Chapter 4

Developments related to banking legislation

key responsibility

A key responsibility of the Bank Supervision Department is to ensure that the legal framework for the regulation and supervision of banks and banking groups in South Africa remains relevant and current. Consequently, the banking legal framework has to take account of local and international developments in regulation and the markets. The Department, therefore, has to review the banking legislation – that is, the Banks Act, 1990, the Mutual Banks Act, 1993, the Regulations thereto and other pieces of related banking legislation – on an ongoing basis and make necessary amendments.

This chapter contains an overview of amendments to the Banks Act, 1990 (Act No. 94 of 1990), promulgated during the year under review. Also outlined are proposed amendments to the legal framework for asset securitisation so as to distinguish between traditional and synthetic securitisation schemes.

Amendments to the Banks Act, 1990

amendments were duly promulgated

Although the previous annual report contained a brief outline of proposed amendments to the Banks Act, the amendments that were duly promulgated as Banks Amendment Act, 2003 (Act No. 19 of 2003), on 5 August 2003, are discussed more comprehensively below.

Provisions promoting gender sensitivity

Amendments were effected to address gender-insensitive provisions in the Banks Act.

Provisions addressing amended legislation

to cater for amendments to other legislation

Certain provisions of the Banks Act were amended to cater for amendments to other legislation, as follows:

- *Definition of "liquid assets"*

Previously, stocks issued under the Exchequer Act, 1975, qualified as liquid assets for purposes of the Banks Act. Following the repeal of the Exchequer Act, 1975, by the Public Finance Management Act, 1999 (Act No. 1 of 1999), the Banks Amendment Act, 2000, effected the necessary amendment to the Banks Act.

Subsequently, however, it become apparent that securities issued by virtue of section 66 of the Public Finance Management Act encompassed a far wider array of securities than had been the case under the Exchequer Act. Since the Registrar of Banks could not comfortably regard all these securities as liquid assets, the Banks Act was amended to limit such securities to those issued to fund the National Government.

- *Reference to the Inspection of Financial Institutions Act, 1998*

The Inspection of Financial Institutions Act, 1984 (Act No. 38 of 1984), was repealed by the Inspection of Financial Institutions Act, 1998 (Act No. 80 of 1998). The amendment to the Banks Act effects reference to the latter Act and to the relevant sections thereof.

- *Concurrent jurisdiction of Competition Commission*

Section 37(2)(b) of the Banks Act previously required the Registrar of Banks to consult with the Competition Board (as it was known under the previous Maintenance and Promotion of Competition Act, 1979) before considering an application for the acquisition of more than 15 per cent of the ordinary shares of a bank or bank controlling company. As indicated in the 2000 annual report, an amendment made to the Competition Act, 1998 (Act No. 89 of 1998), effectively affords the Competition Commission concurrent jurisdiction with the Registrar (and the Minister of Finance) in relation to the acquisition of shares in banks and banking mergers. Consequently, the provisions of section 37(2)(b) of the Banks Act had become superfluous. In order to enhance regulatory certainty, an amendment was made to reflect the concurrent jurisdiction of the Competition Commission.

section 37(2)(b) had become superfluous

Provisions clarifying and reflecting existing practices

to clarify certain provisions in line with their practical application

The following amendments were made to clarify certain provisions of the Banks Act in line with their practical application:

- *Insertion of a definition of and reference to Regulations relating to Branches*

Various sets of regulations have been issued in terms of the provisions of the Banks Act to regulate the banking industry effectively and efficiently. In order to avoid confusion, however, it had become necessary to define each set of regulations and, where appropriate, to refer to a specific set of regulations. Amendments were made to clarify the position with regard to the Regulations relating to Branches, that is, the regulations pertaining to branches of foreign banks in South Africa.

it had become necessary to define each set of regulations

- *Insertion of the words "at any time" in relation to when the Registrar may request a person to complete a questionnaire and provision for an offence*

Section 1(1A)(c) of the Banks Act provides that the Registrar of Banks may request any person to complete a questionnaire in order to form an opinion of the qualities of that person. The purpose of this provision is to determine whether a person in the employ of a bank or controlling company may be regarded as fit and proper for the relevant position. The questionnaire, form DI 020, is contained in the Regulations relating to Banks.

Although the Registrar of Banks had always contended that the Registrar could at any time request a person to complete such a questionnaire, some individuals were of the opinion that the Registrar could insist on such a questionnaire only at the time of a person's appointment as a director or executive officer of a bank or bank controlling company. The amendment reflects the existing practice and provides for any refusal or failure to comply with a request to complete such a questionnaire to be an offence.

- *Issuing of circulars by the Registrar to provide information*

Section 6(4) of the Banks Act provides that the Registrar of Banks may issue a circular to furnish banks with guidelines on the application and interpretation of the provisions of the Act. In practice, however, circulars are also used to provide banks with information and advice on various topics. The amendment reflects the existing practice.

circulars are also used to provide banks with information and advice

- *Furnishing of an auditor's report at the expense of the bank, controlling company or subsidiary concerned*

Section 7 of the Banks Act provides that the Registrar may direct a bank, controlling company or subsidiary to furnish the Registrar with an auditor's report. In practice, such a report has always been commissioned at the reasonable expense of the bank, controlling company or subsidiary concerned. In a recent matter, however, this practice was challenged. The amendment reflects the existing practice and clarifies the position in that regard.

auditor's report commissioned at the reasonable expense of the bank, controlling company or subsidiary concerned

- *References to the Regulations relating to Banks*

The Banks Act provides that when a person wishes to apply for authorisation to establish a bank or for registration as a bank or a controlling company in terms of the provisions of sections 12, 16 or 43, respectively, of the Banks Act, such an application has to be made in the prescribed manner and on the prescribed form. The relevant application form, form DI 002, however, is contained in the Regulations relating to Banks. The amendment refers prospective applicants to the Regulations relating to Banks in order to clarify the position and to reduce the number of enquiries in that regard.

- *Revocation of authorisation to establish a bank*

Section 14(1) of the Banks Act provides that the Registrar of Banks may revoke authorisation granted for the establishment of a bank if the Registrar is satisfied that success with the formation of the bank has not been achieved within a period of six months. Section 16(1) of the Banks Act, however, provides that an applicant may apply for registration as a bank at any time within a period of twelve months of the Registrar having granted authorisation to establish a bank.

It thus appeared that section 16(1) of the Banks Act granted an applicant twelve months as from the date of authorisation to form the bank successfully. A revocation of the authorisation after six months, in terms of the provisions of section 14(1) of the Banks Act, could thus be regarded as a premature or an unfair administrative action by the Registrar. To address the apparent anomaly, section 14(1) was amended to provide for a twelve-month period.

to address apparent anomaly

- *Use by a bank of a name that includes the word "bank" for its division, brand or product*

Section 22(1) of the Banks Act provides that a bank may refer to itself only by the name under which it was registered. In practice, however, banks have for business reasons established divisions, brands and products with names that contain the word "bank". In all cases, the Registrar has approved such names subject to certain conditions, which are aimed at preventing confusion in the marketplace and among the general public. The amendment reflects the existing practice and creates legal certainty in that regard.

creates legal certainty

Sections 22(1) and 22(5) of the Banks Act were amended to provide that an institution registered under section 18A to conduct the business of a bank by means of a branch in the Republic of South Africa, as well as an institution that is registered as a representative office of a foreign institution in terms of the provisions of section 34, may also refer to itself by a name including the word "bank".

- *Order prohibiting anticipated or actual contraventions of certain provisions of the Banks Act*

Section 81 of the Banks Act provides that the Registrar of Banks may apply to the High Court for certain legal relief if the Registrar has reason to suspect that any person that is not registered as a bank is likely to contravene certain provisions of the Act. The provision, however, should also refer to branches of foreign institutions authorised in terms of the provisions of section 18A(1) of the Banks Act. The amendment provides legal certainty in that regard.

provides legal certainty

Provisions enabling subordinated legislation

The following amendments to the Banks Act were made to enable certain subordinated legislation:

- *Regulations relating to Representative Offices*

Section 34 of the Banks Act provides for the establishment of a representative office of a foreign bank in the Republic of South Africa. Representative offices are not permitted to do banking business and are not regulated on a regular basis by the Registrar of Banks. It had become evident, however, that the power to issue regulations in respect of representative offices was required in order to regulate such offices effectively, on a regular basis. The amendment enables the Minister of Finance to issue such regulations.

power to issue regulations

- *Compliance function*

The complexity of banking business and the rapidly changing regulatory environment made it necessary to oblige banks to establish a compliance function in order to enhance the risk-management framework of banks.

The compliance function has to be headed by a compliance officer, for whose functions and duties the Regulations relating to Banks provide. The amendment enables the Minister of Finance to issue further regulations pertaining to the compliance officer and creates legal certainty in that regard.

enables further regulations

- *Corporate governance*

Since banks are regarded as special institutions, which fulfil a unique role within a modern economy, the directors and executive officers of a bank are required to exercise a greater degree of care and skill than the directors of other companies. In order to provide for such requirements, it is necessary for the Minister of Finance to issue regulations in that regard, from time to time.

Certain regulations pertaining to corporate governance have already been incorporated into the Regulations relating to Banks. The amendment enables the Minister to issue further regulations relating to corporate governance and creates legal certainty in that regard. Furthermore, a definition of the term “corporate governance” was inserted into section 1(1) of the Banks Act.

enables further regulations

- *Audit committee*

An enabling provision was inserted into section 64 of the Banks Act to provide the

Minister of Finance with the power to prescribe, by regulation, certain further functions of an audit committee.

power to prescribe certain further functions

Provisions dealing with material issues

The following amendments were made with regard to certain material issues:

amendments to certain material issues

- *Definition of "director"*

Since the amendments to section 60 of the Banks Act differentiate between non-executive directors and executive directors as regards the objections that the Registrar of Banks may raise regarding their appointment, it was necessary to define the term "director".

- *Definition of "employee in charge of a risk management function"*

Compliance risk was included as paragraph (j) in the definition of an "employee in charge of a risk management function", in section 1(1) of the Banks Act, in order to include the compliance officer in the definition of "executive officer".

- *Definition of "executive officer"*

The definition of "executive officer" in relation to banks and non-banks was extended to include the company secretary and the compliance officer, since they fulfil a pivotal role in the corporate-governance structures and compliance functions of a company.

- *Investments by controlling companies*

Section 50 of the Banks Act provides for a controlling company to manage its affairs in such a manner that the amount of certain specified investments does not exceed 40 per cent of the controlling company's share capital and reserve funds. As a result of the principle of consolidated supervision of banking groups, it had become necessary to calculate the limit of 40 per cent on the share capital and reserve funds in relation to both the bank and the controlling company on a consolidated basis. The method of calculation of the amount will be prescribed by regulation.

method of calculation will be prescribed

- *Appointment of directors, chief executive officer and executive officers of a bank or controlling company*

Except in so far as the fiduciary duties of directors towards a company depend on statutory provisions expressly limited to directors, such duties also apply to officers of a company who are authorised to act on the company's behalf and, in particular, to those acting in a managerial capacity. In view of the wide powers of modern chief executive officers and managers, as well as the importance of the risk-management function in the business of a bank, the corporate-governance measures developed by common law in respect of directors have to be extended, by statute, to chief executive officers and executive officers of banks.

The amendments to section 60 of the Banks Act codify the generally accepted common-law principles of a fiduciary duty and a duty of care and skill owed to a company.

The previous provisions of the Banks Act neither defined the duty of care and skill nor

amendments impose a duty of care and skill

provided for such a requirement. The amendments to section 60 of the Banks Act not only impose a duty of care and skill on each director, chief executive officer and executive officer of a bank, but also clearly define the dimensions of such a duty. The amendments also clarify the common-law uncertainty relating to the test that is applicable in determining whether the said duty has been discharged. Common-law interpretations seem to favour a subjective test, whereas the definition provided for in the amendment to the Banks Act requires an objective test.

main purpose

The main purpose of the amendments is to provide depositors (by far the largest source of funding of a bank) with the protection that they may reasonably expect against their exploitation through reckless, negligent or fraudulent management of the business of their bank. Accordingly, in order for a bank to be managed adequately and with due regard to the interests of both the bank and the depositors, the amendments introduce a substantive principle to resolve such conflicts. The amendments also provide the Registrar with the power to institute an action, in terms of the provisions of section 424 of the Companies Act, 1973, against any director, chief executive officer or executive officer who was knowingly a party to the conduct of the business of the bank in the manner envisaged in that section.

power to gather information

Section 60(5) of the Banks Act previously provided for prescribed information to be furnished, by means of the prescribed form DI 020, only in respect of the appointment of new directors of banks or controlling companies. The amendments extend the provisions of section 60(5)(a) to the appointment of chief executive officers and executive officers of banks and controlling companies. The new provisions comply with the minimum requirements of the Core Principles for Effective Banking Supervision, issued by the Basel Committee on Banking Supervision and requiring a framework of banking laws that provides bank supervisors with the power to gather information in respect of directors and managers of banks.

Section 60(5)(b) of the Banks Act, read with regulation 41(1) of the Regulations relating to Banks, previously did not specify the purposes for which such information should be obtained. The said section merely provided that the appointment of a director of a bank or a controlling company would have no legal force unless the information was rendered to the Registrar, in the prescribed manner. The only reasonable inference to be drawn from the previous provisions of section 60(5) of the Banks Act, read with both section 60(6) of the Act and regulation 41 of the Regulations relating to Banks, is that the Registrar was not authorised to exercise a qualitative judgement on the qualities of a designated new director of a bank or a controlling company.

In terms of the aforementioned provisions, the Registrar of Banks was evidently concerned merely with establishing whether the particular bank or controlling company had considered the information required by form DI 020 in respect of such a director, in order for the institution to make a qualitative judgement on the qualities of the designated director, before appointment of the particular individual. Accordingly, once a bank or controlling company had considered the relevant information and had furnished the Registrar with a duly completed form DI 020 at least 30 days prior to the individual's appointment as a director, the appointment became effective without the Registrar having the authority to prevent it.

qualitative judgement

The Core Principles, however, require the aforementioned information to be gathered in order to enable bank supervisors to exercise a qualitative judgement on candidates for appointment. Furthermore, the Core Principles require a banking-law framework that provides bank supervisors with proper authorisation to remove or replace serving

managers or directors of banks or to restrict their powers, in order to prevent the appointment of individuals as directors or managers of banks and to disqualify individuals from becoming managers or directors of banks.

The amendment to paragraph (b) of section 60(5) of the Banks Act not only extends the provisions thereof to chief executive officers and executive officers of banks and controlling companies, but also affords the Registrar of Banks the power to object to a proposed appointment of a director, chief executive officer or executive officer. The Registrar, however, is required to provide written reasons for the objection, and the proposed appointee is afforded a reasonable period to respond.

power to object to a proposed appointment

If the Registrar wishes to pursue the matter and persists in objecting to the appointment after receiving representations by the proposed appointee, appointment of the particular individual will have no legal effect in the case of a non-executive director. In the case of an executive director or officer, the appointment will be terminated within 14 working days of the institution receiving the Registrar's notice of objection. Should the Registrar's decision be challenged, however, the matter will be referred to the Arbitration Foundation of South Africa, for arbitration in terms of expedited procedures approved by the Registrar. A distinction is made between, on the one hand, non-executive directors and, on the other, executive directors and officers, because non-executive directors are appointed in terms of an administrative process under the Companies Act, 1973, whereas executive directors and officers are appointed as employees of a company, resulting in the principles of labour law and the law of contract applying.

- *Appointment of more than one auditor and rotation of auditors*

Section 61(1)(a) of the Banks Act provides for the appointment of an auditor of a bank to be approved by the Registrar of Banks. In terms of the amendment, the provisions of this section are extended to the appointment of an auditor by a bank's controlling company, in order to accord with the established principle of consolidated supervision of banks and controlling companies by the Registrar.

Previously, section 61(1)(b) of the Banks Act provided for a bank with total assets in excess of R10 000 000 000 to appoint not less than two auditors, independent of each other. Since this requirement proved to be somewhat rigid, the amendment provides for the amount to be prescribed by regulation.

The aim of the amended section 61(6) is to ensure the independence of a bank's auditor at all times by means of a system of compulsory rotation after a prescribed period and under such conditions as may be prescribed by regulation. The rotation details will be formulated in consultation with the auditing profession and banks before they are prescribed by regulation, the expectation being that this will be done during 2004.

to ensure the independence of a bank's auditor

- *New committees*

Recent banking failures highlighted the need for certain committees to assist a bank's board of directors in the management of the bank. It had therefore become necessary to require the establishment of a risk committee and a directors' affairs committee. Although some banks had already established such committees, it was necessary, in the interest of sound risk management and corporate governance, to make the establishment of such committees mandatory in all banks.

need for certain committees

- *Large exposures*

To clarify the provision relating to large exposures and to bring it in line with the Regulations relating to Banks, a reference to "any private sector non-bank person" was included in section 73(1)(b) of the Banks Act.

- *Restriction on investments in shares*

restriction on investment in shares

Section 76 of the Banks Act was amended to clarify that the restriction on investment in shares relates to investments in shares of any company and not only property companies, as incorrectly interpreted by a sector of the banking industry.

- *Restriction on investments with associates*

Section 77 of the Banks Act places a restriction on investments that banks may make with their associates. Previously, the restriction related to a percentage of a bank's liabilities, excluding its liabilities in respect of capital and reserves. Since the calculation had become outdated, a new calculation was prescribed by the Regulations relating to Banks. The amendment clarifies the position in that regard.

- *Undesirable practices*

activities and practices regarded as undesirable

Section 78 of the Banks Act contains a list of activities and practices that are regarded as undesirable.

Previously, section 78(1)(b) of the Banks Act provided for a bank not to lend money to any person against security of its own shares only. In line with a recommendation made by Adv J F Myburgh SC, in his November 2001 report on the failed Regal Treasury Private Bank Limited, on which the 2001 annual report reported, this prohibition was extended to the shares of a bank's controlling company.

Recent amendments to the Companies Act, 1973, have made it possible for a company to pay dividends from the share capital of the company. Since the capital requirement of a bank forms an essential part of its prudential requirements, section 78(1)(k) was inserted into the Banks Act to prohibit banks from paying dividends from their share capital without the prior written approval of the Registrar of Banks.

prohibit banks from paying dividends from their share capital without prior written approval

- *Recovery of expenses in respect of an inspection or management of unregistered persons*

Sections 81 to 84 of the Banks Act provide for the control of the activities of unregistered persons. Owing to the complexity of certain cases and the length of time required to investigate complaints against unregistered persons doing the business of a bank, auditing firms are usually appointed to undertake such inspections. The costs and expenses of such an inspection are borne by the budget allocated to the Registrar's Office by the South African Reserve Bank.

costs and expenses of an inspection

When a person is found to have contravened the provisions of the Banks Act by illegally taking deposits from the general public, the Registrar may appoint a manager to seize the assets of such a person and to repay such funds as the manager may find to the investors. For the same reasons as stated above, an auditing firm is appointed to perform the tasks of such a manager.

Section 84(6) of the Banks Act previously provided for the Registrar to pay such a manager such remuneration as determined by the Minister of Finance. The section was amended to remove the reference to the Minister, since payment is made from the budget of the South African Reserve Bank, as indicated above. The amendment also provides for the costs and expenses of the inspection of the affairs of an unregistered person to be included in the said section of the Banks Act. Consequently, the Registrar has the legal right to recover the costs and expenses of both the inspection and the fund management from the person subject to the inspection and/or management.

legal right to recover costs and expenses

- *Increased penalties*

Owing to inflationary factors, as well as the extent and severity of some contraventions of the Banks Act, especially those relating to the illegal taking of deposits from the general public, the fines and prison terms for convictions of offences were increased.

fines and prison terms increased

Synthetic securitisation schemes

As reported in the two previous annual reports, an amended framework for asset securitisation was published as Government Notice No. 1375 (referred to as the securitisation notice), in Government Gazette No. 22948 on 13 December 2001.

As indicated in the 2002 annual report, regulations to provide for the regulation and supervision of credit-derivative instruments were published under Government Notices No. R.1464 and No. R.1465, in *Government Gazette* No. 24088 on 22 November 2002. Consequently, it became necessary to amend the above-mentioned securitisation notice in order to distinguish between traditional and synthetic securitisation schemes.

to distinguish between traditional and synthetic securitisation schemes

Following extensive research on the best international regulatory and market practices, the Bank Supervision Department drafted a proposed amended securitisation notice in order to distinguish between traditional and synthetic securitisation schemes and to regulate both.

In terms of the existing securitisation notice, banks may participate in, amongst other things, a securitisation scheme in a primary role, that is, as an originator, a remote originator, a sponsor or a repackager, or in a secondary role, that is, as a servicing agent, a provider of a credit-enhancement facility or a liquidity facility, an underwriter or a purchaser of senior commercial paper.

A traditional securitisation scheme involves the legal and economic transfer of assets to a special-purpose institution issuing asset-backed securities that are claims against a specific asset pool. In such a scheme, different classes of asset-backed security are issued, and each class has a different priority claim on the cash flows originating from the underlying pool of assets. A synthetic securitisation scheme, on the other hand, refers to a structured transaction whereby an institution uses a portfolio 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. The resulting credit exposures have different levels of seniority.

traditional securitisation scheme

synthetic securitisation scheme

Amended securitisation notice

A draft amended securitisation notice was released for comment on 12 March 2003, 19 June 2003 and 28 August 2003, respectively, and each draft was accompanied by an appropriate circular issued in terms of section 6(4) of the Banks Act, 1990. Each

draft amended securitisation notice was released for comment

release of a draft resulted in the Bank Supervision Department receiving comments from banks and other interested parties, resulting in further amendments being made to the proposed notice.

A subsequent draft securitisation notice was approved by the Standing Committee for Revision of the Banks Act, 1990, at a meeting on 3 October 2003, subject to certain further minor amendments being effected. The notice was published as Government Notice No. R. 681, in *Government Gazette* No. 26415 on 4 June 2004.

The Bank Supervision Department is of the opinion that the amended securitisation notice will create an environment that allows for the development of a strong corporate-debt market in the South African capital market.