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TO ALL BANKS, BRANCHES OF FOREIGN BANKS AND MUTUAL BANKS

BANKS ACT CIRCULAR 4/2003

COMPOSITION OF BOARD-APPOINTED COMMITTEE TO APPROVE LARGE EXPOSURES

EXECUTIVE SUMMARY

The primary risk that banks incur is credit risk, that is, the risk that a counterparty to an asset or a debtor in respect of loans and advances, or the issuer of an instrument will not be able to repay the capital amount and the accrued interest when due and payable.

Because a significant percentage of major bank failures has been due to credit-concentration risk of one kind or another, diversification of risk is a key condition for sound banking practice.

The board of directors of a bank is ultimately responsible for the maintenance of effective risk management in the bank. In discharging its responsibilities, the board of directors has to play a critical role in overseeing, amongst other things, the credit-granting and credit-risk-management functions of the bank. The aforementioned responsibility of the board of directors forms an integral part of the overall process of corporate governance in the bank.

In terms of section 73(1)(a) of the Banks Act, 1990, a bank "shall not make investments with or grant loans or advances or other credit to any person, to an aggregate amount exceeding 10 per cent of such amount of its capital and reserves as may be prescribed, without first having obtained the permission of its board of directors, or of a committee appointed for such purpose (for the composition of which committee the prior written approval of the Registrar has to be obtained), to make such investments or to grant such loans, advances or other credit".

The purpose of this circular is to communicate the criteria that are applied when this Office considers the composition of the aforementioned committee for approval.

1. INTRODUCTION

Banking entails, amongst other things, the management of a series of risk. These risks can take various forms, and the extent and complexity of each risk area differ from bank to bank.

The primary risk that banks incur is credit risk, that is, the risk that a counterparty to an asset or a debtor in respect of loans and advances, or the issuer of an instrument will not be able to repay the capital amount and the accrued interest when due and payable. Banks are increasingly facing credit risk, including counterparty risk, in various financial instruments other than loans and advances.

Because a significant percentage of major bank failures has been due to credit-concentration risk of one kind or another, diversification of risk is a key condition for sound banking practice.

Experience suggests that credit concentrations can result in substantial losses without any commensurate increase in prospective returns. When a bank evaluates a credit application for approval, the bank should take into consideration potential future changes in economic conditions and should assess its credit-risk exposures under stressful conditions.

Core principle 9 of the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision ("Basel Committee") requires banking supervisors to be satisfied that "… banks have management information systems that enable management to identify concentrations within the (credit) portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers".

In order to ensure compliance with core principle 9, the Basel Committee has specified certain matters as essential criteria and others as additional criteria. The aforementioned criteria include the following matters:

Essential criteria

(a) Laws, regulations, or the supervisor sets prudent limits on large exposures to a single borrower or closely related group of borrowers. “Exposures” include all claims and transactions, both on-balance sheet and off-balance sheet.

(b) The supervisor verifies that banks have management information systems that enable management to identify, on a timely basis, concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.

(c) The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.

(d) The supervisor regularly obtains information that enables concentrations within a bank's credit portfolio, including sectoral and geographic exposures, to be reviewed.

Additional criteria

(a) Banks are required to adhere to the following definitions:

(i) Ten per cent or more of a bank's capital is defined as a large exposure.

(ii) Twenty-five percent of a bank's capital is the limit for an individual large exposure to a private-sector non-bank borrower or a closely related group of borrowers.

The purpose of the aforementioned limits is to contribute to an adequately diversified credit portfolio.

2. RESPONSIBILITIES OF THE BOARD OF DIRECTORS

The board of directors of a bank is ultimately responsible for the maintenance of effective risk management in the bank. In discharging its responsibilities, the board of directors has to play a critical role in overseeing the credit-granting and credit-risk-management functions of the bank and has to ensure, amongst other things, that -

(a) Credit activities are conducted within the risk strategy, policies and tolerances approved by the board.

(b) The bank operates within sound and well-defined credit-granting criteria.

(c) All extensions of credit are made on an arm's length basis.

(d) Senior management is fully capable of managing the credit activities conducted by the bank.

(e) Credit activities are subject to adequate internal controls and appropriate internal-audit coverage.

(f) The bank has adequate capital for the risks that it assumes.

The aforementioned responsibilities of the board of directors form an integral part of the overall process of corporate governance in a bank. The process should provide proper incentives for the board and senior management to pursue objectives that are in the best interest of the bank, its shareholders and other stakeholders.

Members of the board of directors, particularly non-executive directors, may be an important source of new business for the bank. Once a potential credit exposure is introduced, however, the bank's established credit processes should determine how much and on what terms credit should be granted.

3. REQUIREMENTS OF THE BANKS ACT, 1990

In order to enhance independence and objectivity, section 60 of the Banks Act, 1990 (Act No. 94 of 1990 - "the Act"), requires the majority of the members of the board of directors of a bank to consist of non-executive directors. Furthermore an effective number of board members should be capable of exercising judgement independently from the views of management or large shareholders.

In terms of section 73(1)(a) of the Act, a bank "shall not make investments with or grant loans or advances or other credit to any person, to an aggregate amount exceeding 10 per cent of such amount of its capital and reserves as may be prescribed, without first having obtained the permission of its board of directors, or of a committee appointed for such purpose (for the composition of which committee the prior written approval of the Registrar has to be obtained), to make such investments or to grant such loans, advances or other credit".

The philosophy of this Office includes, amongst other things, that market principles and risk-management assessment underlie all activities and decisions. Because it is market practice for banks to appoint a committee in order to approve large credit exposures, this Office amended section 73(1) of the Act to provide for the said market practice. In view of the important principles relating to corporate governance and the responsibilities of the board of directors of a bank, as set out above, the said section of the Act also provided for the composition of the said committee to be subject to the prior written approval of the Registrar.

4. COMPOSITION OF BOARD-APPOINTED COMMITTEE TO APPROVE LARGE EXPOSURES

Banks requested this Office to communicate the criteria that it applied when considering whether or not to approve the composition of the aforementioned committee.

This Office is of the opinion that, as a minimum, a credit committee appointed by the board of directors of a bank in order to approve large exposures shall consist of the following members:

(a) Three non-executive directors, that is, persons who are not employees of the bank or of any of its subsidiaries, its controlling company or any subsidiary of its controlling company, and one of whom shall be the chairperson of the said committee.

(b) The chief executive officer of the bank.

(c) The bank's head of finance.

(d) The bank's head of risk or an equivalent function, such as the head of enterprise-wide-risk-management.

(e) The bank's head of credit.

When the board-appointed credit committee requires specific input from particular business units in respect of a proposed credit exposure, the committee may invite the relevant executive director or executive officer to make such required presentations to the committee.

The decisions on large credit exposures made by the board-appointed committee shall be recorded in writing and shall be tabled at the board meeting immediately following the meeting of the said committee, for the board's review and ratification.

The credit committee should periodically assess its own performance, determine where weaknesses exist and, where possible, take appropriate corrective actions.

5. FAILURE OR INABILITY TO COMPLY WITH THE PROVISIONS OF THIS CIRCULAR

When a bank fails or is unable to comply with a provision of this circular, the bank shall report its failure or inability to comply to the Registrar, in writing, stating the reasons for such failure or inability to comply.

The Registrar may summarily take action under the Act or the Regulations relating to Banks against a bank that fails or is unable to comply with the provisions of this circular. Alternatively, if in the circumstances the Registrar deems it fit to do so, the Registrar may condone such non-compliance and afford the institution concerned an opportunity, subject to such conditions as the Registrar may determine, to comply with the relevant provision within a specified period.

6. FUTURE AMENDMENTS TO THE REGULATIONS RELATING TO BANKS

Notice is hereby given that this Office is in the process of drafting amendments to the Regulations relating to Banks in order to incorporate the provisions of this circular.

7. ACKNOWLEDGEMENT OF RECEIPT

Two additional copies of this circular are enclosed for the use of your institution's independent auditors. The attached acknowledgement of receipt, duly completed and signed by both the chief executive officer of the institution and the said auditors, should be returned to this Office at the earliest convenience of the aforementioned signatories.

C F Wiese
Registrar of Banks

The previous circular issued was Banks Act Circular 3/2003 dated 3 February 2003.