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An Essay on the Ethical and Corporate Governance Issues in the 2003/4 Zimbabwean Banking Crisis

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Abstract

This paper reviews the ethical and corporate governance issues that characterized the 2003/4 Zimbabwean banking crisis. There are contrasting views on the legal and moral roots of the crisis, and consequently, different analysts have come up with different assessments of the morality and professional propriety of measures adopted by the Reserve Bank of Zimbabwe (RBZ), as bank regulator, in response to the developments in the banking industry. While there is an almost universal acknowledgement among analysts that corporate governance and ethical shortcomings contributed to the crisis, there appears to be no universal theory justifying the response of the regulator. A critical review of the events surrounding the crisis, with some benefit of hindsight, points to a form of collective responsibility among bankers, regulators, and politicians. This analysis draws on deontological and teleological ethical theories to assess the resolution of the myriad of ethical dilemmas that characterized the period before and during the crisis. The analysis also relies on legal and prudential guidelines on good governance in banking institutions, in particular the Banking Act (Chapter 24:20).

Keywords: Ethics; Deontology; Teleology; Banking crisis; Bank regulation

Introduction

A decade after Zimbabwe's worst banking crisis, the memories of 2003/2004 still resonate throughout the Zimbabwean banking industry. In late 2003, Dr. Gideon Gono was appointed the new RBZ governor, marking a new era in Zimbabwean bank regulation. Upon his appointment, Dr. Gono immediately got down to some serious business, literally reading the 'Riot Act' to allegedly errant bankers, whom he accused of lining their pockets with depositors' funds and violating legal and quasi-legal prudential guidelines on bank governance and management. The Governor directed all banks to unwind all their non-core positions in real estate, shares, bricks, motor vehicles etc., precipitating a widespread crash in all markets where banks had active participation. Concurrently, the RBZ hiked the overnight accommodation rate to 400%, making it prohibitive for banks to fund daily short positions [1]. A serious liquidity crisis ensued, leading to the failure of 13 indigenous banks in one year, and extreme chaos in the Zimbabwean banking industry.

Owner-managers of affected indigenous banks were legally specified, and the majority had to flee the country to avoid prosecution under new laws designed to punish them for their alleged misdeeds. The aftermath of the 2003/4 banking crisis has seen heightened awareness of corporate governance and ethical standards for the banking industry, with new regulations, amendments to banking laws, and the issue of a series of guidelines to banks from the RBZ. There is however still a cloud of mystery hanging over the characterization of the 2003/4 banking crisis as an ethical and governance failure rather than a failure of regulation, and a natural consequence of macroeconomic and micro-structural developments [2].

This paper contributes to the limited literature on the Zimbabwean banking crisis of 2003/4, and lays a foundation for further debate on what constitutes moral conduct by regulators during periods of financial or banking crisis. In particular, the paper reviews the myriad of ethical dilemmas faced by bankers and bank regulators, especially in periods of economic strain. The analysis of these ethical dilemmas from deontological and teleological perspectives highlights controversial moral aspects of bank management and bank regulation.

The rest of the paper is organized as follows: Section 2 gives a brief review of the literature on ethics and corporate governance; Section 3 provides a critical analysis of the ethical and corporate governance issues in the Zimbabwean banking crisis of 2003/4; and Section 4 concludes the paper.

Literature Review on Ethics and Corporate Governance

Definition of ethics

The subject of ethics has evolved over time as part of moral philosophy, an attempt by humanity to define rules of good and bad, right and wrong. Bonevac, as cited in Karaoglu [3], defines ethics as "…a set of rules that define right and wrong…"dealing with moral duty and obligation. De George,as cited in Karaoglu [3], on the other hand, defines ethics as "…a systematic attempt to make sense of our individual and social moral experience, in such a way as to determine the rules that ought to govern human conduct, the values worth pursuing, and the character traits deserving development in life." An interesting and more practical definition of ethics is given by High Court Judge Potter Stewart of the U.S.A as, "…knowing the difference between what you have the right to do and what you ought to do" (Augustine, 1999 as cited in [3]).

Business ethics is defined by Nash as cited in [3] as, "…the study

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of how personal moral norms apply to the activities and goals of commercial enterprise. It is not a separate moral standard, but the study of how the business context poses its own unique problems for the moral person who acts as an agent of this system." Ethics have developed as a natural response to the desire by humankind to attain a higher living by ensuring order in social interactions, engendering the welfare of individuals and society by fostering good and avoiding harm. Oftentimes, individuals are faced with conflicts of duty, a need to decide whose interests to promote and at whose expense. The presence of a difficult choice and the absence of a clear answer is an ethical dilemma. Ferrell and Fraedrich, as cited in Karaoglu [3], draw an important distinction between an ordinary decision and an ethical decision as follows:

"One difference between an ordinary decision and an ethical one lies in the point where the accepted rules no longer serve, and the decision maker is faced with the responsibility for weighting values and reaching a judgment in a situation which is not quite the same as any he or she has faced before."

The preceding statement demonstrates the dynamism of ethics and the importance of experience in shaping ethical decision making. Also, the definitions of ethics given above emphasize universality of moral duty and the submission of self-interest to the interests of humankind in general, as well as the development of individual qualities that promote the greater good of society. The field of ethics is however fraught with controversy regarding what constitute moral or immoral conduct, and in any case, whether the focus should be on actions or intentions of the moral agent, or the consequence of such actions.

Ethical theories

There are basically three key ethical theories, namely deontology, teleology, and virtue ethics.

Deontological theory: Deontological theory is based on duty that is independent of consequences. According to this theory, an action is right or wrong, not because of its consequences but because of its characteristics (De George, as cited in [3]). The most influential voice in deontological theory is German philosopher Kant (1724-1804), whose work in "Foundations of the Metaphysics of Morals" (1785) and "Critique of Practical Reason" (1788) still resonates through modern moral systems (De George, as cited in [3]). Kant developed a set of moral rules thus, consistency (moral actions should not contradict one another), universality (moral rules should be the same everywhere), and moral actions should be a priori (they should not be based on experience).

Villa [4] however identifies four principles based on Kant's ethical theory. The first principle is the categorical imperative: "Act only on that maxim through which you can at the same time will that it should become a universal law" (Kant as cited in [4]). The second principle is the Formula of Humanity: "Act in such a way to treat humanity, whether in your own person or in the person of any other, never simply as a means, but always at the same time as an end" (Kant as cited in [4]). The third principle, The Formula of Autonomy treats mankind as the lawmaker, making moral obligation unconditional. The forth principle is the concept of the Kingdom of Ends by which he meant:

A rational being belongs to the kingdom of ends as a member, when, although he makes its universal laws, he is also subject to these laws. He belongs to it as its head, when as a maker of the laws he is himself subject to the will of no other. The practical necessity of acting on this principle- that is, duty-is in no way based on feelings, impulses, and inclinations, but only on the relation of rational beings on one another, a relation in which the will of a rational being must always be making universal law, because otherwise he could not be conceived as an end in himself (Kant as cited in [4]).

Despite its absolute attractiveness, deontological theory is limited by the difficulty of balancing conflicting interests.

Teleological theory: Teleological theory of ethics, on the other hand, asserts that the goodness of an action depends on the consequences of the action. An important question in teleological ethics is the determination of whose good is to be promoted. This question gives rise to three different ethical positions. Ethical egoism claims that one should promote his own good; utilitarianism promotes the good of the greatest number of people; and a third position claims that we should promote the good of our family, nation or class (Frankena et al., as cited in [3]). The most influential teleological position is utilitarianism, which asserts that an action is good if it produces the greatest amount of good for the greatest amount of people affected by the good [3]. The important point, thus, is that all the people affected by the action must be taken into account (De George as cited in [3]). Utilitarianism appears to be the basis of welfare economics and guides most public policies. The heavy reliance of utilitarianism on "psychological satisfaction" however gives rise to problems for the moral agent, who is forced to evaluate the benefits and costs of every action on all affected parties before making a decision.

Ethics and corporate governance in banking

Villa [4] argues that a bank has a moral duty to abide by its contracts and to adhere to all prudential regulations. He further states that this moral duty means that the bank must maintain adequate controls to ensure the safety of funds under its management. Applying Kantian ethical theory, Villa [4] further submits that banks must always act honestly and transparently, since if dishonesty was taken as a universal maxim, customers would not trust banks and the banks would not trust each other. Ethical concerns in the banking industry relate to fiduciary responsibilities.

Legally, the relationship between a banker and a customer is fundamentally a debtor-creditor relationship per Foley vs. Hill, where money deposited with the bank is deemed to become the bank's own, to apply as it deems fit, provided that it can repay on demand. However, the evolution of banking and the advent of bank regulation have led to a clear recognition of a fiduciary duty of banks to their customers and to society. Banks occupy a position of social trust and therefore should act in cognizance of their moral duty to society. In making decisions, bankers therefore face an ethical dilemma in balancing the interests of shareholders and those of society at large. The rules of conduct are not always clear in all situations (as purported to be the case by Kantian ethics), and this has given rise to codes of ethics and prudential guidelines.

Corporate governance and ethics are inseparable as observed by Villa [4], since the governance of corporations relates to the setting up of decision making and control structures, that are meant to align the actions of agents to the interests of principals, both shareholders and society. Corporate governance therefore deals with attempts to prevent some ethical dilemmas, and where they cannot be prevented, to provide guidelines to agents on how such dilemmas should be resolved.

According to Section 18 of the Banking Act [5], the following corporate governance guidelines apply to banks operating in Zimbabwe:

1. Bank boards of directors must consist of at least five directors (sub-section 1)
2. Executive directors must not exceed two fifths of the board of directors (sub-section 2)
3. The chairman of the board shall not be an officer of the bank (sub-section 3)
4. The quorum of any board meeting shall be three fifths of the total board membership (sub-section 4)

Section 18(5) of the same Act also sets board responsibilities. Sections 19, 20, 40-44 also deal with corporate governance issues relating to appointment of directors and auditors as well as their duties and powers. Sections 32-35 of the Banking Act [5] also outline the restrictions on certain transactions of banking institutions, relating to dealings in own shares, payment of dividends, engaging in non-banking business, and lending to insiders and related parties. The sections of the law outlined above prohibit banks from engaging in non-banking activities without permission, explicitly indicating that banks are not allowed to hold shares in non-banking companies on their own account, except as authorized by the Registrar of banks.

Analysis of Ethical and Corporate Governance Issues Relating to the 2003/4 Banking Crisis

The roots of the ethical dilemmas associated with the 2003/4 banking crisis in Zimbabwe are captured in Table 1 below:

The above legal and moral duties represent the ingredients of the moral dilemmas that bankers and regulators around the world are constantly faced with. A look at the business environment in Zimbabwe prior to 2003 shows that high inflation rates resulted in negative real interest rates, making it difficult for banks to safeguard their income and net-worth within the confines of conventional and legitimate banking business. The most important ethical dilemma among bankers was therefore a decision whether to stick to the rules and sink or to break the rules and survive (or even flourish). From a Kantian perspective, the moral thing to do was to obey the law because it was the 'right' thing to do. However, utilitarian theory would suggest that the right thing to do was for bankers to act in the best interests of the greatest number. In this case, determining the greatest number, as well as evaluating the consequences of actions on all stakeholders was difficult. Bankers who engaged in non-core activities could argue that it was the only way to protect the value of the bank's assets against rising inflation, much to the benefit of shareholders and society at large.

Owner-managers who received massive loans from their banks could argue that there was no legitimate reason to make their actions immoral since they would repay their loans, as any other customer would do. However, this argument could be dismissed based on Kantian theory on the basis that it violated prudential guidelines on insider lending and also as a violation of the principle of humanity. The bankers whose insider loans were non-performing would also be deemed to be acting immorally under the principle of Kingdom Ends, since they set rules that required their borrowing customers to repay their loans, yet they did not consider themselves subject to the same rules.

While ethical egoism could be used to defend the actions of those bankers who were alleged to be lining their pockets with depositor funds or expanding their banks using deposits instead of shareholder funds, the Kantian principle of humanity deems such actions immoral. By engaging in such actions, bankers would be deemed as taking depositors as means to their own attainment of personal wealth, rather than as ends in themselves. Again, based on the Kantian principle of universality, if siphoning of deposits was to be made a universal maxim, then all bankers would siphon depositor funds, and no depositor would trust banks with their money.

The teleological argument is problematic in analyzing the ethical problems in the banking sector before the crisis because the consequences of bank activities on stakeholders were probabilistic in nature. Banks were still meeting withdrawal requests until the RBZ introduced strict measures overnight. What this means is that the bet taken by banks on non-core activities to protect asset values could have paid off after all, despite violation of rules. It is also difficult to establish whether there was a breach of moral duty by banks when they engaged in non-core activities, except to the extent that they violated provisions of the Banking Act. If such action would save the banks from collapse under inflation, then it would be teleologically moral, notwithstanding violation of rules.

Yet another claim by the RBZ is that banks were abusing accommodation facilities extended by the central bank to engage in speculative activities. On that note, an important quote from Adam Smith is helpful in explaining the actions of capitalists (entrepreneurs): "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest…" (Adam Smith, as cited in [4]). The RBZ creates the connotation that a moral duty existed compelling banks to extend benefits accrued to themselves to their customers. However, economic rent-seeking is at the heart of capitalism and entrepreneurship, and if businessmen were to be guided by philanthropy rather than profit in their decision-making, markets could hardly function in any coherent manner [6].

The RBZ also documents cosmetic accounting by bankers to hide losses, create artificial profits, and then pay dividends against them, and to create a false sense of financial soundness in the eyes of regulators. These actions are purely borne out of dishonesty by the bankers and they were immoral according to Kantian ethical theory [7].

The violation of corporate governance guidelines codified in the Banking Act also is an immoral action according to deontological ethical theory. However, owner-managers may argue that they violated the rules because the difficult economic environment required them to be involved in the running of their banks to ensure the banks survived. In any case, there is no consensus on whether the best practice advocated for in the Cadbury and King Reports are best for all situations. Separation of management and ownership may dampen the entrepreneurial spirit of indigenous people and therefore may be deemed to run against the social policy of empowerment. Thus, based on this argument, there would appear to be prima facie contradiction between the corporate governance guidelines of the RBZ and the social policy on indigenization and empowerment [8].

From a corporate governance perspective however, it is important to note that the dominance of bank boards of directors by owner-managers compromises board oversight and effectiveness. An important aspect of bank governance deals with risk management. The documented rampant insider lending, and the nonperforming nature of insider loans, point to a significant laxity of corporate governance structures within banks before the crisis. Rapid expansion of banks without a corresponding increase in capital (as was the case with Trust Bank) is another indication of lax risk controls at board level. Bank boards have the responsibility to ensure adequate risk management

On the part of bankers	On the part of the RBZ
➢ moral duty to safeguard deposits and ensure bank soundness	➢ legal duty to protect depositors
➢ contractual duty to repay depositors on demand	➢ legal and administrative duty to ensure compliance by banks with banking laws
➢ contractual duty to manage the banks profitably on behalf of shareholders	➢ moral duty to do good and prevent harm
➢ duty to self to safeguard their jobs	➢ moral duty to tell the truth
➢ legal duty to operate within the confines of the law	➢ legal duty to operate within the confines of the law

Source: Authors' own analysis

Table 1: Roots of ethical dilemmas in the Zimbabwean Banking Crisis-2003/4.

systems, and through board committees, to provide oversight on executive management [9].

Disclosure is also an important part of corporate governance. Banks are alleged to have been maintaining two sets of accounts, one for regulators, and the other for shareholders. This led to massive misrepresentation of pertinent information, compromising the interests of stakeholders. Internal and external audits of bank financial statements did not serve their purpose as the misrepresentation of financial information was not reported to authorities, which violated the fiduciary duty of auditors.

In response to the developments in the banking sector, the RBZ put in place the following measures:

1. The RBZ gave Corrective orders to banks to unwind their non-core business and restore liquidity
2. The RBZ directed banks to constitute proper boards and adhere to risk management and reporting guidelines
3. The RBZ removed owner-managers from their directorships to restore board independence and effectiveness
4. The RBZ placed banks under curatorship or liquidation
5. The RBZ prosecuted directors of banks for breach of their fiduciary duty
6. The RBZ issued new criteria for the appointment of bank directors
7. The RBZ issued corporate governance and risk management guidelines to banks
8. The RBZ strengthened its supervisory function by introducing risk-based supervision

In responding to the banking crisis, the RBZ was faced with a few ethical dilemmas. The RBZ's greatest ethical duty is owed to the public to ensure the stability of the banking system and the safety of deposits. Because of alleged regulatory forbearance in the past, the new RBZ governor may have been under pressure not to appear to be complicit to the ills of his predecessor. Therefore, the ethical dilemma that confronted him was whether he should crack the whip immediately at banks, disclose which banks are unsound, and watch the bank run on deposits; or to take a more subtle approach involving closed door directives to banks to put their houses in order or else. From a Kantian perspective, the moral thing to do for the RBZ was to tell the truth about what was happening to the banks and let the public aware. That is the public duty of the RBZ after all; stick to the rules, enforce them, and punish offenders accordingly. However, given the likely chaos associated with such actions, teleological theory would define right and wrong on the consequences of such actions. If the actions of the RBZ would only result in a run on deposits and the widespread failure of banks, then such actions inflicted more harm than good, and therefore were immoral.

The directives by the RBZ compelling banks to sell their illiquid assets overnight resulted in the crashing of the real estate and stock markets, affecting legitimate investors who had nothing to do with the malpractices in the banking sector. From a utilitarian perspective, such actions resulted in net social harm because it is difficult to tell who actually benefited from the closures of banks. The depositors the RBZ was meant to protect still could not access their money. It appears that the RBZ adhered to Kantian ethics, recognizing the need to enforce rules no matter what the consequences [10,11].

It is alleged that the RBZ governor had personal scores to settle with former colleagues now that he was at the helm of the apex bank. Dr. Gono spent most of his banking career with Commercial Bank of Zimbabwe and it is alleged that he had some outstanding issues to settle with his contemporaries, and he had all the tools at his disposal. This dimension adds a new twist to the ethical issues discussed above. If the allegations have any trace of truth, then the governor had a serious ethical dilemma too; should he settle scores with fellow indigenous bankers at the expense of the depositors? Teleological ethics say no to that, as the harm to the greater number outweighs the good to him. This would then beg the question; did he then value his personal quest for settling personal vendettas more than the public interest? The preceding shows that the ethical question regarding the RBZ response to the crisis is hard to resolve. Why would the lender of last resort hike accommodation rates to save ailing banks? If public interest was at the center of the response, then was it a juggle between short-term pain and long-term gain?

On the corporate governance front, the conduct of the RBZ during the crisis exposes its own shortcomings. The governor was both chairman and CEO at the RBZ, yet the Banking Act [5] requires the chairman to be non-executive. This is thus contrary to Kant's Kingdom of Ends principle, as the RBZ set corporate governance rules for banks that it did not observe as regulator. The RBZ also engaged in non-core activities in direct competition with banks, by extending concessionary facilities to companies, exactly what the banks had done before the crisis. The administration of curatorships was also heavily directed by the RBZ, meaning that the bank resolution exercise was a one-man band, contrary to best practice.

The measures adopted by the RBZ resulted in gradual return to normalcy in the banking industry, but only after severe suffering by stakeholders. It remains a question whether the severity of deficiencies in banks warranted a heavy-handed response from the regulator. It is clear however that the status of bank governance today is far better than in 2003 and that the approach to risk is relatively more diligent. Nonetheless, the recurrence of bank failures in Zimbabwe (e.g. Interfin and Renaissance) indicates that the measures were either inadequate, or the implementation was selective. Patterson Timba for example was both major shareholder and managing director of Renaissance Merchant Bank at the point of failure, yet that is prohibited under the RBZ guidelines.

The RBZ itself has indicated that curatorships are not supposed to be for a long time, as was the case under its Resolution Framework, an indirect acknowledgement that it could have done better. The risk management guidelines are quite commendable however, and many banks have since adopted Enterprise-wide Risk Management (ERM). Given the changed economic situation however, most of the ethical problems have been eliminated naturally due to limited opportunities for non-core activities in a multi-currency environment and the lack of financial capacity to do so.

Conclusion

Bankers have a fiduciary duty to society regarding the safeguarding of deposits and ensuring the soundness of their banks. However, they also have a duty to themselves and shareholders, to survive under competitive and challenging economic conditions. The ethical dilemmas that arose during the crisis partly explain (though not justifying) the actions of owner-managers of banks, and also the corporate governance shortcomings observed by the RBZ in most failed banks. The actions of the RBZ itself are also found to have been fraught with ethical dilemmas and it cannot be ignored that the regulator also had its own share of ethical and corporate governance shortcomings. The measures adopted by the regulator have however significantly improved the governance of banks and the awareness of banking risk, although the policy environment continues to threaten the survival of banks, again giving rise to new ethical dilemmas within the banking industry.

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