CHAPTER 4

DEVELOPMENTS RELATED TO BANKING LEGISLATION

important function

As indicated in previous Annual Reports, a particularly important function of the Bank Supervision Department is to ensure that the legal framework for the regulation and supervision of banking institutions and banking groups in South Africa remains relevant and current. The Department can fulfil this responsibility only if it ensures that the banking legal framework remains in line with international regulatory and market developments. Therefore, the Department has to review the banking legislation on an ongoing basis and, if necessary, make amendments.

This chapter provides a brief overview of proposed amendments to the Banks Act, 1990, and recent amendments to the Regulations thereto, as well as an overview of the recently promulgated Regulations relating to Representative Offices. Developments in the regulation of certain financial instruments are also outlined.

AMENDMENTS TO THE BANKS ACT, 1990

Although amendments to the Banks Act, 1990 (Act No. 94 of 1990), were not tabled in Parliament during the year under review, the Department drafted a number of proposed amendments for submission to the Standing Committee for the Revision of the Banks Act, 1990, in due course. It is hoped that these amendments will be tabled in Parliament during 2002.

The aim of the most important proposed amendments to the Banks Act may be summarised as being to:

aim of most important proposed amendments

- Address and amend the gender-insensitive provisions in the Banks Act.
- Insert definitions of certain new expressions and amend certain existing definitions.
- Amend certain provisions either to clarify or to reflect existing practices.
- Amend certain sections to reflect a change in institutional names or legislation.
- Insert provisions to enable subordinated legislation in respect of the establishment of representative offices, the compliance function of banks and corporate governance.
- Delete certain provisions that have become outdated or superfluous.
- Grant the Registrar the discretion to determine the value threshold that will require the appointment of a second external auditor to a bank.
- Insert provisions that would grant the Registrar certain powers in the appointment and dismissal of a bank’s and a controlling company’s board members.
- Increase the penalties for contraventions of the Banks Act.

AMENDMENTS TO THE REGULATIONS RELATING TO BANKS

amended Regulations implemented

The amended Regulations relating to Banks, on which the Bank Supervision Department reported comprehensively in its 1999 and 2000 Annual Reports, were implemented on 1 January 2001, after extensive consultation with the banking industry. During the year under review, some further amendments to the Regulations became necessary.

Increase in capital requirement

Ongoing concern worldwide about financial-sector stability necessitated a review of the minimum required capital-adequacy ratio of banks and of mutual banks. During 2000 and 2001, the Bank Supervision Department held discussions with banking institutions on a proposal to increase the prescribed percentage of the minimum capital and reserve funds that banks and mutual banks are required to maintain.

A study of the potential impact of an increase in the capital-adequacy ratio from 8 per cent to 10 per cent revealed that most banks and the two remaining mutual banks already had capital-adequacy ratios in excess of 10 per cent. The study further revealed that those banks that were not complying with the said percentage formed part of banking groups with sufficient capital to capitalise the banks to the required level.

banks carry systemic risk

decided to increase to 10 per cent

It is the bank or banks within a financial group that carry the systemic risk that could influence financial stability and which may even cause bank failures. Consequently, sufficient capital should be held in the bank or banks of a banking group, rather than in the controlling company or elsewhere in the group. It was therefore decided to increase the minimum prescribed capital requirement for banks and mutual banks to 10 per cent.

At a meeting on 15 February 2001, the board of directors of The Banking Council South Africa discussed the proposal to increase the prescribed capital requirement from 8 per cent to 10 per cent and, subsequently, informed the Bank Supervision Department that the banking sector endorsed the proposal. The proposed amendment was tabled at a meeting of the Standing Committee for the Revision of the Banks Act, 1990, on 25 May 2001, and it was decided that the amendment should be implemented with effect from 1 October 2001. The Minister of Finance subsequently approved this decision.

The amended capital requirement for banks was published under Government Notice No. R 1003, in *Government Gazette* No. 22737 on 5 October 2001, with an effective date of 1 October 2001. For mutual banks, the amended requirement, also with an effective date of 1 October 2001, was published under Government Notice No. R 1007, in *Government Gazette* No. 22738 on 5 October 2001.

Amendment of certain statutory returns

exemption of securitisation schemes required amendments to various statutory risk returns

On 13 December 2001, the Registrar, with the approval of the Minister of Finance, designated the acceptance of money from the general public by a special-purpose institution (SPI) against the issue, by such an SPI, of commercial paper in respect of a securitisation scheme as an activity not falling within the meaning of "the business of a bank". The exemption of securitisation schemes from the provisions of the Banks Act, discussed later in this chapter, required amendments to be made to various statutory risk returns. These amendments, as well as amendments necessitated by the increase in banks' and mutual banks' capital requirement to 10 per cent, discussed earlier in this chapter, were therefore incorporated into the various risk returns that banks and mutual banks have to submit to the Bank Supervision Department.

The Minister of Finance subsequently approved amended regulations in the above regard. Those for banks were published under Government Notice Nos. R 1004 and R 1006, in *Government Gazette* No. 22737 on 5 October 2001, with an effective date of 1 October 2001. The amended regulations for mutual banks were published under Government Notice No. R 1008, in *Government Gazette* No. 22738 on 5 October 2001, also with an effective date of 1 October 2001.

REGULATIONS RELATING TO REPRESENTATIVE OFFICES

In terms of section 34 of the Banks Act, 1990, an institution that has been established in a country other than the Republic of South Africa (Republic) and which lawfully conducts in such other country a business similar to the business of a bank may establish a representative office in the Republic after having obtained the written consent of the Registrar of Banks. Such a representative office, however, may not conduct the business of a bank in the Republic.

representative office and supervisor have certain obligations

Both a representative office established in terms of section 34 of the Banks Act and the supervisor have certain obligations. Section 34(5) of the Banks Act provides for a representative office to furnish the Registrar, at such time or at such intervals or in respect of such period and in such form as may be prescribed, with such information as may be required for the performance of the Registrar's functions under the Act. As regards the supervisor's obligations, the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision require, amongst others:

requirements of Core Principles

- The permissible activities of institutions that are licensed and subject to supervision to be clearly defined either by supervisors, or in laws or regulations.
- The law to enable the supervisor to address compliance with laws.
- The law to empower the supervisor to take prompt remedial action when, in a supervisor's judgement, an authorised institution does not comply with legislation.

In order to address the above-mentioned obligations and with a view to drafting Regulations relating to Representative Offices, the Bank Supervision Department engaged in a number of discussions with representative officers of foreign institutions resident in the Republic. At the beginning of January 2001, the Department released draft Regulations relating to Representative Offices for comment, on the South African Reserve Bank's Internet Website. Various representative officers furnished the Department with valuable proposals and comments. The Department also held discussions and workshops with representative officers, in order to clarify and resolve various matters.

At a meeting on 26 July 2001, the Euro Chamber Banking and Finance Committee discussed the proposed Regulations relating to Representative Offices and, subsequently, informed the Bank Supervision Department that the Chamber endorsed the proposed Regulations. On 24 August 2001, the proposed Regulations were tabled at a meeting of the Standing Committee for the Revision of the Banks Act, 1990, and it was decided that the Regulations should be implemented with effect from 1 January 2002.

The Minister of Finance subsequently approved the Regulations relating to Representative Offices, which were published under Government Notice No. R 1370, in *Government* effective date of 1 January 2002

Gazette No. 22939 on 13 December 2001, with an effective date of 1 January 2002.

REGULATION OF FINANCIAL INSTRUMENTS

Ongoing innovation in financial markets includes the development of new financial instruments and new uses of financial instruments. The Bank Supervision Department has to assess the need to regulate such instruments and, if necessary, has to amend the banking legislation accordingly, in line with international best practice and after consultation with the industry. During the year under review, a new regulatory framework for asset securitisation was finalised, and work was done on the possible regulation of preference-share investment structures and credit-derivative instruments.

Asset securitisation

The reasons for and factors influencing the proposed amendment of the legal framework governing asset securitisation were discussed in the previous Annual Report.

new Securitisation Notice

The Minister of Finance consented to the amended framework, which was published under Government Notice No. 1375 (the new Securitisation Notice), in *Government Gazette* No. 22948 on 13 December 2001. The new Securitisation Notice repeals Government Notice No. 153 (the previous Securitisation Notice), published in *Government Gazette* No. 13723 on 3 January 1992, in its totality and provides for the issue of commercial paper in terms of a securitisation scheme established under the new Securitisation Notice. The provisions of Government Notice No. 2172 (the Commercial Paper Notice), published in Government Gazette No. 16167 on 14 December 1994, will thus not apply to commercial paper issued in terms of securitisation schemes established under the new Securitisation Notice.

combined regulatory regime

The new Securitisation Notice, therefore, introduces a combined regulatory regime. This regime will not constrain certain activities merely because of prudential considerations, which are aimed primarily at ensuring the financial soundness of financial institutions and the financial system. The accepted international approach is that the same regulatory objectives can be achieved through market-conduct regulation, which is aimed primarily at the protection of investors through adequate disclosure. An approach of sufficient disclosure of the relevant risks should enable investors to decide whether these risks have been addressed sufficiently.

incorporates international best practice and latest guidelines of Basel Committee

The new Securitisation Notice incorporates both international best practice and the latest guidelines on the regulatory aspects of asset securitisation published by the Basel Committee on Banking Supervision. The main areas that have been amended in accordance with international developments and market needs are the following:

main areas amended

- The definition of securitisation has been broadened by allowing banks to act as originator, remote originator, sponsor or repackager in relation to a securitisation scheme. The amendments also specifically allow for securitisation schemes involving non-banking assets.

- Banks are permitted to provide a multiplicity of services in securitisation schemes. When a bank, however, provides credit-enhancement or liquidity facilities in relation to securitisation schemes, the capital of the bank will be impaired in accordance with the risk undertaken by the bank.

- Certainty is provided in relation to the Commercial Paper Notice. The previous Securitisation Notice required adherence to the "relevant clauses" in the Commercial Paper Notice. This reference created uncertainty, since it was not clear to which clauses reference was being made. The specific clauses have therefore been incorporated directly into the new Securitisation Notice.

Preference-share investment structures

An important function of the Bank Supervision Department is to enforce the provisions of the Banks Act, 1990, in order to ensure that "the business of a bank", as defined in the Act, is conducted only by entities that are either registered as banks in terms of the Act or exempted from the provisions of the Act under certain conditions.

The Department became aware that several entities, including trusts, were possibly conducting the "business of a bank" by means of preference-share investment structures without being registered as a bank in terms of the Banks Act. On 29 November 2000, the Department, therefore, issued Banks Act Circular 10/2000, to be read in conjunction with Banks Act Circular 6/99, in order to set out the Department's position on the issue. The Department held the view that such preference-share investment schemes were possibly being operated in contravention of the provisions of the Banks Act and that regulatory intervention was required.

In response to the above-mentioned circulars, however, the Department received comments and representations from various banks and The Banking Council South Africa. Consequently, the Department reconsidered its initial position and decided to obtain further information from banking institutions on, amongst others, the nature and extent of the preference-share investment schemes being operated before making a final determination. To this end, the Department issued Banks Act Circular 12/2001, requesting banking institutions to submit the said information, which the Department received during October and November 2001.

final decision will be made

A final decision on the regulation of preference-share investment schemes will be made once the Bank Supervision Department has analysed and duly considered the information submitted by banking institutions.

Credit-derivative instruments

credit-derivative instrument

The introduction of credit-derivative instruments is a relatively recent innovation in the financial markets. A credit-derivative instrument is a contract in terms of which the credit risk associated with a financial asset is isolated from the other risks associated with that financial asset. Furthermore, in terms of the contract, the credit risk is transferred from one counterparty, which can be referred to as the protection buyer or credit-risk seller, to another counterparty, which can be referred to as the protection provider or credit-risk buyer. The current regulatory framework in South Africa, however, does not provide for the use of credit-derivative instruments in the mitigation of credit risk.

transfer of credit risk

Bank failures have often arisen from excessive credit exposure to particular borrowers or groups of borrowers that were vulnerable to the same economic shocks. The further development of markets for the transfer of credit risk has the potential to improve the stability and efficiency of financial markets.

instrument offers advantages and opportunities but also additional risks and uncertainties

Furthermore, credit-derivative instruments may improve the ability of banks to manage credit risk separately from funding. A credit-derivative instrument offers the advantages and opportunities common to derivative instruments in general, but may also present certain additional risks and uncertainties. For example, if the buyer of credit risk, that is, the seller of protection, decides to make a loan to a corporate institution instead of providing protection, the credit-risk buyer would typically make a detailed analysis of the risks inherent in extending the credit, undertake a detailed review of the underlying documentation and even obtain legal opinions. The speed and flexibility at which transactions can be executed in the credit-derivative market, however, may create a false sense of security for a protection provider (credit-risk buyer) that buys a large amount of notional corporate debt. The legal effects, jurisdictional peculiarities, enforceability of the underlying documents and the fair value of the transaction may turn out to be materially different from what the credit-risk buyer had anticipated.

credit-derivative market growing rapidly

The credit-derivative market has been growing rapidly during the past number of years. The global notional principal outstanding amount for credit-derivative instruments may have been as high as US$ 1 trillion at the end of 2001. Indications are that this amount will grow rapidly in the forthcoming number of years. Some regulatory authorities have already expressed growing concern about the potential threat of the exponential growth in the credit-derivative market to the global financial system, especially in a period of economic downturn.

The proposed new Basel Capital Accord acknowledges the latest developments in the financial markets by recognising credit-derivative instruments as potential credit-risk mitigation instruments. Following the latest regulatory and market developments in the credit-derivative market, the Bank Supervision Department established a working group, consisting of representatives of all key players in the risk-management process of banks and banking groups, in order to formulate legislation for the regulatory treatment of credit-derivative instruments in South Africa. During 2001, several meetings and discussions were held.

extensive research

The Bank Supervision Department is also conducting extensive research on credit-derivative instruments. The Department envisages releasing amended banking legislation to provide for the regulatory treatment of credit-derivative instruments during 2002.