

UNSAFE AND UNSOUND BANKING PRACTICES IN ZAMBIA; THE CASE OF
ACCESS FINANCE SERVICES AND ACCESS LEASING LIMITED.

By

LIKANDO MAKALA MUBITA

(26003660)


Being a Directed Research essay submitted to the University of Zambia Law Faculty in
Partial fulfillment of the requirements for the Award of the Bachelor of Laws (LLB) Degree.

SP
LLB
2012



DECLARATION

I, **LIKANDO MAKALA MUBITA**, do hereby declare that this Directed Research Essay is my authentic work and to the best of my knowledge, information and belief, no similar piece of work has previously been produced at the University of Zambia or any other Institution for the award of Bachelor of Laws Degree. All other works in this essay have been duly acknowledged. No part of this work may be reproduced or copied in any manner without the prior authorization in writing of the author.



.....
LIKANDO MAKALA MUBITA

(26003660)

THE UNIVERSITY OF ZAMBIA

SCHOOL OF LAW

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LIKANDO MAKALA MUBITA

(Computer No. 26003660)

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ABSTRACT

The purpose of this dissertation is to provide a full analysis of the Central Bank's role in supervision and regulation of activities of financial institutions, in particular, how the Central Bank handles cases where a financial institution engages in unsafe and unsound banking practices. It further attempts to address the need to have a statutory definition of what amounts to unsafe and unsound banking practices. In approaching the concept the research starts by explaining the role of the Central Bank in regulating and supervising financial institution in Zambia. It further examines the extent of the Central Bank's power in its regulatory and supervisory function, in particular, how it handles the issue of unsafe and unsound banking practices. In addition it considers the treatment of unsafe and unsound banking practices in other jurisdictions.

The outcome of the research indicated that in most instances when a financial institution is alleged to have conducted in unsafe and unsound banking practices, the Central Bank takes supervisory action against it, without proper determination of whether indeed the conduct falls within the ambit of unsafe and unsound banking practices.

The conclusion arrived at, is that the Central Bank has too much discretion in its exercise of its supervisory function. When dealing with the issue of unsafe and unsound banking practices as there is no criteria of determining which activities amount to unsafe and unsound banking practices, hence the criteria used is what it thinks fit in each situation. This has led to a number of problems including; bank closures, loss of confidence in the Central Bank as regulator and financial institutions, which ultimately leads to less investment opportunities in the country.

The study therefore, recommends that there should be a statutory definition of what amounts to unsafe and unsound banking practices in Zambia. This can be done by parliament as a long term recommendation, ensuring that this gap in the law is filled. Therefore, the BFSA should be amended so that it includes a definition or an interpretation of the term 'unsafe and unsound banking practices'. It also recommends as short term, that BOZ should give a policy interpretation of the meaning of 'unsafe and unsound practice', given the absence of a statutory definition. BOZ can also emulate how the concept of unsafe and unsound banking practices is dealt with in other jurisdictions. For instance, the United States of America has proved to better deal with the concept of unsafe and unsound banking practices.

DEDICATION

“This is dedicated to my beloved late parents and my dearest husband Mwape Mbita”

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Firstly, I would like to thank my dear Heavenly Father Lord Almighty for giving me the opportunity to be where I am today. Without Him I would not have reached this far.

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TABLE OF STATUTES

The Bank of Zambia Act Chapter 360 of the Laws of Zambia no.43 of 1996

The Banking and Financial Services Act Chapter 387 of the Laws of Zambia

The Banking Act of Malawi Chapter 42:01

The Building Societies Amendment Act Chapter 412 of the Laws of Zambia

The Development Bank of Zambia Act Chapter 363 of the Laws of Zambia

The Reserve Bank of Malawi Act Chapter 44:02

The United Kingdom Financial Services and Markets Act 2000

The United States Federal Deposit Insurance Act

The United States Financial Institutions Supervisory and Insurance Act of 1996

TABLE OF CASES

Access Finance Services and Access Leasing Limited v Bank of Zambia, 2003/HP/359
(unreported)

Briggs v Spaulding 141 US 132 165-66 (1891)

Finsbury Investments v Bank of Zambia and the Attorney General, 2010/ HP/353 (unreported)

First Nat'l Bank of Eden v Development of the Treasury 568 F 2d, 132 (1978)

First Nat'l Bank of La Marque v Smith 453 F2d 645 (1980)

Lippitt v Ashley US 313 Fd2 298 (1886)

Nat'l Bank v Comptroller of the Currency 573 F2d 889 897 (1978)

CONTENTS

Research Topic.....	i
Declaration.....	ii
Supervisor’s Approval.....	iii
Abstract	iv
Dedication.....	v
Acknowledgements.....	vi
Table of Statutes.....	vii
Table of Cases.....	viii

CHAPTER ONE

1.0 INTRODUCTORY CHAPTER

1.1 Introduction.....	1
1.2 Conclusion.....	7

CHAPTER TWO

2.0 THE ROLE OF THE CENTRAL BANK IN ZAMBIA

2.1 Introduction.....	8
2.2 The Role of the Central Bank.....	8

2.3 The Rational for the Central Bank’s Supervisory and Regulatory Functions.....10

2.4 How the Central Bank Regulates and Supervises Financial Institutions.....11

2.5 The Concept of Unsafe and Unsound Banking Practices.....14

2.6 Conclusion.....17

CHAPTER THREE

3.0 THE EXTENT OF THE CENTRAL BANK’S POWER IN REGULATING AND SUPERVISING FINANCIAL INSTITUTIONS

3.1 Introduction.....18

3.2 The Extent of the Central Bank’s Regulatory and Supervisory Power.....18

3.3 The Interpretation of Unsafe and Unsound by the Court.....19

3.4 Political Interference in the Regulatory and Supervisory Functions of the Central Bank.....19

3.5 The Problems Arising from the of the Lack of Definition of Unsafe and Unsound Banking Practices.....22

 3.5.1 Bank Closures22

 3.5.2 Loss of Confidence in the Financial Institutions.....24

 3.5.3 Loss of Confidence in the Central Bank.....24

 3.5.4 The Central Bank has too much Discretion.....25

3.5.5 Financial Institutions still engage in Illegal Activities.....	25
3.6 Conclusion.....	26

CHAPTER FOUR

4.0 UNSAFE AND UNSOUND BANKING PRACTICES IN OTHER JURISDICTIONS

4.1 Introduction.....	27
4.2 United Kingdom	27
4.2.1 Status of Regulatory and Supervisory Framework of Financial Institutions in the UK.....	28
4.2.2 The Concept of Unsafe and Unsound Banking Practices in the UK.....	29
4.3 United States of America	30
4.3.1 Status of Regulatory and Supervisory Framework of Financial Institutions in the USA.....	31
4.3.2 The Concept of Unsafe and Unsound Banking Practices in the USA.....	32
4.4 Malawi.....	35
4.4.1 Status of Regulatory and Supervisory Framework of Financial Institutions in Malawi.....	35
4.4.2 The Concept of Unsafe and Unsound Banking Practices in Malawi.....	36
4.4 Conclusion.....	37

CHAPTER FIVE

5.0 CONCLUSION AND RECOMMENDATIONS

5.1 General Conclusion.....	38
5.2 Recommendations.....	40
Bibliography.....	43

CHAPTER ONE

1.0 INTRODUCTORY CHAPTER

1.1 INTRODUCTION

There are a lot of actors in the Zambian financial sector and these include commercial banks, leasing companies, development finance Institutions, building societies, microfinance institutions, savings and credit institutions, foreign exchange bureau de change and a credit reference bureau.¹ All these actors are regulated and supervised by the Bank of Zambia (BOZ). BOZ is established under section 3 of the Bank of Zambia Act² and is the Central Bank in Zambia. Its mission is to formulate and implement monetary and supervisory policies that achieve and maintain price stability and promote financial system stability in the Republic of Zambia.³

BOZ supervises and regulates the actors in the financial sector to ensure a safe and sound financial system in the country. The Central Bank does this through a number of laws including, the Banking and Financial Services Act (BFSA) of 1994 as amended in 2000 and 2005,⁴ the Development Bank of Zambia Act⁵ as amended in 2005, the Building Societies Act⁶ of 1968 as amended in 2005, the Banking, Financial Services (Microfinance) Regulations of 2006,⁷ and the Banking and Financial Services (Bureau de change)

¹ Denny H Kalyalya “Financial Access and Sustainability of Financial Services in Zambia” Paper Presented by the Deputy Governor – Operations, Bank of Zambia. www.boz.zm (accessed October 11,2011)

² Chapter 360 of the Laws of Zambia as amended by Act no. 43 of 1996.

³ C, Chiumya, *Banking Sector Reform and Financial Regulation Banking Sector Reform and Financial Regulation : It's Effects on Access to Financial Services by low Income Households in Zambia*,(Princeton: Princeton University Press, 2004), 23

⁴ Chapter 387 of the Laws of Zambia.

⁵ Chapter 363 of the Laws of Zambia.

⁶ Chapter 412 of the Laws of Zambia.

⁷ Anonymous. “Financial Sector Development Plan(Fsdp)”www.boz.zm/NonBanksForms/MFIApplicationFormNonBanks (accessed October 11th 2011)

Regulations of 2003.⁸ The primary law governing the financial sector is the BFSA and subsidiary legislation such as Statutory Instruments and Bank of Zambia directives. The Act was amended in 2000 to cover all institutions that provided financial services as defined in the Act, including microfinance institutions, to strengthen the BOZ's regulatory and supervisory powers, to incorporate best practices and internationally accepted standards for licensing, prudential regulation and supervision.⁹

The majority of the banks are subsidiaries of foreign banks and they are also the most dominant and oldest financial institutions in Zambia. Their dominance is reflected in the size of their total assets relative to other financial institutions as well as in their relatively wider role in financial intermediation.¹⁰

Non-bank registered financial institutions include micro finance institutions which complement the role of commercial banks by providing some financial services that commercial banks may not be well placed to provide. They also compete with commercial banks and challenge them to be more efficient and responsive to the needs of their customers.¹¹

A bank under the BFSA is defined as a company conducting banking business. Banking business under the same Act means the business of (a) receiving deposits from the public including chequing account and current account deposits and the use of such deposits, either in whole or in part, for the account of and at the risk of the person carrying on the business, to

⁸ Anonymous. "Financial Sector Development Plan(Fsdp)" www.boz.zm/NonBanksForms/MFIApplicationForm NonBanks (accessed October 11th 2011)

⁹ C, Chiumya. *The Effectiveness of Bank Regulation and Supervision in Zambia*, unpublished Masters Dissertation, (Birmingham: University of Birmingham, 1999),15-16.

¹⁰ Kenneth Mwenda. "Recent Development in Banking supervision and systematic Bank Restructuring: A Legal Perspective" *Zambia Law Journal*, Volume 31, 1999: 54

¹¹ Bank of Zambia. "Development of Microfinance Regulation and Supervision", Project Document, 21 December 1999, (accessed October 13, 2011)

make loans, advances or investments; (b) providing financial services; and (c) any custom, practice or activity prescribed by the Bank of Zambia as banking business.

A financial institution on the other hand is defined under the same Act¹² as a person other than a bank, conducting a financial service business which includes receiving deposits from the public but does not include chequing.

The statement of the problem of this paper is such that, section 77 of BFSA does not provide a definition of ‘unsafe and unsound practice’, but merely refers to the term ‘unsafe and unsound practice’ and highlights the steps that the Bank of Zambia should take whenever, in its discretion, it determines that an act or course of conduct of a particular bank or financial institution constitutes ‘unsafe and unsound practice’.

That section reads;

Where, in the opinion of the Bank of Zambia, a financial service provider or any person on behalf of a bank or financial institution is committing or pursuing or is about to commit or pursue on behalf of the financial service provider any act or course of conduct that is considered by the Bank of Zambia as unsafe or unsound practice, the Bank of Zambia may enter into one or more written agreements with the financial service provider or its board of directors to establish a programme of action to counteract the unsafe or unsound practice and to establish or maintain safe and sound practices in the conduct of the business of the financial service provider.

Although what constitutes an ‘unsafe and unsound banking practices’ may depend on the facts of each case, there are no guidelines or criteria spelling out an interpretation of ‘unsafe and unsound banking practices’. Therefore, the pertinent question is what criterion does the Central Bank use in determining what amounts to unsafe and unsound banking practices. Many financial institutions have been placed under compulsory liquidation by BOZ for alleged conduct in unsafe and unsound banking practices.

¹² Chapter 387 of the Laws of Zambia.

The problem resulting from the of lack of a definition of what constitutes unsafe and unsound banking practices can be seen through a number of cases that have been brought before the court on the issue. One such a case is that of *Access Finance Services and Access Leasing Limited v the Bank of Zambia*¹³ where BOZ took over possession of both Access Finance Services Limited (AFSL) and Access Leasing Limited (ALL) in early 2003 and decided to place them under compulsory liquidation. The two companies were alleged to have been involved in criminal activities that included unsafe and unsound banking practices. But AFSL and ALL were quick to argue that the alleged unsafe and unsound practices committed by AFSL and ALL were not defined anywhere in BFSA.

BOZ submitted that the wording of banking and Financial Services Act 1994 made it clear that parliament left it to BoZ to determine and establish facts that may compel BoZ to take its supervisory actions against any bank or financial institution, and that the determination of what action was necessary to enable it carryout its functions under the BFSA was a matter that parliament entrusted BoZ to resolve.

Therefore, in order to promote the regulator's consistent and well-meaning enforcement of the law, there is need to have some definition or interpretation of this concept of unsafe and unsound banking practices. Although no statutory definition of 'unsafe and unsound practice' can be cited readily in any jurisdiction, that argument alone does not defeat the fact that there should be a provision of interpretation of 'unsafe and unsound banking practice'.¹⁴

The effect of this problem if not addressed leads to the Central Bank having too much discretion as the Act does not mention exactly what is unsafe and unsound banking practices,

¹³ 2003 /HP/359, (unreported)

¹⁴ Kenneth Mwenda, *Legal Aspects of Banking Regulation: Common Law Perspectives from Zambia*. (South Africa: Pretoria University Law Press, 2010) 150

such that whatever the Central Bank thinks or considers to be unsafe and unsound banking practices, it will impose the penalties for engaging in such, even when the alleged acts did not amount to unsafe and unsound banking practices.

The main objective of this paper is to critically look at the problems that arise as a result of the lack of definition of unsafe and unsound banking practices under the BFSA which is the primary law governing financial institutions that the BOZ uses to carry out its regulatory and supervisory function on financial institutions in Zambia.

However, more specifically, the paper will firstly, analyse the extent of the Central Bank's supervisory and regulatory jurisdiction of financial institutions in relation to the BFSA. See whether there is interference politically. Secondly, determine the consequences of the lack of definition of unsafe and unsound banking practices, in Zambia. Also compare how other jurisdictions deal with the concept of unsafe and unsound banking practices.

The research questions that are to be considered in this paper are; what is the extent of the Central Bank's supervisory or regulatory jurisdiction? Is there political influence? What are the criteria used to ascertain whether a financial institution is engaging in 'unsafe and unsound practices'? Is there a definition? What constitutes unsafe and unsound banking practices in other jurisdictions?

This study is important because it highlights the need to have a clearly defined meaning or interpretation of what constitutes unsafe and unsound banking practices, under the BFSA. A definition is important because it will lend more meaning to what the regulator can do and cannot do, that is the regulator is bound to follow what is laid down. Ultimately this will ensure that the regulator's discretionary power is checked, as no power is limitless, even discretionary power has a limit.

This research is a qualitative one. It relies on both desk and fieldwork and will be based on both primary and secondary information. With regard to desk research, that is secondary data in form of statutes, law reports or judicial decisions, textbooks, dissertations, literature written by eminent scholars, journals and credible internet sources.

This research paper is limited to a discussion of the Central Bank's power to place a financial institution under compulsory liquidation if the financial institution or bank in question is engaging in unsafe and unsound banking practices.

The first chapter gives an introduction to the research and in general terms give the synopsis of the research. It also deals with the basic aspects of the research. These include the background, statement of the problem, objectives of the study, research questions, and significance of the study, literature review, methodology, and the scope of the study.

The second chapter will consider the role of the Central Bank in Zambia that is the functions in performs. It will also look at the rationale for the Central bank's supervisory and regulatory functions. It will further consider how the Central Bank carries out its regulatory and supervisory functions. Furthermore the concept of 'Unsafe and unsound' banking practices will be determined.

Chapter three will critically look at the extent of the power of the Central Bank, that is the legal frame work of its power to supervise and regulate. Does the central Bank work independently or there is political interference especially in the way it handles cases of financial institutions conducting illegal business i.e. unsafe and unsound banking practices. The consequences of the lack of definition of unsafe and unsound banking practices in Zambia, the problems that have emerged as a result of this deficit in the banking legislation.

In the fourth chapter the paper considers what or how courts and Central Banks in other jurisdictions have interpreted or defined what amounts to unsafe and unsound banking

practices and also how this concept is dealt with. These jurisdictions include; the United Kingdom, the United States of America, and Malawi.

Chapter five will be the final chapter and it will be the conclusion of this paper. It will give recommendations and possible areas of reform in the functions and powers of the Bank of Zambia.

1.2 CONCLUSION

This chapter has given the introduction to the research and in general terms give the synopsis of the research. It also deals with the basic aspects of the research. These include the background, statement of the problem, objectives of the study, research questions, and significance of the study, literature review, methodology, and the scope of the study.

CHAPTER TWO

2.0 THE ROLE OF THE CENTRAL BANK IN ZAMBIA

2.1 INTRODUCTION

This chapter discusses the role of the Central Bank in Zambia. It looks at the rationale for the Central Bank's supervisory and regulatory role on financial institutions, both banking and non-banking. It further examines how the Central Bank carries out its regulatory and supervisory functions. Furthermore, the concept of 'unsafe and unsound banking practices' in Zambia will be examined. Finally a conclusion will be given.

2.2 THE ROLE OF THE CENTRAL BANK

The Bank of Zambia has origins in the 1938 formation of the Southern Rhodesia Currency Board, which was based in Harare, in present-day Zimbabwe. The Board's jurisdiction included Northern Rhodesia (present-day Zambia) and Nyasaland (present-day Malawi).¹ The sole function of the Board was the issuance of paper money within its jurisdiction, in contrast to multiple functions of central banks which includes currency issuance.²

In 1954 the Southern Rhodesia Currency Board was renamed the Currency Board of Rhodesia and Nyasaland, when its ownership changed from the Southern Rhodesia Government to the Federal Government of Rhodesia and Nyasaland. Views emerged about the need to replace the Currency Board because economists proposed that monetary policy could play a direct role in promoting economic growth through credit expansion. This proposition was as a result of the fact that Currency Boards did not accommodate

¹ Anonymous "The Background of the Bank of Zambia". www.boz.zm/ (accessed February 05, 2012)

² Anonymous "The Background of the Bank of Zambia". www.boz.zm/ (accessed February 05, 2012)

discretionary credit expansion through development in balance of payments.³ As the view that a currency board was inappropriate grew stronger, it was transformed into the Bank of Rhodesia and Nyasaland in 1956. It was equipped with the full powers of a conventional central bank such as conducting monetary policy, banker to government and commercial banks, manager of foreign exchange reserves and so forth.

The Bank of Rhodesia and Nyasaland was transformed into the Bank of Northern Rhodesia in 1963, after the breakup of the Federation of Rhodesia and Nyasaland. The Bank of Zambia was established to take over from the Bank of Northern Rhodesia on the 7th of August, 1964 although its Act was only passed in June, 1965.⁴ This is the current Bank of Zambia.

After its creation, and after the passage of the Bank of Zambia Act in 1965, the Bank grew and was successful down through the decades. The Bank is active in promoting financial inclusion policy and is a leading member of the Alliance for Financial Inclusion. It is also one of the original 17 regulatory institutions to make specific national commitments to financial inclusion under the Maya Declaration⁵ The Maya Declaration is a statement of common principles regarding the development of financial inclusion policy made by a group of developing nations' regulatory institutions during the 2011 Global Policy Forum held in Mexico. Financial inclusion or inclusive financing is the delivery of financial services at affordable costs to sections of disadvantaged and low income segments of society.⁶

The Central Bank in Zambia has by law general functions which include: the maintenance of price and financial system stability through the formulation and implementation of appropriate monetary and supervisory policies, issuing bank licences, supervising and regulating the activities of banks and financial institutions to promote safe , sound and

³ Anonymous "The Background of the Bank of Zambia". www.boz.zm/ (accessed February 05,2012)

⁴ Anonymous "The Back ground of the Bank of Zambia". www.boz.zm/ (accessed February 05,2012)

⁵ Anonymous "The Back ground of the Bank of Zambia". www.boz.zm/ (accessed February 05,2012)

⁶ Anonymous "The Back ground of the Bank of Zambia". www.boz.zm/ (accessed February 05,2012)

efficient payment mechanisms, issuing notes and coins, acting as banker and fiscal agent of the Government, supporting the efficient operation of the exchange system, acting as advisor to the Government on economic and monetary management, etc. The Central Bank also provides current accounts for commercial banks for settlement of commercial banks' transactions and it participates in Zambia Clearing House.⁷ However of importance to this research are the regulatory and supervisory functions of the Central Bank.

2.3 RATIONALE FOR THE CENTRAL BANK'S SUPERVISORY AND REGULATORY FUNCTIONS

While anyone may lend out money, only registered banks are allowed to take deposits from the general public. Should a bank run into financial difficulties and be unable to repay its depositors, the public will lose their money. As a result, in order to ensure that the deposits taken from the public are not used irresponsibly and to protect the public at large, banks have to be supervised.⁸ The author agrees with the fact that banks have to be supervised so that the public is protected. Additionally, supervision ensures that banks conduct their affairs properly for fear of supervisory action being taken against them.

The regulation and supervision of financial institutions is an important part of a strategy to develop a market based financial system in any country. A primary reason for regulating and supervising financial institutions is consumer protection for public depositors in financial institutions. Moral hazard issues arise because the interests of financial institutions vis-à-vis the interests of consumers per se are not necessarily compatible⁹. Individual depositors and investors may not be in a position to judge the soundness of a financial institution much less

⁷ Anonymous "An Overview of the National Payment System in Zambia" Paper presented at the Bank of Zambia Workshop. www.boz.zm/PaymentSystems/VisionAndStrategy2007_2011 (accessed November 15, 2011)

⁸ Anonymous "An Overview of the National Payment System in Zambia" Paper presented at the Bank of Zambia Workshop. www.boz.zm/PaymentSystems/VisionAndStrategy2007_2011 (accessed November 15, 2011)

⁹ David, Llewellyn. *Regulation and Supervision of Financial Institutions*. (London: The Institute of Bankers. 1986), 45.

to influence that institution's management be contagious and affect other banks regardless of their soundness, the protection of the whole. Thus, an impartial third party such as the state or one of its agencies is required to regulate and control the soundness of a country's financial institutions.¹⁰ Since bank failures and problems tend to banking and payment system becomes an additional objective of regulation and supervision.

Another reason for regulation and supervision is setting out rules for entry and exit of financial institutions, determining and limiting their businesses and products, and specifying criteria and standards for the sound and sustainable operation of the industry¹¹.

It can be stated from the above exposition of the rationale of the Central Bank's regulatory and supervisory function, that it is important to have financial institutions supervised for a sound financial system in the country.

2.4 HOW THE CENTRAL BANK REGULATE AND SUPERVISE

The Central Bank does its regulatory and supervisory functions on financial institutions pursuant to the BFSB and other laws that relate to financial matters in Zambia.

It is important to understand what regulation and supervision means in order to fully grasp the regulatory and supervisory function of the Central Bank. To regulate simply means, a sustained and focused control exercised by a public agency over the activities that are valued by a community.¹² The term regulation has no single definition, it can be used in a number of senses including; a specific set of commands, deliberate state influence, an activity that restricts behaviour and prevents the occurrence of certain undesirable activities.¹³ It also

¹⁰ Llewellyn, 47.

¹¹ Llewellyn, 48.

¹² R. Baldwin and M. Care, *Understanding Regulation: Theory, Strategy and Practice*.(Oxford: Oxford University Press 1999),50.

¹³ R. Baldwin and M. Care, 87.

refers to a set of binding rules issued by a private or public body.¹⁴ Generally, these can be defined as those rules that are applied by all regulators in the fulfilment of their functions; in the financial services area, they include such prudential rules as those influencing the conditions of access to the market (intended to prevent the emergence of entities with doubtful reputation or without financial capacity necessary for the operations they intend to implement) and those aimed at controlling the risks associated with financial activities, corporate governance and internal control systems, conduct-of-business rules, and methods of supervision.¹⁵

From the above definitions of the term regulation, it can be stated that these are commands, rules, laws and policies that have been put in place to ensure that the actors in the financial sector adhere to, so that there is order and transparency in the financial sector.

The Central Bank, as noted above, also carries out supervisory function and this is pursuant to the BFSA. Supervision is the process where the bank supervisors take various measures to ensure laws and regulations pertaining to the operations of the bank are complied with.¹⁶ Rosenberg¹⁷ defines supervision as the process of monitoring institutions, ensuring that they are conducting their business in a prudent manner. The BFSA lists the actions that BOZ can take in its supervisory jurisdiction. In particular section 81. (1) of the Act provides that;

Where;

- (a) a financial service provider refuses to comply with an order or directive of the Bank of Zambia under this Act;
- (b) a financial service provider refuses to permit an inspection to be made as provided by this Act or obstructed an inspection;
- (c) in the opinion of the Bank of Zambia, an inspection instituted under this Act shows-

¹⁴ Anonymous "International Compliance Association, *International Diploma in Compliance -Manual 1* (London: International Compliance Association 2003) 12

¹⁵ Anonymous "International Compliance Association, , *International Diploma in Compliance -Manual 1* (London: International Compliance Association 2003) 15

¹⁶ P. Mbewe, "Functions and operations of Bank Supervision" paper presented to ZICAS, 2003, 3.

¹⁷ M.R.Rosenberg, *The Microfinance Revolution Sustainable for the Poor* (Washington DC: WB Press, 2001), 112.

(i) that the financial service provider concerned conducts its business in breach of any written law or engages in a course of conduct that is unsafe or unsound;

(ii) that for any reason the financial service provider is unable, or is likely to become unable, to continue its operations in the ordinary course of its business;

(iii) the financial service provider's capital is less than the prescribed minimum; or (iv) the financial service provider is insolvent; the Bank of Zambia shall take supervisory action against the financial service provider.

Under Sub section(2) of section 81 reads; the Act states that the supervisory action the Bank of Zambia may take includes-(a) taking possession of the financial service provider;

(b) suspending the financial service provider's licence for a period not exceeding six months;

(c) restricting the financial service provider's licence; and

(d) revoking the financial service provider's licence.

(3) For the purposes of paragraph (c) of subsection (2), the Bank of Zambia may, by notice in writing served on a financial service provider, vary the conditions of its licence so as to impose any restriction.

(4) The Bank of Zambia shall, in writing, inform the Minister, regarding the state of affairs of a financial service provider in respect of which it intends to take action under this section.

It can therefore, be stated that the supervisory role of BOZ simply means that it supervises these financial institutions by ensuring that these institutions follow the regulations that have been put in place and if there is any breach of the obligations BOZ takes the action that is necessary. One would therefore, conclude that regulation refers to the rules that govern the behaviour of financial institutions, whereas supervision typically refers to the oversight that takes place to ensure that financial institutions comply with those rules.

2.5 THE CONCEPT OF UNSAFE AND UNSOUND BANKING PRACTICES

The concept of unsafe and unsound banking practices is one which touches upon the entire operations of a financial institution. An unsafe or unsound practice encompasses any action or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would result in abnormal risk of loss or

damage to an institution, its depositors, or its shareholders.¹⁸ However, whether a particular activity is an unsafe or unsound banking practice must be determined in light of all relevant facts to avoid situations where an alleged act does not fall under the ambit of ‘unsafe and unsound’ banking practices.

Under Zambia’s banking law, the concept of ‘unsafe and unsound practice’ is spelt out in section 77 of the BFSA. That section reads:

Where, in the opinion of the Bank of Zambia, a bank or financial institution is committing or pursuing or is about to commit or pursue on behalf of the bank or financial institution any act or course of conduct that is considered by the Bank of Zambia as unsafe or unsound practice, the Bank of Zambia may enter into one or more written agreements with the bank or financial institution or its board of directors to establish a programme of action to counteract the unsafe or unsound practice and to establish or maintain safe and sound practices in the conduct of the business of the bank or financial institution.

Section 77(1) does not provide a definition of ‘unsafe and unsound practice’, but merely refers to the term ‘unsafe and unsound practice’ and highlights the steps that the Bank of Zambia should take whenever, in its discretion, it determines that an act or course of conduct of a particular bank or financial institution constitutes unsafe and unsound practice’.¹⁹

From what has been stipulated, it is clear that the section does not provide a definition of the term unsafe and unsound practices, actually, a thorough search in the Act indicates that there is no definition or interpretation of the term.

Further Section 77(2) of the BFSA goes on to say:

Where the Bank of Zambia is unable to obtain an agreement under subsection (1) within a time, and in a form and content, satisfactory to the Bank of Zambia, or where the Bank of Zambia considers that the need for prompt action makes the negotiating of such an agreement

¹⁸ Kenneth Mwenda, *Legal Aspects of Banking Regulation: Common Law Perspectives from Zambia*. (South Africa: Pretoria University Law Press, 2010), 50

¹⁹ Kenneth Mwenda, 71.

impractical, the Bank of Zambia may direct the bank or financial institution or any director, manager or other person concerned in its management to do either or both of the following:

(a) cease or refrain from doing the act or pursuing the course of conduct;

(b) perform such acts as, in the opinion of the Bank of Zambia are necessary to rectify the situation.

(3) In particular, but without limiting the generality of subsection (2) above, the Bank of Zambia can;

(a) direct the culpable bank or financial institution to refrain from adopting or pursuing a particular course of action or to restrict the scope of its business in a particular way;

(b) impose any limitation on the bank's acceptance of deposits or the payment of interest thereon, the granting of credit, the making of investments or the payment of dividends;

(c) prohibit the bank or financial institution from soliciting deposits or the payment of the interest thereon either generally or from specified persons or classes or persons;

(d) prohibit the bank or financial institution from entering into any other transaction or class of transactions, or from commencing or continuing any activity which it is permitted under the Banking and Financial Services Act 1994 to carry on; or

(e) require the suspension or removal from office of any director, officer or other person.

(4) Directions given under this section shall be given by notice in writing to the financial service provider or person concerned and may in like manner be varied or revoked.

(5) A direction given under this section shall be effective immediately and shall remain in effect in accordance with its terms unless discontinued on appeal.

(6) Any person acting in contravention of the provisions of an agreement made or direction given under this section shall be guilty of an offence and shall be liable on conviction to a penalty not exceeding one hundred thousand penalty units or to imprisonment for a term not exceeding five years, or to both.

(7) An appeal lies under Chapter VIII against a decision of the Bank of Zambia to give a direction under this section.

(8) The Minister may, in consultation with the Bank of Zambia, prescribe Acts which constitute unsafe or unsound practice.

(9) A person shall not carry out any unsafe or unsound practice

(10) A person who carries out any unsafe or unsound practice commits an offence and is liable on conviction to a fine not exceeding one hundred thousand penalty units or imprisonment not exceeding three years or to both.

Section 77 (8) is very interesting in the sense that although the Minister of Finance can, in consultation with the Bank of Zambia, prescribe subsidiary legislation that identifies certain

acts or course of conducts of financial institutions as ‘unsafe or unsound practice’ no such legislation has ever been enacted.²⁰ The author agrees with this assertion as it is doubted if there has ever been a situation where the Minister actually consults BOZ and then prescribes subsidiary legislation that identifies certain acts or course of conducts of banks and non-banks as unsafe and unsound.

The uncertainty that comes with the absence of a statutory definition, or a regulatory norm, or some policy guidance interpreting ‘unsafe and unsound practice’ presents two choices:

(a) The Bank of Zambia can exercise discretionary powers and capture incidents that were not contemplated as ‘unsafe and unsound practices’; and

(b) some banks, financial institutions and investors will become risk averse and avoid pursuing product innovation in the banking sector, fearing that if they did so, they will be caught up by section 77 of the Banking and Financial Services Act 1994 as engaging in ‘unsafe and unsound practices’.²¹

It can therefore, be argued that the first situation can led to abuse of the discretionary power of BOZ in the sense that it can institute investigations against a particular financial institution for alleged conduct of ‘unsafe and unsound’ banking practices , even when in reality there has been no such conduct by the particular financial institution. The other situation can affect investor confidence in the banking sector.

The judiciary in Zambia does not offer much help either in the interpretation of the concept of ‘unsafe and unsound’ banking practices. As mentioned earlier in chapter one of this paper, in 2004 the High Court for Zambia had the interesting case of *Access Finance Services Limited*

²⁰ Kenneth Mwenda, 115

²¹ Kenneth Mwenda, 116

(AFSL) and Access Leasing Limited (ALL) v Bank of Zambia,²² that touched on the concept under discussion. It is sad to note that the court did not even attempt to address the issue of whether indeed the financial institution in question had engaged in the alleged conduct or acts. Although an order for certiorari was granted, on the grounds that BoZ misdirected itself in determining that AFSL and ALL were insolvent and that the two companies should be placed under compulsory liquidation, the court did not address fully the issue whether AFSL and ALL had engaged in unsafe and unsound practice to entitle BoZ to take punitive or corrective measures against the two companies.

It is highly doubted whether, there has been any case where the courts in Zambia actually had to deal with the issue of determining whether or not a financial institution has engaged in unsafe and unsound banking practices.

2.6 CONCLUSION

This chapter has considered the role of the Central Bank in Zambia that is the functions it performs. It has also looked at the rationale for the Central bank's supervisory and regulatory role on the financial institutions. It has further looked at how the Central Bank carries out its regulatory and supervisory functions. Furthermore, the concept of 'unsafe and unsound banking practices' in Zambia has been determined. Zambia does not have a statutory definition of 'unsafe and unsound practice' in its banking regulation law.

²² 2003/HP/359, (unreported).

CHAPTER THREE

3.0 THE EXTENT OF THE CENTRAL BANK'S POWER IN REGULATING AND SUPERVISING FINANCIAL INSTITUTIONS

3.1 INTRODUCTION

This chapter critically looks at the extent of the power of the Central Bank. It seeks to examine whether the Central Bank works independently in the supervision and regulation of financial institutions or whether there is political interference especially in the way it handles cases of financial institutions conducting illegal business, that is; unsafe and unsound banking practices. It also looks at how the courts in Zambia have dealt with the issue of 'unsafe and unsound banking practices'. Further, the consequences of the lack of definition of unsafe and unsound banking practices in Zambia, the problems that have emerged or are likely to emerge as a result of this deficit in the legislation will also be examined. A conclusion will then be given.

3.2 EXTENT OF CENTRAL BANK'S SUPERVISORY AND REGULATORY POWER.

The Central Bank is vested with power to supervise and regulate financial institutions in Zambia through a number of laws, for instance, the BFSA. The Act outlines how the Central Bank should carry out these functions. It defines the scope within which this power can be exercised. While the Act outlines the supervisory actions that BOZ may take it however, leaves gaps as far as the issue of 'unsafe and unsound banking practices' is concerned. The Act has left it to the discretion of BOZ to determine situations which constitute unsafe and unsound banking practices. This means that in this respect, the law is uncertain.

3.3 THE INTERPRETATION OF UNSAFE AND UNSOUND BANKING PRACTICES BY THE COURT.

The Central Bank has wide discretion in particular when dealing with the issue of unsafe and unsound banking practice because the Act leaves it to the opinion of the Bank to determine what constitutes such practices. It is the duty of the court to give an interpretation of the law. However, there is no judicial instruction on what amounts to unsafe and unsound banking practices.¹

The courts in this regard have not been very helpful, when it comes to dealing with the issue of unsafe and unsound banking practices. As stated in the previous chapters, the one time that the court was faced with a case that touched on the subject of unsafe and unsound banking practices, the court simply failed to address the issue electing to deal with other issues in that case.

3.4 POLITICAL INTERFERENCE IN THE REGULATORY AND SUPERVISORY FUNCTIONS OF THE CENTRAL BANK

The extent of the power of the Central Bank is not clearly defined with respect to its regulatory and supervisory functions of financial institutions, especially when dealing with the issue of unsafe and unsound practices. As a result of this lack of parameter, it is easy for the government to interfere in the Central Bank's affairs. It is very important that financial supervisory agencies are not subject to political interference. This independence is essential for consumer and industry credibility, as political authorities may wish to influence a regulatory agency for non-regulatory purposes for instance, favouring certain types of lending

¹ Kenneth Mwenda, *Legal Aspects of Banking Regulation: Common Law Perspectives from Zambia*. (South Africa: Pretoria University Law Press, 2010) 128.

and for short-term political advantage.² The author argues that, this does not mean that the Central Bank should not be accountable in ensuring that it acts in accordance with acceptable standards.

Therefore, there is need for a balance to be struck between the legitimate demands for regulatory agencies to be accountable, and the need for them also to be independent of political influence.³

The author asserts that the Central Bank has its own legal frame work on how it carries out its functions, it still lacks independence. This is because of the fact that the Government has a say in the way the Central Bank carries out it functions, especially supervisory and regulatory functions. In developing countries, Zambia included, one of the common experiences has been heavy politicisation of the Central Bank⁴ which has led to negative consequence on the independent supervision of financial institutions.

Political interference in Zambia can be traced from the time of the one party state through to the multiparty era. During the one party state, the ability of the Central Bank to effectively supervise the banking sector was constrained by the political philosophy of the socialist Government of the time. The regulation of financial institutions was done by the Ministry of Finance and the Central Bank was only mainly concerned with the responsibility of ensuring the compliance of financial institutions with the control relating to foreign exchange and so forth. Instances of this can be seen in the case of Meridian Bank, where problems arose with its parent bank (international Meridian Bank) and BOZ recommended its closure as it believed that continued support to the bank would not help Zambia's foreign exchange crisis.

² James R. Barth Gerard Caprio, Jr Ross Levine, *Bank Regulation and Supervision: What Works Best?* (National Bureau of Economic Research Massachusetts avenue Cambridge, 2002). 33.

³ David T Llewellyn, "Institutional Structure of Financial Regulation And Supervision: the basic issues. Paper presented at a World Bank seminar Aligning Supervisory Structures with Country Needs" (Washington DC, 6th and 7th June, 2006, (accessed, January 20, 2012).

⁴ I, Lestra, "*Central Banking and Regulation*", (London: Financial Market group, 1996), 27

However, the Government rejected the recommendation to close down Meridian Bank without really giving a proper reason. This is a clear case of interference by the Government with the affairs of the Central Bank. BOZ was in a better position to know whether or not it was sound to let Meridian Bank continue operating.

Similarly, during the multiparty governance, there is still political interference with the affairs of the Central Bank, this is evidenced through cases like, *Finsbury Investments v Bank of Zambia and the Attorney General*⁵, where due to political influence, BOZ in exercise of its supervisory authority purportedly conducted an inspection of Finance Bank of Zambia (FBZ). It came up with a report with a lot of allegations; one of which was that FBZ and certain of its shareholders had violated several pertinent provisions of the BFSA and other regulations in a manner that constituted unsafe and unsound banking practices. Later a decision was made by BOZ to take over FBZ and the shareholders' interests in the bank were to be sold to the Government without giving any compensation. During the trial, issues that arose included the allegation that BOZ wanted to destroy FBZ as per instruction from the Government and also that the major shareholders and that the Chairman of FBZ, was not in good terms with the Government. However, the end result was that FBZ was taken over by BOZ and sold. Interesting to note is that, when the Government changed following the elections of September 2011, this sale of FBZ was reversed on the basis that, it was not legally done.

The interference of the Government in the above case is a clear indication of political interference with the way BOZ functions. In the first place, why BOZ should sanction the sale of FBZ and later have the sale reversed by Government on the ground that the sale was fraudulent. Thus, the issued that needs to be dealt with is whether, did BOZ acted within its powers in taking possession and later selling FBZ or was it just some political agenda of the Government of the day? On one hand, if BOZ acted outside its power in taking possession

⁵ 2010/ HP/353 (unreported)

of FBZ and selling it, then it is right to have the sale reversed for lack of legality. On the other hand, if BOZ acted due to political pressure or influence in taking possession, then to have the sale reversed by the current Government is a clear indication of political interference.

3.5 THE PROBLEMS ARISING FROM THE LACK OF DEFINATION OF UNSAFE AND UNSOUND BANKING PRACTICES.

The Central Bank's discretion is very wide in the sense that the Act has left it to the Central Bank's opinion to determine what constitutes unsafe and unsound practices, as the Act itself does not provide an interpretation of the term. As a result, there are a number of problems that have or are likely to arise from this.

3.5.1 BANK CLOSURES

One of the problems that have been caused as a result of the lack of definition of what constitutes unsafe and unsound practices is that of bank closures. Banks have been closed or placed under compulsory liquidation for conducting in practices alleged to constitute unsafe and unsound banking practices. There are many competing theories explaining the causes of bank failure. One theory attributes the failure to Government intervention while another says it is due to some Government policies instability. Kenneth Mwenda notes that, the other causes of bank closure include; legislation, deposit insurance, lack of skills; mismanagement and lack of regulation or regulatory legislation cause bank failures.⁶ However, of importance to this paper is the lack of well-defined regulatory and supervisory legislation.

⁶ Kenneth Mwenda. *Banking and Microfinance Regulation and Supervision: Lesson from Zambia*. (USA: Brown Walker Press, 2002), 111.

From what has been advanced by Kenneth Mwenda, it can be rightly argued that, if there is inadequacy in regulatory and supervisory legislation, it may lead to closures of bank as there will be inadequate forms of control.

Since the many bank closures of the mid-to late-1990s following stiff competition and the tightening of regulation and oversight through the promulgation of the BFSB in 1994, Zambia has not experienced any serious banking closures.⁷ However, the author, is of the view that, due to the fact that the laws relating to unsafe and unsound practices in Zambia are not very precise in defining or interpreting the concept, the problem of bank closures is far from being over.

3.5.2 UNCERTAINTY IN THE LAW

This is one of the problems that arise as a result of having no proper definition of unsafe and unsound banking activities also entails that the law become uncertain. The law is not clear on this subject matter.

The author asserts that, there is no disagreement on the fact that this could actually limit the power of BOZ in its supervisory jurisdiction, in the sense that unsafe and unsound banking practices will only be limited to those situations that are mentioned in the Act. There is still need for the Act to ensure that there are some guidelines that can assist BOZ in its determination of whether indeed a financial institutions is conducting in illegal activities.

3.5.3 LACK OF CONFIDENCE IN FINANCIAL INSTITUTIONS

Another problem that is likely to arise as a result of this lack of definition of unsafe and unsound banking practices is that, many people including investors will have no confidence in financial institutions in Zambia, which will ultimately lead to slow development in the

⁷ Denny H Kalyalya, "Financial access and sustainability of financial services in Zambia", paper presented by the deputy governor – operations, bank of Zambia, www.boz.zm (accessed 12 January, 2012).

country. It is a well-known fact that investment brings about development in any economy, therefore, there is need to ensure that there is a good investment climate in Zambia so as to attract investors. The quality of the investment climate is linked to poverty reduction by the impact of better investment climates on private sector activity, and thus on economic growth and employment.⁸ Therefore, if investors are discouraged or have no confidence in the financial sector in Zambia, then Zambia will suffer as the much needed development will not be possible.

3.5.4 LOSS OF CONFIDENCE IN THE CENTRAL BANK

Those wishing or planning to invest in the financial sector in the country are also put off because of the way BOZ has handled cases where there is alleged illegal activities. As mentioned earlier, a lot of banks were closed due to the fact that, they had engaged in illegal banking practices, these banks include; ⁹ Credit Africa Bank, was placed in receivership in 1997 because of fraudulent transactions discovered during bank inspection, Prudence Bank, also closed down because BOZ said that there was inexperienced management.¹⁰

The author is of the view that when one looks at the failure of banks in Zambia, then one wonders whether, the problem is with those banks or it is with the institution that is responsible for the regulation and supervision of these financial institutions. Hence, if the problem is with the Central Bank, there is fear on part of an investor who wants to invest in the financial sector, because the Central Bank does not carry out its functions in a proper manner.

⁸ Kris Hallberg, "An Evaluation of World Bank Investment Climate Activities: In third World Countries". Cambridge, 2000: 23, (accessed January 15, 2012).

⁹ Kenneth Mwenda, *Banking and Microfinance Regulation and Supervision: Lesson from Zambia*. (USA: Brown Walker Press, 2002),156

¹⁰ Kenneth Mwenda, 117

3.5.5 THE CENTRAL BANK HAVING TOO MUCH DISCRETION

The fact that the Act does not stipulate what exactly amounts to unsafe and unsound banking practices, this leads to BOZ having too much discretion, when it is dealing with such issues. Every power needs to be checked in order to curtail its abuse as absolute power corrupts. The author does not disagree with the view that for BOZ to carry out its functions properly it should be given some kind of discretion, but the issue is that this discretion must still be bound by certain parameters so as to prevent its abuse. The power enjoyed by BOZ needs to be checked, especially when dealing with the interpretation of unsafe and unsound practices. The Act has to address the lacuna it has in this regard.

3.5.6 FINANCIAL INSTITUTIONS STILL ENGAGE IN ILLEGAL ACTIVITIES

Many financial institutions still engage in unsafe and unsound banking practices because there is no clear cut way of knowing that these practices are either unsound or unsafe, as there is no definition in this regard.

Llewellyn¹¹ notes the following as reasons why financial institutions may still engage in illegal activities; firstly, too many stringent rules could cause banks to disregard the measures as they may be seen by the banking sector as superfluous. Secondly, a rigid system of rules could inhibit banks from selecting the most efficient means of achieving regulatory goals set for them and may serve as a disincentive for improvement. It can therefore, be argued that, rules set to regulate financial institutions should not too stringent and rigid as these would cause banks to disregard them.

It can be suggested, that since financial institutions have observed how the Central Bank's failure to fully deal with the issue of unsafe and unsound banking practices. Financial institutions may take advantage of this situation especially where they have some connection

¹¹ David. T. Llewellyn, 65.

with the government of the day; they have nothing to stop them from engaging in illegal banking activities because they have the backing of the government.

3.6 CONCLUSION

The chapter has critically looked at the extent of the power of the Central Bank. It has shown that indeed there is no independence as regards the functioning of the Central Bank in Zambia; there is political interference at its largest. This is seen in the way it carries out its supervisory and regulatory jurisdiction. The courts have not been very helpful in defining the extent of the Central Bank's regulatory and supervisory power. The wide discretion that is enjoyed by the Central Bank in particular when dealing with the issue of unsafe and unsound banking practices, has and is likely to cause a number of problems. Some of which include, lack of confidence in both the Central Bank and the financial institutions.

CHAPTER FOUR

4.0 UNSAFE AND UNSOUND BANKING PRACTICES IN OTHER JURISDICTIONS

4.1 INTRODUCTION

The preceding chapter attempted to discuss the extent of the Central Bank's power in its regulatory and supervisory functions. The present chapter, however, seeks to highlight the status of the concept of unsafe and unsound banking practices in other jurisdictions and see how the Central Banks and courts have interpreted or defined what amounts to unsafe and unsound banking practices, in these jurisdictions. These jurisdictions include; the United Kingdom, the United States of America and Malawi.

4.2 THE UNITED KINGDOM (UK)

The Bank of England is the Central Bank of the United Kingdom. It is the model on which most modern Central Banks have been based around the world. Established in 1694, it is the second oldest central bank in the world (the oldest being the Bank of Sweden, established in 1668). It was established to act as the English Government's banker, and to this day it still acts as the banker for Government.¹

The Bank of England performs all the functions of a Central Bank. The most important of these is maintaining price stability and supporting the economic policies of the British Government, thus promoting economic growth.² Financial stability is a central goal of financial regulation of the Bank of England. The responsibility for financial stability in the

Anonymous "Bank of England" <http://www.bankofengland.co.uk/publications/annualreport> (accessed, April 06, 2012)

² Anonymous "The Bank's core purposes". Annual Report 2011. Bank of England. www.bankofengland.co.uk/.../annualreport/2011/2011full.pdf 23, (accessed, December 06, 2012)

UK is shared by HM Treasury, the Bank of England, and the Financial Services Authority (FSA), which together constitute the “tripartite authorities”.³

The Bank of England used to be responsible for the regulation and supervision of the banking and insurance industries, although this responsibility was transferred to the FSA in June 1998. After the financial crises in 2008 new banking legislation transferred the responsibility for regulation and supervision of the banking and insurance industries back to the Bank of England.

In 2011 the interim Financial Policy Committee (FPC) was created to spearhead the Bank's new mandate on financial stability. The FPC is responsible for macro prudential regulation of all UK banks and insurance companies.

4.2.1 STATUS OF REGULATORY AND SUPERVISORY FRAMEWORK OF FINANCIAL INSTITUTIONS IN THE UK

Under the UK Financial Services and Markets Act 2000 (FSMA), it is the financial regulator's role to represent the public's interest in seeing that banks and financial firms are regulated efficiently to enhance the safety and soundness of the banking system and thereby increase economic growth. UK banking regulation, as implemented by the FSA, contains prudential supervisory and regulatory standards to enhance the corporate governance of UK banks and financial institutions. These standards seek to address the principal-agent problem through; firstly, enhanced monitoring; secondly, improved disclosure and accounting practices; thirdly, better enforcement of corporate governance rules and the corporate governance framework; and fourthly, strengthening of institutions through market discipline.

³ Anonymous “The Bank's core purposes” www.bankofengland.co.uk/.../annualreport/2011/2011full.pdf 23, (accessed, December 06, 2012), 25

They also require banks to establish internal compliance programs to monitor other types of risk arising from the growing problem of financial crime.⁴

In the UK, the financial regulatory framework under the FSMA⁵ requires banks and other authorised financial firms to establish internal systems of control, compliance, and reporting for senior management and other key personnel. Under FSMA, the FSA has the power to review and sanction banks and financial firms regarding the types of internal control and compliance systems they adopt.⁶

These systems must be based on recognised principles and standards of good governance in the financial sector. These regulatory standards place responsibility on the senior management of firms to establish and to maintain proper systems and controls, to oversee effectively the different aspects of the business, and to show that they have done so.⁷

The FSA will take disciplinary action if an approved person, director, senior manager or key personnel deliberately violates regulatory standards or her behaviour falls below a standard that the FSA could reasonably expect to be observed.⁸

4.2.2 CONCEPT OF UNSAFE AND UNSOUND BANKING PRACTICES IN UK.

The phrase 'unsafe and unsound banking practices' in the UK is termed differently. The FSMA provides the statutory framework for the new UK market abuse regime. The FSMA market abuse regime provides new powers to FSA to sanction anyone who engages in "market abuse," that is misuse of information, misleading practices, and market

⁴ Anonymous "The Bank's core purpose" <http://www.bankofengland.co.uk/publications/annualreport/2012/04/06> (accessed April 06,2012)

⁵ Anonymous "The Bank's core purposes" <http://www.bankofengland.co.uk/publications/annualreport/2012/04/06> (accessed April 06,2012) <http://www.bankofengland.co.uk/publications/annualreport/2012/04/06> (accessed April 06,2012)

⁶ Anonymous "The Bank's core purposes" <http://www.bankofengland.co.uk/publications/annualreport/2012/04/06> (accessed April 06,2012)

⁷ Anonymous <http://www.bankofengland.co.uk/publications/annualreport/2012/04/06> (accessed April 06,2012)

⁸ Anonymous <http://www.bankofengland.co.uk/publications/annualreport/2012/04/06> (accessed April 06,2012)

manipulation, relating to investments traded on prescribed UK markets. It also applies to those who require or encourage others to engage in conduct that would amount to market abuse. FSMA's stated objective is to fill the "regulatory gap" by giving the FSA substantial powers to punish unregulated market participants whose market conduct falls below acceptable standards, but does not rise to the level of a criminal offence.⁹

In summation, the UK recognises the concept of unsafe and unsound banking practices. It has laws that deal with the issue in this regard. Under the FSMA, conducts that amount to or constitute market abuses are listed. The Act further, stipulates the actions that the regulatory or supervisory authority can take against financial institutions that engage in market abuses.

From the foregoing, it can be stated that, what conduct is considered market abuse is expressly stated, unlike the Zambian situation, where the BFSB does not provide an interpretation of what constitute unsafe and unsound banking practices.

4.3 UNITED STATES OF AMERICA (USA)

The Federal Reserve is the Central Bank of the United States of America. It was created by the United State Congress in 1913. Before that, the USA lacked any formal organization for studying and implementing monetary policy. Consequently markets were often unstable and the public had very little faith in the banking system. The Federal Reserve is an independent entity, but is subject to oversight from Congress. Basically, this means that decisions do not have to be ratified by the President or anyone else in the Government, but Congress

⁹ K. Alexander, Insider dealing and Market Abuse: The Financial Services and Markets Act 2000, working paper abstracted at <http://ideas.repec.org/p/cbr/cbrwps/wp222.html> (accessed March 31, 2012).

periodically reviews the Federal Reserve's activities.¹⁰ The Federal Reserve is headed by a government agency in Washington known as the Board of Governors of the Federal Reserve.

4.3.1 STATUS OF REGULATORY AND SUPERVISORY FRAMEWORK OF FINANCIAL INSTITUTIONS IN THE USA

The Federal Deposit Insurance Corporation (FDIC) was established by statute during the Great Depression in 1931 to provide deposit insurance to the depositors of failed US banking institutions. The FDIC is charged with the difficult task of administering the deposit insurance fund. Its funding depends on risk premium payments (and the interest those payments earn) made into the fund by covered depository institutions. During its first sixty years, it assessed the insured institutions at the same rate for deposit-insurance coverage. Although the FDIC was crucial for restoring depositor confidence in the US banking system following the 1940s and undoubtedly played an important key role in the recapitalisation of US banks.¹¹

The Banking Supervision and Regulation (BS&R) Division of the Federal Reserve Bank of San Francisco supervises and regulates financial holding companies (FHCs), bank holding companies (BHCs), savings and loan holding companies (SLHCs), and state-chartered member banks (SMBs) in the Twelfth Federal Reserve District, which includes Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington. BS&R also supervises all overseas and international operations owned by District banks, BHCs, FHCs, and SLHCs as well as U.S. branches, agencies, and nonbank operations of foreign banks located in the District. The Federal Reserve works with other federal and state authorities to promote safety and soundness in the operation of the financial industry and fair and

¹⁰ Kenneth Mwenda, *Legal Aspects of Banking Regulation: Common Law Perspectives from Zambia* (Pretoria University Law Press 2010), 180.

¹¹ Kenneth Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator*. (Washington DC: Cato Institute, 2006), 145

equitable treatment of consumers in their financial transactions. This is done through processing applications and through on-site examinations, off-site monitoring, and enforcement actions, when warranted.

There are twelve regional Federal Reserve Banks located in major cities around the country that operate under the supervision of the Board of Governors. Reserve Banks act as the operating arm of the Central Bank and do most of the work of the Federal Reserve. The banks generate their own income from four main sources: services provided to banks includes; interest earned on government securities acquired while carrying out the work of the Federal Reserve, income from foreign currency held, interest on loans to depository institutions, the income gathered from these activities is used to finance day to day operations, including information gathering and economic research. Any excess income is funnelled back into the treasury.¹²

4.3.2 THE CONCEPT OF 'UNSAFE AND UNSOUND PRACTICE' IN THE UNITED STATES OF AMERICA

In the United States of America, FDIC argues that the term 'unsafe and unsound practices' is a generic term, like 'negligence' or 'probable cause' having a central meaning that must be applied to constantly changing factual circumstances.¹³ An unsafe or unsound practice, FDIC argues, is any action, or lack of action, that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk

¹² Kenneth Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator*. Washington DC: Cato Institute, 2006), 145

¹³ The US Federal Deposit Insurance Corporation 'FDIC enforcement decisions and orders: Unsafe or unsound banking practice - Statutory standard' <http://www.fdic.gov/bank/individual/enforcement/5030.html> (accessed, April, 07, 2012)

or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.¹⁴

Section 8(b) of the US Federal Deposit Insurance Act (FDIA)¹⁵ refers to the term 'unsafe or unsound banking practices'. However, the statute does not define the phrase or specify what particular acts and conduct constitute such practices. As FDIC notes in its initial brief,¹⁶ the legislative history of the Financial Institutions Supervisory and Insurance Act (FISIA) of 1966 (which amended section 8 by adding, among other things, subsection (b)) provides some clarity as to what constitute unsafe or unsound banking practices.¹⁷ The FISIA stated that the term 'unsafe or unsound practices' is a generic term, like 'negligence' or 'probable cause', having a central meaning which must be applied to constantly changing factual circumstances.¹⁸

In the USA, the courts have adopted the same definition term 'unsafe or unsound' practices for cases falling under section 8(b) of FDIA.¹⁹ In doing so, the courts have tended to refer to the expertise of the bank regulatory agencies in interpreting or defining what constitutes an 'unsafe or unsound' practice, limiting their review to a determination of whether the agency's action was arbitrary, capricious, or otherwise unsupported by substantial evidence in the record.²⁰ And directors of banks are held to a standard of ordinary care and prudence in the administration of bank affairs.²¹ The directors are entitled to delegate banking business to their duly authorised officers, but may be held liable for negligence if they fail to exercise

¹⁴ The US Federal Deposit Insurance Corporation 'FDIC enforcement decisions and orders: Unsafe or unsound banking practice - Statutory standard' standard' <http://www.fdic.gov/bank/individual/enforcement/5030.html> (accessed, April, 07, 2012)

¹⁵ The US Federal Deposit Insurance Corporation 'FDIC enforcement decisions and orders: Unsafe or unsound banking practice - Statutory standard'

¹⁶ The US Federal Deposit Insurance Corporation 'FDIC enforcement decisions and orders: Unsafe or unsound banking practice - Statutory standard'

¹⁷ Kenneth Mwenda, *Legal Aspects of Banking Regulation: Common Law Perspectives from Zambia*. (South Africa: Pretoria University Law Press 2010), 135

¹⁸ Kenneth Mwenda, 180

¹⁹ First Nat'l Bank of Eden v Department of the Treasury 568 F 2d, First Nat'l Bank of La Marque v Smith 610

²⁰ Nat'l Bank v Comptroller of the Currency 573 F2d 889 (1897)

²¹ Briggs v Spaulding 141 US 132 165-66 (1891)

reasonable supervision over the management.²² For example, where a bank's directors exercise less than ordinary care by permitting loan and liquidity problems to steadily deteriorate after those problems are brought to their attention by the regulator, then the directors can be held liable for allowing the bank to engage in 'unsafe and unsound practices'.

In *Lippitt v Ashley*,²³ the court held the directors of a bank liable for negligence in the failure of the bank due to the defalcations of its treasurer. The court stated that the directors had failed to exercise ordinary reasonable care in supervising the bank's officers, even though they had discharged their duty to select an operating officer, had diligently attended directors meetings, had met often informally to discuss the bank's business, had selected competent auditors and reviewed their work, and had made an inquiry of the dishonest officer as to the condition of the bank.

From the foregoing, it can be concluded that, the FDIA does not define the phrase or specify what particular acts and conduct constitute such practices, however, the term 'unsafe or unsound practices' is stated in the act to be a generic term, like 'negligence' or 'probable cause', having a central meaning which must be applied to constantly changing factual circumstances. The Zambian situation is that the BSFA merely mentions the term and does not lend any guidance on its meaning or how it can be interpreted.

From the American situation, it has been observed that the courts have adopted the same definition as that falling under section 8(b) of FDIA, but have gone a step further by referring to the expertise of the bank regulatory agencies in interpreting or defining what constitutes an 'unsafe or unsound' practice. However, the courts limit their review to a determination of whether the agency's action was arbitrary, capricious, or otherwise unsupported by

²² *Briggs v Spaulding* 141 US 132 165-66 (1891)

²³ *Briggs v Spaulding* 141 US 132 165-66 (1891)

substantial evidence in the record. The courts in Zambia do not determine whether BOZ's action is arbitrary, capricious or lacks substantial evidence.

4.4. MALAWI

The Central Bank of Malawi is the Reserve Bank of Malawi. It was established under an Act of Parliament in July 1964 and started its operations in June, 1965 in Blantyre. It replaced a branch of the Federal Bank of Rhodesia and Nyasaland founded to serve as a Central Bank of the Federation of Rhodesia and Nyasaland. The federation comprised Southern Rhodesia (now Zimbabwe), Northern Rhodesia (now Zambia) and Nyasaland (now Malawi).²⁴ It is responsible for ensuring monetary stability, maintaining a sound financial system and managing foreign exchange.²⁵ Its establishment is similar to that of Zambia as it also broke away from the Federation of Rhodesia and Nyasaland.

4.4.1 STATUS OF REGULATORY AND SUPERVISORY FRAMEWORK OF FINANCIAL INSTITUTIONS IN THE MALAWI

The Reserve Bank of Malawi is the regulatory and supervisory authority of all financial institutions licensed under the Banking Act, 1989. Although the ultimate authority to issue a banking license is vested in the Minister of Finance, the Reserve Bank handles and processes all applications from prospective investors wishing to establish a bank in Malawi and makes a recommendation to the Minister of Finance.²⁶

The supervisory and regulatory jurisdiction of the Central Bank Malawi is pursuant to a number of laws. These include; Banking Act²⁷, Reserve Bank of Malawi Act,²⁸ Bank

²⁴ Anonymous "Reserve Bank of Malawi" <http://www.rbm.mw> (accessed, April 13, 2012)

²⁵ Anonymous "Reserve Bank of Malawi" <http://www.rbm.mw> (accessed, April 13, 2012)

²⁶ Kenneth Mwenda, "The Malawi economy and its Banking System: RBM Annual report, 2000." Volume 2, 2002, 23.

²⁷ Chapter 45:01

²⁸ Chapter 44:02

Supervision Directives, New Bank License Application Forms, Guidelines on Mergers and Acquisitions, and Risk Management Guidelines.

4.4.2 THE CONCEPT OF UNSAFE AND UNSOUND BANKING PRACTICES IN MALAWI

The concept of unsafe and unsound banking practices under Malawi's Banking Act is found under section 31, which deals with situations where a bank or financial institution conducts business in an unlawful or unsound manner. The section provides:

- (1) If it is found upon inspection under section 22 that a bank or financial institution is conducting its business in an unlawful or unsound manner, or that its solvency or liquidity are endangered, the Reserve Bank, in addition to any other course of Bank action open to it under this Act or any other written law, may-
 - (a) require such bank or financial institution to take such measures as the Reserve Bank deems necessary to rectify the situation
 - (b) with the approval of the Minister, add conditions to the licence granted to the bank or financial institution;
 - (c) remove from office any of its executive officers.
 - (d) appoint a person who, in the opinion of the Reserve Bank, has the proper training and experience to advise the bank or financial institution concerned on the necessary remedial measures, and shall determine his remuneration to be paid by the institution concerned, and the advice of a person so appointed shall have the force and effect of a directive issued by the Reserve Bank.
- (2) Prior to taking any measures under subsection (1) (b), (c) and (d), the Reserve Bank shall-
 - (a) give the bank or financial institution notice in writing regarding the intended measure;
 - (b) give the institution concerned an opportunity to present its views;
 - (c) consult with the Minister.
- (3) The Minister may, on the recommendation of the Reserve Bank, revoke any licence issued under this Act.

Section 31 of the Banking Act of Malawi deals with situations where a financial institution conducts business in an unlawful or unsound manner. It lists the supervisory action that can be imposed on the financial institution under investigation. However, the Act does not define what constitutes unlawful and unsound practices.

Like the Zambian situation, section 31 of Malawi's Banking Act, creates two main difficulties, firstly, it is difficult to capture incidents that were not contemplated by the legislative draftsman or the bank regulator as there is no interpretation of the phrase 'unlawful and unsound'. Secondly, is that some banks, financial institutions and investors may become risk-averse and avoid pursuing product innovation in the banking sector, fearing that if they did so they might be caught by section 31 of the Banking Act 1989.²⁹

In summation, the Malawian situation is not very different from that of Zambia in the sense that, the Banking Act of Malawi brings out the concept of conducting business in an unlawful and unsound manner but it fails to provide an interpretation of the phrase.

4.5 CONCLUSION

This chapter has examined the concept of 'unsafe and unsound practice' in other jurisdictions in comparison to the situation in Zambia. It can be concluded that the United States of America deals with the concept of unsafe and unsound banking practices appropriately even in the absence of a proper definition of the concept. Malawi's treatment of the concept is no different from that of Zambia, it does not provide an interpretation of the concept. The United Kingdom's treatments of the concept presents no problems as the Act that makes mention of the concept also provide an interpretation of the concept of unsafe and unsound practices.

²⁹ Kenneth Mwenda, 125

CHAPTER FIVE

5.0 CONCLUSION AND RECOMMENDATIONS

5.1 GENERAL CONCLUSION

This dissertation has demonstrated that section 77 of the BFSA does not provide an interpretation of the phrase 'unsafe and unsound practices. The Act has left it to BOZ to determine what constitutes to unsafe and unsound practices. This has given BOZ very wide discretion and widening the extent of its power in its determination of what amounts to unsafe and unsound banking practices.

The role of the Central Bank in Zambia has been examined in chapter two. It has looked at the rationale for the Central Bank's supervisory and regulatory role on financial institutions, both banking and non-banking. It has further examined how the Central Bank carries out its regulatory and supervisory functions. In chapter three the research has concluded that the extent of BOZ's power when carrying out its regulatory and supervisory functions, in particular when dealing with the issue of unsafe and unsound practices is almost limitless because of the wide discretion that the Act has given it.

This research further concludes that because of having no parameters within which to operate, the Central Bank's functions are subject to interference, in particular by the Government. This is evident in Government's involvement in the Finsbury case, where due to the Government's own agenda directives were given to BOZ to take possession of Finance Bank of Zambia.

In addition, courts in Zambia have not offered much help in providing judicial instruction with regards the issue of unsafe and unsound practices. The research, further concludes, that

as a result of the lack of definition of unsafe and unsound practices, a number of problems have arisen and these include; bank closures, loss of confidence in both the Central Bank as regulator and the in the financial institutions.

Chapter four has looked at the treatment of unsafe and unsound banking practices in other jurisdictions these include; the United Kingdom, the United States of America and Malawi. The research concludes that the treatment of the concept of unsafe and unsound banking practices in jurisdictions like Malawi is not different from the Zambian situation. The United Kingdom does not present many problems in its treatment of unsafe and unsound practices as there is an interpretation.

From the analysis in chapter four it can be concluded that the United States of America has a very appropriate way of dealing with the concept of unsafe and unsound banking practice. This is because, the courts have in addition to using the definition provided for in the FDIA, gone further and look at whether the action taken by the agency was arbitrary, capricious or unsupported by substantial evidence in the record.

5.2 RECOMMENDATIONS

Based on the conclusions reached above, this paper proposes the following recommendations for purposes of reform or as an attempt to improve upon the legal framework governing the treatment of the concept of unsafe and unsound banking practices in Zambia:

- Although what constitutes an ‘unsafe and unsound practice’ depends on the facts of each case, Parliament should, in the ordinary course of things, provide a statutory definition of ‘unsafe and unsound practice’ as all laws in Zambia that deal with the concept have failed to exactly provide a definition let alone an interpretation. Most of

these laws merely make mention of the concept without adequately defining it. Therefore it is the responsibility of Parliament to fill this gap in the laws as this is the function of the legislature to make sure that if there are any gaps in the law, they must be filled. Therefore, as a long term recommendation the BFSA should be amended so that it includes a definition or an interpretation of the term 'unsafe and unsound banking practices'.

- As a short term recommendation, BOZ should give a policy interpretation of the meaning of 'unsafe and unsound practice', given the absence of a statutory definition. It would be helpful if BOZ had in its policies or regulations promulgated some examples of 'unsafe and unsound practice'. Such a policy statement need not provide an exhaustive list of examples, but should allow for constructive ambiguity so that BOZ can, with time, be able to determine or include other incidents that are not listed as 'unsafe and unsound practice'. That way each time the issue of a financial institution engaging in unsafe and unsound practices arises, it will be easy for the regulator to deal with the situation. This can be done through legal opinions of the Bank Secretary, as head of the Legal Department, or through a policy statement, or through guidance notes, on what, according to the Central Bank, constitutes 'unsafe and unsound practice' As Mwenda asserts, 'while we recognise that it is not the primary responsibility of either the courts or the Central Bank to legislate a definition of 'unsafe and unsound practice', the Central Bank is not prohibited by any law from providing policy guidance on the meaning of the term 'unsafe and unsound practice'. Indeed, while it is Parliament that should have provided a definition, in the absence of such a definition, the Central Bank should give a policy statement interpreting the term 'unsafe and unsound practice'.

- The Central Bank can emulate how the concept of unsafe and unsound banking practices is dealt with in other jurisdictions. For instance, the United States of America's treatment of unsafe and unsound practices has proved to be an appropriate way of as it has attempted to define or give an interpretation of what constitutes unsafe and unsound banking practices. Additionally, the Bank of Zambia could codify in a manner like the Statement on Unsafe and Unsound Banking Practices issued by the State Banking Department, in the United States, which lists instances or situations that could be considered as unsafe and unsound banking practice.

- The Central Bank, should also find out why most financial institutions still engage in unsafe and unsound banking practices. One reason would be the way the regulator and supervisor carries out functions. Hence, BOZ should check its regulations and rules and also make sure it supervises these financial institutions accordingly, so that the financial institutions are well aware of the consequences that await them should they disregard the rules and regulations that they are expected to follow.

It is thus recommended that in as much as these recommendations have been given, they are by no means an end in itself. The Central Bank in order to carry out its regulatory and supervisory jurisdiction properly needs some form of discretion. However, too much discretion is bound to abuse, as can be seen from the way the Central Bank has dealt with the concept of unsafe and unsound banking practices.

There has been a lot of political interference, and one of the reasons has been because of the fact that there is not a statutory definition of the term unsafe and unsound banking practices,

hence the government can step in at any time and dictate that such a financial institution is conducting unsafe and unsound banking practices even when that is not the case.

It is hoped that the commendations and reforms, once implemented, will prevent the possible problems that are likely to arise as a result of the lack of definition of the term of 'unsafe and unsound banking practices' in Zambia.

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