Isle of Man, its banking licence being renewed from year to year, until 25th June 1982 when its licence was revoked. Many individuals, including the appellants, and corporate bodies had deposits trapped in the bank. The appellants claimed, in the main that, the bank regulators owed statutory duties and/or common law duties to depositors of monies with SIB and to persons who were minded to deposit monies with SIB. These duties included adequate supervision of banks, in this case SIB. They alleged a breach of these duties and sued for damages. Their claim was dismissed as disclosing no reasonable cause of action. Lord Goff[166], though sympathising with the Plaintiffs and other depositors in the same situation as the Plaintiffs, held that,

> [W]hen it is sought to make some third person responsible in negligence for the loss suffered through the bank's default, the question whether that third person owes a duty of care to the depositor has to be decided in accordance with the established principles of the law of negligence. In the present case the Acting Deemster, having reviewed the authorities with care, concluded that neither the members of the Finance Board nor the Treasurer owed any such duty to the appellants, and so struck out their statement of case as disclosing no reasonable cause of action. Their Lordships are in no doubt that the Acting Deemster was right to reach that conclusion, substantially for the reasons given by him.

While unlike Lord Keith in *Yuen's case* who avoided public policy concerns in coming to his decision, Lord Goff addressed this aspect of the matter. According to his Lordship[167],

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166 *Radcliffe's case, ibid* at 540.

167 *Radcliffe's case, ibid* at 541.

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> There are, in the opinion of their Lordships, certain considerations, each of which militates against the imposition of any such duty, and which taken together point to the inevitable conclusion that no such duty should be imposed.... First, it is evident that the functions of the Finance Board, and indeed of the Treasurer, as established by the Finance Board Act 1961, are typical functions of modern government, to be exercised in the general public interest. These functions are, as already indicated, of the broadest kind, for which parallels can doubtless be drawn from other jurisdictions. The functions vested in the Treasurer, and in the Finance Board, by the Banking Act must be seen as forming part of those broader functions. No doubt, in establishing a system of licensing for banks, regard was being had (though this is not expressly stated in the long title of the Act) to the fact that the existence of such a licensing system should provide an added degree of security for those dealing with banks carrying on business in the Isle of Man, including in particular those who deposit money with such banks. But it must have been the statutory intention that the licensing system should be operated in the interests of the public as a whole; and when those charged with its operation are faced with making decisions with regard, for example, to refusing to renew licences or to revoking licences, such decisions can well involve the exercise of judgment of a delicate nature affecting the whole future of the relevant bank in the Isle of Man, and the impact of any consequent cessation of the bank's business in the Isle of Man, not merely upon the customers and creditors of the bank, but indeed upon the future of financial services in the Island. In circumstances such as these, competing considerations have to be carefully weighed and balanced in the public interest, and, in some circumstances...it may for example be more in the public interest to attempt to nurse an ailing bank back to health than to hasten its collapse. The making of decisions such as these is a characteristic task of modern regulatory agencies; and the very nature of the task, with its emphasis on the broader public interest, is one which militates strongly against the imposition of a duty of care being imposed upon such an agency in favour of any particular section of the public.

The arguments in the above cases and the judicial opinion give an indication of some of the more important policy concerns that appear to militate against holding bank regulators liable in the event of a collapse of a banking institution under their supervision. It will be argued below, however, that the public interest will be better served if a scheme of statutory remedies is put in place to enable depositors have recourse to regulators in the event of a collapse. More will be said on this in the course of the chapter.

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There are no reported cases in Nigeria on the important issues treated in the above decisions. However, there are no indications that Nigerian courts will come to any conclusion different from what their Lordships came to in the above decisions[168]. A Canadian case which may be instructive on this point is the case of *Baird v. The Queen.*[169] In that case, an action was commenced by the appellants against the Crown for breach of statutory duty and negligence in the exercise of statutory duties by the Minister of Finance and the Superintendent of Insurance. It was alleged that Astra Trust Company ("Astra") had been permitted to conduct its business fraudulently, wrongly representing that two entities were its mortgage division when they were in fact carrying on a separate, uninsured mortgage brokerage business. Amounts received for deposit with Astra were deposited to the credit of the mortgage companies. It was alleged that the Superintendent was negligent in failing to examine Astra's operations, form an opinion as to the inadequacy of Astra's assets and report to the Minister as required by law. In the alternative, it was alleged that if the Superintendent had properly discharged his duties, the Minister was in breach of his duties in not revoking Astra's licence. It was further alleged that the Minister had been negligent in licensing Astra in view of certain facts known to him concerning the financial condition and conduct of Astra's principal director and shareholder.

[168] Section 32 of the *Interpretation Act, Laws of the Federation of Nigeria 1990, c.192,* requires Nigerian Courts to apply the doctrines of equity and the principle of common law in adjudication. The practice has always been that the courts adopt these principles whenever it is relevant for the purpose of the matter under consideration.

[169] [1983] 148 DLR (3d) at 1 [*Baird's case*]

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Without going into too much details of this case as this is not essential to the arguments here, the court did hold here, contrary to the conclusion in *Yuen's case*, that the case disclosed a reasonable cause of action and accordingly the appeal was allowed so that the case could be tried on its merits. The court reviewed the extensive powers of oversight given to the Superintendent under the *Trust Companies Act*[170], and concluded that "in respect of the duty of the Superintendent of Insurance to examine the affairs of the company or to cause them to be examined and to report thereon to the Minister, it is not plain and obvious that because of the nature of that duty an act or omission in respect of it could not in principle give rise to liability"[171]. It should be noted here that there was no discussion of any statutory immunity. What was argued was whether in view of the provisions of the *Crown Liability Act,*[172] the Crown could be held vicariously liable for the torts of either the Minister or the Superintendent.[173]

However, two cases recently adjudicated upon by the Supreme Court of Canada border on the broad issue of the liability of statutory regulators to members of the public that might have been affected by misconduct of institutions or corporations subject to such regulation. In the case of *Cooper v. Hobart*[174] the issue was whether a statutory regulator, the Registrar of Mortgage Brokers of British Columbia, owed a private law duty of care to members of the investing public for (alleged) negligence in failing to properly oversee

170 *R.S.C. 1970, c. T-16* repealed by *s. 562 Trust and Loans Companies Act* 1991, c. 45

171 *Baird's case, supra* note 169 at 17 *per* Le Dain J.

172 *R.S.C 1970, c C-38.*

173 For more on this aspect of the case, see *Baird, supra* note 169 at 18-22.

174 [2001] 3 S.C.R 537 [*Cooper's case*]

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the conduct of an investment company, Eron Mortgage Corporation ("Eron"), licensed by the regulator. In that case, the Registrar of Mortgage Brokers, a statutory regulator, suspended a registered mortgage broker's licence and issued a freeze order in respect of its assets because funds provided by investors were allegedly used by the broker for unauthorized purposes. The appellant, one of over 3,000 investors who advanced money to the broker, brought an action against the Registrar alleging that he breached the duty of care that he owed to the appellant and other investors. The appellant asserted that by August 1996 the Registrar was aware of serious violations of the *B.C. Mortgage Brokers Act*[175] committed by the broker and should have acted earlier to suspend its licence and to notify the investors that the broker was under investigation. According to the appellant, if the Registrar had acted more promptly, the losses suffered by the investors would have been avoided or diminished. The trial judge concluded that the pleadings disclosed a cause of action in negligence but, on appeal, the Court of Appeal reversed this decision, holding that the pleadings did not disclose a cause of action against the Registrar.

The Supreme Court, upholding the decision of the Court of Appeal, held that "[t]he question is whether the Registrar owes a private law duty of care to members of the investing public giving rise to liability in negligence for economic losses that the investors sustained. Such a duty of care is as yet unrecognized by Canadian courts"[176]. The court made it clear that Lord Wilberforce's test in *Ann's case* was still very much

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175 *R.S.B.C. 1996, c. 313*

176 *Cooper's case, supra* note 174 at 542.

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applicable in Canada[177] and, in particular the second arm of the test relating to public policy considerations, will be used to deny the existence of liability even where the facts establish a *prima facie* case of negligence.

In this case the Court held, *inter alia,* that there was insufficient proximity between the Registrar and the investors to ground a *prima facie* duty of care. The Court however stated that even if the facts had disclosed sufficient proximity to establish a *prima facie* duty of care under the first stage of the test in *Ann's case*, such would have been negated under the second stage of the test for overriding policy considerations. The Court made a distinction between government policy decisions and execution of the policy – both of which fall to be considered under the second stage in the *Ann's case.* The Court stated that government actors are not liable in negligence for policy decisions, but only operational decisions.[178]

It will be noted that their Lordships indicated that their decision was based on an application of the tests in *Ann's case*. Whether or not this was in fact the case has been a subject of scholarly writings.[179] For the purpose here however, an analysis of that subject is beyond the scope of the thesis.

177 The court held that "In our view, Anns continues to provide a useful framework in which to approach the question of whether a duty of care should be imposed in a new situation", *Cooper's case, ibid* at 551.

178 For a full text of the court's reasoning and analysis, see *Cooper's case, supra* note ...556-561.

179 Russel Brown, "Still Crazy After All These Years: Anns, Cooper v. Hobart and Pure Economic Loss", (2003) 36 U.B.C.L. Rev. 159; Fasken Martineau's *Litigation Bulletin,* November 2003 at 3.

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Though the above decision did not relate to bank regulation, the principles enunciated by the courts are, nonetheless, applicable since it addresses the issue of potential culpability of a statutory regulator in respect of the misdeeds of an institution or actor subject to regulation. Their Lordships' decision is instructive in many respects as it adduced some reasons why the judiciary will not be the appropriate forum for making statutory regulators liable under the law of negligence for loss occasioned by the improvidence of an entity subject to their (*i.e.* regulators') regulatory oversight[180]. These reasons will be addressed in the final portion of this chapter.

The case of *Edwards v. Law Society of Upper Canada*[181] presented another opportunity for the Canadian Supreme Court to re-affirm the principles enunciated in *Coopers case.* In that case, the appellants were involved in a gold transaction in which they paid substantial amounts of money into a solicitor's trust account. The transaction turned out to be a ruse resulting in financial loss to them. They sued the Law Society of Upper Canada ("Law Society") contending, *inter alia,* that it failed to take reasonable steps to ensure that the solicitor was operating his trust account in the proper manner. The main issue that fell to be determined was whether the Law Society owed a duty of care to persons who deposited money in a solicitor's account in respect of losses cause by a misuse of that account. The Supreme Court held that there was no such duty for reasons identical to the ones given in *Cooper's case.*

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180 *Ibid.*

181 [2001] 3 S.C.R. 562.

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Misfeasance in Public Office

Though this tort is not as common as the tort of negligence nor is it as widely used, it is clear from the elements necessary to constitute it that it is, perhaps, the only viable remedy open under private law to depositors of a failed bank against the regulators, notwithstanding the immunity provisions contained in the statutes. This is because an important ingredient of the tort is the requirement of bad faith, the presence of which effectively makes inapplicable the immunity provisions. The purpose of this section is to distill some of the salient ingredients necessary to constitute this tort.

Though the courts have stated that there is a broad range of misconduct that can found an action for this tort[182], it is incumbent upon a plaintiff to adduce facts and evidence to establish each element of the tort. The elements of this tort were oulined by the English House of Lords in the landmark case of *Three Rivers District Council v. Bank of England*[183]*(No.3)*. According to Lord Hope[184],

> First, there must be an unlawful act or omission done or made in the exercise of power by the public officer. Second, as the essence of the tort is an abuse of power, the act or omission must have been done or made with the required mental element. Third, for the same reason, the act or omission must have been done or made in bad faith[185]. Fourth,

182 *Odhavji Estate v. Woodhouse* (2003) SCC 69 [*Woodhouse*]

183 [2001] 2 All E.R. 513; For the historical development of the tort and other related issues, see the House of Lord's decision in the same case *Three Rivers, supra* note 5 at 1. According to the court, the rationale for this tort is "in a legal system based on the rule of law executive or administrative power "may be exercised only for the public good" and not for ulterior and improper purposes", see *Three Rivers, supra* note 5 at 7.

184 See *Three Rivers,* [2001] 2 All E.R. at 526.

185 Regarding the issue of the mental element and bad faith, the court was of the view that both will be satisfied "where it is shown that the public officer was aware of a serious risk of loss due to an act or omission on his part which he knew to be unlawful but chose deliberately to disregard that risk. Various phrases may be used to describe this concept, such as "probable loss", "a serious risk

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> as to standing, the claimants must demonstrate that they have a sufficient interest to sue the defendant. Fifth, as causation is an essential element of the cause of action, the act or omission must have caused the claimants' loss[186].

In the case of *Roncarelli v. Duplessis*[187] (the Plaintiff's liquor license was revoked by the *Quebec Liquor Commission* at the instigation of the Premier whose duty had nothing to do with the granting or revocation of liquor licensing), the Supreme Court of Canada found the Premier liable for acting outside his legal functions. This case is widely viewed as having established the tort of misfeasance in public office in Canada[188].

There have been a number of cases in Canada after *Three Rivers*[189]. In the case of *Alberta (Minister of Public Works) v. Nilsson*[190], the Alberta appeal court, affirming the decision of the lower court held that deliberate misconduct is an essential element necessary to constitute the tort. The Court went on to hold that deliberate misconduct may be established by proving, first, an intentional act which is either (a) an intentional use of statutory authority for an improper purpose; or (b) actual knowledge that the act or omission is beyond statutory authority; or (c) reckless indifference or willful blindness to the lack of statutory authority for the act. The second leg of establishing the tort involves

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of loss" and "harm which is likely to ensue". Although I have used the phrase "serious risk of loss"", see Lord Hope, *Three Rivers ibid* at 527.

186 For a more extensive analysis of the various heads of this tort, see *Three Rivers, supra* note 5 at 7-12; See also, *Three Rivers,*[2001] 2 All E.R. at 526-527.

187 [1959] S.C.R. 121[*Roncarelli* cited to SCR]

188 *Woodhouse, supra* note 182 at para.19.

189 *Uni-Jet Industrial Pipe Limited v. Canada (Attorney General)* (2001) 156 Man. R. (2d) 14; *Powder Mountain Resorts v. British Columbia* [2001] 11 W.W.R. 488.

190 (2003) 220 D.L.R. 4th 474 [*Alberta Public Works* cited to D.L.R]

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proving intent to harm an individual[191] or a class of individuals. This is satisfied by either (1) an actual intention to harm; or (2) actual knowledge that harm will result; or (3) reckless indifference or willful blindness to the harm that can be foreseen to result[192].

In *Woodhouse* (some police officers were alleged to have committed misfeasance in public office following their failure to co-operate fully with an investigative panel looking into the circumstances surrounding the fatal shooting of someone from the plaintiffs' family), the Supreme Court of Canada used the opportunity to examine *Three Rivers* and other common law decisions on this tort. Their Lordships largely came to the same conclusions as the other cases regarding the ingredients necessary to constitute the tort. What is perhaps instructive in this case is that the court enumerated a number of factors which may restrict the application of the tort. According to Iacobucci J[193],

> [M]isfeasance in a public office is not directed at a public officer who inadvertently or negligently fails adequately to discharge the obligations of his or her office.... Nor is the tort directed at a public officer who fails adequately to discharge the obligations of the office as a consequence of budgetary constraints or other factors beyond his or her control. A public officer who cannot adequately discharge his or her duties because of budgetary constraints has not deliberately disregarded his or her official duties. The tort is not directed at a public officer who is unable to discharge his or her obligations because of factors beyond his or her control but, rather, at a public officer who could have discharged his or her public obligations, but yet willfully chose to do otherwise... Another factor that may remove an official's conduct from the scope of the tort of misfeasance in a public office is a conflict with the officer's statutory obligations and his or her constitutionally protected rights, such as the right against self-

191 Where the attempt is to harm a specific individual, as happened in *Roncarelli, supra* note 187 it is regarded as "targeted malice": see *Alberta v. Nilsson* 246 A.R. 201.

192 *Alberta Public Works, supra* note 190 at 509.

193 *Woodhouse, supra* note 182 at para. 26-27.

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> incrimination. Should such circumstances arise, a public officer's decision not to comply with his or her statutory obligation may not amount to misfeasance in a public office. I need not decide that question here except that it could be argued. A public officer who properly insists on asserting his or her constitutional rights cannot accurately be said to have deliberately disregarded the legal obligations of his or her office. Under this argument, an obligation inconsistent with the officer's constitutional right is not itself unlawful.

From the above therefore, where a public officer is able to prove any of the instances enumerated by the court, then the tort will not be constituted. The aim here is not to analyze the implications of the restrictions placed by the court on the operations of this tort. It may however be mentioned that the scope gives much leeway to public officers to avoid liability under this tort. The thesis will discuss one possible way that this might happen in the course of this chapter.

The tort of misfeasance in public office is also an important head of tort in Australia for persons desirous of making claims under private law against public officials.[194] In one of its most important decisions on the matter in recent times, the High Court of Australia in the case of *Northern Territory of Australia & Others v. Mengel and others*[195] took the time to re-establish the essential elements[196] of the tort while also overruling a previous authority which stated that 'a person who suffers harm or loss as the inevitable consequence of the unlawful intentional and positive acts of another is entitled to recover

194 See generally, F. Trindade and P.Cane, *The Law of Torts in Australia*, (Melbourne: Oxford University Press, 1999) 242-248. [*Tort in Australia*].

195 (1996) 185 CLR 307, [*Mengel's case*].

196 For a detailed analysis of the various elements under Australian law, see *Tort in Australia, supra note* 194 at 242 – 248.

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damages from that other'[197]. Deane J summarised the elements of the tort as being (1) an invalid or unauthorised act; (2) done maliciously; (3) by a public officer; (4) in the discharge of his or her public duties ;(5) which causes loss or ham to the Plaintiff[198]. Regarding the required mental element, the court extended the parameters of malice to include acts done "with reckless indifference or deliberate blindness" [199].

Comments

Undoubtedly, this tort provides a useful alternative for a person who seeks private law remedies in a typically public law domain. In applying this tort however, the courts will need to strike the right balance between protecting the interests of an individual and ensuring that public officials are not unduly constrained in the proper[200] performance of their legitimate duties. Allot, while commenting on the decision of the House of Lords in *Three Rivers,* speaks about concerns that the courts "should not, by way of the tort of misfeasance in public office, take on themselves the role of an ombudsman, a parliamentary committee, or an organ of public opinion in reviewing even egregious acts of misadministration, official incompetence or bad judgment"[201]. He believes that this

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197 *Beaudesert Shire Council v Smith* (1966) 120 CLR at 156

198 *Mengel's case, supra* note 195 at 370.

199 *Mengel's case, ibid* at 371.

200 The word "proper" is used here since, as revealed by the cases, the manner in which statutory power is exercised could form the basis of an action under this tort.

201 Phillip Allot, "EC Directives and Misfeasance in Public Office",(2001) 60 Cambridge L. J. Part 1 4 at 6.

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concern was evident in the approach their Lordships used in their analysis of the various elements of the tort.[202]

The Alberta Court of Appeal also echoed similar sentiments in *Alberta Public Works* where it emphasized the need for courts to be circumspect in the application of the tort. According to the court,[203]

> The test for the tort of abuse of public office is evolving...This evolution may reflect increasing government involvement in the economy and society; that involvement creates conditions where the government, through its agents, may adversely affect individual interests. Because it is a key function of government to devise and execute policies involving the application of state power or the gathering or distribution of resources, it is inevitable that the acts or omissions of government agents will have adverse effects on some individuals. Therefore, the test for the tort of abuse of public office is not exclusively defined by the fact that government agents have caused damage to an individual. Loss or damage to individuals may occur as a result of lawful and non-tortious activity. Accordingly, there must be a tortious character to the acts or omissions of the government agents that are the operative cause of the damage. To approach the matter otherwise than cautiously is unwise.

The critical question here is whether this tort[204] can be used to successfully found an action against bank regulators in the event of a collapse of a bank subject to their supervision.[205] To clearly analyze this issue, the circumstances leading to the revocation

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202 *Ibid.*

203 *Alberta Public Works, supra* note 190 at 505-506.

204 Consideration is given here only to the tort of misfeasance in public office. The immunity provisions removes any right of action against regulatory officials, even if the case

205 *Three Rivers* is yet to be finally resolved.

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of the banking license of *Savannah Bank*, one of the Nigerian banks discussed in the previous chapter, will be examined as it provides a good illustration of typical regulatory conduct that may be impugned. As revealed by the events preceding the closure of the bank in 2002, the bank did not publish its audited accounts as required by law in 1999, 2000 and 2001.[206] It seems though that hurriedly prepared drafts were confidentially made available to CBN in 2001 when CBN and the Nigeria Insurance Deposit Corporation (NDIC) conducted a joint onsite examination of the bank's books[207]. The law however is that banks are to prepare, keep and publish "**proper** books of account" on an annual basis,[208] and a hurriedly prepared draft can hardly be said to meet the statutory requirements.

Excerpts from the CBN Report[209] stating the findings of the officials who conducted the onsite examination indicated that 74 percent of the bank's credit exposure were non-performing loans.[210] It was also found that the bank made several bogus claims regarding its financial situation, distorting figures and misrepresenting information. As a remedial measure, the bank was required to inject ₦5.4 billion into its capital base[211]. It should be noted here that the crisis in the bank began as far back as 1993 after its raucous Annual General Meeting and this fact was known to the regulatory authorities as they made

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206 For more details on the *Savannah Bank* incident, see Salif Atojoko, "Crash of Savannah", *Newswatch,* (4 March, 2002). [*Atojoko]*

207 Lanre Oloyi & Gbenga Agbana, "CBN revokes Savannah Bank's Licence, Court Halts Liquidation", *The Guardian, (*19 February 2002).

208 *Sections 24, 27* and *28* of *BOFIA.*

209 This Report was dated March 31, 2001, see *Atojoko, supra* note 206.

210 *Ibid.*

211 *Ibid.*

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efforts to reconcile the warring factions in the bank. CBN also assisted in constituting a new board and management for the bank.[212]

Analysis

The above facts reveal a number of improprieties on the part of CBN. First, CBN condoned persistent contravention of provisions of BOFIA,[213] a statute it is mandated to duly administer. CBN did not take prompt steps to close the bank earlier upon realizing its (the bank's) dismal financial position; rather it waited for almost a year before revoking its license when more deposits had been lodged at the bank. One other relevant aspect of this case is the media blitz sponsored by CBN encouraging people to make deposits in Nigerian banks and reassuring them that all the operating banks in the country were safe and sound.[214] Clearly, CBN could not vouch for the financial soundness of all the banks, making such claims in the advert therefore, suggests *mala fides* on its part.

Using the case of *Alberta Public Works* as the authority here, one of the essential requirements for constituting the tort is deliberate misconduct. This can be proved in any of the ways enumerated by the court in that case. Condoning persistent contravention of BOFIA is conduct clearly outside the statutory mandate of CBN, and the fact that non-compliance with the provisions of that law is made a criminal offence re-enforces the fact that non-compliance is viewed seriously by the legislature. CBN cannot claim ignorance

212 *Ibid*

213 *Savannah Bank* did not keep nor publish proper books of account for three years.

214 Marcel Okeke, "The Lessons of Savannah Bank", *The Guardian* (26 February, 2002). Since the financial crisis in the country in the 90s, people have generally stopped making deposits in the banks, preferring to keep their money at home, or abroad – for those who could afford that.

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of this or the general tenor of BOFIA. Therefore, CBN has actual knowledge that condoning the non-publication of a bank's financial statements for three years is outside its mandate.

Though bank regulatory authorities are usually given a measure of latitude in determining if and when to take immediate and decisive action when a statutory infraction occurs, CBN, however, cannot argue regulatory forbearance here because of the importance of what was involved – financial statements – and the fact that it was not prepared for three consecutive years. No responsible bank regulator will waive the statutory requirement of proper preparation and publication of a bank's financial statements for three consecutive years.

It should be noted that when CBN *did* take action to conduct a special examination in 2001, *Savannah Bank* was already in a precarious financial position; yet, it was still allowed to operate for almost an additional year before it was eventually closed on February 15, 2002. Even though BOFIA does not expressly stipulate prompt corrective action on the part of CBN in the event a bank becomes distressed, it is nonetheless believed that this is an implicit mandate, given the tenor of BOFIA to ensure proper bank supervision.[215] By reason of this, CBN's tardiness in responding to *Savannah Bank's* distress situation constitutes an act outside its statutory mandate.

Another element necessary to establish the tort is that there should be intent to harm an individual or a class of individuals. This is proved by establishing that a party acted with

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215 Section 38(b) of the *Central Bank of Nigeria Act,* places an express duty on CBN to ensure "high standards of conduct and management throughout the banking system" in Nigeria.

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reckless indifference or willful blindness to the harm that can be foreseen to result. There is no doubt that CBN's conduct in this case amounts to reckless indifference or willful blindness regarding the losses that will potentially be borne by depositors when the bank collapsed. If CBN had been sensitive to this fact, it would not have allowed *Savannah Bank* to operate for almost a full year after an examination of its books revealed its precarious state.

It should be noted that the re-injection of new capital proposed by CBN for the bank was a totally unrealistic and unviable option for a couple of reasons[216]. First, the undeveloped state of capital markets[217] in many African countries – including Nigeria, coupled with the general public apathy towards share purchases in the country –, makes it highly improbable that the bank would have been able to secure such a huge capital through a public offering.[218] Also, requiring a bank to suddenly raise that much – about three times the required authorized capital for new banks – would only have heightened public consternation. It is also much doubtful if any foreign investor would have been interested

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216 *Atojoko, supra* note 206.

217 See generally Cohn Stuart, *The Development of Micro-cap Securities' Markets in Sub-Saharan Africa: New Approaches to Fostering Enterprise Growth, United Nations Institute for Training and Research Papers,* Document No. 18 2002; Odife Dennis, *Implementing the New Partnership for African Development (NEPAD) by Promoting the Development of the SME Sector in the Context of Capital Markets in Africa, United Nations Institute for Training and Research Papers,* Document No. 18 2002.

218 Financing through the capital markets would have been *Savannah Bank's* best option because it was already greatly indebted to other banks through its frequent borrowing at the inter-bank lending market, see *Atojoko, supra* note 206.

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in the bank given its financial state,[219] and, at any rate, it would have made better business sense for the investor to start a new bank altogether with far less capital.

It is submitted, in the light of the above, that the facts and circumstances surrounding the case of *Savannah Bank*, *prima facie,* indicate regulatory improprieties to the level required to establish the tort of misfeasance in public office. The other question here, however, is whether any of the factors outlined in *Woodhouse* by the Canadian Supreme Court will avail CBN. In that case, the court held that the tort of misfeasance in public office is not directed at a public official who "inadvertently or negligently fails to discharge his duties" or could not discharge such duties due to reasons beyond his control.[220] The court held that the tort is directed at a public officer who "could have discharged his or her obligations, but yet willfully chose to do otherwise". The operative word here is "willfully". This word literally means "said or done deliberately or intentionally; doing as one pleases"[221]. The Canadian case of *Whyte v. Whyte*[222] adopted the meaning of Lord Russell in *R v. Senior* that the word describes an act "done deliberately and intentionally, not by accident or inadvertence, but so that the mind of the person who does the act goes with it" [223]. It should be noted that though the case defined the meaning of the word as used in a criminal law context, it is believed that it is closely

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219 By 2000, the bank had completely eroded its shareholders' funds: see Gbenga Agbana, "Savannah Bank May be Delisted from the NSE", *The Guardian,* (19 February, 2002).

220 Is this a *force majeure* defence?

221 *Webster's New World Dictionary Third College Edition, Victoria Neufeldt (ed)* 1988.

222 11 D.L.R. (2d) 391.

223 [1899] 1 Q.B. 283 at 290-291.

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related to the literal meaning in the dictionary, and hence can be taken as the meaning intended by the court in *Woodhouse.*

It is hard to see how CBN's conduct in the above case can be taken as anything other than an intentional shirking of responsibility. CBN could have discharged its obligations but chose not to do so – for whatever reason. One would have thought that the bank insolvencies of the 1990s should have impelled CBN to act more quickly to avert another crisis. The facts, however, reveal that instead of acting decisively at the earliest time – *Savannah bank's* capital was already eroded as far back as 2000 –, CBN delayed and condoned grave improprieties on the part of the bank. In view of this, CBN's conduct suggest willful neglect of its statutory obligations and by reason of this, none of the factors outlined in *Woodhouse* will avail it.

The Nigerian situation has been used in this case as the events and circumstances leading to the revocation of *Savannah Bank's* license provide a good illustration of how the tort may be applied in the context of bank regulation and as mentioned above this tort may be employed in spite of the immunity provisions.

Fiduciary Obligations

In certain situations, the specific nature of a relationship between two parties and the circumstances under which it arose may create a fiduciary relationship between such

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parties whereby one of them will be held to a higher standard of conduct in respect of his dealings with the other party[224]. It has been said that[225],

> The policy underlying the law of fiduciaries is focused on a desire to preserve and protect the integrity of socially valuable or necessary relationships which arise from human interdependency. Fiduciary law's preservations of relationships that come under its auspices requires that fiduciaries adhere to a high standard of conduct. This is achieved through the imposition of certain restrictions on fiduciaries' fulfillment of their special office, a requirement necessitated by virtue of the inherent inequality of the parties created by the nature of their interaction.

Traditionally, fiduciary duties typically arise in the context of private law relationships. However, the Canadian courts appeared to have expanded the categories of persons and institutions on whom fiduciary duties may be imposed. According to the Supreme Court (Canada) in *Guerin v. Canada*[226], where fiduciary obligations was imposed on the Crown

> It should be noted that fiduciary duties generally arise only with regard to obligations originating in a private law context. Public law duties, the performance of which requires the exercise of discretion, do not typically give rise to a fiduciary relationship. As the 'political trust' cases indicate, the Crown is not normally viewed as a fiduciary in the exercise of its legislative or administrative function. The mere fact, however, that it is the Crown which is obligated to act on the Indians' behalf does not of itself remove the Crown's obligation from the scope of the fiduciary principle. As was pointed out earlier, the Indians' interest in land is an independent legal interest. It is not a creation of either the legislative or executive branches of government. The Crown's obligation to the Indians with respect to that interest is therefore not a public law duty. While it is not a private law duty in the strict sense either, it is nonetheless in the nature of a private law duty. Therefore, in this *sui generis* relationship, it is not improper to regard the Crown as a fiduciary[227]

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224 Rotman L, *Parallel Paths: Fiduciary Doctrine and the Crown-Native Relationship in Canada,* (Toronto: University of Toronto Press, 1996) at 152 [*Rotman*].

225 *Ibid.*

226 [1984] 2 S.C.R.335, [*Guerin's case* cited to SCR]

227 *Guerin's case*, *supra* note 227 at 385.

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Though the courts have held that the categories of fiduciaries are not closed,[228] there are, however, some *indicia* used by them to determine if a fiduciary relationship exists in a particular situation. In the case of *Frame v. Smith,*[229] Wilson J identified some characteristics which are consistent with the existence of a fiduciary relationship. First, fiduciaries have "scope for the exercise of some discretionary power". Also, they can "unilaterally exercise their power or discretion so as to affect the beneficiaries' legal or practical interests". Lastly, the beneficiaries are "particularly vulnerable to or at the mercy of the fiduciary holding the discretion or power".

The question here is: Can an action be brought by depositors under the head of fiduciary duties against the bank regulators in the event of a bank failure? As has been made clear by the above cases, the concept of fiduciary obligation can operate in the public law domain, hence making the bank regulator amenable to this head of liability is nothing novel. However, would the nature of the relationship of the bank depositor and the bank regulator come within the parameters set by Wilson J? It is believed that the relationship, arguably, has all the ingredients of a fiduciary relationship.[230] However, the courts have made it clear that the fact that all the indicia are present is not conclusive of the existence of a fiduciary relationship and the fact that none is present does not preclude a finding

[228] "It is the nature of the relationship not the specific category of the actors involved that gives rise to the fiduciary duty": *Guerin's case, ibid* at 224.

[229] [1987] 2 S.C.R. 99 at 136; see also, *Lac Minerals Ltd. Appellant v. International Corona Resources Ltd. Respondent* [1989] 2 S.C.R. 574 [*Lac Minerals* cited to SCR].

[230] It seems however, unlikely that the courts will hold that bank regulators are acting in the interests of a class of the public as opposed to acting in what is considered, generally, to be in the public interest.

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that the relationship does exist.[231] This flexible approach adopted by the courts, in effect, suggests that every case in which the question is raised will be considered on its own merits and the courts will not be hamstrung by any pre-determined formula for establishing the existence of fiduciary duties.

As was indicated earlier, the immunity provisions bars lawsuits against bank regulators in both Canada and Nigeria for any conduct done in pursuance of their duties, except where litigants are able to show that the regulators did not act in good faith. Fiduciary relationships require a strict standard of conduct which includes an expectation to act in good faith.[232] Therefore, assuming, for purposes of arguments, that bank regulators are held to be fiduciaries in relation to bank depositors, then, a finding that there has been a breach of fiduciary duties by the regulators may also reveal evidence of acting in bad faith.[233] Where this is this case, then the immunity provisions will not avail bank regulators.

The question here, however, is will OSFI be held to be a fiduciary? According to Dickson J in *Guerin's case*, "[w]here by statute...one party has an obligation to act for the benefit of another and that obligation carries with it a discretionary power, the party thus

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[231] *Lac Minerals supra* note 230 at 599.

[232] See King Graham, "Extending Fiduciary Principles to the Director-Creditor Relationship: A Canadian Perspective", [2002] 29 Man. L. J. 243.

[233] "A decision-maker who acts surreptitiously and without candour may be suspected of lacking good faith. A hasty decision pushed through without following the decision-maker's usual practice of consultation and study may also be suspect. A decision that singles out one individual or different treatment may be questioned. A decision made for an improper purpose or on the basis of extraneous considerations may be evidence of bad faith": Blake S, *Administrative Law in Canada,*(Toronto: Butterworths, 1992) at 89.

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empowered becomes a fiduciary. Equity will then supervise the relationship by holding him to the fiduciary's strict standard of conduct"[234]. Though acting to protect the interest of bank depositors is one of the roles of OSFI – and to this extent it may, arguably, be called a fiduciary in relation to bank depositors – its other equally important mandates of promoting the general soundness of all financial institutions in Canada and ensuring healthy competition in the industry make it difficult to hold OSFI to a fiduciary obligation in relation to bank depositors.[235] The ultimate beneficiary of the services of OSFI is the public as a whole and not just a section of it.[236]

In view of the above, it is believed that OSFI would not be held to stand in a fiduciary relationship relative to bank depositors. The final portion of this thesis examines, *inter alia,* a proposal for the establishment of a statutory scheme of remedies.

ISSUES ARISING

The collapse of any business enterprise almost always occasions pecuniary loss to many classes of persons. The failure of a bank wrecks much more havoc on persons and businesses, not to mention its hapless depositors who might be brought to the edge of financial ruin as a result of the collapse. Undoubtedly, the question of making bank

[234] *Guerin's case, supra* note 227 at 384.

[235] The multiple and often conflicting relationship OSFI has with different interest groups makes it inappropriate for the courts to hold it to a fiduciary in relation to one of those groups. Arguments were made along similar lines by the Attorney General in *Yuen's case, supra* note 157.

[236] On this, see ss. 3.1, and 4(2) of the *Office of the Superintendent of Financial Institutions Act, R.S. 1985, c.18 (3rd supp.)*;See also online:<http://www.osfi-bsif.gc.ca/eng/about/mission/index.asp >.

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regulators accountable to those that may have suffered loss is a most controversial one given the potential spectre of liability.

The incidence of bank failures has caused several governments to devise and operate safety nets. For instance, in order to allay the fears of depositors about the possibility of loss of their deposits and further boost their confidence in the banking industry, the governments of both Canada and Nigeria, like many other countries, operate a deposit insurance scheme[237]. In Canada, the Canada Deposit Insurance Corporation (CDIC), established in 1967, is the institution that administers the insurance scheme[238] while in Nigeria, the scheme is operated by the Nigeria Deposit Insurance Scheme (NDIC) established in 1988.[239]

The essence of the deposit insurance scheme is, basically, to reassure depositors that in the event of a collapse of their bank, they will not lose their money, but would be eligible for insurance cover up to a maximum amount. In Canada, the total amount of insured

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237 The law on the banker – customer relationship is that the banker is under a duty to honour his customers cheques each time such is presented up to the maximum amount in the customer's account or up to the limit of an agreed overdraft. See the cases of : See the cases of *Foley v. Hill* (1848) 2 HL Cas.28; *Thermo King v. Provincial Bank* 34 OR (2d) 369. Hence, even where a bank is facing a liquidity crisis, it is not a valid ground for withholding payment on a cheque where there are sufficient funds in the customer's account. For a bank to do otherwise may amount to a breach of contract. Basically, the intention of governments in establishing deposit insurance schemes is to forestall panic withdrawals in the event of a financial crisis, as this would only exacerbate the crisis.

238 For more on the powers and duties of this institution, see generally *Canada Deposit Insurance Corporation Act* R.S., c C-3. [*CDIC Act*]

239 For more on the powers and duties of this body, see generally *Nigeria Deposit Insurance Corporation Act*, Cap. 301, *Laws of the Federation of Nigeria 1990.* [*NDIC Act*]

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deposit is $60,000 per depositor[240] and in Nigeria, the amount is ₦50,000[241]. The critical question here is what happens to persons having deposits exceeding this maximum insurance cover? In other words, what sort of statutory protection exists for larger depositors? A prudent practice may be to ensure that one's deposit's in any one bank does not exceed the maximum insured amount. However, while this may be a good idea for some depositors, employers who pay large amounts to their employees on a monthly or weekly basis may find it most impractical. It is largely because of this, and the need to ensure that bank regulators exercise more diligence in the discharge of their duties, that the establishment of a statutory scheme of remedies against bank regulators is being advocated in this study.

The few cases on the point show the readiness of litigants to fight their claims up to the highest courts. Clearly, it would have been imprudent for them to have instituted these actions and gone all the way if they believed their claims to be frivolous, as they would have incurred further losses in form of legal fees. They, obviously, felt strongly that they should have recourse to the regulators since they are the ones charged with the responsibility of ultimate oversight over banks, coupled with the fact that they are statutorily empowered to take a number of actions against erring or imprudently run banks.

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240 Section 12(c) of the *CDIC Act.*

241 Section 26 of the *NDIC Act.*

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Given the scope of the statutory mandate of the regulatory institutions and the statutory arsenals given them to effect supervisory control over banks, it is difficult to see how they should not do everything in their powers to promote the soundness and stability of the banking industry. The relevant statutes do not require public officers representing the regulatory institutions to exercise any degree of diligence or care in the discharge of their duties. Under Nigerian law, the oath of office required to be sworn to by all prospective employees of CBN only mandates them to carry out their duties 'to the best of their individual ability'. There are no objective criteria they are required to measure up to in the performance of their duties.

It has been opined that,

> Public authorities, like individuals in the private sector, ought to be required to conduct themselves reasonably in furtherance of their statutory mandates, with due regard to the interests of others who are foreseeable victims of their carelessness. If they fail to do so, they ought to be subject to tort liability.[242]

Kane also argues that "[s]hortfalls in regulatory performance can only be defined relative to an explicit standard of regulatory duty"[243] . It is clearly beyond argument that Parliament expects nothing less of public officers but to perform their functions with due care and diligence. Consequently, an express provision should be contained in the regulatory statutes for both Canada and Nigeria, requiring that officials of the regulatory institutions should discharge their functions the way a 'reasonable prudent regulator would'. This requirement would provide a basis for establishing an action under the proposed statutory scheme of remedies.

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242 L. Klar, *supra* note 156 at 243 - 244.

243 Kane, E, "Ethical Foundations of Financial Regulation", *Working Paper 6020,* National Bureau of Economic Research, 1997 online: < http://www.nber.org/papers/w6020.pdf>[*Kane*]

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Some of the concerns associated with making bank regulators liable have already been highlighted in arguments made in some of the cases discussed above. The main ones will be addressed below. It is important to note that none of the views expressly disapproved of having a statutory scheme of remedies established in favour of depositors. The arguments were only to the effect that the courts may not be the proper forum to impose such liability without statutory backing.

The issues arising from the proposal being made here include: How would such a scheme be structured? Would it open the doors to a flood of cases against the regulators? Would potential liability affect the way bank regulators exercise their judgments or discretion? Would a finding of liability against the regulators open the doors for others, such as creditors, investors – other than equity holders – to bring claims against the regulators too? How would such a scheme allow the regulators to properly balance the contending interests they need to take into account in the performance of their duties? Is it in the overall interest of the public that such a scheme be established? Should the regulators be made accountable to the depositors given the fact that the nature of their duties is more to the public at large? Would such a scheme increase the moral hazards in banks by encouraging the board and management to take on ill-advised risks? Would it create an indeterminate liability to an equally indeterminate class of persons?

Structure of Statutory Scheme

There is no doubt that the banking system is one of the institutions in any polity that depends on public trust and confidence to thrive. A single bank failure may cause such a

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hiccup in the whole financial system that the whole economy might be brought to its knees. It is also beyond cavil that trust and confidence are qualities that cannot be decreed. The establishment of the statutory scheme, therefore, will serve as a source of reassurance for depositors that there is now every need for the regulators to take their work more seriously.

Contemporary realities of banking regulation reveal growing concerns about the quality of bank supervision and arguments have been made on the need to make bank regulators accountable as a way of ensuring better performance[244]. Also, as Clarke rightly stated "[n]obody can ignore the growing readiness of those with a complaint against the central bank or the regulatory authority to take legal action"[245]. A good example of this is *Three Rivers* which is still going through the UK court system. This is one of the reasons why the legislature should seize the imitative and develop a statutory framework prescribing standard of regulatory conduct and outlining remedies where standards are not complied with and loss occurs. Leaving it to the courts to deal with may not be a good option, given the uncertainty of judicial outcomes and the fact that it would have taken the issues out of the control of the organ that will likely "bear the brunt" of the judicial decisions.

The primary question here, therefore, is not whether the proposal being made is feasible but whether it is desirable, and for the reasons already given, it is believed to be a

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[244] See generally, *Page*, *supra* note 4; Goodhart Charles, "Regulating the Regulator –An Economist's Perspective on Accountability and Control", in E.Ferran & C. Goodhart eds., *Regulating Financial Services and Markets in the 21st Centuy,* (Oxford: Hart, 2001) at 151; Kane, *supra* note 244.

[245] William Clarke, *Opening Comments, Central Banking Annual Training Course/Seminar Series, Legal Risks and Good Governance for Central Banks and Supervisors, London* Autumn 2003.

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desirable regulatory reform. The idea is not as far fetched as it may first appear. In Austria – though a civil law country[246] – the *Public Liability Act* establishes the liability of public officials to citizens for financial loss through official acts and this law was recently invoked in the context of bank regulation in the case of *Oberster Gerichtshof).*[247] In that case, bankruptcy proceedings were commenced with respect to the *Bank für Handel und Industrie AG* ("BHI"), an Austrian bank. In the course of the proceedings, inconsistencies and mistakes in the audits of BHI were revealed. Under Austrian law, a bank auditor is deemed to be acting on behalf of the bank regulators and hence qualifies as a public official[248]. Some of the depositors of BHI sued the Republic of Austria pursuant to the *Public Liability Act,* contending that the reason for the collapse of BHI was insufficient supervision by the regulatory authorities. The Austrian Supreme Court held that the Republic of Austria was liable as a result of the negligence of the auditor in performing its duties.

Recommendations

One of the arguments made against making bank regulators liable is the possibility that it will open a floodgate of cases. This will not necessarily be the case. The right of action will be expressly reserved for those having amounts exceeding the insured limits. In real

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[246] Given the nature of banking business however, the legal system operated in a country does not materially affect the nature of the business or supervision and this is evident in the composition of the *Basel Committee on Banking Supervision* which has members from both common law and civil law countries. For more on this see online: < http://www.bis.org/bcbs/aboutbcbs.htm >.

[247] 1 Ob 188/02 g, Judgement given by the Austria Supreme Court on March 25, 2003. For more comments on this case, see Markus Heidinger, *Liability of the Republic of Austria,* Case Comment, (2004) 19 J.I.B.L.R. No. 2 at N12-13.

[248] Section 63 *Banking Act* (Austria).

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terms therefore, this will considerably reduce the number of litigants, though not necessarily the amount of claim. The statute should enjoin the regulators to enter into negotiations with those classes of people who are entitled to bring action under the proposed *Bank Regulators (Accountability) Act* ('the Act') with a view to an amicable resolution of the issue. It is believed they will be more amenable to an out of court settlement since this will save them the legal fees they would have incurred. It is most likely that those who will fall under this category will be big businesses and undertakings which makes it all the more easy for the regulators to deal with.

One other argument against the proposed statutory scheme is that it may impair the way regulators exercise their judgement or discretion. It is believed that this argument is also not as compelling as it appears. Public officers ought not to be given a *carte blanche* in the exercise of discretion. They should have a rational or justifiable basis for the exercise of such discretion one way or another and the circumstances which informed that particular decision should be well documented for future reference.

It will seem inappropriate to question the exercise of a person's discretion on the grounds that someone else seised of the same situation would have acted differently. In the context of bank regulation, however, there has to be a basis for the exercise of discretion by bank regulators in the discharge of their duties. There should be no room for arbitrariness. The regulators will have done their statutory duties if they document the considerations that informed the exercise of the discretion in a particular way. To this end, it should be a necessary requirement of the Act that there should be adequate

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documentation of those issues and considerations that were taken into account by the regulators before they exercised their judgement in a particular way. The essence is not to allow the courts to second-guess their decisions but rather to allow a litigant to contest the basis for which the discretion was exercised. Such litigant should be able to prove, in order to succeed, that a reasonably prudent regulator seised of the same circumstances would not have exercised the discretion the way the regulators did. It will be recalled that one of the findings in the *CCB and Northland Report* was that the regulators did not exercise their discretion to act in a timely fashion to avert the bank failures.

Another concern here relates to the likely fallouts of a finding of liability under the Act against the regulators. Should this finding allow other categories of persons – such as creditors – that may have suffered loss to plead this judgement to establish their own claims against the regulators? It is believed that creditors of a failed bank should not be amongst the classes of persons that should be given a right of action under the Act. This is because they should have taken issues such as these into contemplation at the time of entering into the financing transaction and made adequate provisions for it in their agreements. At any rate, the bank regulators are not there to protect the interests of bank creditors.

One argument raised in the cases was that bank regulators discharge their duties in the interest of the public as a whole and do not owe any responsibility to any class of persons, including depositors. There is absolutely no doubt about this, and it was in fact made clear in the *CCB and Northland Report* that no regulatory scheme should be so

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fashioned so as to ensure that no bank will fail as it may even be in the interest of the public to allow some banks to fail[249]. Whilst it is true that the bank regulator has a responsibility to the public at large, this in no way detracts from his duties to ensure adequate and proper supervision of banks. Gavin and Hausman argue that some bank failures are "predictable and thus preventable by competent bank supervision and regulation"[250]. It is believed that the interests of the public will be better served if the regulators are seen to be showing more diligence in the supervision of banks. While acting to promote the public interest, the regulators should be mindful of that primary class of persons who stand to suffer most in the event of a collapse of a bank. The measure being proposed is to further boost public confidence in the banking system. The possibility that this statutory scheme may increase the financial burden of the State cannot be a sole reason for rejecting it.

There is also the argument that the statutory scheme may provide an incentive for bank management and directors to take imprudent risks. A way around this problem is to give the bank regulators the power to bring an action *via* third party proceedings to join the bank management and its directors in any lawsuit against them (i.e. bank regulators) where they are believed to have imprudently run the banks under their control.

It is believed that in order to make this statutory scheme workable, litigants should not be required to prove if and how the bank regulators had been negligent or careless in the

249 See *CCB and Northland Report, supra* note 11 at 200.

250 Gavin Michael and Ricardo Hausman, *The Roots of Banking Crises: the Macroeconomic Context*, Inter-American Development Bank, Working Paper 318, January 1996 at 2.

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performance of their duties. Rather, a presumption should operate in favour of the litigant that regulatory lapses was part of the cause of the bank failure. The bank regulators should then be required to present evidence to rebut this presumption, and show that they had done all that a 'reasonably prudent regulator' would have done in comparable circumstances. This recommendation of reverse onus is similar to what generally obtains in relation to proof of breach of fiduciary obligations[251].

If the litigants are required to prove lack of regulatory oversight, they may not be able to establish this, as most of the information that would be required will be obtained from the regulators who might not be too forthcoming in providing the necessary information. A perfect instance of this is the refusal of the *Bank of England* to hand over relevant documents to the litigants in *Three Rivers.* Once the regulators are able to prove that they had duly complied with the provisions of the law and had acted the way that would be expected of any reasonably prudent regulator sesied of the same situation, then they would have discharged their onus.

Conclusion

It is believed that if this statutory scheme – though radical – is established, it will promote a stronger and more stable banking industry. This recommendation is made more in the case of Nigeria, as regulatory lapses were principally to blame for the collapse of several banks in quick succession in the 1990s.

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[251] For more on this see, *Rotman, supra* note 224 at 183-184.

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