CHAPTER 4

DEVELOPMENTS RELATED TO BANKING LEGISLATION

important responsibility

The Bank Supervision Department is tasked with ensuring that the legal framework for the regulation and supervision of banking institutions and banking groups in South Africa continues to be relevant and current. In order for the Department to fulfil this important responsibility effectively, the banking legal framework has to remain in line with regulatory and market developments, locally and internationally. Consequently, the Department continuously has to review the banking legislation – that is, the Banks Act, 1990, as well as the Mutual Banks Act, 1993, and the Regulations thereto – and make the necessary amendments.

As in previous years, this chapter contains a brief overview of proposed amendments to the Banks Act, 1990. The chapter also provides an outline of recent amendments made to the banking regulatory framework in order to provide for, amongst others, the regulation and supervision of credit risk-mitigation instruments.

Although not a development in banking legislation itself, an important court ruling on the investment of attorneys' trust funds in a bank, of relevance to both the banking industry and the legal fraternity, is also reported.

AMENDMENTS TO THE BANKS ACT, 1990

Amendments to the Banks Act, 1990 (Act No. 94 of 1990), were not tabled in Parliament during the past two years. In 2002, the Department drafted a number of further proposed amendments, in addition to those outlined in the 2001 annual report, and consolidated these amendments into the proposed Banks Amendment Bill. The amendments were approved by the Standing Committee for the Revision of the Banks Act, 1990, and subsequently submitted to the Minister of Finance, for approval and submission to Cabinet. The proposed Bill was tabled in Parliament early in 2003.

objective of the most important amendments

The objective of the most important proposed amendments to the Banks Act made in 2001 (as previously reported, but repeated below) and in 2002 may briefly be stated as being to:

- Address and amend 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 the implementation of subordinated legislation relating to the establishment of representative offices, the compliance function of banks and corporate governance.
- Delete certain provisions that have become outdated or superfluous.
- Insert provisions that would grant the Registrar of Banks certain powers in the appointment and dismissal of a bank's and a controlling company's board members and executive officers.
- Provide for the Registrar to approve the appointment of an external auditor to a bank and a controlling company, since this will accord with the established principle of con-

solidated supervision of banks and their controlling companies by the Registrar.

- Enable the value threshold that will require the appointment of a second external auditor to a bank to be prescribed by regulation.
- Enable the criteria, conditions and procedure whereby a bank's auditor is subject to a system of compulsory rotation to be prescribed by regulation.
- Compel all banks to establish a risk committee and a directors' affairs committee in the interest of sound risk management and corporate governance.
- Restrict certain investments made by banks, especially those relating to investments in shares of any company, and not only property companies (as interpreted by some banks).
- Augment certain provisions relating to activities and practices that are regarded as undesirable.
- Increase the penalties for contraventions of the Banks Act.

BANKING REGULATORY FRAMEWORK

amended Regulations

On 13 November 2002, the Minister of Finance granted approval for the publication and implementation of amendments to the Regulations relating to Banks and the Regulations relating to Capital-adequacy Requirements ("CAR") for Banks' Trading Activities in Financial Instruments (CAR Regulations). The amended Regulations were published under Government Notices R.1464 and R.1465, in *Government Gazette* No. 24088 on 22 November 2002, and apply in respect of the reporting periods of January 2003 onwards. The amendments became necessary to provide for:

- Requirements relating to the risk-management processes, policies and procedures of banks and their controlling companies.
- The regulatory and supervisory treatment of credit risk-mitigation instruments, including credit-derivative instruments.

Risk-management processes, policies and procedures of banks and controlling companies

The primary objective of the Regulations relating to Banks is to provide for the establishment of basic principles pertaining to the maintenance of effective risk management by banks and controlling companies. An ancillary objective is that the benefits that banks and controlling companies derive from compliance with the Regulations should exceed the cost of such compliance.

risk-management processes, policies and procedures

In order to promote the achievement of the above-mentioned primary objective, the amended Regulations require every bank and every controlling company to have in place comprehensive risk-management processes and board-approved policies, as well as procedures to identify, measure, monitor, control and report on, amongst others, the main risk areas to which the bank or controlling company are exposed. Furthermore, the amended Regulations prescribe that the risk-management processes, policies and procedures shall:

- Be adequate for the size and nature of the activities of a bank or controlling company and be adjusted periodically in the light of the changing risk profile of the bank or controlling company, as well as external market developments.

- Clearly specify the business strategy of a reporting bank or controlling company.
- Clearly specify the limits and allocated capital relating to the various risks.
- Be subject to adequate internal controls and appropriate internal audit coverage.
- Include appropriate board and senior-management oversight.

Credit-risk mitigation

reduction of credit exposure

Credit-risk mitigation relates to the reduction of credit exposure by, for example, obtaining collateral, credit-derivative instruments or guarantees, or taking an offsetting position subject to a netting agreement.

The 1988 Capital Accord recognises only collateral instruments and guarantees of the highest quality for risk-mitigation purposes. Since 1988, however, the markets for the transfer of credit risk have become more liquid and more complex. The number of suppliers of credit protection has increased, and new products, such as credit-derivative instruments, have allowed banks to unbundle their credit risks and to sell those risks that they do not wish to retain.

The aforementioned innovations in financial markets are welcomed, because greater liquidity in instruments reduces the transaction costs of intermediation between borrowers and lenders. Greater liquidity also encourages a more efficient allocation of risks in the financial system.

In designing the new Capital Accord, on which there is a comprehensive report in chapter 2 of this annual report, the Basel Committee on Banking Supervision is pursuing three main objectives in respect of risk mitigation, namely, to:

main objectives

- Improve the incentives for banks to manage credit risk in a prudent and effective manner.
- Continue to offer a prudent and simple approach, which may be adopted by a wide range of banks.
- Relate capital treatments to the economic effects of the different credit risk-mitigation techniques, in order to ensure greater consistency and flexibility in the treatment of different forms of credit-risk mitigation.

approach focuses on economic effects

The approach to credit risk-mitigation techniques focuses on the economic effects. Collateral, netting, guarantees and credit-derivative instruments, however, typically have different risk characteristics. For example, collateral represents so-called funded protection, whereas guarantees and most credit-derivative instruments are unfunded.

risk-weighting treatment differs

Furthermore, whereas collateral instruments are subject to market risk, guarantees are not, and credit-derivative instruments are more likely than collateral to be subject to maturity or asset mismatches. Consequently, although the treatment of collateral, netting, credit-derivative instruments and guarantees is based on similar concepts, the risk-weighting treatment differs.

Collateral and guarantees

The risk exposure of a bank may be secured by the pledge of an asset or a deposit, or guaranteed by a guarantor. When such security or guarantee attracts a lower risk weighting than the transaction or exposure itself, the risk weighting applicable to the relevant transaction or exposure may be reduced to the lower risk weighting, provided the bank meets certain criteria. These criteria relate mainly to the following:

criteria

- Legal certainty.
- Documentation.
- Low correlation with the relevant exposure.
- Robust risk management.
- Maturity mismatches.

Credit-derivative instruments

As indicated in the 2002 annual report, credit-derivative instruments are a relatively recent innovation in the financial markets. The Bank Supervision Department undertook extensive research on these instruments in order to ensure that the regulatory framework kept pace with the latest regulatory, supervisory and market practices in that regard.

In its review process, the Department consulted widely with the banking industry and the auditing profession. In March 2002, the Department issued draft amendments to the Regulations relating to Banks and the CAR Regulations for comment. Thereafter, the Department processed the valuable and comprehensive comments that it had received and also held discussions and workshops with key players in order to clarify and resolve various matters.

term credit-derivative instrument is used to describe various contracts designed to transfer credit risk

The term credit-derivative instrument is used to describe various contracts designed to transfer credit risk from one party (the protection buyer) to another party (the protection seller). When a portion of a credit exposure is protected, a bank that is a protection buyer may substitute the risk weighting relating to the protection provider for the risk weighting of the underlying asset or exposure. The protection seller, on the other hand, is normally exposed to the credit risk associated with the reference asset, reference entity or underlying asset. In terms of the amended Regulations, the position will be treated as though the protection seller has a direct exposure to the reference asset, reference entity or underlying asset.

The amended Regulations cover various aspects relating to credit-derivative instruments. These include that a distinction is made between funded and unfunded credit-derivative instruments, single-name and multiple-name instruments, and cash settlement and physical settlement.

Credit-derivative instruments are subject to criteria in addition to those listed above for collateral and guarantees. These criteria include requirements relating to:

requirements

- Rules, conditions or regulations issued by the Exchange Control Department of the South African Reserve Bank.
- Risk-management systems.
- Credit events.
- Asset mismatches.

Synthetic securitisation schemes

As reported in the previous annual report, an amended regulatory framework for asset securitisation was published under Government Notice No. 1375, in *Government Gazette* No. 22948 on 13 December 2001. The publication of regulations on credit-derivative instruments necessitated further amendment of the asset-securitisation framework in order to provide for synthetic securitisation schemes.

synthetic securitisation scheme

traditional securitisation scheme

In essence, a synthetic securitisation scheme refers to a structured transaction in which an institution uses a credit-derivative instrument to tranche and transfer the credit risk and/or market risk associated with a specified pool of assets to a special-purpose institution. A traditional securitisation scheme, on the other hand, involves the legal and economic transfer of the assets themselves to a special-purpose institution issuing asset-backed securities that are claims against a specific asset pool.

ATTORNEYS' TRUST FUNDS - THE CASE OF SAAMBOU BANK LIMITED

As reported in chapter 1 of this annual report, Saambou Bank Limited (Saambou) was placed under curatorship on 9 February 2002, in terms of section 69 of the Banks Act, 1990. Subsequently, two firms of attorneys demanded the release of certain funds invested with Saambou in terms of section 78(2A) of the Attorneys Act, 1979 (Act No. 53 of 1979). The curator of Saambou was of the opinion that investments made in terms of the above-mentioned section of the Attorneys Act and not linked to a guarantee constituted an ordinary deposit and could not be released. This led to the attorneys applying to the High Court of South Africa (Transvaal Provincial Division) for a declaratory order that such trust funds be kept separate from the assets and liabilities of the bank.

trust property

The court discussed whether the funds that the firms of attorneys had invested with Saambou qualified as trust property, as defined in section 1, read with sections 4(4) and 4(5), of the Financial Institutions (Protection of Funds), 2001 (Act No. 28 of 2001 - the 2001 FI Act). Should the funds indeed qualify as trust property, the attorneys' application had to succeed. Should the funds, however, not qualify as trust property, the court had to determine whether or not Saambou qualified as a financial institution.

common-law position

The court accepted the common-law position that a bank that accepts deposits from a depositor does not in any way act as a trustee of the money so deposited. It was also common cause that under the Financial Institutions (Investment of Funds) Act, 1984 (Act No. 39 of 1984 - the1984 FI Act), monies deposited in an attorney's trust account in terms of section 78(2A) of the Attorneys Act did not constitute trust property and were accordingly not protected under section 4(5) of the 1984 FI Act. The court, however, further held that the 2001 FI Act, which came into operation on 23 November 2001, altered both the statutory and the common-law position.

conclusion

The court concluded that the written instructions that the firms of attorneys had given to Saambou to invest the funds as trust monies in terms of section 78(2A) of the Attorneys Act should be seen as an offer that was accepted by Saambou. The court reached the somewhat strained conclusion that the invested monies were received and treated as trust monies. In terms of section 4(4) of the 2001 FI Act, therefore, the trust monies had to be kept separately from the assets belonging to Saambou.

effects of the court decision were held to be untenable

The effects of the court decision were held to be untenable, since they would necessitate a restructuring of the trust-property process of the entire banking sector. For example, a bank as trustee would not be able to invest trust property in the ordinary course of business. This would result in diminished profit for the bank and less or no interest being earned on the trust property. The curator of Saambou, the Registrar of Banks and the South African Reserve Bank, therefore, took the decision on appeal to the Supreme Court of Appeal.

appellants' argument

The basis of the appellants' argument was that one could not infer that the intention of the legislature was to change the common-law and the current statutory position radically through minor changes to the wording of legislation. The court referred to authority and found that when a bank accepted deposits, it became the owner thereof and had a personal obligation to repay the amount together with interest (if applicable).

The court could not find any indication or express language in the 2001 FI Act to suggest a change in the mindset of the legislature so as to vary the common-law position and the position under the 1984 FI Act. It would be contrary to the established rules of interpretation to effect such a change without an express intention of the legislature to do so.

The court consolidated its finding by stating that section 4(5) of the 2001 FI Act should be read in the context of section 4 of that Act as a whole. Section 4(1) of the 2001 FI Act requires that trust property be invested in accordance with an instruction from the principal, or in terms of an agreement. Section 78(2A) of the Attorneys Act, on the other hand, requires that an attorney give an instruction. The court was of the view that an instruction by an attorney could be construed neither as an instruction to the bank by the attorney's client (the principal), nor as an agreement between the client and the bank. Consequently, there was no trust relationship between the bank and the attorney's client.

no trust relationship

Finally, therefore, and based on the arguments expressed by the court, it was held that the more detailed wording of the definition of trust property and of section 4(5) of the 2001 FI Act did not change the meaning of trust property. The court was of the view that the purpose of the 2001 FI Act was simply to provide for and consolidate the investment and administration of trust property by financial institutions.

common-law position remains unchanged

The appeal was therefore upheld, and the common-law position, in effect, remains unchanged.