GENERAL REPORT

Absa Group Limited
Absa Bank Limited

FirstRand Bank Holdings Limited
FirstRand Bank Limited

Investec Limited
Investec Bank Limited

Nedcor Limited
Nedbank Limited

Standard Bank Group Limited
Standard Bank of South Africa Limited

General Report by Adv J F Myburgh SC in terms of the Banks Act, 94 of 1990.

Date: 30 April 2003

List of abbreviations

Banks Act	The Banks Act, no 94 of 1990
the regulations	Regulations relating to Banks published in Government Notice R112 on 08/11/2000
Companies Act	Companies Act, no 61 of 1973
King II	King Report on Corporate Governance for South Africa, March 2002
NACD Report on Board Evaluation	Report of the National Association of Corporate Directors (“NACD”) Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness
the banks	The banks subject to the review in terms of the Banks Act
NACD Report on Director Professionalism	Report of the NACD Blue Ribbon Commission on Director Professionalism
the Code	The Code of Corporate Practices and Conduct incorporated in King II
NYSE	New York Stock Exchange
SEC	Securities Exchange Commission
the Listing Standards Committee	The NYSE Corporate Accountability and Listing Standards Committee
the Listing Standards Report	The Report of the New York Stock Exchange Corporate Accountability and Listing Standards Committee
BRT Principles of Corporate Governance	A White Paper from The Business Roundtable, May 2002, on Principles of Corporate Governance
OCC	Office of the Comptroller of the Currency

The Director's Book	The Director's Book: The Role of the National Bank Director.
HKMA	Hong Kong Monetary Authority
the HKMA Manual	Supervisory Policy Manual on Corporate Governance of Locally Incorporated Authorised Institutions
Absa Group	Absa Group Limited, Absa Bank Limited and its subsidiaries
FirstRand Holdings	FirstRand Bank Holdings Limited
Nedcor	Nedcor Limited
Investec	Investec Limited
Standard Bank Group	Standard Bank Group Limited

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GENERAL REPORT

Section A:

The establishment of the review

1 In the first week of August 2002, the Registrar of Banks directed the five major banking groups (‘the groups”) in South Africa to seek an independent review of certain corporate governance aspects of their business. The groups were directed, in terms of the Banks Act, no 94 of 1990 (“the Banks Act”) to furnish the Office of the Registrar of Banks with a report by me. The groups were informed that I would be supported in my responsibilities by a team from the Bank Supervision Department (“BSD”) of the South African Reserve Bank (“SARB”), who would also form part of the review process in terms of the Banks Act. The team comprised the following persons: Adv Hermann Krull (AGM and Divisional Head: Other Banks: BSD); Adv Jabu Kuzwayo (AGM: Legal Section: BSD) and Ms Judy Teixeira (analyst: BSD). The five major banking groups, subject to the review, are:

- Absa Group Limited, Absa Bank Limited and its subsidiaries (“Absa Group”);

- FirstRand Bank Holdings Limited ("FirstRand Holdings");
- Nedcor Limited ("Nedcor");
- Investec Limited ("Investec");
- Standard Bank Group Ltd ("Standard Bank Group").

2 The Terms of Reference of the review are the following:

"1. Purpose of the review

The purpose of the review is to investigate compliance with corporate governance best practices as laid down, for example, in the Banks Act, the Regulations Relating to Banks ("the regulations") and the recommendations of the King Committee on Corporate Governance ("King II") of March 2002.

In particular, and without limiting the generality of the aforementioned statement, the purpose of the review is to establish to what extent an adequate and effective process of corporate governance within the controlling company, the bank, and its subsidiaries has been established and maintained, and to what extent the overall effectiveness of the process is monitored by the board of directors.

2. Scope of the review

Although not limited to, the scope will be to establish, describe and express an opinion on the adequacy of, the following areas:

(a) The structure, composition role and functions of the board of directors.
(b) The role and functions of the risk management committee.
(c) The role and functions of the audit committee.
(d) The role and functions of the remuneration committee.
(e) The role of the chairperson of the board of directors.
(f) The role of the chief executive officer.
(g) Director selection, career path and development.
(h) The independence of directors.
(i) Leadership.
(j) Systems of control.
(k) The decision-making process and decision-making capability of the board.
(l) The reports from management to the board.
(m) Monitoring by the board of the activities reported to the board.
(n) Remuneration, including share incentives, of executive and non-executive directors.
(o) Incentive schemes for staff.
(p) The status, role and scope of the internal audit function.
(q) The role and function of the external auditors.

(r) Disclosure to stakeholders.
(s) Related party lending, conflicts of interests and related matters."

3 In addition to looking at the Banks Act and the regulations, this report refers to a set of amendments to the Banks Act dated September 2002 which are proposed by the SARB ("the proposed amendments"). Subsequent to the publication of King II in March 2002, two significant developments in corporate governance occurred, one in the United States of America and the other in the United Kingdom. Following on the collapse of Enron, the chairperson of the Securities Exchange Commission ("SEC") asked the New York Stock Exchange ("NYSE") to review its corporate governance listing standards. The NYSE then appointed a high-powered committee called the New York Stock Exchange Corporate Accountability and Listing Standards Committee ("the Listing Standards Committee") to review the NYSE's current listing standards, along with recent proposals for reform, with the goal of enhancing the accountability, integrity and transparency of the NYSE's listed companies. On 6 June 2002 that committee produced a report ("the Listing Standards Report"). In April 2002, the Chancellor of the Exchequer and the Secretary of State for Trade and Industry commissioned Derek Higgs to write a report on the role and effectiveness of non-executive-directors. On 20 January 2003, the report was published ("the Higgs' report"). Although the United Kingdom did

not have Enron-type corporate scandals, "…the Government had little choice but to undertake some financial tweaking of its own, once America started to clean up Wall Street and company boardrooms….Britain caught the reform bug because once the world's most important capital market started overhauling its financial practices, rivals have to follow those 'best practices'…Even though Britain has not suffered Enron-type scandals recently, major companies, notably Marconi and Cable and Wireless, have seen their share prices collapse, raising questions about proper financial reporting."[1]

Since its release, the Higgs' report has raised a storm of protest from UK businessmen. Some of the more choice words are those of Mr Donny Gordon, chairman of Liberty International, who described the bulk of the Higgs' recommendations as "unrealistic, impractical and likely to be seriously detrimental if fully adopted." Mr Gordon said that Higgs' proposed ban on chief executives becoming chairmen was "palpably absurd and unhelpful".[2] Sir Stanley Kalms, former chairman of Dixons, the electrical retailer, attacked the Higgs' report as "ludicrous" and as "a new high in lows".[3]

Because references to the Higgs' report are made throughout this Report, it is important to appreciate that the recommendations of Higgs

[1] "No Enrons here, thank you", The Guardian, 30 January 2003.
[2] "Malls boss mauls Higgs", The Guardian, 13 February 2003.
[3] "Kalms says that Higgs' report is ludicrous", Financial Times, 5 March 2003.

which generated the most heat – and which are *not* endorsed in this Report – are that:

- a senior independent director ("SID") be identified;
- the SID should be available to shareholders;
- the SID should chair meetings between non-executive directors where the chairman does not attend;
- the nomination committee should be chaired by an independent non-executive director, not the chairman of the board;
- non-executive directors should serve for 6 years rather than 9 years;
- senior non-executive directors should hold regular meetings with shareholders.

On 10 March 2003, the results of a survey conducted by the Confederation of British Industry ("CBI") were published. The survey showed that 82% of FTSE 100 chairpersons feel that if the SID's extra powers were enforced, their roles as chairmen would be undermined and their boards divided.[4]

The response of the UK Government was said to be that it would not be bullied by special interest groups.[5] Gordon Brown, the Chancellor of the Exchequer, said that the Government would press ahead with the Higgs

[4] "Corporate safeguards go back to the board", The Guardian, 10 March 2003; "Leave some room for the chairs", The Guardian, 10 March 2003, "Top chairmen condemn Higgs", Timesonline, 10 March 2003; "Higgs overlooks investor behaviour", Financial Times, 10 March 2003.
[5] "Ministers set to snub pleas on non-executives", Financial Times, 26 February 2003.

reforms.[6] Patricia Hewitt, the Trade and Industry Secretary, is reported to be unlikely to give way over barring chairmen from heading the nominations committee. The Government is also unsympathetic to pleas to allow non-executive directors to serve a maximum of 9, rather than 6, years.[7]

4 In a press release issued at the time that this review was commissioned, it was said that the SARB and the banking groups had agreed to undertake a review to assess compliance with corporate governance best practices. The purpose of the review was to establish to what extent an adequate and effective process of corporate governance within each group had been established and maintained, and to what extent the overall effectiveness of the process could be improved and enhanced by the board of directors and the regulatory authorities. It was stressed that the review was undertaken with the view to measuring to what extent the South African banking industry complied with international standards and norms as regards good corporate governance and best practice, and to ensure that the South African banking industry's credibility as a competitor in the global market was maintained.

[6] "Ministers support Higgs", Timesonline, 11 March 2003.
[7] "FTSE 100 chiefs oppose Higgs reforms", Financial Times, 10 March 2003.

5 While the United States experienced the dramatic failures of Enron and WorldCom, South Africa experienced a string of bank failures in the past decade or so, culminating in 2002 with the seventh largest bank, Saambou Bank Limited ("Saambou"), being placed under curatorship in terms of the Banks Act. Following on Saambou's collapse, there was a run on BoE Bank Limited ("BoE"), the sixth largest bank, which led to BoE being acquired by Nedcor. In his testimony in 2001 before the Commission of Inquiry into Regal Bank, the Registrar of Banks testified that approximately a bank a year had failed in the past decade due to corporate governance failures. A list of banks whose failures can be attributed to a lack of corporate governance is attached hereto marked "A".

6 The Registrar of Banks subsequently appointed Mr J Martin and Ms N Drutman of KPMG to prepare the reports on remuneration, including share incentives, of executive and non-executive directors and key staff. They have prepared reports which will be submitted to the Registrar of Banks independently of this report.

The review process

7 Before the interviews referred to later were held, the following preliminary steps were taken:

- the five banking groups were requested to provide various documents, including minutes of meetings for the period 1 January 2000 to date;
- the documents and minutes of meetings were analysed;
- Mr Phillip Armstrong, Managing Director, ENF Corporate Governance Advisory Services (Pty) Ltd and the principal convenor and main editor of King II, was requested to make a presentation to the review team. He provided the team with documents on corporate governance, many of which are referred to in this report;
- a meeting was held with members of the BSD in order to solicit the BSD’s views on corporate governance at the five banking groups;
- on 4 September 2002 a memorandum on the applicable corporate governance principles and a list of questions were sent to the company secretary of each banking group for distribution amongst those who would be interviewed. The memorandum on corporate governance is not attached hereto as an annexure as its

contents, suitably expanded upon, are included in this report. The list of questions is attached hereto marked "B". It will be seen, for example, that the executive and non-executive directors were required to consider no less than 94 questions, arising from the relevant corporate governance principles.

8 In order to avoid spending time on investigating in detail the *form* of corporate governance in each banking group, the company secretary of each group was requested to prepare a statement on corporate governance. The statements are attached to this report as annexures "F1" to "F5".

9 During the period 9 September to 25 November 2002 interviews were conducted at the five banking groups with:

- all the directors of all the banks;
- the head of compliance;
- the head of internal audit;
- the head of risk management;
- both sets of external auditors.

In January and February 2003, follow-up interviews were conducted. The lists of interviews conducted, totalling 133, are attached hereto marked "C1" to "C5". The company secretaries were later requested to furnish statements on their particular role in the corporate governance of the bank concerned.

10

10.1 In order to enable the review team, the SARB and the banks to learn from other people's mistakes, case studies were undertaken, all focussing on corporate governance failures. The case studies based on information in the public domain are:

- Enron - annexure "D1" hereto;
- WorldCom - annexure "D2" hereto;
- Regal Bank - annexure "D3" hereto.

What follows is a summary of some of the major points which emerge from those case studies.

10.2 On 2 December 2001, Enron Corporation, then the seventh largest publicly traded corporation in the United States, declared bankruptcy, at that stage the largest in American history. Enron employed 19 000 employees in more than 40 countries. According to Enron, it had a market capitalisation of $36 billion and assets of over $65 billion, of which $7.3 billion were current assets and $288 million was cash. Between 1996 and 2000, Enron reported an increase in sales from $13.3 billion to $100.8 billion.

(In 2001, the GDP of South Africa was \$110 billion, when converted at an average rate of R8.60 to the US dollar).

10.3 According to one estimate, Enron lost \$2 billion on broadband, \$2 billion on water, \$2 billion on a Brazilian utility and \$1 billion on an electricity plant in India. Enron's balance sheets overstated its income by as much as \$600 million during the 5 years preceding its bankruptcy. Within 2 months after filing for bankruptcy, Enron's assets plummeted to \$24.7 billion, down by more than \$40 billion. Enron's share price dropped from \$90.56 in August 2000 to 67 cents on 10 January 2002.

10.4 The Permanent Subcommittee on Investigations ("PSI") of the Committee on Governmental Affairs, United States Senate, conducted an investigation into Enron and subsequently issued a report. The PSI made the following findings on the role of the board of directors in the collapse of Enron:-

(1) The Enron board of directors failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high-risk accounting, inappropriate conflict of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation. The board witnessed numerous indications

of questionable practices by Enron management over several years, but chose to ignore them to the detriment of Enron shareholders, employees and business associates.

(2) The Enron board of directors knowingly allowed Enron's use of high-risk accounting practices.

(3) Despite clear conflicts of interest, the Enron board of directors approved an unprecedented arrangement allowing Enron's chief financial officer to establish and operate the LJM private equity funds which transacted business with Enron and profited at Enron's expense. The board exercised inadequate oversight of LJM transactions and compensation controls, and failed to protect Enron shareholders from unfair dealing.

(4) The Enron board of directors knowingly allowed Enron to conduct billions of dollars in off-the-books activity to make its financial condition appear better than it was, and failed to ensure adequate public disclosure of material off-the-books liabilities that contributed to Enron's collapse.

(5) The Enron board of directors approved excessive compensation for company executives, failed to monitor the accumulative cash drain caused by Enron's 2000 annual bonus and performance unit plans, and failed to

monitor or halt abuse by board chairman and chief executive officer Kenneth Lay of a company financed-multi million dollar, personal credit line.

(6) The independence of the Enron board of directors was compromised by financial ties between the company and certain board members. The board also failed to ensure the independence of the company's auditor, allowing Andersen to provide internal audit and consulting services while serving as Enron's outside auditor.[8]

10.5 On 21 July 2002, WorldCom filed for protection under chapter 11 of the bankruptcy code. In the bankruptcy petition it listed assets of $107 billion as at 31 March 2002, against debts of $41 billion. The petition for chapter 11 protection had been preceded by the disclosure on 27 June 2002 that company officials had misstated accounting figures in the sum of R3.8 billion, a figure later revised upwards to $7.1 billion, and which could reach $9 billion. According to a statement issued by the company, monies that were actually expenses were booked as capital, in contravention of generally accepted accounting practices ("GAAP"). The company apparently discovered the problems during a routine audit.

[8] The Case Study on Enron, Annexure "D1" hereto.

10.6 WorldCom claimed a profit of $1.4 billion in 2001 and $130 million in profit for the first quarter of 2002. Proper accounting would have resulted in a reduced cash flow of $6.3 billion in 2001 and $1.4 billion for the first quarter of 2002, forcing WorldCom to disclose a net loss in 2001 and the first quarter of 2002. WorldCom shares worth $64.50 per share in June 1999 are now worthless.

10.7 On 26 June 2002 the SEC filed a civil action complaint in the New York Federal District Court. The SEC alleged in its complaint that:

- from at least the first quarter of 2001 through to the first quarter of 2002, WorldCom defrauded its investors;
- in a scheme directed and approved by its senior management, WorldCom disguised its true operating performance by using undisclosed and improper accounting that materially overstated its income before tax and minority interests by approximately $3 billion 2001 and $797 million during the first quarter of 2002;
- by improperly transferring certain costs to its capital accounts, WorldCom falsely portrayed itself as a profitable business during the period in question;
- by this transfer, WorldCom violated GAAP;

- this improper transfer was not disclosed to investors in a timely fashion, and misled investors about WorldCom's reported earnings;
- this improper accounting was intended to manipulate WorldCom's earnings during the period in question to keep them in line with estimates by Wall Street analysts;
- by engaging in this conduct, WorldCom violated the anti-fraud and reporting provisions of the federal security laws.

10.8 Mr Sidgmore, who became CEO of WorldCom in April 2002, blamed past management and Arthur Andersen, the external auditors, for WorldComs plight. It has emerged that WorldCom's executives repeatedly brushed off warnings about shady accounting practices. It was reported that some seized documents revealed a strange pattern of people inside the corporation discovering bad practices, trying to do something about it and ultimately failing until recently. It took a woman "of demeanour but exceptional guts and sense", Cynthia Cooper, to explode the bubble that was WorldCom, when she informed its board that the company had covered up $3.8 billion in losses through phoney bookkeeping. Former SEC chairman, Arthur Levitt, who left in August 2001, conceded that the system of financial reporting was seriously flawed. He said the problem was that the accountants were compromised by the fact that they felt and acted as if their loyalties belonged to management rather than to the stakeholders.[9]

10.9 The enquiry into the collapse of Regal Bank made the following findings:

(1) Levenstein was not a fit and proper person to be an executive director, CEO and chairman of Holdings and the bank in that:

- he did not exercise the utmost good faith and integrity in his dealings with and on behalf of the bank;
- he did not exercise reasonable skill and care;
- he did not always act in the best interests of the bank, depositors and shareholders;
- he permitted a conflict of interest to arise between his interests and those of the bank, its depositors and shareholders;
- his management of the bank was incompetent and amateurish;
- he acted dishonestly and fraudulently;
- he confused corporate governance with thuggery.

[9] Case study on WorldCom, Annexure “D2” hereto.

In summary he lacked three of the qualities of a director required of a bank in terms of s1A(a) of the Banks Act, namely, probity, competence and soundness of judgment. He ran the bank with little sophistication. He had no idea of the concept of corporate governance and, even if he did have, he was indifferent to it. Levenstein carried on the business of the bank and Regal Holdings in a reckless manner.

(2) The directors, executive and non-executive of Regal Holdings and Regal Bank acted in breach of the Banks Act and the Regulations relating to Banks[10] in that they failed:

- to act exclusively in the best interests and for the benefit of Regal Holdings, Regal Bank and its depositors;
- to perform their functions with diligence and care and with such a degree of competence as could reasonably be expected from a person with their knowledge and experience;
- to ensure that the risks that were of necessity to be taken by the bank were managed in a prudent manner.

[10] Regulations published on 28 April 1996 in the Government Gazette 17115 ("the regulations").

(3) The directors acted in breach of the standards of corporate governance recommended by the King Report in that they failed:

- to exercise the utmost good faith, honesty and integrity in all their dealings with or on behalf of Regal Holdings and the bank;
- to exercise the care and skill which can reasonably be expected of persons of their expertise;
- to act in the best interests of Holdings and the bank;
- to ensure that the bank's strategies were collectively agreed by the board;
- to ensure that the boards of Holdings and the bank monitored the performance of management against budgets or business plans or industry norms.

(4) The directors failed to ensure that the audit committee operated in accordance with the Banks Act and the King Report and were knowingly party to the carrying on of business in a reckless manner.

(5) The non-executive directors were either not aware of their duties and responsibilities or were aware and acted in conflict with their duties and responsibilities. They were not prepared to do what Mark Springett described as

"facing the bully in the schoolyard". The non-executive directors might just as well have been playing bowls on a hot Sunday afternoon for all the energy they put into the discharge of their duties.[11]

11 At my request, Mr John Martin of KPMG prepared an analysis of performance trends of the big five banks from 1992 to 2001. A copy of the analysis is attached hereto marked "E".

The value of the process

12 The process of this enquiry in terms of the Banks Act was designed, not only to enable the reports to be written, but to enhance the awareness of corporate governance at the banks by:

- furnishing each director with the memorandum on the applicable corporate governance principles;
- requiring each director to apply his or her mind to the questions contained in Annexure "B" hereto;
- debating those principles in the interviews;
- by asking each director pertinently what his or her view was on what comprised effective corporate governance;

[11] Case study on Regal bank, Annexure "D3" hereto.

- debating possible failures of corporate governance that might have occurred in the experience of the directors.

13 The SARB's concerns about corporate governance at the five banking groups were put to the directors in order to enable them to deal with the concerns and to express *their* concerns. For example, during the course of the interviews, a number of directors expressed concerns that the present emphasis on corporate governance:

- would lead to a "tick-the-box" mentality which over-emphasised the *form* rather than the *substance* of corporate governance;
- would have the potential to inhibit the entrepreneurial spirit of a bank;
- could result in overregulation. Some directors complained that bank board meetings were increasingly dominated by compliance issues rather than focussing, as they should, on the business of the bank.

Substance over form

14 Any anxiety that form will trump substance deserves consideration. King II, p 142, in dealing with compliance and enforcement, quoted

with approval the statement by The Business Roundtable[12] that "…The substance of good corporate governance is more important than its form; adoption of a set of rules or principles or of any particular practice or policy is not a substitute for, and does not itself assure, good corporate governance." In its submissions to the Listing Standards Committee, the Business Roundtable made the same point in a different way, by stating:

"Good governance is far more than a 'check-the-box' list of minimum board and management policies and duties. Even the most thoughtful and well-drafted policies and procedures are destined to fail if directors and management are not committed to enforcing them in practice. A good corporate governance structure is a working system for principled goal-setting, effective decision-making and appropriate monitoring of compliance and performance." In a White Paper from the Economist Intelligence Unit,[13] the author quotes two opinions, one by Peter Forstmoser, chairperson of Swiss Re and the other by Alistair Johnston, who is managing partner of Global Markets at KPMG International. Peter Forstmoser commented:

"In America in particular there is too much emphasis on form. You hear stories about board members attending meetings flanked by their attorney and everyone having a very tick-box mentality. If you have that approach, you can't have an open discussion to find a solution to problems." Mr Johnson is quoted as saying: "We need to empower boards, the audit committee and the

[12] The Business Roundtable is an association in the United States of CEO's of leading corporations with a combined workforce of more than 10 million employees and $3.5 trillion in revenues.

[13] "Corporate Governance, the New Strategic Imperative" 2002 p 6

accounting profession, so whatever the detailed rules may say, they can assert that substance matters more than form".

15 An assertion that substance should take precedence over form, is a statement of the obvious. No-one contends that the banks should create the requisite committees, appoint the minimum number of non-executive directors, formulate mandates for the board and committees and so on, and then ignore the substance of corporate governance. Clearly, the banks must comply with the substance of corporate governance.

16 Nevertheless, it seems to me, having said that, that it is required of the banks to comply with the form of corporate governance required by the Banks Act, the regulations and King II (insofar as is relevant). The regulator (whose duty it is to regulate and supervise the business of banks), the shareholders, depositors and other stakeholders, will seek the assurance that, as a minimum, the banks meet corporate governance standards in regard to form. Any bank that does not comply with the form of corporate governance runs the risk that it will suffer reputational damage if it does not do so.

Entrepreneurial spirit

17 King II points out that it must constantly be borne in mind that entrepreneurship and enterprise are still among the important factors that drive business. The key challenge for good corporate citizenship is to seek an appropriate balance between enterprise (performance) and constraints (conformance) taking into account the expectations of shareowners for reasonable capital growth and the responsibility concerning the interests of other stakeholders of the company. Conforming to corporate governance standards results in constraints on management. Boards have to balance this with performance for financial success and the sustainability of the company's business.[14] The Economist Intelligence Unit, in dealing with the power of information, states:

> "Tight governance can protect firms and investors from fraud, error and undue risk, but it can also threaten agility and innovation. Yet regulators, the media and the public are uncomfortable with the notion that accounting and governance are a legitimate area of discretion. The solution to the dilemma lies in transparency about a company's governance policies.
>
> As long as key players within the company understand and approve governance policies, and as long as investors and shareholders are then given clear and accessible information about those policies, the market can be

[14] §'s 7 and 8 p 8 of King II.

allowed to do the rest, assigning an appropriate risk premium to companies that have too few independent directors or an overly aggressive compensation policy, or cutting the costs of capital for companies that adhere to conservative accounting policies."

In §1.17 p13 of his report, Derek Higgs states: "Good corporate governance must be an aid to productivity, not an impediment. It is an integral part of ensuring successful corporate performance, but of course only a part. It remains the case that successful entrepreneurs and strong management, held properly to account and supported by effective boards, drive wealth creation."

18 It is within the power of a board to ensure that compliance does not inhibit the board itself and management in being innovative and demonstrating entrepreneurial flair. The banks must learn to do business within the confines of the constraints, in the same way, to use a simple analogy, that one can enjoy driving a car using a safety belt.

Overregulation

19 The concern that the present post-Enron climate will lead to overregulation is legitimate. It is a natural reaction of a regulator increasingly to use its power to regulate in an endeavour to avoid the collapse of banks. The White Paper from the Economist Intelligence Unit revealed concern among executives that hasty regulation and overly

strict internal procedures might impair their ability to run their business effectively. An investment analyst is quoted as saying: "…Working on the something-must-be-done principle, the temptation for regulators is to come up with a new, stricter set of rules that won't be understood and indeed may even obfuscate things and fail to win respect."[15] In the Listing Standards Report, the Listing Standards Committee strongly urges policy makers to avoid imposing additional liability on directors.[16] In his covering letter to the Chancellor and the Secretary of State, Derek Higgs said: "The brittleness and rigidity of legislation cannot dictate the behaviour, or foster the trust, I believe is fundamental to the effective unitary board and to superior corporate performance."

20 The SARB, too, must avoid overregulation. A danger of overregulation, in addition to those dangers mentioned earlier, is that potential suitably qualified non-executive directors will be discouraged from making themselves available to serve on bank boards. The Banks Act, the regulations, and the proposed amendments appear to me to go far enough. I share the view expressed in the Listing Standards Report that the most crucial element of effective corporate governance is the service of competent, ethical people as directors of public companies. If directors enjoying those qualities are deterred from serving on bank

[15] p 4
[16] p 4 of Listing Report

boards because their responsibilities become too onerous, it does not matter how many committees or structures are put in place by way of regulation.

The value of corporate governance

21 Although due weight must be given to the concerns of bank directors about over-emphasis on corporate governance and overregulation, it is important to stress the value of corporate governance to a bank (or company). King II, after stating that South Africa may arguably offer investment returns comparable with some of the best in the world, even after accounting for political, currency and other risks, proposes that South Africa must visibly demonstrate impeccable governance standards in all sectors of commercial activity not only in principle, but also in practice, if it is to remain a destination of choice for emerging market global investors. King II quotes Arthur Levitt, the former chairperson of the US Securities and Exchange Commission ("SEC") who said: "If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere."

22 Derek Higgs expresses the view that corporate governance shortcomings have contributed to falling markets. A combination of the two has in

some cases been the trigger for corporate collapse. Corporate malpractice, lapses of governance and value destruction – all these raise questions about the role and effectiveness of non-executive directors.[17]

23 King II refers to a survey published in June 2000 by McKinsey and Company in which it was found that more than 84% of the more than 200 global institutional investors, together representing more than USD 3 trillion in assets, indicated a willingness to pay a premium for the shares of a well-governed company over one considered poorly governed but with a comparable financial record.

24 In an article in the Bank Director Magazine, "Putting a value on Corporate Governance", the authors provide three reasons why investors will pay a premium for good governance:

- some believe that a company with good governance will perform better over time, leading to a higher stock price;
- others see good governance as a means of reducing risk , as they believe it decreases the likelihood of bad things happening to a company; or
- when bad things do happen, they expect well-governed companies to rebound more quickly.

[17] Higgs' report on corporate governance §1.3 p11.

The importance of corporate governance

25 In a speech delivered on 17 March 2000 on "The importance of corporate governance in banks", David Carse, Deputy Chief Executive, Hong Kong Monetary Authority ("HKMA") said: "I do however believe that sound corporate governance is particularly important for banks. The rapid changes brought about by globalisation, deregulation and technological advances are increasing the risks in banking systems. Moreover, unlike other companies, most of the funds used by banks to conduct their business belong to their creditors, in particular to their depositors. Linked to this is the fact that the failure of a bank affects not only its own stakeholders, but may have a systemic impact on the stability of other banks. All the more reason therefore to try to ensure that banks are properly managed."

Section B: The board of directors of a bank

Statutory requirements

26 No South African bank may conduct the business of a bank unless it is a public company.[18] Every public company must have at least two

[18] s11(1) read with the definition of "banks" in s1 of the Banks Act.

directors.[19] The Banks Act draws a distinction between employees and non-employees of a bank or controlling company[20] in that not more than 49% of the directors of a bank or controlling company shall be employees of the bank or controlling company[21] and at least two of the members of the board of directors of a bank shall be employees of the bank.[22] It follows that a bank board must have at least five directors.

The size and composition of a bank board

27 The Banks Act and the regulations do not prescribe the maximum size of a bank board nor does King II recommend any particular size.

28 On the one hand, the board must be large enough to accommodate:

- executive directors and non-executive directors;
- a sufficient number of non-executive directors to serve on the ever growing number of board committees;
- the requirement that a company should consider the demographics of the board.

On the other hand, the board should not be so large that its size renders it ineffective; that its meetings are unnecessarily protracted; and that

[19]s208(1) of the Companies Act.
[20]A “controlling company” is defined in s1 of the Banks Act as a public company registered in terms of the Banks Act as a controlling company in respect of bank.
[21]s60(3)
[22] except when the Registrar grants consent to a deviation: reg 40(5).

directors are rendered passive by their anxiety not to unduly protract the meeting by asking questions or raising concerns.

29 The one way to limit the size of a bank board is to restrict the number of executive directors. It is unnecessary for the proper functioning of a board that there should be more than a few, say three or four, members of management on the board.

30 A survey conducted by Deutsche Bank Securities Inc of the 73 major South African companies found that the number of members on the boards ranged from 5 to 30, with the average board size being 12 members: "companies with too many board members are perceived poorly given the collegial approach that large boards tend to adopt."[23] Purely co-incidentally, the report of the Belgian Commission on Corporate Governance took the view that in most cases, the board of directors should not consist of more than 12 members. The experience of many members of The Business Roundtable suggests that smaller boards are often more cohesive and work more effectively than larger boards.[24] One survey showed that the average board of a bank in the United States consists of 16 directors.[25]

[23] Deutsche Bank Securities Inc, Global Corporate Governance, 19 August 2002, p12.
[24] A White Paper from The Business Roundtable, May 2002, p A-38.
[25] Bank Director Magazine for fourth Quarter 2002: "Scorecards on Governance: Are Banks Up to Par?"

31 An analysis of information provided by the banks reveals that the composition of the boards is the following:

Bank	Holding Company				Bank			
	EDS	NEDS (non-indepen-dent	Indepen-dent NEDS	Total	EDS	NEDS(non-indepen -dent	Indepen-dent NEDS	Total
Absa	3	2	11	16	9	3	11	23
FirstRand	6	2	5	13	6	2	5	13
Investec	4	3	6	13	11	5	8	24
Nedcor	9	7	9	25	9	7	9	25
Standard Bank	3	1	10	14	3	1	10	14

The average size of the holding company boards is 16. The average size of the bank boards is 19.

32 It is recommended that:-

- the board of a bank should consist of no more than about 16 members;
- the number of executive directors on the board of a bank should be restricted to no more than about four;
- the majority of non-executive directors should be independent directors with immediate effect;
- the banks should aim to have a majority of its directors to be independent directors within the next five years.

Executive and non-executive directors of a bank

33 The Banks Act and the regulations do not expressly draw a distinction between an executive director and a non-executive director of the board of a bank.

34 The Code of Corporate Practices and Conduct ("the Code") which is incorporated in King II applies to banks. In terms of the Code the board should comprise a balance of executive and non-executive directors, preferably with a majority of non-executive directors, of whom sufficient should be independent of management.[26] The Code provides that in the annual report, the capacity of the directors should be categorised as follows:

"- Executive director – an individual that is involved in the day-to-day management and/or is in full time salaried employment of the company and/or any of its subsidiaries.

- Non-executive director – an individual not involved in the day-to-day management and not a full-time salaried employee of the company or of its subsidiaries. An individual in the full-time employment of the holding company or its subsidiaries, other than the company concerned, would also be considered to be a non-executive director unless such individual by his/her conduct or executive authority could

[26] §2.2.1 p23 of King II

be construed to be directing the day-to-day management of the company and its subsidiaries.

- Independent director is a non-executive director who:
  - (i) is not a representative of a shareowner who has the ability to control or significantly influence management;
  - (ii) has not been employed by the company or the group of which it currently forms part, in any executive capacity for the preceding three financial years;
  - (iii) is not a member of the immediate family of an individual who is, or has been in any of the past three financial years, employed by the company or the group in an executive capacity;
  - (iv) is not a professional advisor to the company or the group, other than in a director capacity;
  - (v) is not a significant supplier to, or customer of the company or group;
  - (vi) has no significant contractual relationship with the company or group; and
  - (vii) is free from any business or other relationship which could be seen to materially interfere with the individual's capacity to act in an independent manner."[27]

[27] § 2.4.3 page 25 of King II

35 Directors, irrespective of whether they meet the black letter definition of an independent director, should be independently minded:

"The independence of directors must be *de facto* as well as *de jure*. In practical terms, independence may be considered as:

- the ability to think independently;
- the ability to consider board matters with objectivity, impartiality, fairness and flexibility;
- the exercise of independent judgment about management's actions and competence;
- the courage to challenge management's current or projected future actions – and vote against them when this is warranted;
- the commitment to review and discuss all proposals of importance; and
- a governance environment that encourages directors to voice their opinions without the fear that they will incur the wrath or ridicule of other board members or management."[28]

36 In their representations to the Listing Standards Committee a number of organisations emphasised the need for, and importance of, independent directors. For example, the American Federation of Labor and Congress of Industrial Organisations submitted: "Corporate Governance starts with boards of directors. Public company boards need strong independent directors

[28]National Association of Corporate Directors ("NACD") Blue Ribbon Commission Report on Board Evaluation, p8. The NACD is based in Washington DC and is apparently the premier educational, training, publishing, research and consulting organisation in board leadership and the only membership association for boards, directors, director candidates and board advisors.

who are accountable to investors. Part of the problem with Enron was that Enron touted directors as independent who really had significant ties to Enron management, ties that Enron did not have to disclose." The Fidelity Management and Research Company, after calling for the creation of a nominations committee to nominate independent directors, stated: "This would enhance the likelihood that persons selected to serve as independent directors will not only meet the black letter test of 'independence' under the NYSE's listing rules, but also will serve with an independence of mind. Independent directors elected to the board through this process are unlikely to be beholden to management for their positions, and are more likely to maintain their independent-mindedness throughout their tenure on the board, guided by the interests of shareholders." The Institute of Internal Auditors submitted that: "The vast majority of the directors should be independent in both fact and appearance so as to promote arms-length oversight."

37 Following on those representations, the Listing Standards Committee recommended to the NYSE that listed companies should have a majority of independent directors: "Effective boards of directors exercise independent judgment in carrying out their responsibilities. We believe requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest."

38 The Office of the Comptroller of the Currency ("OCC") is the agency responsible for regulating national banks in the United States. In March 1997, the OCC issued guidelines for the banking industry, The Director's Book: The Role of the National Bank Director ("The Director's Book"). In The Director's Book, the OCC emphasises that directors of a bank should be objective and independent when overseeing the bank's affairs. Examples of situations in which a director could feel uncomfortable exercising independent judgment include:

- executive directors who may feel a need to support management actions to keep their jobs;
- executive directors who may have a biased judgment because of their involvement in specific bank operations;
- non-executive directors who may believe that they do not know enough about banking to evaluate meaningfully management's recommendations;
- non-executive directors invited by the CEO to join the board who may feel pressure to support management if they wish to remain directors;
- both executive and non-executive directors who may feel compelled to vote with a controlling shareholder, who is also a director, to keep their positions.

Despite these fears, pressures and concerns, individual directors must exercise independent judgment. Each director contributes an important perspective to the board. The exercise of objective judgment is critical to the board's effectiveness.[29]

39 On 21 September 2001 the HKMA issued a Supervisory Policy Manual on Corporate Governance of Locally Incorporated Authorised Institutions ("the HKMA Manual"). The manual stresses that the board of directors of a bank should maintain an appropriate level of checks and balances against the influence of management and shareholder controllers in order to ensure that decisions are taken with the bank's best interest in mind. The manual continues:

"Independent directors play an important role in corporate governance. They help to provide the necessary checks and balances to ensure that [a bank] operates in a safe and sound manner and that its interests are protected. Independent directors can also assist by bringing in outside experience and providing objective judgment. They are particularly useful in a monitoring role, eg as members of the Audit Committee."

40 According to Derek Higgs, a major contribution of the non-executive director is to bring wider experience and a fresh perspective to the boardroom. Although they need to establish close relationships with

[29] The Director's Book pp 72-73

executives and be well-informed, all non-executive directors need to be independent of mind and willing and able to challenge, question and speak up. Although there is a legal duty on all directors to act in the best interests of the company, it has long been recognised that in itself this is insufficient to give full assurance that these potential conflicts will not impair objective board decision-making. After referring to the new NASDAQ and NYSE listing rules, which require that the majority of the board must be independent, and the Bouton report on corporate governance in France which recommends that half the board should be independent, Derek Higgs concludes: "I agree with the conclusions of these reports that a board is strengthened significantly by having a strong group of non-executive directors with no other connection with the company. These individuals bring a dispassionate objectivity that directors with a closer relationship to the company cannot provide. In the light of the need to manage conflict of interests, the increasing role of the board committees, and the positive benefits of independence, I recommend that the [UK] Code should provide that at least half of the members of the board, excluding the chairperson, should be independent non-executive directors."[30]

[30] Higgs' report, §9.1 – 9.5 p35.

<u>Non-executive directors to meet without executive directors</u>

41 The Listing Standards Committee recommended to the NYSE that the non-management directors of each company must meet at regularly scheduled executive sessions without management and that the independent directors must designate, and publicly disclose the name of, the director who presided over the executive sessions. In motivating that recommendation, it is stated in the Listing Standards Report: "To promote open discussions among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. Regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative influence from attaching to the calling of such executive sessions."[31] Derek Higgs says that he received a number of submissions suggesting that non-executive directors should meet on their own to increase their effectiveness and to allow for more organised discussions of issues of governance and overall performance. His proposal is that the non-executive directors should meet as a group at least once a year without the chairperson or executive directors present. There should be a statement in the annual report on whether the

[31] Listing Standards Report p8.

non-executive directors had met without the chairperson or executives present.[32]

The Higgs' proposal that the non-executive directors should meet without the chairperson is not supported. Instead, the recommendation is that the non-executive directors, under the leadership of the chairperson of the board, should meet at least twice a year without the executives.

Qualifications of a director of a bank

42 Every director of a bank or of a controlling company is obliged by South African law to acquire a basic knowledge and understanding of the conduct of the business of a bank and of the laws and customs that govern the activities of a bank. Although not every member of the board of directors of a bank or of a controlling company is required to be fully conversant with all aspects of the conduct of the business of a bank, the competence of every director of a bank shall be commensurable with the nature and scale of the business conducted by that bank and, in the case of a director of a controlling company, shall be commensurable with the nature and scale of the business conducted by the banks in the group.[33]

[32] Higgs' report, §'s 8.7 and 8.8 p34.
[33] Reg 39(1).

43 Every director of a bank should have a basic knowledge and understanding of the risks to which the bank is exposed in that:

- the board of directors of a bank is ultimately responsible for the maintenance of effective risk management;[34]
- one of the matters on which a new director of a bank is required to furnish information in the form of a form DI020 is whether the director has a basic knowledge and understanding of the risks to which banks are exposed;[35]
- one of the prescribed duties of a director of a bank is to ensure that risks that are of necessity taken by such a bank in the conduct of its business are managed in a prudent manner.[36]

44 All members of the board of a bank must have absolute integrity to meet their onerous obligations and responsibilities.[37] On 18 November 1999 the Registrar of Banks issued Banks Act Circular 13/99 in which he reiterated that all bankers are required to be fit and proper: "This means that their behaviour must be ethical and that all their business dealings must be conducted with integrity. This is particularly important in view of the position of trust that bankers occupy in their positions and in relation to the integrity of the banking system as a whole. This Office therefore expects all bankers to

[34] Reg 38(1) and (2).
[35] s60(5)(a) of the Banks Act read with reg 41(1).
[36] Reg 39(3).
[37] §2 chapter 1 p47 of King II.

underscore and follow core ethical values, such as honesty, integrity, fairness, responsible citizenship and accountability."

45 The *non-executive* directors of a bank should be individuals of calibre and credibility, and have the necessary skill and experience to bring judgment to bear independent of management, on issues of strategy, performance, resources, transformation, diversity and employment equity, standards of conduct and evaluation of performance.[38]

46 The NACD Blue Ribbon Commission Report on Director Professionalism, having stated that the accepted governance paradigm is simple: management is accountable to the board, and the board is accountable to shareholders, continues:

"A professional boardroom culture requires that the governance process be collectively determined by individual board members who:

- are independent of management;
- are persons of integrity and diligence who make the necessary commitment of time and energy;
- recognise that the board has a function independent of management and explicitly agree on that function, and

[38]The Code §2.4.2 p25 of King II.

- are capable of performing that function as a group, combining diverse skills, perspectives and experiences."[39]

The report draws a distinction between the personal characteristics of directors and the core competencies of the board of directors. In terms of the report, to be considered for board membership, individual directors should possess all of the following *personal characteristics*:

"- *Integrity and accountability*. Character is the primary consideration in evaluating any candidate for board membership.
- *Informed judgment*. The ability to provide wise, thoughtful counsel on a broad range of issues ranks high among the quality sought in any director.
- *Financial literacy*. One of the important roles of a board is to monitor financial performance.
- *Mature confidence*. Directors who value board and team performance over individual performance, and who possess respect for others, facilitate superior board performance. Openness to other opinions and the willingness to listen should rank as highly as the ability to communicate persuasively.
- *High performance standards*. In today's highly competitive world, only companies capable of performing at the highest levels are likely to prosper."

[39] 2001 Edition, p. xi.

The report goes on to state that a whole host of core competencies need to be represented on the board to adequately fulfil the board's complex roles – from overseeing the audit and monitoring managerial performance to responding to crises and approving the company's strategic plan. The recommendation is that the board *as a whole* should possess all of the following core competencies, with each candidate contributing knowledge, experience and skills in at least one domain:

"- *Accounting and finance*. Among the most important missions of the board is ensuring that shareholder value is both enhanced through corporate performance and protected through adequate internal financial controls.
- *Business judgment.* Shareholders rely on directors to make sensible choices on their behalf.
- *Management*. To monitor corporate managers, boards need to understand management trends in general and in relevant industries.
- *Crisis response*. Boards and the organisations they serve inevitably experience both short- and long-term crises. The ability to deal with crises can minimise very negative ramifications and limit the impact on firm performance.
- *Industry knowledge*. Companies continually face new opportunities and threats that are unique to the industries.
- *International markets*. To succeed in an increasingly global economy, companies need directors who appreciate the importance of global

business trends and who have first-hand knowledge of international business practices.

- *Leadership*. Ultimately, a company's performance will be determined by the directors' and CEO's ability to attract, motivate, and energise a high-performance leadership team.
- *Strategy/vision*. A key board role is to approve and monitor company strategy, so as to ensure the company's continued high performance."

47 The OCC is of the view that the principal qualities of an effective bank director includes strength of character, an inquiring and independent mind, practical wisdom, and sound judgment. The qualifications of a candidate seeking to become a member of the board of directors of a national bank include:

- basic knowledge of the banking industry, the financial regulatory system, and the laws and regulations that govern the operations of the institution;
- a willingness to put the interests of the bank ahead of personal interests;
- a willingness to avoid conflicts of interests;
- knowledge of the communities served by the bank;
- background, knowledge and experience in business or another discipline to oversee the bank;

- a willingness and ability to commit the time necessary to prepare for and regularly attend board and committee meetings.[40]

48 Derek Higgs states that in order to fulfil their role, non-executive directors must acquire the expertise and knowledge necessary to properly to discharge their responsibilities. They must be well-informed about the business, the environment in which it operates and the issues it faces. This requires a knowledge of the markets in which the company operates as well as a full understanding of the company itself. Understanding the company is essential to gain credibility and reduce the inevitable disparity in knowledge between executive and non-executive directors. Developing such knowledge cannot be done within the confines of the boardroom alone. The personal attributes required of the effective non-executive director are founded on:

- integrity and high ethical standards;
- sound judgment;
- the ability and willingness to challenge and probe; and
- strong interpersonal skills.[41]

[40] The Director's Book p4-5
[41] Higgs' report, §'s 6.11-6.17 pp 28-29.

49 The Listing Standards Report expressed the belief that "…the most crucial element of effective corporate governance is the service of competent, ethical people as directors of public companies."[42]

50 The business of a bank is so complex that it is impossible for a non-banker non-executive director to acquire knowledge of the bank's business and the risks associated with it by attending four or five board meetings a year. A good induction programme and continuing education are no substitute for "on the job training". In the case of a non-executive director, that means serving on at least one board committee, as a minimum. This view is shared by many of the directors who are not ex-bankers.

51 Another reason for involving non-executive directors in board committee work is to avoid a disparity of knowledge being created amongst the non-executive directors. An inequality in knowledge has the potential to create two classes of non-executive directors: one which can make a meaningful contribution to the board and another which cannot. The latter class will be disempowered and might over time become disillusioned and alienated.

[42] p. 5

Time

52 Being the director of a bank is increasingly taking more time. The director of a bank – and this applies particularly to a non-executive director – must have sufficient time to discharge his or her onerous duties. Executive directors usually can make the time. The difficulty that a non-executive director of a bank has who occupies a senior, time-consuming, position with another corporation, is to make time for his or her non-executive directorships. If the non-executive director does not have, or does not make, time for the bank's business, the non-executive director should be disqualified from being the director of a bank. "Part-time, ornamental 'star directors' may appear to add lustre to a board roster, but a director cannot provide outstanding professional service on a board unless his or her energies and competencies are truly available."[43] A similar point is made in The Bankers Magazine of March/April 1993 pp 46-48: "…it is increasingly difficult for outside directors not … involved in day-to-day bank operations to fulfil their legal responsibilities. … any person serving on the board must devote reasonable time to the bank's activities to fully comprehend its changing financial condition and performance. … it is important to emphasise that a bank is not a social institution or country club. The landscape is littered with the bodies of institutions such as the Bank of

[43] NACD Report on Director Professionalism p 13.

Credit and Commerce International with celebrity boards that failed to govern."

53 In the July 2002 Bank Directors' Briefing, the author of an article with the title "Keeping the 'Scandals of the Week' in Perspective" refers to a presentation entitled "Corporate Governance After Enron". The article states that directors who see the current crop of business disasters as a call to redouble the efforts can follow action points covered in the presentations. The one action point is to spend more time on the job. Reference is made to the view of one of the judges of the Delaware Court of Chancery. Most US corporations are Delaware corporations and that Court's rulings affect not only those companies but also those in states whose laws or courts recognise the importance of Delaware corporate law. The judge thought that directors should spend at least 200 hours a year, in total, on all aspects of their director duties, including preparation, meetings, and follow-up on meetings.

54 Having made the point that it is essential that non-executive directors commit the necessary time to the role, Derek Higgs recommends that the non-executive directors should undertake that they will have available sufficient time to meet what is expected of them, taking into account their other commitments. These commitments should be disclosed to the

company before appointment, with an indication of the time involved. He proposes that the nomination committee should articulate the time and responsibility envisaged in the appointment of a non-executive director and should annually review the time required and performance evaluation should be used to assess whether the non-executive director is spending enough time to fulfil their duties. Research undertaken for the purposes of the Higgs report suggested that in the United Kingdom the non-executive director role usually involves a time commitment of between 15 and 30 days a year.[44]

Remuneration of non-executive directors

55

55.1 The remuneration of non-executive directors on a bank board must be reconsidered in view of the increasing demands on the time of the non-executive directors; the complexity of the business of a modern bank; the need for properly qualified directors; the onerous responsibilities of a bank director; and the vital role that non-executive directors play in the effective corporate governance of a bank. The following principles enunciated by Higgs, in my view, are appropriate when

[44] Higgs' report, §'s 12.10 – 12.19 pp 54 – 55.

considering the remuneration of a non-executive director of a South African bank:

- remuneration for directors needs to be sufficient to attract and retain high calibre candidates but no more than is necessary for this purpose;
- the level of remuneration appropriate for any particular non-executive director role should reflect the likely workload, the scale and complexity of the business and the responsibility involved;
- in practice, it may be helpful in assessing remuneration for non-executive directors to use as a benchmark the daily remuneration of a senior representative of the company's professional advisors;
- the risk of high levels of remuneration prejudicing independence of thought is real and should be avoided.[45]

55.2 In an article in the Financial Times of 10 March 2003, "Boardroom pay levels could soar", reference is made to a report by Halliwell Consulting, which advised boards on directors' remuneration. According to the report, salaries on some committees would need to increase from between £1 500 to £3 000 to £10 000 - £15 000 to offset the extra demands placed on

[45] Higgs' Report §12.24, p56.

non-executives. Base levels of pay in main boardrooms will shoot up by 25% to about £40 000 a year. The report states: "There have been considerable changes to the roles and responsibilities of non-executive directors over the last twelve months due to the current business climate, regulation and corporate governance reports. As a result it is inevitable that non-executive remuneration levels will increase significantly over the coming months."

56 In a separate exercise to that conducted by KPMG, the non-executive directors of the five banks were asked in the interviews that were conducted for the purposes of this review, for their views on the *quantum* and form of their remuneration. The dominant view was that:

- the form should be fees (and not share options);
- the fees had been low historically;
- the fees should be increased, particularly having regard to the increased responsibilities of a bank director.

<u>Board appointments</u>

57 King II recommends that non-executive directors should carefully consider limiting the number of appointments they take in that capacity in order to ensure that the board of companies on which they serve enjoy

the full benefit of their expertise, experience and knowledge.[46] The NACD Report on Director Professionalism makes the following recommendations:

"- CEO's and other senior executives of public corporations: Boards should prefer individuals who hold no more than one or two public-company directorships (including the position to be offered) in addition to membership on their own company board;

- other individuals with full-time positions: Boards should prefer individuals who hold no more than 3 or 4 public-company directorships (including the position to be offered) in addition to membership on their own organisation's board;

- other individuals: boards should prefer individuals who hold no more than 5 or 6 public-company directorships (including the position to be offered)".[47]

58 While the popular perception in the UK was that there were a large number of people holding multiple non-executive directorships, Derek Higgs found that less than one fifth of non-executive directors held more than one non-executive directorship in a UK listed company; thirteen individuals held five or more such posts; one in fourteen non-executive

[46] p60 King II
[47] pp 14-15.

directors also hold an executive director post. He believes that best practice should be that:

- a full-time executive director should not take on more than one non-executive directorship, nor become chairperson, of a major company, and
- no individual should chair the board of more than one major company.[48]

Induction and continuing education

59 King II recommends that the board should establish a formal orientation programme to familiarise incoming directors with the company's operations, senior management and its business environment, and to induct them in their fiduciary duties and responsibilities. Directors should receive further briefings from time to time on relevant new laws and regulations as well as on changing commercial risks.[49] In regard to a national bank in the US, the OCC recommends that a board should consider orientation programmes for new directors. These programmes should explain the operation of the bank and the banking industry, and clearly outline the responsibilities of board members both individually and as a group. Ongoing education programmes that describe the

[48] Higgs' report, §'s 12.15-12.19 p55.
[49] p 64 of King II.

emerging industry developments, opportunities, and risks also are often helpful.[50]

60 One of the conclusions of the Listing Standards Committee was the following:

"We end with a word about director education. It is not enough that, through our recommendations and otherwise, directors be given the tools they need to do their jobs. Rather, steps must be taken to assure that directors will actually know how to use all the instruments in their toolboxes. We therefore recommend that the NYSE encourage all public companies to establish orientation programmes for their new directors. Each company is unique, and an executive or directorial background with one company may not adequately prepare a person for a directorship with another company. An effective orientation programme will familiarise new directors with the company's strategic plans; its significant financial, accounting and risk-management issues; its compliance programmes; its conflict policies and other controls; its principle officers; and its internal and independent auditors. Through such orientation programmes, directors can be fully informed as to their responsibilities and the means at their disposal for the effective discharge of those responsibilities."[51]

[50] The Director's Book p 3.
[51]The Listing Standards Report p29.

61 Derek Higgs is of the view that to be effective, newly appointed non-executive directors quickly need to build their knowledge of the organisation to the point where they can use the skills and experience they have gained elsewhere for the benefit of the company. A comprehensive, formal and tailored induction should always be provided to new non-executive directors to ensure an early contribution to the board. As part of running an effective board, companies need to set aside adequate resources and ensure that sufficient time is allowed for a thorough induction for directors. The chairperson should take the lead in providing a properly constructed induction programme, facilitated by the company secretary. As part of the evaluation process, non-executive directors should regularly appraise their individual skills, knowledge and expertise, and determine whether further professional development would help them develop their expertise and fulfil their obligations as members of the board. Companies should acknowledge that to run an effective board they need to provide resources for developing and refreshing the knowledge and skills of their directors, including the non-executive directors.[52]

[52] Higgs' report, §'s 11.1 – 11.18 pp 47 – 49.

The duties of the directors of the board of a bank

62 Under the Banks Act, the directors of a bank or controlling company have the following obligations:

- to stand in a fiduciary relationship to the bank or controlling company;
- to act honestly and in good faith, and, in particular, to exercise the powers he or she may have to manage or represent the bank exclusively in the best interests and for the benefit of the bank and its depositors or controlling company.[53]

63 In terms of the regulations, all directors of a bank shall perform their functions with diligence and care and with such a degree of competence as can reasonably be expected from persons with their knowledge and experience. It is the duty of every director of a bank to ensure that risks that are of necessity taken by such a bank in the conduct of its business are managed in a prudent manner.[54]

64 The regulations prescribe that the board of a bank is ultimately responsible for ensuring that an adequate and effective process of corporate governance, which is consistent with the nature, complexity

[53] s60(1) and (2)(a).
[54] reg 39(2) and (3).

and risk inherent in the bank's on-balance sheet and off-balance sheet activities and which responds to changes in the banks environment and conditions, is established and maintained. The overall effectiveness of the process of corporate governance must be monitored on an ongoing basis by the board or by a committee appointed by the board.[55]

65 The Code provides that the board is the focal point of the corporate governance system. It is ultimately accountable and responsible for the performance and affairs of a company. The board must give strategic direction to the company, appoint the Chief Executive Officer ("CEO") and ensure that succession is planned. The board must retain full and effective control of the company, and monitor management in implementing board plans and strategies. The board should ensure that there is an appropriate balance of power and authority on the board, such that no one individual or block of individuals can dominate the board's decision taking.[56]

66 One must be careful to distinguish between what the functions of the board of a bank are and what are not the functions of the board. In regard to what the functions *are*, the NACD Report on Board Evaluation

[55] reg 38(1) and (4).
[56] §'s 2.1.1, 2.1.3, 2.1.4 and 2.4.1 pp 22-24 of King II.

states: "The tasks of the board of directors of a public company … are complex and delicate. Directors must approve the corporate mission and vision. They must select, monitor, evaluate, compensate and, if necessary, replace the CEO. They must oversee the development and implementation of the company's strategic plan, and ensure ethical behaviour and legal compliance. These are just a few of the many areas of oversight." The function of a board is not to manage the enterprise, and in this case, the bank: "…there is another line, that between a director who contributes ideas to company strategy and one who tries to manage the company. This is the line which separates governance from management, and … although the line need not be permanently fixed, once directors cross it, the company has real problems. Directors should not run the company, and the board should not interfere with the management's duty and capacity to do so."[57]

67 A similar distinction can be drawn between the roles of executive directors and non-executive directors:

"Although the law does not separate the competencies of executive and non-executive directors and all directors bear joint responsibility for the affairs of a corporation, the intended role of non-executive directors is quite clear. They are to provide an independent assessment of executive performance while being accountable for the power they vest with the executives. If this power is to be effective, managers must be spared undue interference with their

[57]In Search of Good Directors, Corporate Boards in Market and Transition Economies, 1998, p 8.

functions. This … makes the effectiveness of corporate boards very much a matter of non-executive directors' ability to balance the pressures of accountability against the requirements of non-interference."[58]

68 Derek Higgs asserts that the role of the non-executive director is frequently described as having two principal components: monitoring executive activity, and contributing to the development of strategy. He cautions that an over-emphasis on monitoring and control risks non-executive directors seeing themselves, and being seen, as an alien policing influence detached from the rest of the board. An over-emphasis on strategy risks non-executive directors becoming too close to executive management, undermining shareholder confidence and the effectiveness of board governance. The research conducted for the purposes of his report concludes that it is important to establish a spirit of partnership and mutual respect on the board. The role of the non-executive director is therefor both to support executives in their leadership of the business and to monitor and supervise their conduct.[59]

69 In his speech, "The importance of corporate governance in banks" referred to earlier, David Carse, the Deputy Chief Executive of the HKMA, said:

[58] In Search of Good Directors, supra, p 42.
[59] Higgs' report, §'s 6.1-6.8 pp 27-28.

> "While the day-to-day running of banks should certainly be left in the hands of the management, the board must play a leadership role in approving the objectives, strategy and business plans of the bank, monitoring the performance of management and ensuring that the internal control and risk management systems of the bank are effective. The board must also make sure that the bank conducts its affairs with integrity and in accordance with high ethical standards. The board is part of the system of checks and balances that ensures that neither large shareholders nor management abuse their power and that decisions are taken with the bank's best interest in mind. If the board does not play its full part, a vacuum in leadership will be created. This vacuum may be filled by the shareholders becoming directly involved in running the bank's affairs, or by the executive management acting more or less in isolation. In either case, the board of directors is bypassed and checks and balances are lost."

70 One of the primary functions of a board of directors is to "hire and fire" the CEO. In practice, it seldom comes to the actual dismissal of a CEO. Usually some more benign way is found for the board and the CEO to part their ways, often at great expense to the company and its shareholders and to the enormous benefit of the departing CEO. Perhaps the most important decision a board makes, however, is the *appointment* of the CEO. If the board gets that right, and the CEO, supported by the

board, puts the right management in place, the first round for good corporate governance has been won.

71 That is the American experience:

"…in the American board reality, non-executive directors have traditionally seen their primary responsibility as identifying, recruiting, and supporting a competent CEO. The following sample of outside directors' views reported in Lorsch's study of American corporate boards, is fairly typical: 'I guess the most important role that the board plays is selecting the CEO … The board doesn't run the company, but it has to make sure that the people who do are the best that are available'"[60]

The Business Roundtable supports the guiding principle that the paramount duty of the board of directors of a public corporation is to select a chief executive officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.[61] Having stated that a profitable and sound bank usually is the result of talented and capable management, the OCC expresses the view that one of the board's fundamental responsibilities is to select and retain competent management:

"When a bank hires a CEO, the board or a designated board committee should actively manage the selection process. Selection criteria should include

[60] In Search of Good Directors, supra, p 42.
[61] BRT Principles of Corporate Governance p A-32

integrity, technical competence, character and experience in the financial services industry. The board's choice for a CEO should share the board's operating philosophy and vision for a bank to assure that mutual trust and a close working relationship are maintained."[62] In the Bank Director Magazine, in an article entitled "Strengthening Corporate Governance", the following conclusion is reached:

"Finally, understand that in the end, it's all about people. The best intentions and the most carefully designed processes will be useless unless people at all levels have the intelligence, technical and industry skills and, most important, the strength of character to make the right and sometimes difficult decisions."

The modern banker

72 One of the issues that was debated in the interviews with the bank directors, was whether the board and senior management of the bank had sufficient "bankers" on board. That in turn raised the obvious question: what is a banker in the modern world? Is it someone who began his career at age 18 in the branch of the local bank in his home town, and 40 years later is the CEO? Is it the chartered accountant who has worked in a merchant bank for 20 years and who has had no intimate exposure to a retail bank? Is it possible, in fact, for any one person to know all the business of a large, diverse banking group, which

[62] The Director's Book p 23.

includes in its embrace retail banking, corporate banking, merchant banking, treasury, and so on?

73 The most complete answer was given by the chief executive of one of the five banks:-

73.1 A “pure” banker, in his view, was someone who developed in an environment where there was significant manual intervention, where credit decisions were taken, where companies of magnitude stood behind their subsidiaries. These days because business and the operating environment has changed, you assess the subsidiary of a major company when lending to the subsidiary. The CEO’s sense today is that one’s abilities at an executive level need to be very different. He is not denying in any way or lessening the need for pure banking, treasury, or credit skills, but at the same time one needs to understand that one’s investments in technology are as mission-critical to the organisation as lending to a large conglomerate.

73.2 Fifteen years ago the banks had a very limited remit in terms of what they did and it was a lot easier to depict what a banker should be. Today banks can be classified as a universal financial services business. They are in a business that has credit risk, market risk, counterparty risk, and the dynamics of technology risk. A banker today is a technology expert, with regard to what he has to deliver. The industry performs 6 million transactions a day. You cannot do that with manual intervention, so you need to understand the issues of process management. If you look at the reality, banks run businesses that are very wide and diverse in activities. The real trick is to have some competencies that are highly technical in their nature, and other competencies which are highly general in their nature, and to find the ability to synthesise or fuse those in the way so that the businesses interact and react with each other. Then, at an executive level, one should make sure that the executives have skills that transcend in their general nature and in their specific nature; in other words, skills that can transcend all of those activities. Approximately ten years ago, the banks had too many pure bankers in the frame and not enough people who understood the dynamics of where the industry was going.

73.3 The concept of a banker means different things to different people. In the *retail* environment, a banker might be the branch manager or somebody who is a web-based, mobile-based, cellular-based person, who can distribute through a new channel. In the micro-lending environment, a banker is somebody who can explain the complexity of forms and processes and tangibility of money. In the *commercial* environment, a banker is somebody who is virtually part of the business, who understands the cash flows, the peaks and valleys, and has sensitivity around what happens in the geared business in high interest rates, sees the business through, understands where the value attribution lies and where the other stores of value are. A *corporate banker* is very different. The client wants to know that he or she gets quick turnaround times, that the internalisation of the problem is immediate, that the corporate banker's ability to multi-task is immediate or instantaneous around treasury answers on the one side, derivative answers on the other, securitisation on another, and so on. Those businesses may even transcend geographies; and may transcend vertical industries, they may evolve into conglomerates. One may in fact require of a banker to be knowledgeable about *full financial services,* issues of investment management, issues of multi management, of unit trust product offerings, of life product offerings, of credit life offerings, of issues relating to off-shore in terms of stores of value, in terms of yield protection, NAV protection. So, the CEO confesses, he does not honestly know how to define a banker in general terms.

74 What flows from the above discussion is that the complete banker in the modern world is a mythical being. Rather than focussing on whether a particular individual is a "banker", one should look at the make-up of a management team, such as the executive committee ("exco") of a bank or the exco of a division or cluster (retail, corporate, treasury, whatever) and consider whether the exco contains an appropriate collection of skills and experience to manage the particular bank or division or cluster. In one bank a necessary skill on the team may be marketing, on another it may be human resources, on another it may be risk management, on another it may be information technology. On any team, of course, there must be executives with the requisite core skills. For example, on the exco of a retail bank there should be retail bankers, notwithstanding the other skills that are represented on the committee.

Separating the roles of chairperson and CEO

75 The Code recommends that there should be a clearly accepted division of responsibilities at the head of the company, to ensure a balance of power and authority, such that no one individual has unfettered powers

of decision-making. Given a strategic operational role of the CEO, this function should be separate from that of the chairperson.[63]

Section C: The chairperson

76 The Banks Act and the regulations prescribe that the chairperson of a bank or controlling company shall not be:

- an employee of the bank, any subsidiaries of the bank, the controlling company of the bank or any subsidiary of the controlling company;
- a member of the audit committee of the bank or the controlling company.[64]

77 In terms of the Code, the chairperson should preferably be an independent non-executive director.[65]

78 In its more detailed analysis of the role and function of the chairperson, King II recommends that:

- all boards should be subject to the firm and objective leadership of a chairperson who brings out the best in each director;

[63] §'s 2.3.1 and 2.3.3 p 24 of King II
[64] reg 40 and s64(3).
[65] §2.3.2 p 24 of King II.

- the chairperson's primary function is to preside over meetings of directors and to ensure the smooth functioning of the board in the interest of good governance.[66]

79 King II points out that the role and function of the chairperson will be influenced by such matters as the size or particular circumstances of a company, the complexity of its operations, the qualities of the CEO, the management team, and the skills and experience of each board member.[67]

80 There are a number of common, core functions performed by the chairperson, which usually include:

- providing overall leadership to the board without limiting the principle of collective responsibility for board decisions;
- actively participating in the selection of board members, as well as overseeing a formal succession plan for the board, CEO and senior management;
- arranging for new directors appointed to the board to be properly inducted and oriented, and monitoring and evaluating board and director appraisals;

[66] §1 & 2, Chapter 2, p 51 of King II.
[67] §3, Chapter 2, p 51 of King II.

- determining, normally in conjunction with the CEO and the company secretary, the formulation of an annual work plan for the board against agreed objectives and goals, as well as playing an active part in setting the agenda for board meetings;
- acting as the main informal link between the board and management, and particularly between the board and the CEO;
- maintaining relations with the company's shareowners and perhaps, some of its important stakeholders, although the latter may be more in the nature of an operational issue to be conducted by the CEO and the senior management team;
- ensuring that all directors play a full and constructive role in the affairs of the company and taking a lead role in removing non-performing or unsuitable directors from the board; and
- ensuring that all the relevant information and facts, objectively speaking, are placed before the board to enable the directors to reach an informed decision.[68]

81 After pointing out that in principle it is better that the functions of chairperson and CEO are kept separate, King II emphasises:

"The chairperson is primarily responsible for the working of the board. This position is made more onerous by the complex environment in which many

[68] § 3 Chapter 2, pp 51-52 of King II.

modern companies now operate. The Chief Executive Officer's task is to run the business and to implement the policies and strategies adopted by the board."[69]

82 Derek Higgs contends that a strong relationship between the chairperson and CEO lies at the heart of an effective board. The relationship works best where there is a valuable mix of different skills and experiences which compliment each other. The chairperson should not seek executive responsibility and should let the CEO take credit for his achievements. The chairperson can be an informed, experienced and trusted partner, the source of counsel and challenge designed to support the CEO's performance, without becoming an obstacle to questioning of the CEO by the non-executive directors.[70]

83 Derek Higgs, after stating that a degree of detachment from the executive can be valuable in ensuring objective debate on strategy and other matters, expresses the view that at the time of appointment the chairperson should meet the test of independence.[71] Once appointed, so says Derek Higgs, the chairperson will have a much greater degree of involvement with the executive team than the non-executive directors;

[69] §4 Chapter 2, p 52 of King II
[70] Higgs' report, §5.4 p24.
[71] Higgs' report §5.8 p24.

applying a test of independence at this stage is neither appropriate nor necessary.[72]

84 It is true that the chairperson is likely to interact more closely with management than the non-executive directors. It does not follow, however, that he should lose his independence. On the contrary, it is vitally important that, throughout his tenure as chairperson, he should retain his independence of mind, provide the necessary independent leadership of the non-executive directors, and ensure that the necessary checks and balances on the board are in place.

85 In addition to being an independent non-executive director, the chairperson of a bank should have the characteristics that are required of a non-executive director, which include:

- integrity;
- independence of mind;
- the ability to consider board matters with objectivity, impartiality, fairness and flexibility;
- having knowledge and understanding of the business of a bank;
- having knowledge and understanding of the risks to which the bank is exposed;
- being a person of calibre and credibility;

[72] Higgs' report §'s 5.8 and 5.9, p24.

- being financially literate.

86 Derek Higgs says that his research highlighted the potential difficulties of the chairperson being a former CEO of the same company. Having been responsible for the day-to-day running of the company and with the detailed knowledge of it that this brings, such a chairperson can sometimes find it difficult in practice to make room for a new CEO. In addition, a chairperson who was formerly the CEO of the same company may simply take for granted their inside knowledge and fail as an informational bridge to the non-executive directors. He recommends that the Code should provide that a CEO should not become chairperson of the same company.[73]

87 There may be other reasons for the CEO not to become the non-executive chairperson. The first is that the management team that the CEO leaves behind is one that he was instrumental in appointing and which remains beholden to him when he becomes chairperson. The other is the risk that the chairperson, who was the former CEO, might not look at the strategy of the company with the necessary detachment because the strategy was one he formulated and was in the process of

[73] Higgs' report, §'s 5.6 and 5.7 p24.

implementing as a member of management before being appointed chairperson.

88 The Higgs recommendation that a CEO should not become chairperson of the company is not feasible in the South African banking industry in which there is a severe shortage of ex-bankers to serve on bank boards as non-executive directors. Instead, it is recommended that a three-year period should elapse between the CEO retiring and becoming chairperson of the bank. This is consistent with King II.

89 There is another general principle. It would be placing form above substance if one were to split the roles of chairman and CEO and then have the two positions occupied by persons who were closely related or close friends or “blood brothers”, so to speak. In the context of a board of directors, one should avoid what happened in the 1960’s in the United States when George Wallace, the governor of Alabama, was prohibited from serving two terms in a row. He then arranged that his wife Lurleen would become governor *in name*. She won the election in 1966, and after she died, Wallace became governor again in 1970. The common belief was that George Wallace *in fact* remained governor throughout the period.

Section D: The CEO of a bank

90 The Banks Act and the regulations do not deal with the role and function of the CEO.

91 In terms of King II, the CEO:

- has a critical and strategic role to play in the operational success of a company's business;
- should maintain a positive and ethical work climate that is conducive to attracting, retaining and motivating a diverse group of top-quality employees at all levels of the company;
- is expected to foster a corporate culture that promotes ethical practices, encourages individual integrity, and fulfils social responsibility objectives and imperatives. [74]

92 Some of the functions that a CEO fulfils are usually to:

- develop and recommend to the board a long-term strategy and vision for the company that will generate satisfactory levels of shareowner value and positive, reciprocal relations with relevant stakeholders;

[74] §'s 1 and 3 of Chapter 3 p 53 of King II.

- develop and recommend to the board annual business plans and budgets that support the company’s long-term strategy;
- strive consistently to achieve the company’s financial and operating goals and objectives, and ensure that the day-to-day business affairs of the company are appropriately monitored and managed;
- ensure continuous improvement in the quality and value of the products and services provided by the company, and that the company achieves and maintains a satisfactory competitive position with its industry(ies);
- ensure that the company has an effective management team and to actively participate in the development of management and succession planning (including the chief executive officer’s own position);
- formulate and oversee the implementation of major corporate policies; and
- serve as the chief spokesperson for the company.[75]

93 The following description of the prominent part played in fact and perception by a CEO could equally apply to the CEO of a South African bank:

[75] §1 of Chapter 3 p 53 of King II.

"In the US and the UK … the Chief Executive Officer is seen as an individual leader who is much more 'equal' than others. To quote a commentator: 'shareholders in the market are far more interested in CEO's than directors. When we read about big business in the financial press, CEO's usually are the centre of attention and directors are obscure. In fact, under normal circumstances very little attention is paid to directors by shareholders, the market or the press.' True, the CEO has the support of able managers and there is often a management committee, but they are all picked by him and the relationship between them is definitely one of superior/subordinate. The gap between the CEO and the others is recognised both in their pay and in the public recognition of their contributions. Chief Executives are often the heroes of the media – until something goes wrong, when they quickly become the villains."[76]

Section E: Committees of the board of a bank

Introductory

94 As some South African banks have grown in size and complexity, it has become practice that more and more of the effective work of the board has to be done by the committees of the board. That is also the experience in the United States and United Kingdom:

[76] In Search of Good Directors, supra, p 108.

> "Boards are busy and their tasks complex, and a growing number of them now make use of committees. This is undoubtedly true of the American and British boards, and it allows the directors to cope with the two factors that constrain their board involvement the most: the limited time they can devote to the company and the complexity of information with which they must deal."[77]

95 According to King II, committees of the board can help to efficiently advance the business of the board. At the same time, committees can demonstrate that directors' responsibilities are being adequately and properly discharged. However, the board is the focal point of the corporate governance system and is ultimately accountable and responsible for the performance and affairs of a company. Delegating authorities to board committees or management does not in any way mitigate or dissipate the discharge by the board and its directors of their duties and responsibilities. Board committees are merely a mechanism to aid and assist the board and its directors in giving detailed attention to specific areas of their duties and responsibilities in a more comprehensive evaluation of specified issues such as audit, internal control, risk management, remuneration, etc.[78] King II makes a number of recommendations in regard to board committees, four of which deserve emphasis in this report:

[77] In Search for Good Directors, supra, p 121.
[78] §1, Chapter 8 p 67 of King II.

- there should be a formal procedure for certain functions of the board to be delegated, describing the extent of such delegation, to enable the board to properly discharge its duties and responsibilities and to effectively fulfil its decision taking process;
- at a minimum, each board should have an audit and a remuneration committee;
- non-executive directors must play an important role in board committees;
- all board committees should preferably be chaired by an independent non-executive director, the exception being a board committee fulfilling an executive function.[79]

96 As will be seen from what follows, a bank board must have as a minimum:

- an audit committee (in terms of the Banks Act and King II);
- a remuneration committee (in terms of King II);
- and if the proposed amendments to the Banks Act are passed by Parliament, a directors' affairs committee and a risk committee.

[79] Chapter 8, p69 of King II.

Audit Committee

97 In terms of the Banks Act, the board of directors of a bank shall appoint at least 3 of its members to form an audit committee. All the members of the audit committee may be, and the majority of such members, including the chairperson of the audit committee, must be persons who are not employees of the bank, its subsidiaries or controlling company, provided that the chairperson of the board of directors of a bank shall not be appointed as the chairperson of the audit committee. The functions of the audit committee shall be to:

- assist the board of directors in its evaluation of the adequacy and efficiency of the internal control systems, accounting practices, information systems and auditing processes applied within the bank in the day-to-day management of its business;
- facilitate and promote communication, regarding the matters referred to above or any other matter, between the board of directors and the executive officers of the bank, the external auditor and the internal auditor; and
- introduce such measures as in the committee's opinion may serve to enhance the credibility and objectives of financial statements and reports prepared with reference to the affairs of the bank.[80]

[80] s64 of the Banks Act.

98 In terms of the Code, the board should appoint an audit committee that has a majority of independent non-executive directors. The majority of the members of the audit committee should be financially literate. The chairperson should be an independent non-executive director and not the chairperson of the board. The better view is that the chairperson of the board should not be a member of the audit committee, but could be invited to attend meetings as necessary. The audit committee should have written terms of reference that deal adequately with its membership, authority and duties. Membership of the audit committee should be disclosed in the annual report. Companies should, in the annual report, disclose whether or not the audit committee has adopted formal terms of reference and, if so, whether the committee has satisfied its responsibilities for the year in compliance with its terms of reference.[81]

99 In its submissions to the Listing Committee, the NACD recommended that audit committees should meet independently with both internal and independent auditors.

[81] §6.3 p 39 of King II

100 In late July 2002, the UK Government asked the Financial Reporting Council ("FRC") to put in hand the development of the existing Combined Code guidance on audit committees. In September 2002, the FRC appointed a group chaired by Sir Robert Smith to prepare a report. The report was published in January 2003 ("the Smith report"). The Smith report should be circulated amongst all those who have an interest in the proper functioning of an audit committee, including the members of the audit committee, head of internal audit and the external auditors of the bank. Some of the more pertinent findings and recommendations are highlighted:

- While all directors have a duty to act in the interest of a company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control.
- The most important features of the relationship between the audit committee and the board, the executive management, internal auditors and external auditors cannot be put into a code of practice: a frank, open working relationship and a high level of mutual respect are essential, particularly between the audit committee chairperson and the board chairperson, the CEO and the finance director. The audit committee must be prepared to

take a robust stand, and all parties must be prepared to make information freely available to the audit committee, to listen to their views and to talk through the issues openly.

- The management is under an obligation to ensure the audit committee is kept properly informed, and should take the initiative in supplying information rather than waiting to be asked.
- Audit committees have wide-ranging, time-consuming and sometimes intensive work to do. Companies need to make the necessary resources available. This includes suitable payment for the members of audit committees themselves. They – and particularly the audit committee chairperson – bear a significant responsibility and need to commit a significant extra amount of time to the job. Companies also need to make provision for induction and training for new audit committee members and continuing training as may be required.
- No-one other than the audit committee's chairperson and members is entitled to be present at a meeting of the audit committee. It is for the audit committee to decide if non-members should attend for a particular meeting or a particular agendum item. It is to be expected that the external audit lead partner will

be invited regularly to attend meetings as well as the finance director. Others may be invited to attend.

- The audit committee should, at least annually, meet the external and internal auditors, without management, to discuss issues arising from the audit.
- Whistleblowing: the audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting, financial control or any other matters

Remuneration Committee

101 King II recommends that companies should appoint a remuneration committee consisting entirely or mainly of independent non-executive directors to make recommendations to the board within agreed terms of reference on the company's framework of executive remuneration and to determine specific remuneration packages for each of the executive directors. This is ultimately the responsibility of the board. The committee must be chaired by an independent non-executive director. In order to obtain input on the remuneration of the other executives the committee should consult the CEO, who may attend meetings by

invitation. However, the CEO should play no part in decisions regarding his/her own remuneration.[82]

Nomination/Corporate Governance/Directors' Affairs Committee

102 In terms of King II, shareowners are responsible ultimately for electing or removing board members. In practice, the board as a whole usually plays a major role in selecting its own members, and should accordingly plan for its own continuity and succession. The board should select, appoint, induct, develop and remove board members as and when necessary. Incompetent or unsuitable directors (including those who fail to attend meetings without proper explanation) should be removed, taking relevant legal and other matters into consideration, with the chairperson usually leading the process.[83]

103 King II recommends that, in appropriate circumstances, a nomination committee can provide a useful forum in which to assist the board to identify suitable candidates for consideration. In looking at the skills mix for a board, there are three dimensions of board effectiveness requiring consideration:

[82] p 61 of King II.
[83] p 62 chapter 5 §'s 1 and 3 of King II.

- the knowledge or information required to fill a significant gap on the board;
- the capacity of an individual to influence preferred outcomes (internally and externally) through their involvement on the board;
- the extent to which an individual has the opportunity or availability to meaningfully contribute their time and abilities to the affairs of the board. The nomination committee could fulfil some broader functions by maximising the collective wisdom of the non-executive directors serving on the committee (which should comprise a majority of independent non-executive directors). Increasingly, the nominating process for new directors has been incorporated into a board committee dealing with a range of corporate governance issues referred to it by the board.

The name of the committee could simply be the corporate governance committee.[84]

104 The proposed amendments to the Banks Act seem to embrace the King II recommendation of a nomination/corporate governance committee. In terms of the proposed s64B(1) the board of a bank must establish a

[84] p 63, chapter 5 §'s 4 and 5 of King II.

directors' affairs committee consisting of only the non-executives of a bank. The functions of the committee shall be, *inter alia,* to:

(a) assist the board of directors in its determination and evaluation of the adequacy, efficiency and appropriateness of the corporate governance of the bank;

(b) establish and maintain a board directorship continuity programme to include as a minimum the review of performance and succession planning of executive directors; the continuity of non-executive directors; a regular review of the composition of the board of directors, including the skills, experience and other qualities required to enhance the effectiveness of the board of directors; and an annual self-assessment, under co-ordination of the chairperson, of the board as a whole and of the contribution of each individual director;

(c) assist the board in the nomination of successors to the key positions in the bank in order to ensure that a management succession plan is in place;

(d) assist the board in determining whether the employment of directors should be terminated;

(e) assist the board in ensuring that the bank is at all times in compliance with all applicable laws, regulations and codes of conduct and practices.

The proposal contained in s64B that the directors' affairs committee must consist of *all* the non-executive directors could make it unworkable. Some bank boards consist of between 11 and 16 non-executive directors.[85] A committee of that size is too large to be effective. It is recommended that s64B should rather refer to a defined number of non-executive directors, for example, three or five.

However, it is invaluable for non-executive directors to meet regularly and to assess the functioning of the bank and its executives. Consideration should be given to establishing sub-committees to deal with ongoing issues, and reporting to a full meeting of the committee at least twice a year.

105 The proposed directors' affairs committee, consisting as it will of only non-executive directors, can fulfil the function called for by the Listing Standards Report and Derek Higgs, namely, of meeting regularly without members of management present.

Managing Risk

106 The Code and King II place great emphasis on risk management.[86] For present purposes it is sufficient to refer only to some of the key

[85] See the analysis in §31 hereof.
[86] The Code §3 pp 30-34 of King II; s2 pp 73-85 of King II.

recommendations. King II begins the discussion on risk management by stating that *corporate governance* can, in part, be viewed as a company's strategic response to the need to assume prudent risks, appropriately mitigated, in exchange for measurable rewards. *Risk management* can be defined as the identification and evaluation of actual and potential risk areas as they pertain to the company as a total entity, followed by a process of either termination, transfer, acceptance (tolerance) or mitigation of each risk.[87] The recommendations include the following:

- the board should make use of generally recognised risk management and internal control models and frameworks in order to maintain a sound system of risk management and internal control to provide reasonable assurance regarding the achievement of defined organisational objectives;
- the board is responsible for the total process of risk management, as well as for forming its own opinion on the effectiveness of the process;
- management is accountable to the board for designing, implementing and monitoring the process of risk management, and integrating it into the day-to-day activities of the company;

[87] Chapter 1 §'s 3 and 4 p 73 of King II.

- the board should set the risk strategy policies in liaison with the executive directors and senior management;
- the board is responsible for ensuring that a systematic, documented assessment of the processes and outcomes surrounding key risks is undertaken at least annually for the purposes of making its public statement on risk management;
- risks should be assessed on an ongoing basis, and controlled activities should be designed to respond to risks throughout the company;
- companies should develop a system of risk management and internal control that builds more robust business operations;
- reports from management to the board should provide a balanced assessment of the significant risks and the effectiveness of the system of internal control in managing those risks;
- the board is responsible for disclosure in relation to risk management and should, at a minimum, disclose, for example, that it is accountable for the process of risk management and the system of internal control;
- there must be an ongoing process for identifying, and evaluating and managing the significant risks faced by the company;

- there must be an adequate and effective system of internal control in place to mitigate the significant risks faced by the company, and so on.[88]

107 In terms of the Code, a board committee, either a dedicated committee or one with other responsibilities, should be appointed to assist the board in reviewing the risk management process and the risks facing the company.[89]

108 In terms of the proposed amendments to the Banks Act, s64A(1) will provide that the board of a bank must appoint at least three of its members, of which at least two members shall be non-executive, to form a risk committee. S64A(2) will provide:

"The functions of the risk committee shall be to-

(a) assist the board of directors in its evaluation of the adequacy and efficiency of the risk policies, procedures, practices and controls applied within that bank in the day-to-day management of its business;

(b) assist the board in the identification of the build up and concentration of the various risks to which the bank is exposed;

(c) assist the board of directors in developing a risk mitigation strategy to ensure that the bank manages the risks in an optimal manner;

[88] Pp 75-84 of King II.
[89] §3.1.6 of the Code.

(d) assist the board in ensuring that a formal risk assessment is undertaken at least annually;

(e) assist the board in identifying and regularly monitoring all key risks and key performance indicators to ensure that its decision-making capability and accuracy of its reporting is maintained at a high level at all times;

(f) facilitate and promote communication, through reporting structures regarding the matters referred to in paragraph (a) or any other related matter, between the board of directors and the executive officers of the bank;

(g) ensure the establishment of an independent risk management function and in the case where the bank forms part of a group, a group risk management function (including any global activities), the head of which will act as the reference point for all aspects relating to risk management within the bank, including the responsibility to arrange training to members of the board of directors in the different risk areas that the bank is exposed to;

(h) introduce such measures as in the committee's opinion may serve to enhance the adequacy and efficiency of the risk management policies, procedures, practices and controls applied within that bank;

(i) co-ordinate the monitoring of risk management on a globalised basis; and

(j) perform such further functions as may be prescribed."

Section F: Company Secretary

109 In terms of the Code, the company secretary, through the board, has a pivotal role to play in the corporate governance of a company. The board should be cognisant of the duties imposed on the company secretary and should empower the company secretary accordingly to enable him or her to properly fulfil those duties. The company secretary must provide the board as a whole and directors individually with detailed guidance as to how their responsibilities should be properly discharged in the best interests of a company. The company secretary has an important role in the induction of new or inexperienced directors and in assisting the chairperson and CEO in determining the annual board plan and the administration of other issues of a strategic nature at board level. The company secretary should provide a central source of guidance and advice to the board, and within the company, on matters of ethics and good governance.[90]

Section G: Internal Audit

110 The Banks Act, the regulations and the proposed amendments do not deal with internal audit.

[90] §2.10 p 30 of King II and see chapter 10 pp 70-72 of King II.

111 The Code and King II contain detailed provisions relating to the status, role, function and scope of internal audit. In terms of the Code, *inter alia*, companies should have an effective internal audit function that has the respect and co-operation of both the board and management. Internal audit should operate at a level within the company that allows it to fully accomplish its responsibilities. The head of internal audit should report administratively to the CEO and should have ready and regular access to the chairperson of the company and the chairperson of the audit committee. Internal audit should report at all audit committee meetings. Internal audit is an independent, objective assurance and consulting activity to add value and improve a company's operations. It helps a company accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.[91]

Section H: Compliance function

112 A bank is obliged to establish an independent compliance function as part of its risk management framework in order to ensure that the bank continuously manages its regulatory risk, that is, the risk that the bank

[91] The Code, §4 pp 34-35 of King II; s3 pp 86-90 of King II

does not comply with applicable laws and regulations or supervisory requirements.[92] The primary responsibility of compliance with the provisions of the Banks Act and the regulations remains on directors and executive officers.[93] The compliance function must be headed by a compliance officer of the bank, who shall perform a compliance officer's functions with diligence and care and with such a degree of competence as can reasonably be expected from a person responsible for such a function.[94] The compliance function shall have adequate resources and stature in order to ensure that non-compliance with laws and regulations or supervisory requirements by the bank can be addressed adequately.[95] Reg 47(4) sets out minimum requirements in regard to effectiveness, monitoring, reporting, resources, and a compliance manual.

113 In terms of the proposed amendments to the Banks Act, the new s60A will require a bank to establish an independent compliance function as part of the risk management framework of the bank. This requirement was previously found only in the regulations. The compliance function must be headed by a compliance officer.

[92] Regulation 47(1).
[93] Regulation 47(5).
[94] Regulation 47(2).
[95] Regulation 47(3).

Section I: External auditors

114 In terms of the Banks Act, the appointment of the auditor of a bank must be approved by the Registrar of Banks. If the assets of a bank exceed R10 billion at the close of its last preceding financial year, the bank must appoint two auditors who are independent of each other.[96] In terms of proposed amendments to s61, the amount which will trigger the appointment of two auditors will not be R10 billion but rather a prescribed amount and the appointment of an auditor will be for a prescribed period and on prescribed conditions. In terms of s63(1)(a) and (b) of the Banks Act, the auditor of a bank is obliged to inform the Registrar of Banks:

- of an irregularity or suspected irregularity in the conduct of the affairs of the bank for which he has been appointed as auditor;
- of any matter relating to the affairs of a bank which, in the opinion of the auditor, may endanger the bank's ability to continue as a going concern or may impair the protection of the funds of the bank's depositors or may be contrary to the principles of sound management (including risk management) or amounts to inadequate maintenance of internal controls.

[96] S61(1).

115 The external auditors of a bank must annually review the process followed by the board of directors in assessing the corporate governance arrangements, including the management of risk and report to the Registrar whether any matters have come to their attention to suggest that they do not concur with the findings reported by the board of directors. If the auditors do not concur with the findings of the board, they must provide reasons therefore.[97] In terms of reg 39(4)(d) the external auditors of a bank must annually report to the Registrar whether or not they concur with the reports submitted by the directors of a bank to the Registrar in terms of reg 39(4)(a) and (b). Independently of the obligation which rests on the auditors to verify, so to speak, those reports which the directors of the bank are obliged to submit to the Registrar, the auditors must furnish reports to the Registrar:

- on the bank's financial position and the results of its operations;
- whether, in the auditors' opinion, the information contained in the returns at year-end in all material respects was complete or accurate or in accordance with the directives and instructions of the Banks Act and the regulations;
- on any significant weaknesses in the system of internal controls relating to financial regulatory reporting and compliance with the Banks Act and the regulations;

[97] Regulation 38(6).

- on any significant weaknesses in the system of internal controls that come to the auditors' attention while performing the necessary auditing procedures as regard to the policies, practices and procedures of a bank relating to the granting of loans, making of investments, ongoing management of the loan and investment portfolios, and loan provisions and reserves.[98]

116 It is not necessary to deal in any detail with the provisions in the Code and King II which refer to accounting and auditing.[99] In terms of King II, the external audit provides an independent and objective check on the way in which the financial statements have been prepared and presented by the directors when exercising their stewardship to the stakeholders. An annual audit is an essential part of the checks and balances required, and is one of the cornerstones of corporate governance. While external auditors have to work with management, they must be objective and consciously aware of their accountability to the shareowners. The auditors must be able to turn to the non-executive directors in regard to any concerns they may have about the company or its business. Auditors

[98] Regulation 45.
[99] Code §6 pp 38-39; s5 pp 125-129 of King II.

should observe the highest standards of business and professional ethics.[100]

117 The external auditors of banks face two dilemmas:

- the one is that the auditors have statutory obligations towards the SARB, which they must meet while retaining a cordial relationship with their client, the bank;
- the second is that the auditors are required to act independently and objectively and yet the audit of a large bank produces a substantial income for the auditors.

118 The external auditors of the five major banking groups are:

Auditors	Banking Group
Deloitte & Touche	FirstRand, Nedcor
Ernst & Young	Investec, Absa
KPMG	Standard Bank, Nedcor, Absa and Investec
PwC	Standard Bank, FirstRand

[100] Chapter 1 §'s 1.1, 1.2 and 1.5 p 125 of King II.