

Legal risk and compliance risk in the banking industry in South Africa

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B Comm (Law) LLB LLM

Dissertation submitted in fulfillment of the requirements for the degree Doctor Legum at the Potchefstroom Campus of the North-West University


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September 2013

Declaration

I, the undersigned, Janet René Terblanché, student number 10774289, hereby declare that the work contained in this thesis is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

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Date: 30 August 2013

Abstract

The Basel Committee on Banking Supervision has defined operational risk, legal risk and compliance risk. However, the definitions might not be adequate for countries with a hybrid legal system, such as South Africa. This study aims to provide a practical solution to the problems faced by countries with a hybrid legal system wishing to comply with the Basel Committee's standards. It is argued that compliance, compliance risk and regulatory risk should all be viewed as constituent components of legal risk, and in turn necessarily also of operational risk in a hybrid legal system. Legal risk is a wide concept which includes all aspects of a legal system, while compliance risk is a narrower concept which only includes the codified aspects of a legal system. Legal risk therefore includes compliance risk. However, the opposite is not true as compliance risk does not include legal risk, and the two concepts are decidedly shown not to be synonymous in a mixed legal system.

Keywords: Legal risk, compliance, compliance risk, regulatory risk, legal compliance, regulatory compliance, operational risk, Basel Committee

Opsomming

Die Basel Komitee oor Banktoesighouding het operasionele risiko, regsrisiko en nakomingsrisiko (ook genoem voldoeningsrisiko) gedefinieer. Hierdie definisies is nie noodwendig toepaslik vir lande met 'n gemengde regsstelsel nie, soos byvoorbeeld in Suid-Afrika. Hierdie studie poog om 'n praktiese oplossing te vind vir lande wat met die dilemma sit van om 'n gemengde regsstelsel te hê, maar tog graag aan die Basel Komitee se standaarde wil voldoen. Dit word geargumenteer dat nakoming, nakomingsrisiko, en regulatoriese risiko beskou behoort te word as onderafdelings van regsrisiko. Regsrisiko is om die beurt weer 'n onderafdeling van operasionele risiko in 'n gemeenregtelike regsstelsel. Regsrisiko is 'n wye begrip wat alle aspekte van 'n regsstelsel insluit. Nakomingsrisiko is 'n enger beginsel wat slegs die gekodifiseerde aspekte van 'n regsstelsel insluit. Regsrisiko sluit derhalwe nakomingsrisiko in. Die teenoorgestelde is egter nie waar nie aangesien nakomingsrisiko nie regsrisiko insluit nie. Die twee beginsels is nie sinonieme in 'n gemeenregtelike regsstelsel nie.

Sleutelwoorde: Regsrisiko, nakoming, nakomingsrisiko, regulatoriese risiko, regsnaakoming, regulatoriese nakoming, operasionele risiko, Basel Komitee

With thanks to my family and friends. I need to specifically thank my husband, Carel, my boys Jan-Carel and Gustav, my father Jan, my mother René, and my mother-in-law Marita. Without their understanding, support and encouragement this research would not have been possible.

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Foreword

I have spent the bulk of my career as an operational risk manager or compliance officer in the banking and insurance industries of South Africa. One of the aspects that I found frustrating was the lack of clarity on what legal risk is and how to manage it. My experience has shown that compliance officers were managing only the adherence to statutes and operational risk managers seemed indifferent to the fact that there were large parts of the law neglected by compliance officers. This study emanates from my need to understand and find a comprehensive definition of the concept of legal risk and resultantly find a practical manner in which to manage it. I intend to establish if there is a gap between operational risk, compliance risk and legal risk within the South African legislative framework and, if so, find an appropriate way in which to bridge it.

CHAPTER 1

Introduction

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1 Introduction

During the course of my employment in the corporate governance field, I have found myself increasingly frustrated by the fact that although compliance risk is managed, it only focuses on legislation and not on indigenous law and common law. I accordingly feel compelled to explore whether legal risk is wider than mere compliance with legislation. If it is indeed the case, I would need a practical manner in which to manage the residual of the law of South Africa. My perception is that internationally, through the prescribing of banking industry standards such as the Basel Committee's framework for banking supervision, a legal language associated with compliance was created. This "international" legal language is then imposed upon the South African legal framework, often without taking due cognisance of the unique South African legislative context. Therefore, while terms such as "regulatory compliance" might not have created confusion internationally, it did in South Africa. In the context of this thesis "regulation" is a form of subordinate legislation; however, a more accurate term would be "statutory compliance" or "legislative compliance", which encompasses a broader set of rules. Regulation may have a wider meaning and refer to a broad concept

whereby authority is used to guide behaviour.¹ Unlike many European countries such as France and Germany, whose legal systems are based on a codified system, South Africa's legal framework is founded upon a common law system, necessarily requiring that a broader context informs legal decisions. As a result, the aforementioned prescribed international legal language is biased towards prescribing industry standards within the context of a codified legal system, thus posing a significant challenge to its direct application to the South African context. In international legal language legal risk and compliance risk are used as synonyms, while the common law, law of contract, delict and so forth are simply ignored. The language and definitions used internationally do therefore not naturally fit into the South African legal system. However, it nevertheless needs to be applied in South Africa because international guidance, such as that issued by the Basel Committee on Banking Supervision (forthwith referred to as "the Basel Committee"), is applied by South African regulators. The Basel Committee's framework has accordingly been legislated in South Africa through the revised *Banks Act*.²

As the foremost international regulatory authority on banking supervisory standards, it is an objective of the Basel Committee to achieve more consistent regulatory treatment where different types of institutions engage in similar types of activities across jurisdictions.³

A comprehensive study of all legal risks impacting the banking industry is beyond the scope of this inquiry. It is therefore limited to the banking industry in South Africa. This study only focuses on the law and the distinction (or not) between compliance risk and legal risk. A practical suggestion is made in chapter 5 on how to manage legal risk. This thesis does not deal with risk appetite or the quantification of the risk as these may form the basis of subsequent studies.

1 Selznick *Regulation* 3;
Black *Regulatory conversations* 163.

2 *Banks Act* 94 of 1990.

3 Market Risk Basel I 9;
Alexander *Regulation* 74-75.

This study is achieved mainly through a literature review of various texts, including books, academic articles, case law and reputable internet sources. It should be noted that research material on legal risk is limited because it is a relatively new concept. This is also the reason why the study utilises sources from international organisations, foreign jurisdictions and Southern Africa. Although texts from foreign jurisdictions have been utilised, this is not a comparative study. This study will not deal with every aspect of banking in detail, as the main focus is placed on legal risk and compliance risk.

2 Research question

In view of the above, my research question has been formulated as follows:

What is the legal position with regard to legal risk and compliance risk in the South African banking industry?

3 Problem statement

3.1 Introduction

When drafting national banking legislation, the international trend is to follow best practice, recommendations, or guidelines of both formal (or traditional) international institutions, for instance the International Monetary Fund⁴ and the International Bank for Reconstruction and Development,⁵ as well as informal international institutions, for instance the Basel Committee⁶ and the Financial Stability Board.⁷

4 IMF.

5 World Bank.

6 Basel Committee.

7 FSB;

Hiscock and Van Caenegem *Internationalisation of Law* 5.

The rationale for this study originates from the definition of operational risk as contained in the Basel Committee's Capital Accord,⁸ which includes legal risk but which is not defined as separate concept. Moreover, it should be noted that the terminology "operational risk", "legal risk" and "compliance risk" is being used interchangeably and loosely, which in turn has led to a lack of legal certainty regarding these terms.

Operational risk is defined by Basel II as:

...the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. Legal risk includes, but is not limited to, exposure to fines, penalties or punitive damages resulting from supervisory actions, as well as private settlements.⁹

Basel II defines compliance risk as:

the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities.¹⁰

South Africa has adopted Basel II in its entirety by way of amendments to the *Banks Act*¹¹ and the regulations issued in terms thereof (the regulations). The *Banks Act* defines operational risk in regulation 67 as:

...the risk of loss resulting from inadequate or failed internal processes, people or systems or from external events, including legal risk such as exposure to fines, penalties, or punitive damages resulting from supervisory actions and private settlements, but does not include strategic or reputational risk.

8 Basel II.

9 Basel Committee *Basel II* 144.

10 Basel Committee *Compliance* 7.

11 *Banks Act* 94 of 1990.

In addition, regulation 49 refers to and sets specific requirements for a compliance function.¹² However, the *Banks Act* and the regulations do not define legal risk or compliance risk. No South African precedent is available on the topic either.

The ensuing challenge is that banks operating under the *Banks Act* need to adhere to regulations 49 and 67, but it is difficult to do so. In contrast, it is relatively easy to comply with the requirements for compliance risk management, because these requirements are dealt with specifically in the regulations. The requirements for legal risk management are not clear and many banks have interpreted this to mean that legal risk and compliance risk are synonymous as seems to be the international preference.

3.2 Background and historical information

The Basel Committee is part of the Bank for International Settlements situated in Basel, Switzerland. It was established by the Governors of the central banks of the Group of Ten (G10)¹³ countries at the end of 1974. The G10 countries are the largest and most influential economies in the world. The G10 consists of eleven members, namely Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States and later evolved into the G20.¹⁴

The Basel Committee does not possess any formal supranational supervisory authority and its decisions do not have legal force. It formulates best practice guidelines and broad supervisory standards with the expectation that individual authorities will implement them in their home countries. The Basel Committee covers a wide range of financial issues, one of which is regulatory capital requirements against credit risk, market risk, liquidity risk and operational risk. Credit risk is the risk of a counterparty defaulting against loan obligations, while

12 Also refer to chapter 3.

13 G10.

14 IMF *Factsheet March 2011* 4-5.

market risk is the risk that the value of an investment will decrease due to market fluctuations. On the other hand, operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk includes legal risk but excludes strategic risk and reputational risk.¹⁵

During the 1980s banks were eroding their capital base through competitiveness, thereby prompting the Basel Committee to establish minimum capital requirements for banks in order to protect depositors. In 1988, the Basel Capital Accord¹⁶ was introduced, which is essentially a capital measurement system. Initially the Basel Capital Accord (hereinafter referred to as Basel I) only required banks to hold capital against credit risk to ensure that banks identified, mitigated and monitored their credit risks in order to minimise losses. During the mid 1990s, market risk capital requirements were introduced, along with market risk management principles similar to those of credit risk.¹⁷

In June 1999 Basel II was proposed before finally being issued in 2004. It refined the standardised rules of Basel I, with operational risk being defined and included. Basel 2.5 was implemented in December 2011, but does not have any reference to legal risk or compliance risk. Basel III was subsequently published in December 2010, but does not deal with either legal or compliance risk and is therefore excluded from this study.¹⁸

As mentioned above, Basel II defined operational risk as the risk of loss due to inadequate or failed people, internal processes, systems or external events. This includes legal risk, but excludes strategic risk and reputational risk.¹⁹ What this means in practice is that the day-to-day operations of an organisation may lead

15 Basel Committee *History* <http://www.bis.org/bcbs/history.htm>.

16 Basel I.

17 Basel *History* <http://www.bis.org/bcbs/history.htm>.

18 Basel *History* <http://www.bis.org/bcbs/history.htm>.

19 Hoenipwela *Credit Onions* http://www.bis.org/search/?sp_q=legal+liability&adv=1.

to losses being incurred instead of the intended profits being realised. Examples of operational risks (called events if the risks materialise) are:

- **People:** Human error, such as a teller in a branch typing the incorrect amount into the bank's system on a cash deposit;
- **Internal processes:** Where two signatures are required for a payout to be effected, but the payout was made based on a single signature;
- **Systems:** A hardware failure resulting in an outage; and
- **External event:** Syndicate fraud or cash-in-transit heists.

Furthermore, strategic risk is incurred when, for example a bank focuses on the incorrect target market, while reputational risk is any event that damages a bank's reputation. There are various sources of reputational risk to banks, for instance system errors resulting in incorrect statements to depositors or a lack of information security leading to hackers gaining access to bank records.

However, in view of the fact that Basel II defined legal risk as a component of operational risk, a comprehensive, uniform definition of legal risk remained elusive until late in the 21st century, when the international banking industry enquired about a definition or description of legal risk as a form of operational risk. The Basel Committee accordingly published consultative papers on compliance risk, which defined and described compliance risk, but not legal risk.²⁰ This led to the South African banking industry erroneously interpreting legal risk and compliance risk as synonyms.

The Compliance Institute of South Africa (the Compliance Institute) defines compliance as "obedience or adherence to applicable laws, rules, codes and standards".²¹ Based on this definition, the Compliance Institute concomitantly defines compliance risk as:

20 Basel Committee *Compliance* 7-16.

21 CISA *The profession* <http://www.compliancea.com/profession.asp>.

...the current and prospective risk of damage to the organisation's business model or objectives, reputation and financial soundness arising from non-adherence with regulatory requirements and expectations of key stakeholders such as customers, employees and society as a whole.²²

It should be noted that this definition is limited to legislation, because it refers to "regulatory requirements". These two definitions illustrate the problem in that the Compliance Institute's definitions of "compliance" and "compliance risk" are not aligned.

According to the Compliance Institute, compliance risk comprises regulatory and reputational risk. Regulatory risk is described as:

...the risk that a business [bank] does not comply with regulatory requirements or excludes provisions of relevant regulatory requirements from its operational procedures.²³

Reputational risk in this context is:

...the risk that the business [bank] might be exposed to negative comment and opinion due to the contravention of applicable regulatory requirements. This can occur through negative publicity, public sanction by regulators or by word of mouth on the part of staff, competitors, customers and other stakeholders.²⁴

It may be possible to explain the problem based on the difference between a codified and common law, mixed or hybrid legal systems.

If it is assumed that Basel II was drafted based on a codified legal system, for implementation in a codified legal system, there would be no problem. This

22 CISA *Framework* Definitions.

23 CISA *Framework* Definitions.

24 CISA *Framework* Definitions.

assumption is made because the Basel Committee is based in Switzerland, and Switzerland has a codified legal system.²⁵ In a codified legal system, there is only one source of law, being legislation²⁶ and therefore compliance would include the entire legal system. South Africa, however, has a mixed legal system²⁷ and the sources of law are legislation, the doctrine of precedent,²⁸ common law,²⁹ custom,³⁰ indigenous law,³¹ works of modern authors³² and the *Constitution*, which is the supreme law of South Africa.³³

South Africa does not have a codified legal system and large areas of the law is potentially excluded by bankers, industry lawyers, legal advisors and compliance officers who assume that legal risk is synonymous with compliance risk.

3.3 Statement of the problem

As mentioned earlier, the Basel Committee³⁴ introduced the concepts legal risk and compliance risk, with the international perception being that legal risk and compliance risk are synonyms. This is not necessarily true. It may be that while these concepts may be used as synonyms, they may also be sub-components of each other. In other words, compliance risk may be a form of legal risk or, *vice versa*, legal risk may be a form of compliance risk.

I therefore postulate that the original Basel Accord was drafted by civil law country lawyers, economists and accountants, who were only familiar with the concept of codified law. However, as an international standard, the Basel

25 The term codified legal system and codified law is used with a wide meaning throughout this thesis.

26 Statutes and regulations.

27 There are elements of both the common law and codified law (legislation).

28 The policy of courts to abide by principles established by decisions in earlier cases.

29 Roman, Roman-Dutch and English law.

30 Unwritten law by which people live because they regard it as the law, e.g. Islam.

31 A form of custom, in South Africa it refers to the indigenous communities.

32 Books and journals only has persuasive authority, it does not have binding authority.

33 LAWSA Vol 5(3);

Kleyn and Viljoen *Beginners' guide* 43-95.

34 Basel Committee *Basel II* 144.

Accords are intended for adoption and implementation in all countries.³⁵ It may readily be assumed that the notion behind the creation of the law is that it needs to be complied with. In codified legal systems, such as those employed by countries such as France and Germany, the law consists only of legislation and the Basel Committee's definition of compliance risk would include legal risk. This does not present a problem for countries with codified legal systems. However, in countries with hybrid or mixed legal systems, such as South Africa, the law consists of more than only legislation.³⁶ This notion of compliance with legislation only may create problems in a hybrid or mixed legal system because large areas of the law are excluded.

In South Africa, as per the Compliance Institute's aforementioned definition, compliance risk is adherence to legislation or codified law, while legal risk is adherence to the law in a wider sense. Legal risk in South Africa thus includes, but is not limited to, compliance risk. South Africa follows the Basel Committee guidance and implements it by way of amendments to the *Banks Act* and the regulations relating thereto. Therefore there is a need to clarify what the legal position is regarding legal risk and compliance risk in the banking industry in South Africa; whether there is a difference between the two; and, if so, what the differences are. Foundational thereto are the questions of what the South African law with regard to legal risk and compliance risk is; what the implications of differences or similarities between the two risks are; whether the one includes the other and whether the South African law could be improved. These questions are at the core of the problem to be addressed in this research.

4 Assumptions and hypothesis

4.1 Assumptions

For the purposes of this study, it is assumed that it is in the best interest of South Africa to follow the Basel principles as it is accepted by most of the developed

35 <http://www.bis.org/bcbs/about.htm>.

36 For example precedent, the *Constitution* and customary law.

world to provide guidelines for banking best practice. Some historical background will be provided in this regard, but the study will not focus on the legitimacy of following the Basel Accord.

4.2 Hypothesis

Basel Committee's definition of operational risk includes legal risk. Legal risk is accepted by the Basel Committee to be compliance with legislative provisions. My hypothesis is that legal risk and compliance risk are related, yet distinctly separate concepts in the South African banking industry. Legal risk is not synonymous with compliance risk. It is accordingly posited that legal risk in a bank in South Africa will entail more than a mere adherence to the legislative provisions for the banking sector because operational risk also includes legal risk and compliance risk in South Africa.

5 Objectives of the study

The concern, and object of this study, is the fact that the Basel Committee has defined legal risk, but the definition is too narrow for a mixed legal system such as South Africa. The intention is to give a theoretical background of all the concepts. This will as a minimum include the definitions, theory and principles of, and need for, risk management, operational risk, the Basel Committee and, in as far as can be established, legal risk and compliance risk. Thereafter the intention is to establish whether South African banking law is aligned with the Basel Committee's principles and whether or not a strict alignment with the Basel Accord creates confusion and leads to misinterpretation. The aim of the research is to determine if it is advisable to follow the Basel principles regarding legal risk and compliance risk verbatim, or whether there is a more appropriate alternative for the mixed South African legal system. This study will mitigate confusion in the South African banking sector as it is important for banks to know what the South African legal position with regard to their obligations relating to legal risk and compliance risk is. It is also important to determine whether South Africa is on par with international best practice or other jurisdictions regarding legal risk and

compliance risk. The aim of the study is not only to arrive at a comparison of the South African law to international standards and similar jurisdictions, but also to arrive at a suggestion as to how to improve the South African law in this regard. A legal risk management framework will be proposed in this study.

6 Framework of the thesis

Each of the topics will be a chapter of the thesis.

The research is divided into the following chapters:

1. Introduction
2. The history of and background to legal risk and compliance risk
3. Classification of different types of risk
4. Legal risk and compliance risk in the South African banking industry
5. A proposed legal risk management framework
6. Conclusion

7 Research methodology

In order to define and describe the concepts of legal risk and compliance risk, a literature review will be undertaken. The comparison is, however, limited to the Basel Committee, international best practice and the implementation thereof in English-speaking jurisdictions³⁷ and South Africa. Literature research will initially be conducted to determine the international framework and some reasons for adopting this international framework in South Africa. The hypothesis is that compliance risk and legal risk are related, yet distinctly separate concepts in the South African banking law. This forms the theoretical base of the study. The proposed study will comprise of a critical review of relevant international

³⁷ The UK, USA, Canada and Australia. In some instances English text is available from other jurisdictions and this is also utilised.

standards, South African legislation, textbooks, journal articles and electronic material.

CHAPTER 2

The history and background to legal risk and compliance risk

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1 Introduction

The purpose of this chapter is to provide a historical background to legal risk and compliance risk in banks, with specific reference to South Africa. This will be done by providing a historical background to the law in general, banking law¹ specifically, internal audit and risk management, as well as the interrelationship between these.

Although the law, internal audit and risk management developed separately, they converged during the 20th century to form a separate discipline, namely compliance risk, which is also referred to as legal risk management.² A brief history of each of these three elements is provided in this chapter.

The law of South Africa is a combination of common law (Roman, Roman-Dutch and English law), legislation, precedent (court cases), customary law, indigenous law and the *Constitution*. The history of banking law in South Africa is dealt with in a separate subsection of this chapter. South Africa is a member of the international Basel Committee and because of its membership, South Africa is implicitly bound to follow the recommendations of the Basel Committee. Although

1 Also refer to chapter 4.

2 This thesis will clarify if there is a difference between legal risk and compliance risk or not.

there is no legal need to implement the Basel Committee's standards, the increasing globalisation of banking means that there is commercial and economic pressure and moral suasion on governments to adhere to these standards. The South African government has committed itself to meeting the Basel Committee's standards. The Basel Committee has made recommendations on the management of legal risk and compliance risk, which will be dealt with in both this chapter and the next.

Auditing practices emerged in various cultures throughout the ages. Initially the purpose of auditing was to detect fraud and errors, and to ensure that all taxes were collected. However, after the crash of Wall Street in 1929 the focus shifted to providing credibility to organisations' financial statements. Auditing techniques have accordingly evolved significantly in the last 80 years.

Risk management developed out of gambling and attempts to mathematically predict the future. Risk management is considered to form a part of corporate governance. The King III Code on Corporate Governance is applicable to banks in South Africa. Risk management in banking is linked to the Basel Committee, which sets the standards for risk management in banking. Risk management, within the context of this thesis, is defined later in this chapter. Compliance is considered to be a type of risk. The concept that the law needs to be complied with is as old as the Code of Hammurabi.

Compliance risk management is a combination of the law, internal audit and risk management. It is the law that needs to be adhered to, and the manner in which banks ensure adherence to the law is by using a risk management process (identification, management, monitoring and reporting). The monitoring that is conducted in a compliance risk management process is based on auditing techniques.

As already mentioned in chapter 1, the Basel Committee defines operational risk, which definition includes legal risk. The inference is therefore drawn that it includes compliance risk. The problem is that the Basel Committee's definition is too narrow for a mixed legal system such as South Africa.

2 The law

The Code of Hammurabi, which dates back to circa 1760 BC³ is the most comprehensive of the earliest Codes currently available to us. Babylonian law was codified when King Hammurabi had it inscribed in stone and placed several copies thereof throughout the Kingdom of Babylon.⁴ These were followed by the Torah and the Koran, both of which date back to circa 1200 BC and which may be the oldest bodies of law still relevant to modern legal systems. These Jewish (Torah) and Islamic (Koran) laws are essentially religious rather than legal in nature. In contrast, the Twelve Tables,⁵ which form the foundation of Roman law, is secular and does not have a religious base. Even before the Twelve Tables, during the period of the Roman kings, the Romans distinguished between law and religion.⁶ Roman law is probably one of the oldest foundations of the South African legal system.⁷ The introduction of Roman law into the rest of European law occurred around 500 AD by way of the *Leges Romanae Barbarorum* in the Western Roman Empire.⁸ This introduction included the Netherlands and it led to the formation of Roman-Dutch law.

3 The date is disputed. Some scholars date the Code of Hammurabi to 2250 BC or to 1950 BC, which would make it the oldest known codified law.

4 Langdon *Sumerian Law compared with Code of Hammurabi* 489; Duncan *Code of Moses and Code of Hammurabi* 188.

5 450 BC.

6 Liebesney *Religious law* 492-493.

7 Kleyn and Viljoen *Beginners' Guide* 22-32; Edwards *History of South African Law* 3-8; Kopel *Business law* 16.

8 Du Plessis *Elementary introduction to law* 14.

When Jan van Riebeeck came to the Cape of Good Hope in South Africa in 1652, he brought the Roman-Dutch law with him. The Roman-Dutch law was applied by the governors and later also by the *Raad van Justitie*, who were essentially laymen, until 1795.

The Cape was occupied by the British from 1795 to 1803 and again from 1827 to 1910. This brought the influence of English law into the South African legal system.⁹ During the period 1838 to 1910, a group of farmers who were dissatisfied with the British rule and the constant strife with the Xhosa tribes on the eastern border began the Great Trek north and east of the Cape. This led to the establishment of the Voortrekker Republics. In Port Natal, the Voortrekkers declared that Roman-Dutch law would be followed. This was short-lived, because seven years later, the British occupied this territory and Port Natal was declared a district of the Cape colony where Roman-Dutch law, as modified by English procedural statutes, was followed.

In the Voortrekker Republics of Transvaal and the Orange Free State, Roman-Dutch law was followed, but there were definite influences from English law. Towards the end of the 19th century, judges of the High Court would use English authorities when necessary to make a ruling.¹⁰ The Voortrekker republics and the Colony were unified on 31 May 1910 as a union with legislative powers under the British Crown.¹¹ The appellate division of the Supreme Court of South Africa was also established in 1910. The chief justice and the judges of appeal applied Roman-Dutch law, but *lacunae* were supplemented with English law.

9 Edwards *History of South African Law* 65-83;
LAWSA Vol 4(1);
Kleyn and Viljoen *Beginners' Guide* 35, 82;
Kopel *Business law* 18.

10 Edwards *History of South African Law* 84-85.

11 Edwards *History of South African Law* 87.

There were three events that led to the formation of the South African common law: the creation of a common law for the four provinces of the South African Union (1910); the promotion of law reform; and the movement towards pure Roman-Dutch sources and away from foreign doctrines such as English law.¹² Edwards¹³ is critical of the legislature's attempts to codify the common law during the period of the South African Union. He believes that legislation needs to be drafted carefully, foreign laws should not merely be copied, and that consolidating existing laws should be done with care. He is also of the view that there should be an exchange of ideas between the legislator and academics when drafting legislation.

South Africa gained independence from the British Crown in 1961 to form the Republic of South Africa.¹⁴ Two schools of thought developed during the time of the South African Union¹⁵ and continued into the Republic, namely the purists (who believed that Roman-Dutch law should be applied and that South African law should exclude contaminants such as the English law) and the modernists (who accepted Roman-Dutch law as the basis for South African law, but who believed the law should be developed to suit modern demands). Today it is accepted that English law had a permanent influence on South African law.¹⁶

The above historical outline disregards the fact that when Jan van Riebeeck and company landed in the Cape, South Africa was already inhabited by people who lived according to their own legal systems, called "indigenous" or "customary" law. Customary and indigenous laws were mostly disregarded until political reform led to an overhaul of the South African legal system which started in the early 1990s. During the period of the Republic of South Africa, the political

12 Edwards *History of South African Law* 88-92;
Kopel *Business law* 19.

13 Edwards *History of South African Law* 92-93.

14 Edwards *History of South African Law* 87.

15 Kopel *Business law* 18.

16 LAWSA Vol 5(3);
Kleyn and Viljoen *Beginners' Guide* 36.

ideology of Apartheid¹⁷ was introduced and the law, specifically statutes, was used to realise this ideology.¹⁸ Since the interim *Constitution* was promulgated in 1994, all legal developments have had to be aligned with the *Constitution*.¹⁹ Human rights are now officially recognised in the South African Bill of Rights as part of the *Constitution* of 1996, alongside the recognition of South African customary and indigenous laws.²⁰

South African customary law comprises unwritten customs that are passed on orally from generation to generation, and varies based on the tribe or territory.²¹ A strongly organised state structure does not exist in customary law, therefore customs mainly regulate the relationships between individuals. The customary law system is community or group orientated, as opposed to the individualistic orientation of Western legal systems, such as Roman-Dutch law.²² South African courts sometimes make use of customary law, but because customary law is an unwritten law by virtue of being inscribed in the habits and customs, indeed the very culture, of the community in which it is used, it does not immediately qualify as law. To qualify it must be proved that it has existed for a long time; that it is observed generally by the community in which it applies; that it is reasonable; and that its content and meaning are certain and clear. It may also not be contrary to the *Constitution*.²³

17 Kopel *Business law* 19.

18 LAWSA Vol 5(3) and 5(4);
Kleyn and Viljoen *Beginners' Guide* 37.

19 LAWSA Vol 5(3) and 5(4);
Kleyn and Viljoen *Beginners' Guide* 40;
Kopel *Business law* 19.

20 LAWSA Vol 5(3) and 5(4);
Kleyn and Viljoen *Beginners' Guide* 38;
Kopel *Business law* 19.

21 LAWSA Vol 5(2);
Kleyn and Viljoen *Beginners' Guide* 39.

22 LAWSA Vol 5(2);
Kleyn and Viljoen *Beginners' Guide* 39.

23 LAWSA Vol 5(3) and 5(4);
Kleyn and Viljoen *Beginners' Guide* 88.

Indigenous law is a form of customary law, recognised by African or black communities of South Africa. The *Law of Evidence Amendment Act*²⁴ permits a court to take judicial notice of indigenous law if it is not in conflict with public policy or the principles of natural justice.²⁵

Broadly speaking there are two kinds of legal systems in the Western world. The one is called codified (or civil, continental, or Romano-Germanic) law, and the other is called mixed (or common, uncodified, or Anglo-American) law.²⁶

In a codified legal system, the law is written down and must be applied by judges in each individual case.²⁷ These laws are called "codes" or "statutes" and are approved by the government of that country, whereafter it becomes the primary source of the law for that country. Examples of such systems are Germany, France and Switzerland. In contrast, in mixed and common law systems the law is found in many sources and has been developed over hundreds of years as the legal precedent.²⁸ Examples of mixed and common law systems are the Republic of South Africa, Scotland, Louisiana, Quebec, Puerto Rico, the Philippines, Mauritius, Sri Lanka, British Guiana, St Lucia and Israel.²⁹

As a country with a mixed legal system, the sources of law for South Africa are legislation, precedent, common law (Roman, Roman-Dutch and English law),

24 *Law of Evidence Amendment Act* 45 of 1988.

25 LAWSA Vol 5(2);
Kleyn and Viljoen *Beginners' Guide* 90.

26 LAWSA Vol 5(2);
Kleyn and Viljoen *Beginners' Guide* 20-21
Palmer *Mixed jurisdictions* 1-9.

27 A code is a written record of the law (an Act or Statute) that has been approved by the parliament of a country.

28 Kleyn and Viljoen *Beginners' Guide* 20-21
Palmer *Mixed jurisdictions* 1-9.

29 Palmer *Mixed jurisdictions* 18.
There is a plethora of sources on codified, civil, common law, mixed and hybrid legal systems available. However this topic is not investigated in detail as the focus of this thesis is not on the various legal systems, but on the system applicable to South Africa.

customary law, indigenous law, the works of modern authors and the *Constitution*. Foreign jurisdictions may also be taken into account.³⁰

Historically, the *Constitution* was a source of law, similar to any other South African statute. This was changed by the promulgation of the *Constitution* of the Republic of South Africa, 1993 on 27 April 1994, and the subsequent *Constitution* of the Republic of South Africa, 1996. The *Constitution* is now the supreme law of South Africa, which means that legislation and common law in conflict with the *Constitution* may be struck down by the courts. Section 39(2) of the *Constitution* stipulates that in the interpretation and development of legislation, common law and customary law, the court must promote the objectives of the Bill of Rights.³¹ Section 39(1) states that courts must take international law into account, and consider foreign law, when interpreting the Bill of Rights.³²

All of the above deals with the development of South Africa's national law. National law is the law of a state (also called positive law), and is again divided into substantive and adjective law. Substantive law³³ determines the content and meaning of legal principles, while adjective law deals with the enforcement of substantive law.³⁴

South African law is not only the national legal system, as there is also the aspect of international law.³⁵ The law of nations, or public international law, governs the relationship between independent states. International rules are created by international treaties, conventions or custom. Treaties can be between two states (bilateral) or between many states (multilateral). Private

30 LAWSA Vol 5(3) and 5(4);
Kleyn and Viljoen *Beginners' Guide* 43-44, 91.

31 See also chapter 3.

32 LAWSA Vol 5(3) and 5(4);
Kleyn and Viljoen *Beginners' Guide* 94.

33 Also referred to as material law.

34 LAWSA Vol 5(3) and 5(4);
Kleyn and Viljoen *Beginners' Guide* 98-99.

35 See also chapter 4.

international law governs the relationship between natural and/or juristic persons across national borders.³⁶

During the Apartheid era, the African National Congress (ANC) received assistance from international organisations and after 1994 the ANC government placed value on compliance with international standards. After an evaluation of South Africa in 2009, the Financial Action Task Group (FATF) specifically noted that the South African government had enhanced consumer protection; the regulation of the financial sector was in line with Basel I and II, and that South Africa had implemented the FATF recommendations and the International Organisation of Securities Commission (IOSCO) standards.³⁷

This section dealt with the general history of the law globally and of South Africa in particular. The nature of this thesis is such that a brief history of banking law, and South African banking law specifically, is necessary. This is provided in the next section.

2.1 History of banking law

The need for bank-type intermediaries might possibly have arisen once individuals started trading and bartering in prehistoric times. The original purpose of such an intermediary was to ensure the safekeeping of a depositor's money or goods.

During Roman times (circa 27BC to 312AD), the main purpose of a banker was to record the conditions of contracts, account for money, transactions, payments

36 LAWSA Vol 5(3) and 5(4);
Kleyn and Viljoen *Beginners' Guide* 98.

37 Cenfri *Standard Setting Bodies* 6.

and expenses of his³⁸ clients. The Roman banker performed the dual role of banker and bookkeeper.³⁹ The earliest banking law concepts are found in Rome during the time of Justinian (circa 527-565AD). Roman bankers kept a register or book of accounts called the *rationes*, arranged alphabetically. This was for the accounts held by each customer. There were separate pages for debits and credits and these were balanced on agreed-upon times. The banker had to render an account and, if requested, he had to produce an extract of the account before the *praetor*. The prefects of the towns and the governors of the provinces supervised the bankers. If an account was in credit, the banker had to pay the balance to the customer, unless the customer specifically authorised him to retain the balance. Romans used to pay their creditors in cash, and the cash was usually kept by a cashier slave. The father of a rich family (the paterfamilias) would pay by way of a type of cheque drawn on his banker.⁴⁰

The Kārimī merchants⁴¹ formed caravans and traded pepper and other spices from Egypt to Africa during the Middle Ages. Prosperity in these mercantile activities resulted in the accumulation of wealth, which led to these merchants supplying loans and credits to individuals and governments. The first recorded instance of such a loan transaction is in 1288 at the time of the Mamluk Sultan Qalā'ūn.⁴² Throughout the centuries thereafter, banks continued to offer loans to individuals and later to corporates.⁴³ Today, loans are regulated in detail by means of the *National Credit Act*⁴⁴ in South Africa.

38 While I am fully aware of the normal practice of acknowledging both sexes in such non gender-specific contexts, women in Ancient Rome were not allowed to hold the position of a banker. I have accordingly decided to use "him/he/his" consistently in this chapter.

39 Moorcroft *Banking Law* 1-1 – 1-2.

40 Accountant Town *History of Ancient Accounting* 4;
Kopel *Business law* 16.

41 In the dynasties of Egypt under Ayyubid and Mamluk.

42 Walter *Spice Trade* 158, 169-170;
Kopel *Business law* 16-17.

43 Hapgood *Paget's Law of Banking* 618.

44 *National Credit Act* 34 of 2005.

Bills of exchange⁴⁵ payable to bearer or to order became known during the Frankish Empire in the ninth century. By the 12th century Italy had the first two banks that resembled our modern banks.⁴⁶ During the 13th century in Italy, bankers started keeping rudimentary records of transactions. By the 13th century negotiable instruments were freely used and discounting became common practice in Italy, Germany, England, the Netherlands and France.⁴⁷ German and French records from the 14th century attest to the existence of some form of banking dating from this period.⁴⁸

Historically, persons would pay in cash, usually either in gold or in coins. Over time, however, because of safety and security concerns in handling large sums of cash, a practice developed to issue a document that promised payment of a sum of money to the bearer of the document. Such a negotiable instrument is a form of contract. The South African law of negotiable instruments originated in medieval Italy and the rest of Europe through the customs of merchants. These customs were observed during trade (especially international trade fairs) and became a law of nations applicable throughout the commercial world. The prevailing law at the time did not provide sufficient protection from the dangers of transporting money from one country to the next and from converting money to another currency every time a border was crossed into a new country. The body of law which developed is called the *lex mercatoria*.⁴⁹ Some of these basic principles are still present in the South African law of negotiable instruments, for example that a bill of exchange is payable to order or to the bearer.

By the Middle Ages in Europe a variety of coins of different origin were in circulation, which resulted in money changers becoming necessary. They have

45 Also refer to chapter 4.

46 Moorcroft *Banking Law* 1-1 – 1-2.

47 Moorcroft *Banking Law* 1-1 – 1-2.

48 Accountant Town

49 Sharrock and Kid *Understanding cheque law* 10-11;
Hosten *South African Law* 905-906.

some resemblance to modern bankers. In turn English law was strongly influenced by the mercantile law from Europe and from 1795, English law in turn had a significant impact on the South African law.⁵⁰ In general in South Africa, both commercial law and banking law are derived from English law. However, the first banking legislation in South Africa was adopted in 1942, prior to the English *Banking Act*, which was only passed into law in 1979. So although the principles of English banking law are part of the foundation of South African banking law, South African banking legislation was passed some 27 years prior to the English legislation being promulgated.⁵¹ Today, it could be argued that coins have become a negotiable instrument, because the actual value of the coin (if the metal is melted and sold) is less than the value which a coin represents as a bartering mechanism.⁵²

The main body of law which governs banking law in South Africa is the *Banks Act*⁵³, the Regulations relating to Banks, directives, circulars and guidance notes. Bessis⁵⁴ states that the aim of banking regulation is to improve the safety of the banking industry, whilst banks aim for profitability, which results from risk-taking activities.

Banking law in South Africa is not a discrete area of law like contract or delict – it is a collection of legal principles which govern the relationship between a depositor and a bank, as well as the relationship between a bank and the state.⁵⁵ Banking law therefore spans across both public and private law. It is also part of public law because it is regulated by an *Act* of parliament and criminal sanctions may be imposed for non-adherence to such an *Act*. The Registrar of Banks has

50 Moorcroft *Banking Law* 1-1 – 1-2.

51 Moorcroft *Banking Law* 1-3.

52 Also refer to chapter 4.

53 *Banks Act* 94 of 1990.

54 Bessis *Risk management in banking* 39-40.

55 Wentworth *Banking Law* 1;
Moorcroft *Banking Law* 1-2 – 1-3.

certain administrative rights in terms of the *Banks Act*.⁵⁶ But banking law is also part of private law, specifically mercantile (also called commercial) law and the law of negotiable instruments.⁵⁷ The business of a bank may also touch on other parts of private law such as the law of contract, delict, unjustified enrichment, property, persons, family, company, intellectual property, insolvency and insurance, which concepts will be discussed in more detail in chapter 4.

A bank is a public company that is registered to act as a bank in terms of the legislation of the jurisdiction in which it operates. In South Africa banks are regulated and supervised by the central bank, which is called the South African Reserve Bank, when conducting the business of taking cash deposits, cheques and bills of exchange, paying or receiving interest, lending and providing other financial services. A bank is an institution that accepts deposits and channels the money into lending activities. Banks also hold and safeguards cash and other reserves for future use. On the basis of a financial institution's charter and activities, the organisation will be considered a bank in South Africa if it accepts deposits, provides a payment clearing system and grants loans.⁵⁸

The South African *Banks Act*⁵⁹ defines a bank as a public company, registered as a bank in terms of the *Act*. The business of a bank is to accept deposits from the general public; solicit or advertise for deposits; utilise money, interest or other income earned on money (fees) for lending, investing or financing; or to engage in derivatives trading. All South African banks, subsidiaries and branches of foreign banks are required to be licensed either in terms of the *Banks Act*, the *Co-operatives Banks Act* or the *Mutual Banks Act*, unless if explicitly excluded or exempted.⁶⁰

56 *Banks Act* 94 of 1990.

57 Moorcroft *Banking Law* 1-2.

58 Van Jaarsveld *Banking Regulation* 72.

59 S1 *Banks Act* 94 of 1990.

60 Smith *Standard Setting Bodies* 6;
Moorcroft *Banking Law* 2-1 – 2-8.

The Minister of Finance has overall political control and responsibility for the banking sector in South Africa. The Registrar of Banks and the Office for Banks are part of the Bank Supervision Department of the South African Reserve Bank. This department is responsible for the setting of regulatory standards and supervision of banks in South Africa. It follows and aligns the South African legislative framework related to banks with the Bank for International Settlements' Basel Committee standards and has done so since the 1990s.⁶¹ South Africa is a member of the Basel Committee, which although might not have legislative authority, member countries are implicitly bound to follow its recommendations due to moral suasion. Various countries, especially those who are also members of the G20, elect to be members of the Basel Committee, which sets the internationally agreed standards with regard to banking regulation and supervision. Although the Basel Committee does not have legislative or enforcement powers *per se*, countries are regularly assessed by the International Monetary Fund (IMF) and the World Bank for their compliance with these standards and results are publically disclosed. Moral suasion is used by the Basel Committee in order to elicit compliance.

Similarly, the National Payment Systems Department of the South African Reserve Bank is a member of the Bank for International Settlements' Committee on Payment and Settlement Systems. This committee is a standard-setting body for payment, clearing and securities settlement services, which aims to strengthen the financial market infrastructure by promoting sound and efficient payment and settlement systems. The Committee on Payment and Settlement Systems also sets standards relating to financial market infrastructure, systemically important payment systems, securities settlement systems, central counterparties as well as codes and best practices. The function of the National Payment Systems Department of the South African Reserve Bank is to facilitate

61 Moorcroft *Banking Law* 2-8;
BSD *Annual report* 69-70.

the payment process between banks and other persons, which includes all the laws, rules, systems, mechanisms, institutions, agreements and processes from where one person issues an instruction to pay another person or a business, through to the final interbank settlement of the transaction in the books of the central bank.⁶²

Combating money laundering and terrorist financing is a duty placed on both the South African Reserve Bank and the commercial banks by the *Financial Intelligence Centre Act*.⁶³ The Financial Intelligence Centre aligned the *Financial Intelligence Centre Act*⁶⁴ and the *Protection of Constitutional Democracy against Terrorist and Related Activities Act*⁶⁵ to the international standard set by the Financial Action Task Force's⁶⁶ 40 recommendations.⁶⁷

South African banking law therefore has its roots in ancient accounting and legal systems and is currently aligned with international standards. The basis of banking law has not changed over the ages. The need to safeguard depositors' money or goods; facilitate payment by negotiable instruments, notes and coins; and grant loans is still present in today's technology-driven banking environment.

3 Auditing

The second of three elements comprising modern compliance risk management auditing, and specifically internal auditing.⁶⁸ Auditing emerged from accounting,

62 [http://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem\(NPS\)/Pages/Introduction%20and%20Overview.aspx](http://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Pages/Introduction%20and%20Overview.aspx);
<http://www.bis.org/cpss/index.htm?ql=1>;
National Payment System Act 78 of 1998.

63 *Financial Intelligence Centre Act* 38 of 2001.

64 *Financial Intelligence Centre Act* 38 of 2001.

65 *Protection of Constitutional Democracy against Terrorist and Related Activities Act* 33 of 2004.

66 The Financial Action Task Force is an inter-governmental policy-setting organisation which sets standards in order to implement legal, regulatory and operational measures to combat money laundering, terrorist financing and other related threats to the integrity of the international financial system.

67 Smith *Standard Setting Bodies* 4.

68 Also refer to chapter 5.

which goes back to the method of counting, which in turn goes back to the "dawn of intelligence among human beings".⁶⁹ When social life evolved to create sovereigns, so did the levying of taxes.⁷⁰ This necessitated a method of holding count and ensuring financial reckoning. While this was a far cry from accounting records as they are known today, it did necessitate more than just the mere ability to count. It also required the ability to record what was counted. The levying of taxes led to individuals holding money on behalf of the sovereign, and whenever one person was entrusted with the property of another, it became necessary to check the trustworthiness of the first person.⁷¹

As mentioned earlier, the Code of Hammurabi is a code of laws promulgated by King Hammurabi of Babylon,⁷² who was a contemporary of Abraham in the Bible.⁷³ It contained laws regarding commerce, for example if an agent was entrusted with trading goods such as corn, wool or oil, he had to seal the money and hand it over to the merchant. If the trading agent neglected to give the sealed money to the merchant, then he was not allowed to put it into his accounts, but required to keep it separate from his own funds. Business records as old as 2600 BC have been found in Babylon dealing with sales, letting, hiring, money-lending and partnerships and were inscribed in clay and then baked or dried in the sun.⁷⁴

In Ancient Egypt, taxes were received in kind as the use of money was not known. This entailed storing goods in warehouses, protecting it and keeping records thereof throughout the provinces. The least perishable goods were sent to the central treasury and the perishable goods were used to "pay" the workmen

69 Accountant Town *History of Accounting* 1.

70 Accountant Town *History of Ancient Accounting* 1.

71 Ainsworth *Accounting* 7;
Accountant Town *History of Auditing* 1;
Accountant Town *History of Ancient Accounting* 1.

72 Now Iraq, Baghdad.

73 Depending on which date is correct about when Hammurabi lived.

74 Accountant Town *History of Ancient Accounting* 1;
Ainsworth *Accounting* 7.

and administrators. These warehouses employed porters, accountants, guards and scribes. The ancient Egyptians implemented a process by which the fiscal receipts were recorded separately by two officials.⁷⁵ The scribe was the most important person in the treasury and he needed to be able to read, write, count and do elementary bookkeeping. Preserved records show that the scribe kept records on papyrus with a *calamus* (a type of pen), describing in detail what was received, how much of it, from whom, when it had come in and how it was used. Pictures in tombs indicate that the scribe was present at all times, squatting next to a case of papyrus rolls, whether cattle were led past or corn was being measured out. Absolutely nothing was released from the treasury without it being written down.⁷⁶

There is little information available regarding the accounting methods of the Persians, Phoenicians, Rhodians and Israelites, except that they had some form of rudimentary accounting.⁷⁷ Checking activities were also present in the ancient Chinese community.⁷⁸

The Greek administration had many boards and officials under the Greek Senate.⁷⁹ In order to attempt to ensure honesty, the accounts of public officials were engraved on stone tablets and exposed to the public, because wealth was considered to be the property of the gods. The Parthenon was completed in 438 BC and served as the main storehouse for such sacred treasure. The treasure was administered by a board of ten men, one from each of the Greek tribes. Accounts were rendered annually and were inscribed in marble every four

75 Accountant Town *History of Auditing* 1;
Lee and Azham *Evolution of Auditing* 2.

76 Accountant Town *History of Ancient Accounting* 1-2.

77 Accountant Town *History of Ancient Accounting* 2.

78 Accounting Town *History of Auditing* 1;
Lee and Azham *Evolution of Auditing* 2;
Ainsworth *Accounting* 8.

79 Accountant Town *History of Ancient Accounting* 2;
Ainsworth *Accounting* 8.

years, during the Greater Parthenon Festival.⁸⁰ The ancient Greeks checked public accounts by means of employing checking clerks and every public official had his accounts scrutinised at the end of his term of office.⁸¹ The Greeks coined money in 630 BC, but the practical use of these coins spread slowly.⁸²

The Roman financial administration system during the time of the Roman Kings (circa 753 to 509BC) and the Roman Republic (circa 509 to 27BC) was simple at first, but later developed into an elaborate system to support the entire Roman Empire, ultimately under Diocletian.⁸³ During the time of the Roman Kings and the Roman Republic, there was no direct tax or direct state expenditure. The incumbent king managed the finances and most of the income was from domain lands, cattle fines, confiscations and gains of war. The king gave no compensation for serving in the army as this was funded by either the district served or by donations from a person who could or would not serve in the army.⁸⁴

The concept of a treasury was first introduced in Rome during the time of the Roman Republic. The treasury was governed by the Roman Senate, administered by the consuls and managed by the *quaestors* (appointed public officials). This was based on a private system from early times, where the *paterfamilias*⁸⁵ entered all receipts and payments of their households into a book called an *adversaria*.⁸⁶ Later, under Sulla,⁸⁷ the scribes of the treasury recorded the transactions in *tabulae publicae* (public records), which were journals similar

80 Accountant Town *History of Ancient Accounting* 3;
Ainsworth *Accounting* 8.

81 Accountant Town *History of Auditing* 1;
Lee and Azham *Evolution of Auditing* 2;
Ainsworth *Accounting* 8.

82 Ainsworth *Accounting* 8.

83 Accountant Town *History of Ancient Accounting* 3.

84 Accountant Town *History of Ancient Accounting* 3.

85 The father of the family.

86 Accountant Town *History of Ancient Accounting* 4.

87 Roman general and statesman, 138-78 BC.

to the *adversaria* of the *paterfamilias*.⁸⁸ A monthly register wherein receipts and payments were entered separately was also kept. It contained the dates, names of payers and receivers, the nature of the transactions and the balance at month-end.⁸⁹

The Romans recognised the need to distinguish between the official who imposed taxes and authorised expenditure, and the person responsible for the actual receipt and payment of cash. They therefore developed an elaborate system of checks and counterchecks among the various financial officials.⁹⁰ In the Roman Republic, the Senate controlled legislation regarding public revenue and expenditure. From the time of Sulla, only a magistrate could order payment and often the identity of the magistrate and that of the creditor had to be attested by witnesses.⁹¹ The word "audit" was probably derived during this time from the Latin "*audire*", which means "to hear".⁹² Auditing was primarily used to verify the honesty of persons with fiscal responsibilities. Citizens or slaves were entrusted with public funds for collection and disbursement. They had to present themselves to an "auditor" to give an oral account of their handling of those funds.⁹³ The various systems and legislation made committing fraud very difficult, because public funds were supervised by the Senate, censors, consuls and the college of *quaestors*. If an illegal act could not be prevented, the offender would be prosecuted by the tribunes.⁹⁴

The Roman Empire's system of administration was suitable to a small municipality, but not to a vast empire. The governors of the provinces did not

88 Accountant Town *History of Ancient Accounting* 4.

89 Accountant Town *History of Ancient Accounting* 4.

90 Accountant Town *History of Auditing* 1;
Lee and Azham *Evolution of Auditing* 2.

91 Accountant Town *History of Ancient Accounting* 4.

92 Lee and Azham *Evolution of Auditing* 1;
Porter *External Auditing* 3.

93 Lee and Azham *Evolution of Auditing* 3;
Porter *External Auditing* 3.

94 Accountant Town *History of Ancient Accounting* 4.

respect the rights of the treasury or the provincial constitution. Augustus tried to maintain the unity of the public treasury, but the needs of the army led to the establishment of a military treasury. Under Claudius, Nero and Diademenus, the military treasury operated very similar to the public treasury. It was only under Hadrian that a special administration was made responsible for the collections, with a central treasury in Rome and offices in the provinces. There were numerous officials in both the central and military treasury who had to render accounts to their superior officials, the Senate or reigning emperor. There were severe penalties, yet bribery and corruption were rife. The separation of duties, distinguishing between persons with the power to pay and the power to handle money, disappeared. This led to adverse consequences.⁹⁵

After the fall of the Western Empire, the Eastern Empire continued with elaborate accounting methods. These accounting methods were carried forward to the dark ages in the Frankish Empire of Charlemagne and the Pope, and there is evidence that these accounting methods were still applied in the year 812 and even in 1001.

During the Middle Ages in Italy, cashier transactions were checked and a separate record was kept by a notary.⁹⁶ The earliest record found is of a Florentine banker in 1211.⁹⁷

Later, during the Dark Ages, across the channel in England, royal accounts were audited under the reign of the two Norman kings. Later, during the reign of Henry I (1100 to 1135) in England and Scotland, two sets of records of the Exchequer Accounts were kept and these were checked by a third person at the end of the year, with it being a requirement that the records had to correspond.

95 Accountant Town *History of Ancient Accounting* 4-5.

96 Accountant Town *History of Auditing* 1;
Lee and Azham *Evolution of Auditing* 2.

97 Accountant Town *History of Bookkeeping* 1;
Ainsworth *Accounting* 9-11.

The oldest account that has been preserved is the treasurer's record, known as the Pipe Roll, of the year 1130/1131. A similar accounting system existed in Scotland during the same period and it was known as the "Chekker". These accounts were audited at Michaelmas (29 September) and Easter (a moveable date, the first Sunday following the full moon in March) and any discrepancies in the accounts would result in imprisonment of the relevant sheriff. Auditing of the Exchequer Accounts started in 1327 and of the Chekker in 1424.⁹⁸ The influence of the Roman Empire is evidenced through the use of Roman numerals in these records until 1673.⁹⁹

Until the Industrial Revolution (1760-1840) auditing was restricted to affairs of state, because businesses were small and individually owned and managed,¹⁰⁰ whereafter the *Joint Stock Companies Act* was passed in the UK in 1844. The *Act* stipulated that auditors needed to be appointed to check the accounts of companies, with the objective of an auditor being to detect errors and fraud.¹⁰¹

After the crash of Wall Street in 1929, the focus of auditing shifted to providing credibility to the financial statements produced by organisations, rather than the detection of errors and fraud.¹⁰² In the 1960s, the growth in the volume of business transactions led to the concept of materiality and sampling techniques. It was no longer possible to check and verify every individual transaction. Since then, with the growth in business transactions, increased complexity in financial markets and developments in technology, the auditing focus has shifted from verifying each transaction to testing the effectiveness of systems and processes.

98 Accountant Town *History of Auditing* 1;
Lee and Azham *Evolution of Auditing* 2;
Mautz and Sharaf *Auditing* 1;
Accountant Town *Early forms of Accounts* 1-2;
Ainsworth *Accounting* 8-9.

99 Accountant Town *Early forms of Accounts* 7.

100 Lee and Azham *Evolution of Auditing* 2.

101 Lee and Azham *Evolution of Auditing* 3.

102 Ainsworth *Accounting* 12.

Since the 1980s auditing techniques have moved towards risk-based auditing, which entails focusing an audit on the areas most likely to contain errors. This expanded to a business risk approach in the 1990s. Many business risks may materialise out of day-to-day operations and, if they are not controlled, they will eventually affect the financial statements of the business.

The quality of audits was placed under scrutiny following a series of large corporate failures in the early 2000s, such as Worldcom and Enron. This led to regulatory reforms such as the *Sarbanes Oxley Act* in the USA.¹⁰³ Table 1 below lists a number of global economic events that led to increased scrutiny of risks in organisations and countries, as well as the management of and responses to such risks. Global political and economic events and natural disasters also have an impact on risk management. Due to the adverse effect that these events have on businesses and specifically on banks, risk managers will use such incidents to assist in managing risks in order to prevent or mitigate the impact of those kinds of risks materialising in future.

Table 1 – Risk incidents

| | |
|------|--|
| 1992 | ERM (European Exchange Rate Mechanism) crisis ¹⁰⁴ |
| 1992 | Swedish banking crisis ¹⁰⁵ |
| 1992 | UK small banks crisis ¹⁰⁶ |
| 1994 | US bond market crash ¹⁰⁷ |
| 1995 | Mexican country crisis ¹⁰⁸ |

103 Lee and Azham *Evolution of Auditing* 4-6.

104 Lee and Azham *Evolution of Auditing* 4-6;
http://europa.eu/legislation_summaries/economic_and_monetary_affairs/institutional_and_economic_framework/l25082_en.htm.

105 Lee and Azham *Evolution of Auditing* 4-6;
<http://oxrep.oxfordjournals.org/content/15/3/80.short>.

106 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.bankofengland.co.uk/publications/fsr/2000/fsr09art4.pdf>.

107 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.bis.org/publ/work32.pdf>.

| | |
|--------------|---|
| 1997 | Asian crisis ¹⁰⁹ |
| 1998 | Russian default, Ruble collapse, (Long-term Capital Markets (LTCM) bailout ¹¹⁰ |
| 1999 | Gold price plummets ¹¹¹ |
| 2000 | TMT (Telecommunications, media & technology) collapse ¹¹² |
| 2001 | Turkish banking crisis ¹¹³ |
| 2001 | September 11 payments system disruption ¹¹⁴ |
| 2002 | Argentine crisis – government default ¹¹⁵ |
| 2002 | German banking crisis ¹¹⁶ |
| 2004 | Russian banking crisis ¹¹⁷ |
| 2007 to 2008 | US subprime mortgage collapse, oil price surge, US investment banking collapse ¹¹⁸ |
| 2010 to 2011 | Greece, Ireland, Portugal, Italy and Spain country crises ¹¹⁹ |

108 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.sjsu.edu/faculty/watkins/mexico95.htm>.

109 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.imf.org/external/np/exr/facts/asia.HTM>.

110 Lee and Azham *Evolution of Auditing* 4-6;
<https://openknowledge.worldbank.org/bitstream/handle/10986/3797/WPS5312.pdf?sequence=1>.

111 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.usagold.com/reference/prices/1999.html>.

112 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.apra.gov.au/CrossIndustry/Documents/7c-Leonard-Matz-Some-thoughts-on-liquidity-scenarios.pdf>.

113 Lee and Azham *Evolution of Auditing* 4-6;
[http://www.ifc.org/ifcext/cgf.nsf/AttachmentsByTitle/PaperCananYildirim/\\$FILE/Yildirim_Canan7.pdf](http://www.ifc.org/ifcext/cgf.nsf/AttachmentsByTitle/PaperCananYildirim/$FILE/Yildirim_Canan7.pdf).

114 Lee and Azham *Evolution of Auditing* 4-6;
http://www.newyorkfed.org/research/staff_reports/sr239.pdf.

115 Lee and Azham *Evolution of Auditing* 4-6;
<http://theinflationist.com/sovereign-default/argentine-sovereign-default-2002-argentina-financial-crisis>.

116 Lee and Azham *Evolution of Auditing* 4-6;
Hüfner 2010 "The German Banking System: Lessons from the Financial Crisis";
<http://dx.doi.org/10.1787/5kmbm80pjkd6-en>.

117 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.frontlineonnet.com/fl2116/stories/20040813000306000.htm>.

118 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.economywatch.com/us-subprime/effects-banking-sector.html>.

119 Lee and Azham *Evolution of Auditing* 4-6;
<http://www.economist.com/node/21540259>.

Today there is a distinction between external and internal auditing. External audit primarily focuses on the integrity of financial statements. Traditionally internal auditing was compliance based; the internal auditors would merely assess compliance with existing processes and procedures in the organisation without evaluating whether it constituted an adequate control. The *King III Report*¹²⁰ advocates a risk-based approach to internal auditing which determines whether the controls are efficient in managing the risks that arise from the strategic direction that an organisation has adopted. In my opinion it is no longer sufficient for the internal audit function to assess whether existing processes are adhered to. The internal audit function needs to provide assurance that the all material risks faced by the business, be it strategic or operational risks, are controlled in an appropriate manner. In other words, historically internal audit would take a process manual and check whether it was followed in all areas of the business. This is no longer practical because business volumes, complexity and speed of change in the business environment has increased. Now internal audit is expected to use the enterprise risk management information and plan their audits according to that. They do not necessarily audit all areas of the business any more, they will focus on areas that have an inherent high risk rating or a high audit need. Audit plans focus on a high audit need and this is derived from business strategy. When a business expands into new markets, this expansion will be audited to ensure new operation is well controlled from the start. A lot of audit work is also thematic in nature revolving around, regulatory requirements/concerns, technology, change projects, fraud, supplier management, finance and known control breakdowns. There is a focus on highest and best use of staff resources. Continuous monitoring of business operations has also emerged over the last couple of years bringing together information from enterprise risk management, external audit, regulators, fraud and business and external market sources, allowing auditors to change audit

120 King *Report III* 14.

plans on a regular basis to ensure emerging risks are reported to audit committees timeously.¹²¹

In the same manner, the compliance function in an organisation traditionally merely checked whether applicable legislation was adhered to. My experience is that initially, the compliance function in a bank would draw up compliance risk management and monitoring plans, based on every section of a particular piece of legislation applicable to the bank. Business processes would then be monitored to ensure compliance with the various sections of an *Act*. The relevant *Act* was effectively checked section by section, and regulation by regulation to ensure adherence to all requirements. Unfortunately, due to the increase in the number of pieces of legislation with which banks are expected to comply, it has become impossible to monitor compliance with every section of every piece of legislation. Compliance officers now assist business in implementing every requirement, but not all requirements are actively monitored after they have been implemented. Because compliance¹²² partly emerged out of internal audit principles, it is suggested that compliance should also adopt a risk-based approach to compliance monitoring. This entails that each bank rates its risks and ranks the legislation applicable to its particular operations. Thereafter, the sections of the legislation are ranked according to the risk posed and the most pertinent risks are those that the compliance officer will focus on during monitoring.

The principle that underpins any audit is that the auditor has a mandate to check the activities of another party. This holds true from the Babylonian, Grecian and Roman periods to today. Although auditing techniques have become increasingly sophisticated over time, the basic principle remains the same, namely "trust but check".

121 FSA *Effective Internal Audit* 1.

122 Specifically compliance monitoring.

4 Risk management and corporate governance

The roots of risk management are said to be in ancient Mesopotamia, Greece and Egypt, with the development of the Hindu-Arabic numbering systems and the concept of "zero", which was difficult to understand in the context of counting livestock.¹²³

One of the earliest examples of risk taking is probably gambling. However, it was not influenced by any form of risk management theory, but purely a game of luck. It is said that Pontius Pilate's soldiers cast lots for Christ's robe while He was dying on the cross.¹²⁴ The earliest dice game was played with an *astragalus*¹²⁵, the likes of which have been found in many archaeological excavations. It is also depicted in Egyptian tomb paintings dating from 3500 BC. The Crusaders (during various wars from 1095 to 1291) brought these dice to Europe and games involving these were referred to as *hazard*.¹²⁶ Card games were developed in Asia and became popular in Europe after the invention of printing.¹²⁷ Girolamo Cardano wrote a book called *Liber de Ludo Aleae* on gambling in the 1500s, which was first in a serious effort to develop statistical principles of probability.¹²⁸

The 1500s and 1600s were a time of geographical exploration which led to an increase in trade and commerce, which in turn led to increased wealth, but also increased risk because of the dangers of travelling and the confrontations with foreigners. The increased trade led to accounting techniques and forecasting in order to link risk taking with direct pay-offs.¹²⁹

123 Hay-Gibson *River of Risk* 3;
Covello and Mumpower *Risk Analysis* 33.

124 Bernstein *Against the Gods* 11-13.

125 A knuckle bone from a sheep or deer used to play dice.

126 From the Arabic word for dice, *al zahr*.

127 Bernstein *Against the Gods* 13.

128 Bernstein *Against the Gods* 45-49.

129 Bernstein *Against the Gods* 45-49.

The study of risk began during the Renaissance (14th to 17th century).¹³⁰ In 1654 Chevalier de Méré, a French nobleman, gambler and mathematician, challenged Blaise Pascal, a famed French mathematician, to solve a puzzle. The challenge was how to divide the stakes of an unfinished game of chance between two players when one of them was ahead. Pascal in turn requested the assistance of Pierre de Fermat, a lawyer and mathematician. Their collaboration led to the theory of probability, which is said to be the heart of the modern concept of risk. As time elapsed, mathematicians transformed the theory of probability from a gambler's toy to a powerful instrument for organising, interpreting and applying information.¹³¹

In 1703, Jacob Bernoulli invented the "Law of Large Numbers" and methods of statistical sampling, many of which are still used today in, for example opinion polling and the testing of new drugs. In 1730 Abraham de Moivre suggested the "bell curve", or structure of normal distribution which led to the discovery of the standard deviation. Together, the bell curve and the Law of Large Numbers make up the "Law of Averages", which is still used for quantifying risk.¹³²

One of the applications of risk during the 1700s was in insurance. Life expectancy was being calculated and life annuities were being sold as early as 1725, and by 1750 marine insurance was a flourishing business in London.¹³³ The first captive insurance company, Tanker Insurance Company Limited, was established in 1920. This is said to have started a movement that exploded in the 1970s and 1980s and linked finance, insurance and risk.¹³⁴ This was a precursor to the development of risk management as a discipline in banking.

130 Bernstein *Against the Gods* 3.

131 Bernstein *Against the Gods* 3-4.

132 Bernstein *Against the Gods* 4-5;
Crockford *History of Risk Management* 169.

133 Bernstein *Against the Gods* 4.

134 Hay-Gibson *River of Risk* 4;
Covello and Mumpower *Risk Analysis* 39.

Major wars, such as World Wars I and II, the Korean War and various regional conflicts, and world events, such as the Great Depression, the advent of the automobile, radio, television, computers, global warming, the atom bomb, nuclear power, communism, and disasters such as the nuclear disaster at Chernobyl, assisted in allowing risk management to develop into a separate discipline.¹³⁵

Risk management is linked to corporate governance, which is a term that was developed during the 1990s and took various forms in various jurisdictions. Corporate governance simply is the way any given organisation conducts business when it thinks no one is looking. It involves the establishment of structures and processes, with appropriate checks and balances that enable the board of directors to discharge its legal responsibilities. The overarching corporate governance principles are fairness, accountability, responsibility and transparency.¹³⁶ During the late 1990s the Organisation for Economic Cooperation and Development ("OECD") developed a set of corporate governance principles, guided to a large extent by the UK Cadbury and Turnbull reports. Revised corporate governance principles were published in 2004 which aim to assist governments in implementing corporate governance frameworks in their countries. It is intended to be used by the stock exchanges, investors and corporations (both financial and non-financial) in that country.¹³⁷

The Basel Committee¹³⁸ states that corporate governance affects how banks align corporate activities and behaviours with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations. Today, corporate governance places a duty on boards of directors to ensure that businesses not only focus on profits, but also on people and the long-term sustainability of the planet. Put differently, boards of directors have to ensure that their organisations have adequate internal processes and produce an

135 Hay-Gibson *River of Risk* 4.

136 King Report III 6.

137 OECD *Principles on Corporate Governance* 5-15.

138 Basel Committee *Enhancing Corporate Governance* 3.

integrated report on the so-called "triple bottom line". The triple bottom line focuses on an organisation's internal control environment and profitability, risk management and assurance (internal and external audit).¹³⁹

In South Africa, the King Code on Corporate Governance¹⁴⁰ is the standard against which banks and other organisations are measured in terms of corporate governance. The board of directors and the executive officers of a bank are required to establish and maintain an effective and adequate corporate governance process.¹⁴¹

It may be concluded that risk management is now considered part of the corporate governance process.

But what is risk management?

The scientist [Arthur Rudolph] who developed the Saturn 5 rocket that launched the first Apollo mission to the moon put it this way: "You want a valve that doesn't leak and you try everything possible to develop one. But the real world provides you with a leaky valve. You have to determine how much leaking you can tolerate".¹⁴²

Risk management in banking, as it is known today, has been in existence for approximately 50 years. It started by banks applying basic risk management techniques to determine whether or not a client or counterparty was likely to repay a loan in the 1960s. The historical purpose of a bank, namely that of protecting deposits, expanded rapidly into a profitable business by lending out borrowing those deposits in the form of loans or by investing client money for the profit of both the bank and the client. The loans extended to clients led to credit risk and the investments led to market risk being introduced into the banking

139 King *Report III* 11.

140 King *Report III* 11.

141 S60B of the *Banks Act* 94 of 1990.

142 Bernstein *Against the Gods* 2.

system.¹⁴³ Much of the development of risk management principles for banking is linked to the Basel Committee. As briefly mentioned in chapter 1, the Basel Committee was established by the Governors of the Central Banks of the Group of Ten ("G10") countries at the end of 1974 around the General Arrangements to Borrow.¹⁴⁴ The G10 countries are arguably the largest or most influential economies in the world. The G10 initially was called the G10 because it had 10 member countries. Today it consists of eleven members, but is still called G10. The current members are Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.¹⁴⁵ Although the legal systems represented on the G10 are civil law, common law or mixed legal systems, my opinion is that because individuals who represent their countries are mostly accountants and economists, they do not fully understand legal risk. The Basel Committee does not possess any formal supranational supervisory authority and its decisions do not have legal force. It formulates best practice guidelines and broad supervisory standards with the expectation that individual authorities will implement them in their home countries. The Basel Committee covers a wide range of financial issues, one of which is regulatory capital requirements against credit, market and operational risk. The Basel Committee defines credit risk as the risk of a counterparty defaulting against loan obligations¹⁴⁶. Market risk is the risk that the value of an investment will decrease due to market fluctuations.¹⁴⁷ Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes legal risk but excludes strategic risk and reputational risk.¹⁴⁸

143 Crockford *History of Risk Management* 169-170.

144 Alexander *Global Financial Standard Setting* 867.

145 IMF *Factsheet March 2011* 4-5.

146 Basel Committee *Risk Management Practices* 21.

147 Basel Committee *Basel II* 171.

148 Basel Committee *History* <http://www.bis.org/bcbs/history.htm>.

During the 1980s banks were eroding their capital base through competitiveness and the Basel Committee established minimum capital requirements for banks in order to protect depositors. In 1988, the Basel Capital Accord ("Basel I") was introduced, which is a capital measurement system. Initially the requirement was only to hold capital against credit risk. The purpose was to ensure that banks identify, mitigate and monitor their credit risks in order to minimise losses. During the mid-1990s, market risk capital requirements were introduced, along with market risk management principles similar to those of credit risk. Operational risk capital adequacy requirements were introduced in 1998.¹⁴⁹

This quotation probably sums up what risk and risk management means in practice. Risk management guides us in our decisions, from allocating wealth to safeguarding public health, from waging war to planning a family, from paying insurance premiums to wearing a seatbelt and from planting corn to marketing corn flakes.¹⁵⁰

The word "risk" derives from the Latin *risicare* which means "to dare".¹⁵¹ The word is used frequently and has various meanings. Dictionaries and authors¹⁵² define risk as "danger", "jeopardy", "peril", "hazard", "menace", "threat" or "an exposure to the chance of injury, loss, a hazard or danger".

Both Feder and Boyle¹⁵³ define risk as the chance that a future event might happen with adverse consequences. However, in business, the word "risk" has

149 IMF *Factsheet March 2011* 4-5.

150 Bernstein *Against the Gods* 2.

151 Hay-Gibson *River of Risk* 3;
Merna an Al-Thani *Corporate risk management* 9.
Bernstein *Against the Gods* 8.

152 Steinmetz *Dictionary* 392;
Summers *Dictionary* 902;
Hanks *Dictionary* 414;
Hay-Gibson *River of Risk* 1.

153 Boyle and Boyle *Derivatives* 1;
Feder *Derivatives* 1-2.

positive and negative meanings because risk is not only the chance of loss, but also the prospect of gain.

The International Organization for Standardization¹⁵⁴ describes risk as the effect of uncertainty on objectives, whether positive or negative, and risk management as identifying risk followed by coordinated economical application of resources to minimise, monitor and control the probability and impact of unfortunate events or to maximise the realisation of opportunities.

Hay-Gibson¹⁵⁵ is of the view that risk is the chance of an event occurring in terms of its likelihood, usually with a negative connotation, especially if it is in a financial context. Risk is also used in the description of the outcomes of a scenario, for instance, drinking more than a recommended number of units of alcohol per week.

Taking the above into account, for the purposes of this study, risk is taken to mean simply the uncertainty attached to activities, which may have positive or negative consequences.

The management of risks evolved from insurance law and principles, and currently covers financial activities and physical objects (for example the risk of a building being destroyed).¹⁵⁶

Risk management is the practice of identifying, measuring, reporting on and appropriately managing the risks that could impact the company's governance objectives. For example, risk managers look for competitive threats, political situations and new government regulations that could impact the business. They study the known risks and come up with ways to mitigate them.¹⁵⁷

154 ISO31000:2009 *Risk Management*.

155 Hay-Gibson *River of Risk* 1.

156 Thompson *Risk Management* 1.

157 Musthaler *GRC* 2.

Bernstein¹⁵⁸ defines risk management as maximising the areas where we have some control over the outcome, minimising the areas over which we have absolutely no control, and when the link between cause and effect is not known. This definition is accurate but too wide for the purposes of this study.

Hay-Gibson¹⁵⁹ defines risk management firstly as interpreting risk either by itself or within a specific discipline, and secondly as the act of assessing and reacting to risk. For the current study this definition is not adequate, because it fails to take all aspects of risk management into account, for example identification, reporting and controlling risk.

Jelatianranat¹⁶⁰ describes risk management as a process to identify, measure and prioritise risks. According to him, it also entails the assessment of the adequacy of existing controls, developing control improvement plans, creating a continuous programme for reaching objectives, and risk and control assessment. This definition is acceptable, except that it does not include the reporting, tracking or monitoring of control improvements in order to protect the interests of stakeholders.¹⁶¹

PricewaterhouseCoopers¹⁶² defines risk management as the identification, assessment and prioritisation of risks. Similar to Jelatianranat's definition, the criticism with this definition is that it does not include reporting on the risks or following up on action plans.

158 Bernstein *Against the Gods* 197.

159 Hay-Gibson *River of Risk* 1.

160 Jelatianranat *Corporate Governance* 5.

161 Stakeholders in a bank may include the board of directors, shareholders, employees, clients and regulators.

162 LFA Training *PWC Risk Management Methodology* 1.

Deloitte & Touche¹⁶³ describes risk management as the process that an organisation uses to establish its risk management goals and objectives, assess and monitor the risks, and select and implement measures to address the risks in an organised and coordinated fashion. The purpose of risk management is to ensure the continued operation and the survival of the organisation. This may include maintaining quality operations, providing a safe environment and moderating personal liability. Risk management is not only about preventing "bad things" (also called down-side risk), but also about enhancing the likelihood of "good things" (also called up-side risk) happening. This definition is comprehensive and may be acceptable for current purposes.

Feder¹⁶⁴ defines risk management as the controlling of risk by one or more trades. This definition is incomplete, because many aspects of risk management are excluded. Risk management is also not necessarily about controlling risk, but about having response plans in the event of a risk materialising. Similarly, Shimell¹⁶⁵ mentions that risk management is about controlling risks. This definition is therefore also incomplete.

The New York Federal Reserve¹⁶⁶ defines risk management as a coordinated process for measuring and managing risk on a firm-wide basis. At a high level, this definition is correct, but it is wide and lacks the necessary detail.

KPMG¹⁶⁷ states that risk management is about taking risks knowingly, not unwittingly. Risk management is about how an organisation can better understand risk to improve performance and deliver on objectives. This definition is not comprehensive and neglects various aspects of the management of risk.

163 Deloitte <http://www.pfisherassociates.com>.

164 Feder *Derivatives* 679.

165 Shimell *Universe of Risk* 5.

166 Shimell *Universe of Risk* 5.

167 Kihlbom and Foulkes *A Rogue Trader* 23.

King II¹⁶⁸ defines risk management as the identification and evaluation of actual and potential risks applicable to an organisation in its entirety. Thereafter the risk is terminated, treated, transferred or tolerated. While The definition is correct, it is incomplete, because risk needs to be monitored as well.

King III¹⁶⁹ uses the term risk management to refer to a process that entails:

the planning, arranging and controlling of activities and resources to minimise the negative impacts of all risks to levels that can be tolerated by stakeholders whom the board has identified as relevant to the business of the company, as well as to optimise the opportunities, or positive impacts, of all risks.

This definition is acceptable, but again, it fails to address the aspect of tracking, reporting or monitoring implementation of action plans relating to risk.

The Institute of Risk Management of South Africa¹⁷⁰ defines enterprise risk management, which for the purposes of this thesis is regarded as a synonym for risk management, as a structured and systematic process which forms part of existing management responsibilities and is designed to respond to every conceivable risk in every part of the business. At a high level, this definition is wide but correct. However, it should be expanded to include all aspects of risk management.

During 1994, the Basel Committee¹⁷¹ defined risk management as a comprehensive risk measurement approach with a detailed structure of limits, guidelines and other parameters used to govern risk taking and a strong management information system for controlling, monitoring and reporting risks. In

168 King *Report II* 73-81.

169 King *Report III* 56.

170 Brier *Code of Practice* 10.

171 Basel Committee *Risk Management* 6.

2006, the Basel Committee¹⁷² defined risk management as a comprehensive process to identify, evaluate, monitor and control or mitigate all material risks. This definition is also acceptable, although the aspect of reporting will need to be added.

In view of the numerous definitions provided above, for the purposes of this thesis, risk management is defined as a process that underpins a corporate culture aimed at protecting stakeholder interests. It is also a process used by management to identify all risks that pertain to the business before assessing the risk and deciding whether to terminate, tolerate, treat or transfer the risk, and it includes regularly monitoring and reporting on the identified risks.

4.1 Compliance

It could be said that the concept that the law needs to be adhered to is as old as the Code of Hammurabi, because it is the longest surviving legal text from the Old Babylonian period (2000 to 3000BC). Two-hundred and eighty-two laws, carved in forty-nine columns on a basalt stele (a pillar or standing block), addressed a variety of topics related to civil, criminal, and commercial law.¹⁷³ Failure to adhere to the Code of Hammurabi would result in dire consequences for the transgressing individual.

Governments have intervened to protect its citizenry since ancient times. These interventions included protection against natural disasters, such as against flooding in Egypt (1000BC), China (2000BC) and Mesopotamia (3000BC) by building canals, dams and dykes. Historically, governments passed and enforced laws to promote protection against epidemic disease, for example the Black Death (bubonic plague), leprosy and typhus in the Middle Ages. In 1307, King Edward I of England passed a royal proclamation prohibiting the use of soft coal

¹⁷² Basel Committee *Core Principles* 3.

¹⁷³ Kreis *The Code of Hammurabi*.

in kilns in an effort to curb air pollution. Shortly after passing the law, King Edward I also established a commission to investigate why the proclamation was not being adhered to. Therefore, in various jurisdictions and since ancient times, governments passed various laws, but these laws were not adhered to if the government did not have the means to ensure enforcement by way of fines and even the death penalty.¹⁷⁴

Apart from government regulation, voluntary, private self-regulation started occurring in the late 19th and early 20th centuries. Industrial self-regulation coincided with the Industrial Revolution, where factory owners chose to adhere to minimum standards in order to ensure a safer workplace. Their reason for ensuring a safer workplace was probably not moral or altruistic, but was in self-interest for fear of monetary loss, punitive or restrictive government action, and civil or criminal litigation.¹⁷⁵ It was not until the late 20th century that compliance risk management as a separate risk discipline, emerged.¹⁷⁶

Under a common law system, one person is protected from the nuisance and negligence of another person by way of compensation paid in the event of damages resulting from the nuisance or negligence. This acts as a deterrent to wrong-doing, which is a form of risk management. Adherence to the law (also called compliance with the law) is thus achieved.¹⁷⁷

The history of compliance risk management is partly the history of the law, audit and risk management, because the compliance risk management process entails the identification of relevant legislation that needs to be complied with; implementing processes and controls to ensure adherence to the legislation; and monitoring the implemented controls and processes, and reporting thereon. The

174 Covello and Mumpower *Risk Analysis* 42-44.

175 Covello and Mumpower *Risk Analysis* 47.

176 Basel Committee *Compliance* 7.

177 Covello and Mumpower *Risk Analysis* 39.

monitoring process is essentially an audit process. The compliance process in its entirety is similar to a risk management process.

There is a growing trend towards internationalism in terms of compliance risk management, where various countries are moving closer together to find solutions and guidance for their local jurisdiction in a process called "legal comparison".¹⁷⁸

When drafting national legislation with regard to banking, the international trend is to follow best practice, recommendations, or guidelines of both formal or traditional international institutions (for example the IMF and the International Bank for Reconstruction and Development [World Bank]) as well as informal international institutions (e.g. the Basel Committee and Financial Stability Board (FSB)).¹⁷⁹

Specific guidance or best practice principles on risk management in banks is provided by the Basel Committee. As mentioned earlier in this chapter, South Africa chooses to follow the standards set by the Basel Committee. South Africa has adopted these Basel recommendations by way of amendments to the *Banks Act* 94 of 1990 and the regulations issued in terms of the *Act*. These Basel Committee recommendations represent the principles known as Basel I, Basel II, Basel 2.5 and Basel III. For current purposes, only Basel II is relevant.

If it is assumed that Basel II was drafted based on a codified legal system, for implementation in a codified legal system, there would be no problem. In a codified legal system, there is only one source of law, being legislation (statutes and regulations). South Africa has a mixed legal system and the sources of law are legislation, court decisions, common law (Roman, Roman-Dutch and English

178 Kleyn and Viljoen *Beginners' Guide* 21-22.

179 Hiscock and Van Caenegem *Internationalisation of Law* 5.

law), custom (unwritten law by which people live because they regard it as the law, e.g. Islam), indigenous law (a form of custom, in South Africa it refers to the "black" communities), works of modern authors (books and journals only has persuasive, and not binding, authority) and the *Constitution* (the supreme law of South Africa).¹⁸⁰

In South Africa large areas of the law are potentially excluded by bankers, industry lawyers, legal advisors and compliance officers who assume that legal risk is synonymous with compliance risk.

As articulated in the problem statement in chapter 1, Basel II seems slanted towards codified law. However, Basel I is intended for adoption and implementation in all countries, including countries such as South Africa with a mixed legal system. In codified legal systems, the law consists only of legislation and an interpretation of the Basel Committee definition of compliance risk would, in such countries, include legal risk. This does not present a problem. However, in countries with mixed legal systems, such as South Africa, the law consists of more than only legislation (for example precedent, the *Constitution* and customary law). Kleyn and Viljoen state that:

Lay people are usually under the impression that our law as a whole originates in legislation and that consequently one can find it there. This is incorrect. Legislation is an important source of our law, and a whole area of law may be governed solely by legislation. This means that that specific area of law is codified. The law of criminal procedure, for example, is codified...but our entire legal system is not codified and therefore legislation is not the only source of South African law.¹⁸¹

180 Kleyn and Viljoen *Beginners' Guide* 43-95.

181 Kleyn and Viljoen *Beginners' Guide* 44.

This notion of compliance with legislation only may create problems in mixed legal systems such as South Africa because large areas of the law are excluded.¹⁸²

My theory is that, in South Africa compliance risk is adherence to legislation or codified law, while legal risk is adherence to the law in a wider sense. It is not limited to only legislation; it includes the entire legal system such as common law and indigenous law. Legal risk includes, but is not limited to, compliance risk. The inference that is drawn from the explanatory Basel Committee publication on the compliance function in banks¹⁸³ is that legal and compliance risk are similar concepts. This is problematic in South Africa because it is unclear whether adherence only to legislation or the law in general is intended.

As mentioned in the objectives of this study, South Africa follows the Basel Committee guidance and implements it by way of amendments to the *Banks Act* and regulations. Therefore there is a need to clarify what the legal position regarding compliance risk and legal risk in the banking industry in South Africa entails, whether there is a difference between the two, and if so what the differences are. Foundational thereto is the question what the South African law with regard to legal risk and/or compliance risk is, what the implications of differences or similarities between the two are, whether the one includes the other and whether the law should be improved. This would be at the core of the problem to be addressed in this research.

For the purposes of this study, it is assumed that it is in the best interest of South Africa to follow the Basel Committee's principles as it is accepted by most of the developed world to provide guidelines for banking best practice.¹⁸⁴

182 Conversely, large areas of the law, and specifically banking law has been codified in for example the *Banks Act*, *Companies Act* and *National Payment Systems Act*.

183 Basel Committee *Compliance 7*.

184 The study does not focus on the legitimacy of following the Basel Accord(s).

As mentioned in chapter 1, the Basel Committee defines operational risk which includes legal risk. Legal risk is accepted by the Basel Committee to be compliance with regulatory and legislative provisions. The hypothesis is that legal risk and compliance risk are related, yet distinctly separate concepts in the banking law of South Africa. Legal risk in a bank in South Africa will entail more than a mere adherence to the regulatory and legislative provisions for the banking sector. Operational risk includes legal risk and compliance risk, also in South Africa.

Initially operational risk was defined by the Basel Committee as any risk not categorised as market or credit risk or as every type of unquantifiable risk faced by a bank.¹⁸⁵ In 1988 Committee members defined it as the risk of loss arising from various types of human or technical error. Others defined it as settlement or payment risk, business interruption, administrative and legal risk.¹⁸⁶

In January 2001, the Basel Committee defined operational risk as the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes legal risk, but excludes strategic and reputational risk.¹⁸⁷

In August 2003, the Basel Committee amended the definition of operational risk to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This includes legal risk but excludes strategic and reputational risk.¹⁸⁸ There is no generally accepted definition of legal risk in the banking, insurance and securities sectors at this time.¹⁸⁹

185 Jayamaha *Basel II and Operational Risk* 1.

186 Basel Committee *Operational Risk Management* 5.

187 Basel Committee *Working Paper on Operational Risk* 8.

188 Basel Committee *Working Paper on Pillar 3 – Market Discipline* 16.

189 Basel Committee *The joint forum: Operational risk transfer* 14.

The concern, and object of this study, is that the Basel Committee has defined legal risk, but the definition is too narrow for a mixed system such as South Africa. The intention is to give a theoretical background of all the concepts. This will at least include the definitions, theory, principles and need for risk, risk management, operational risk, the Basel Committee, and in as far as can be established, legal- and compliance risk. Thereafter the intention is to establish whether South African banking law is aligned with the Basel principles and whether a strict alignment creates confusion and leads to misinterpretation or not. The aim of the research is to determine if it is advisable to follow the exact Basel principles regarding legal risk and compliance risk or whether there is a more appropriate alternative for the South African legal system.¹⁹⁰ From a South African perspective it is important for banks to know what the legal position with regard to their obligations relating to legal risk and compliance risk is. It is also important to determine whether South Africa is on par with international best practice or other jurisdictions regarding legal risk and compliance risk.¹⁹¹

In South Africa, compliance risk is managed because it is legislated.¹⁹² Moorcroft¹⁹³ states that the establishment of a compliance function within financial institutions in South Africa originated in section 90 of the *Banks Act and regulation 47* of the regulations relating thereto.¹⁹⁴ Subsequently the *Financial Intelligence Centre Act*¹⁹⁵ and the *Financial Advisory and Intermediary Services Act*¹⁹⁶ also made a compliance function a legislative requirement. The same does not necessarily hold true for legal risk, which is discussed in more detail in chapter 3.

190 Also refer to chapter 6.

191 Corporate Compliance Committee *Survey* 1759.

192 For example *Banks Act 94 of 1990*;
Financial Advisory and Intermediary Services Act 37 of 2002; and
Financial Intelligence Centre Act 38 of 2001.

193 Moorcroft *Banking Law* 10-1.

194 Now Reg 49 of the *Banks Act 94 of 1990*.

195 *Financial Intelligence Centre Act 38 of 2001*.

196 *Financial Advisory and Intermediary Services Act 37 of 2002*.

5 Conclusion

It has been established that legal risk and compliance risk developed out of the law, internal audit and risk management, specifically operational risk management.

In addition, it has been shown that the law in South Africa is not codified as there are aspects of the law which are not legislated. The banking law in South Africa is currently influenced by the international Basel Committee which, among other functions, sets standards with regard to risk management in banking. South Africa is implicitly bound to follow the recommendations of the Basel Committee. One such definition pertains to the definition of operational risk, which includes legal risk. The application of this definition is essentially the problem statement of this study as the inclusion of legal risk under operational risk is problematic in a country with a mixed legal system such as South Africa. This issue is dealt with in more detail in the next chapter.

It has furthermore been indicated in this chapter that legal risk includes compliance risk, which in turn is based on adherence to legislation. The manner in which banks ensure adherence to the law is based on risk management principles, with the addition of monitoring techniques. These monitoring techniques are essentially internal audit principles, the history of which was discussed in great detail.

The next chapter will be used to discuss the concepts of legal risk and compliance risk specifically within the context of risk management, narrowed down, where possible, to banking. In the next chapter I shall also illustrate the difficulties in regarding legal risk and compliance risk as synonyms in a mixed legal system such as South Africa.

CHAPTER 3

Classification of different types of risk

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1 Introduction

As discussed in depth in chapter 2, legal risk and compliance risk developed out of the culmination of the law, internal audit and risk management,. This chapter will provide background information about the classification of some basic risk types, such as credit risk, market risk, liquidity risk and operational risk, the latter of which includes legal risk and compliance risk. Within the context of legal risk and compliance risk, and being a South African lawyer I find the language used in South Africa convoluted and confusing. There are no uniform definitions, or perhaps even a general understanding of what compliance, compliance risk, legal risk, legal compliance, regulatory compliance and regulatory risk are. The purpose of this chapter is to identify the defining features of these terms, with an aim to provide clarity regarding the overlap and distinguishing elements of these terms. This will be done by researching the ordinary meaning of the words and conducting a literature study on the terms as used in South Africa, in international guidance and by other jurisdictions. As mentioned in chapter 1, it is not intended to be a comparative overview of the meanings of the terms in different

jurisdictions, although opinions from other jurisdictions may provide insight. Such opinions will be included where appropriate.

This chapter is aimed specifically at understanding both legal risk and compliance risk in the context of a bank in South Africa. My hypothesis articulated in chapter 1, namely that legal risk is not synonymous with compliance risk in the South African context and that it is insufficient that legal risk is defined as part of operational risk as it creates the assumption that legal risk is synonymous with compliance risk, will be tested. It is possible that compliance risk is a component of legal risk.

2 Classification of different types of risk

The Basel Committee publishes the Core Principles for Effective Banking Supervision (“the Core Principles”). National banking regulators and supervisors are regularly assessed for compliance with these Core Principles. This may be by means of a self-assessment (usually conducted annually); by an external party such as the IMF or the World Bank as part of its Financial Sector Assessment Program (“FSAP”) which results in a Report on the Observance of Standards and Codes (“ROSC”); by another third party such as consulting firms; or through a peer review such as regional groupings of banking supervisors.¹

The purpose of such assessments is to identify the nature and extent of weaknesses, if any, in the banking regulator’s supervisory framework or regulations in the jurisdiction being assessed. It may also assist the regulator and its government in setting a strategy to improve the banking supervisory system. Assessments are invariably based on essential and additional criteria.² The

1 Basel Committee *Core Principles 2012* 7.

2 Basel Committee *Core Principles 2012* 81.

essential criteria are used to gauge full compliance with the Core Principles,³ while the additional criteria are suggested best practices which countries should aim to attain.⁴ Assessments to determine the level of compliance with the Core Principles are normally done by persons with either legal or accounting expertise in the interpretation of compliance with the Core Principles, because the interpretation must necessarily be in relation to the legal and accounting structure of that jurisdiction.⁵

More than 100 countries have been assessed in one or more of the above-mentioned assessment methods. The most recent such assessment of South Africa was in 2012 and South Africa was found to be generally compliant with the Core Principles.⁶ Regular follow-ups are performed by the IMF on findings raised. Since regulators are assessed against the Core Principles, they chose to implement the Basel Committee standards in their jurisdictions. Adherence to or compliance with the Core Principles is regarded as being a tool to ensure an effective banking supervisory system. In turn this may have other positive consequences, such as foreign investment.⁷ It is therefore imperative that South Africa adheres to the international standards as far as is practically possible.

Although the international standard adopted by national banking regulators and imposed on banks in their jurisdiction is set by the Basel Committee, the regulators also take cognisance of other international standard-setting bodies such as the Financial Stability Board's *Compendium of Standards* when formulating domestic legislation.⁸ The Compendium of Standards is wider than the Basel Committee's work and has 12 policy areas which regulators need to

3 The rating scale used is “compliant”; “largely compliance”; “materially non-compliant”; or “non-compliant”.

4 *Basel Core Principles 2.*

5 *Basel Core Principles 2.*

6 *IMF SA ROSC 2012.*

7 *Basel Core Principles 1.*

8 *FSB Compendium of Standards.*

prioritise when implementing legislation. This includes macroeconomic policy and data transparency, financial regulation and supervision, and institutional and marketing infrastructure, for instance the FATF recommendations on combating money laundering.⁹

Against the background of the Core Principles and the assessment of regulators' implementation thereof, most jurisdictions, especially the members of the G20,¹⁰ chose to adhere to the Basel Committee standards. This poses a challenge to countries with a mixed legal system due to the wording used by the Basel Committee in relation to legal risk as it is defined as part of operational risk. This challenge is not limited to South Africa, because approximately one third of the world has common law or mixed legal systems. Other G20 countries, such as Canada, the United States, the United Kingdom and Australia, either have common law legal systems or a mixture of common law and codified law.

Core Principles 7-16¹¹ deal with the risk management process as well as specific risk types, which a banking supervisor needs to pay attention to in its jurisdiction. Initially, it was the Basel Committee¹² that introduced the concept of risk management in banking, in 1988 in the form of the International Convergence of Capital Measurement and Capital Standards,¹³ commonly referred to as Basel I. This has been developed further over the past 25 years and currently includes the focal topics of credit risk, market risk, liquidity risk and operational risk (which includes legal risk).

9 http://www.financialstabilityboard.org/cos/key_standards.htm.

10 The G20 brings together finance ministers and central bank governors from 20 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States of America and the European Union.

11 Basel Committee *Core Principles* 15-27.

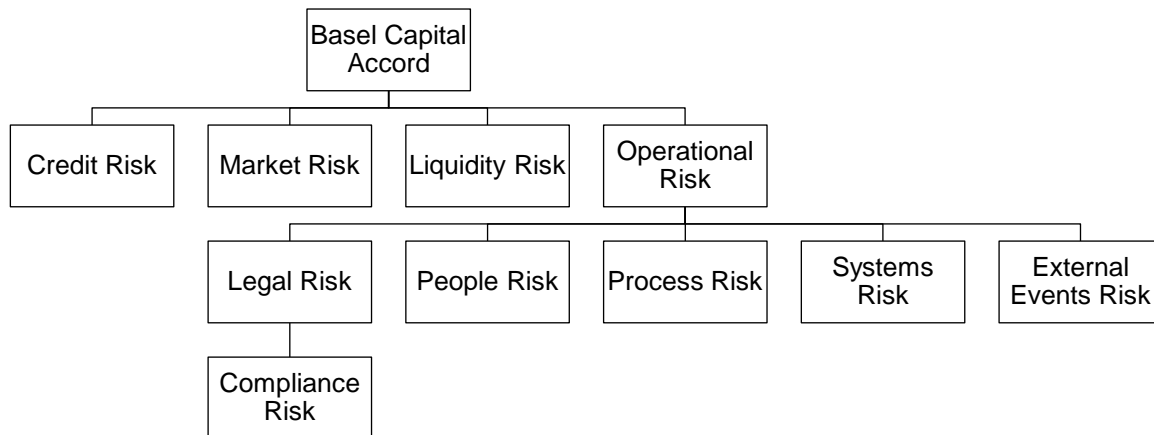
12 Basel Committee *Core Principles* 3-5;
Basel Committee *Basel II* i-iv.

13 Basel Committee *Basel I* 1.

Generally, in order to assist in the management of risk, various other categories of risk have also been developed, for example strategic risk, business performance risk, competitiveness risk, and investment risk. These are not discussed in detail as this study will focus primarily on the Basel Committee's risk categorisation, of which a cursory overview is provided below. The specific object of this study is to research a subcategory of the one risk category, namely legal risk as defined as part of operational risk. Although the objective of this study is not to comment on other categories of risk, these categories are briefly discussed for background purposes. These categories are credit risk, market risk, liquidity risk and operational risk, and are discussed in this order below.

Therefore, the risk categories applicable to a bank in South Africa may be illustrated as follows:

Figure 1 - Risk categories applicable to a bank



2.1 Credit risk

Initially the Basel Committee, in Basel I,¹⁴ only defined credit risk and all other risks were grouped together as “market risk”. Basel I focused on credit risk as the major risk in a bank in 1988. In 1996 the Basel Committee introduced a distinction between credit risk and market risk, when market risk was more accurately defined.¹⁵ The Basel Committee¹⁶ currently defines credit risk as an exposure to the bank through a loan, which exposure is unilateral and only the lending bank will face the risk of loss.

The Basel Committee mentions that credit risk is interconnected with other risks. Loans are the largest and most obvious source of credit risk, but credit risk may emerge from many activities in a bank, whether in the banking book¹⁷ or trading book,¹⁸ on balance sheet¹⁹ or off balance sheet,²⁰ acceptances,²¹ interbank transactions,²² trade financing,²³ foreign exchange transactions,²⁴ financial

14 Basel Committee *Basel I* 8.

15 Basel Committee *Basel I Market Risk* 9.

16 Basel Committee *Guideline for Derivatives* 11.

17 A banking book is an accounting entry for all securities that are not actively traded by the bank. They are held until they mature.

18 A trading book is also an accounting book that includes securities, but in contrast to a banking book, it is actively traded on the market and is valued by the performance of the market.

19 On-balance-sheet items are, for example assets which the bank owns.

20 Off-balance-sheet items are assets or liabilities which not appear on the bank’s balance sheet. The bank does not have a legal claim to or responsibility for these assets. These assets are difficult to track and may make it difficult for investors to determine the financial health of a company. These assets may become a hidden liability, for example a securitisation.

21 Acceptances are promised future payments, which are accepted and guaranteed by a bank and drawn on a deposit at the bank.

22 Interbank transactions usually refer to overnight settlements between the banks in a system, but may be used for any transaction between banks and do not need to involve the entire banking system.

23 Trade financing is the management of money, banking, credit, investments and assets for international trade transactions. It is often used by importers, exporters, financiers and insurers.

24 Foreign exchange transactions refer to cross-border trade and financing where foreign currency is used.

futures,²⁵ swaps,²⁶ options,²⁷ equities,²⁸ and guarantees,²⁹ or the settlement of transactions.³⁰

In the context of a counterparty in a derivative transaction, the risk of loss is bilateral because the market value of the transaction can be positive or negative to either counterparty to the transaction. Counterparty credit risk³¹ is defined as the risk that a counterparty to a transaction could default before the final settlement of the transaction's cash flows. A loss will occur if the transaction(s) or portfolio of transactions with that counterparty has a positive economic value at the time of default.

In another Basel Committee publication,³² credit risk is defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. This may also be in terms of individual credits or transactions or in terms of a portfolio of transactions.

In Core Principles 8 to 12³³ and the revised Core Principles 17 to 21³⁴ the Basel Committee includes problem assets,³⁵ provisions³⁶ and reserves,³⁷ concentration

25 Futures are standardised contracts to buy or sell a specified asset at an agreed future date and price. These contracts are negotiated on futures exchanges.

26 A swap is a derivative instrument where counterparties trade or exchange cash flows in each other's financial instruments. It is a type of derivative because the value of the swap is derived from the value of the underlying asset such as an interest rate, foreign exchange rate, or equity or commodity price.

27 Options are also derivative instruments where the counterparties enter into a contract for a future transaction on an asset at a reference price. The buyer of the option gains the right (but not the obligation) to fulfil the transaction.

28 Equity is shareholders' funds or capital. Various classes of equity exist, which affect the seniority of a claim against the company in the event of insolvency after all liabilities have been paid.

29 A guarantee is a promise by a person to assume responsibility for the debt obligation of a borrower should that borrower default. It is also known as a surety.

30 Settlement of transactions refers to a process whereby contractual obligations are fulfilled.

31 Basel Committee *Guideline for Derivatives* 11.

32 Basel Committee *Principles Credit Risk* 1.

33 Basel Committee *Core Principles* 17.

34 Basel Committee *Revised Core Principles* 46.

risk³⁸ and large exposure limits,³⁹ transactions with related parties, country⁴⁰ and transfer risks⁴¹ in the management of credit risk.

When the various Basel Committee definitions and principles are read in conjunction, it addresses all aspects of credit risk in a bank, namely that it is the risk that a person is unwilling or unable to fulfil his obligations as and when they fall due, under various circumstances and across various banking products.

For the purposes of this thesis, the Basel Committee descriptions of credit risk are accepted and not critically analysed. These descriptions are merely restated here for the purpose of providing context.

Credit risk may link to legal risk, for example when a loan agreement proves inadequate to enforce a bank's rights.⁴²

2.2 Market risk

During the 1990s, after the collapse of Barings Bank, the Basel Committee realised that banking was more than credit risk and the definition of market risk was refined in 1996.⁴³

35 A problem asset is also called an impaired asset. It is not limited to non-performing loans and includes off-balance-sheet exposures.

36 A provision is an accounting liability.

37 In this context, a reserve may be the deposit a bank is required to hold with the central bank, along with the currency it physically holds in its vaults and shareholders' equity.

38 Concentration risk is present if a bank has significant exposures to single or related debtors.

39 The regulatory authority will set limits for the risk exposure that a bank may have to a single counterparty.

40 Country risk is the risk attached to investing in a particular country, based on the business, regulatory and political environment of that country.

41 Transfer risk is the risk that currency may not be sent out of the country due to central bank restrictions.

42 Also refer to chapter 4.

43 And subsequently the definition of operational risk.

The Basel Committee⁴⁴ currently defines market risk as the risk of loss in on- and off-balance-sheet positions arising from adverse movements in market prices in the trading book (debt and equity instruments and related off-balance-sheet contracts), and in foreign exchange rates and commodity prices. This would include interest rate risk and liquidity risk. Put differently, market risk is the day-to-day potential for an investor to experience losses due to fluctuations in prices or rates.

Similar to credit risk, the Basel Committee description of market risk is not critically analysed in this thesis. It is mentioned for the purpose of providing the context within which the concept of operational risk developed. Market risk may link to legal risk, for example where contractual arrangements prove inadequate to hedge the market risk as intended.

2.3 Liquidity risk

Due to the global financial crisis of 2007 onwards,⁴⁵ the Basel Committee increased its focus on liquidity risk. In its simplest form, liquidity is essentially cash flows which allow banks to be able to meet their obligations as they fall due. The Basel Committee⁴⁶ states that liquidity is the ability to fund increases in assets and meet obligations of the bank as they fall due, without incurring unacceptable losses. There are two kinds of liquidity risk, namely funding liquidity risk and market liquidity risk. The Basel Committee⁴⁷ defines funding liquidity risk as the risk that the bank will not be able to meet expected and unexpected current and future cash flow and collateral needs without affecting either daily operations or the financial condition of the bank. On the other hand, market liquidity risk is:

44 Basel Committee *Basel I* 1.

45 BIS Quarterly *Global financial crisis* 1.

46 Basel *Liquidity risk* 1.

47 Basel *Liquidity risk* 1.

the risk that a firm cannot easily offset or eliminate a position at the market price because of inadequate market depth or market disruption.

Various aspects of liquidity risk, such as the liquidity coverage ratio and the net stable funding ratio are topical due to their prominence in the Basel III framework, but not necessarily relevant to this study and are therefore not explored. Again, the Basel Committee definitions of liquidity risk are not critically analysed for purposes of this thesis; they are accepted and provided as background information.

Banks currently hold or will in future have to hold capital against credit, market and liquidity risk.

2.4 Operational risk

Similar to credit, market and liquidity risk, banks need to hold capital against operational risk in terms of the Basel Committee standards.⁴⁸

The Basel Committee⁴⁹ originally described operational risk as a type of risk with no agreed upon universal definition. During the mid-1990s operational risk was defined as any risk which could not be classified as either credit risk or market risk. Soon thereafter, some banks defined operational risk as the risk of loss arising from various kinds of human or technical error. Some Basel Committee members associated operational risk with settlement or payment risk and business interruption, administrative and legal risks. They highlighted that some events, for example settlement,⁵⁰ collateral⁵¹ and netting⁵² risks were not

48 This is referred to as Basel I, Basel II, Basel 2.5? and Basel III.

49 Basel *Operational Risk 3*;
Basel *A new framework* 50.

50 Settlement risk is the risk that a counterparty does not deliver a security or its value.

51 Collateral risk is the risk that the specific property that was pledged to secure repayment of a loan is not sufficient to cover the default amount or cannot be realised.

necessarily classifiable as operational risk and therefore might contain elements of more than one risk. The Basel Committee stated that it acknowledged the importance of risks other than credit risk and market risk for banks, but initially did not attempt to define or describe any other types of risks. The Basel Committee stated that a rigorous control environment was essential for the prudent management of, and limiting banks' exposure to, all risks.⁵³

By the late 1990s the Basel Committee encouraged banks to develop a framework for explicitly measuring and monitoring operational risk and expressed its concern regarding the lack of quantification of some elements of the broad category of operational risk, for instance reputational and legal risks.⁵⁴

The first concrete attempt by the Basel Committee⁵⁵ to define operational risk was in 1998. This definition is that operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk. However the Basel Committee did not define legal risk at that stage. The Basel Committee advocated that banks should start measuring or quantifying their operational risk. The Basel Committee's definition of operational risk was criticised because of the inclusion of the words "direct or indirect loss". Banks and supervisors pointed out that direct losses were relatively easily quantifiable, but indirect losses might not be quantifiable at all. The Basel Committee then amended the definition of operational risk to exclude the words "direct or indirect",⁵⁶ resulting in what is still the current Basel Committee⁵⁷ definition of operational risk:

52 Netting risk is the risk that set-off of a negative value against a positive value cannot be effected due to a legal or other impediment.

53 Basel A *new framework* 50.

54 Basel A *new framework* 50.

55 Basel Committee *Operational risk 2*.

56 Basel Committee *Basel II* 144.

57 Basel Committee *Basel II* 144.

...the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.

Other than the Basel Committee, many authors have attempted to define and describe operational risk, for example Feder,⁵⁸ who defines operational risk as the possibility that internal systems will fail to measure adequately, monitor effectively or control intelligently the risks to which the consumer is exposed. This definition is inadequate, because it only focuses on internal systems and only in a consumer context. A system within the context of risk usually refers to an information technology solution and therefore this definition disregards manual processes. It also lacks reference to other sources of risks, such as errors made by humans, for example typing errors in capturing amounts in a system, and the external environment, for example *vis major* (acts of God) or theft. Feder's definition is also limited to the consumer, who cannot be the only person affected by operational risk. Due to the fact that the organisation and other stakeholders will also be affected when operational risk materialises, legal risk should also be included.

Johnson⁵⁹ defines operational risk as an organisation's failure to monitor and control its own activities, having inadequate internal systems and control, human error and management failure. This definition is relatively comprehensive, but it disregards external factors such as syndicate fraud, *force majeure* (acts of God) and legal risk.

Krawiec⁶⁰ defines operational risk as the risk of loss occurring as a result of inadequate systems or controls, human error or management failure. The same criticism raised against Johnson's above-mentioned definition of operational risk

58 Feder *Derivatives* 727.

59 Johnson *Bank finance* 22.

60 Krawiec *Derivatives* 39.

is raised against Krawiec's definition, namely that external triggers and legal risk may also result in operational risk events.

DeSanze and Sun⁶¹ define operational risk as the risk associated with human error, system failures or procedural failures. This definition is also inadequate because it does not include external events, such as external fraud, which may lead to operational losses. Referring to human error is also inadequate because it is a narrower concept than human negligence and does not include intentional or malicious acts. This definition also lacks reference to legal risk.

Bessis⁶² defines operational risk as a malfunctioning of information systems, reporting systems or internal risk monitoring rules. This definition is not sufficient, it should include losses caused by human negligence or malice, external factors and legal risk.

Van Greuning and Bratanovic⁶³ define operational risk as the risk of failure of a bank's organisation, functioning of internal systems (including computers and technology), compliance with bank policies and procedures, and measures against mismanagement and fraud. This definition is also incomplete, because it does not include compliance with the law in general, but is limited to internal bank policy and procedure. Again, this definition also disregards external factors (except fraud, which may be internal or external) and legal risk.

The South African *Banks Act*⁶⁴ defines operational risk, in a manner similar to the Basel Committee, as:

61 DeSanze and Sun *Derivatives* 16.

62 Bessis *Risk management in banking* 12.

63 Van Greuning and Bratanovic *Analyzing banking risk* 3.

64 Reg 67 *Banks Act* 94 of 1990.

...the risk of loss resulting from inadequate or failed internal processes, people or systems or from external events, including legal risk such as exposure to fines, penalties, or punitive damages resulting from supervisory actions and private settlements, but does not include strategic or reputational risk.

This definition is adequate, because it refers to all the factors that may lead to operational risk materialising. The part of the definition regarding legal risk will be discussed in more detail in section 2.4.1 below.

When the above definitions are read together, for the purposes of this study, the elements of operational risk may be identified as follows:

- There is a potential or actual failure (an actual failure would indicate that the risk has materialised).
- The failure may result in a loss, which may take the form of a quantifiable financial loss or, in my opinion, unquantifiable reputational damage.
- The failure in internal controls (and subsequent loss) may be caused by humans or systems.
- If the failure is caused by humans, it may be because of a wilful action, for example fraud, or due to negligence, for example by failing to take the appropriate steps in terms of company policies, processes or procedures.⁶⁵
- The human element may be internal (for example internal fraud) or external (for example syndicate operations) to the bank.
- If the failure is caused by systems, it may be due to technical errors such as hardware or software failure. Again, the human element might be the cause of the failure, for example internal staff not following change management processes; external persons hacking into the systems; or a

65 General legal requirements or a “reasonable person” test may be applied in addition to the requirements of company policies, processes and procedures.

- third-party supplier of, for example telecommunications infrastructure, failing.
- Both a failure caused by humans and systems may lead to legal risk, for example payment and settlement not occurring because the information technology (IT) platform is not operational, which could lead to claims for damages suffered.

Based on the elements of operational risk, and for the purposes of this thesis, operational risk is defined as the risk of failure or loss resulting from an intentional human act or negligence, or system failure, which includes failure to adhere to company policies, procedures or processes, external events, or legal risk.⁶⁶

The remainder of this chapter is dedicated to one specific aspect of operational risk, namely legal risk, and the terminology used in the context of legal risk.

2.4.1 Legal risk

As has been established in section 2.4, above, legal risk is a component of operational risk in a bank. Legal risk may also arise out of other risk categories of risk such as credit risk and market risk.

The hypothesis of this thesis is that legal risk and compliance risk are related, yet distinctly separate concepts, and that legal risk is not synonymous with compliance risk. In order to determine whether this hypothesis holds true, it is necessary to determine what is meant by the terms “legal risk” and “compliance risk”, as well as other similar concepts or terminology used in literature,⁶⁷ such as

66 It is assumed, at this stage of the study, that legal risk and compliance risk are indeed synonyms. However, this needs to be read in conjunction with the remainder of this chapter.

67 Some terms are not used in literature, but rather colloquially and are therefore included both for completeness and to avoid any further confusion regarding terminology.

“compliance risk”, “legal compliance”, “regulatory compliance” and “regulatory risk”.

This section of chapter 3 aims to define, describe and, where appropriate, distinguish the terminology in order to provide a level of clarity which may enable a bank to appropriately manage the legal aspects of its business.

As already mentioned, the Basel Committee includes legal risk into the definition of operational risk. It is not questioned or disputed whether it is correct to classify legal risk as a form of operational risk. I am of the opinion that there most certainly is legal risk and as long as the risk itself is clearly identified and managed, it is irrelevant under which general risk category it is classified. The question that therefore needs to be answered is “what is legal risk”? In an attempt to answer this question, this study deals with the opinion of various authors and other publications. In the conclusion to this chapter a definition of legal risk will be suggested.

Gopinath states that:

There appears to be no concrete definition for the expression “legal risk”...⁶⁸

McCormick states that:

Legal risk management is not a well-established or well-defined concept, which like risk management in general is of a proactive nature.⁶⁹

Despite Gopinath and McCormick’s opinion that there is no concrete definition for legal risk, I was able to discover various definitions and descriptions of legal risk.

68 Gopinath *Legal risks in the financial sector* 1.

69 McCormick *Legal risk* 105-113.

As mentioned earlier, Basel I does not mention operational risk, legal risk, compliance risk or any similar risk type which is discussed in this chapter. However, according to Basel II, legal risk:

... includes, but is not limited to, exposure to fines, penalties or punitive damages resulting from supervisory actions, as well as private settlements.⁷⁰

The Basel Committee⁷¹ names examples of legal risk being the inability to seize, or realise in a timely manner, collateral pledged (on the default of a counterparty); refusal or delay by a guarantor to pay; and ineffectiveness of untested documentation. The Basel Committee⁷² mentions that mitigating some risks, for example mitigating credit risk by means of collateral, guarantees or credit derivatives, may give rise to other risks such as legal risk, documentation risk or liquidity risk. Basel II⁷³ classifies legal risk and regulatory risk under political and legal environment in its supervisory rating grades for object finance exposures in specialised lending.

When the Basel Committee definition of legal risk is applied in civil law countries it is acceptable, but I find that it is too narrow in a mixed legal system. The definition of legal risk should also refer to damages either paid or due in terms of a court order. Not all fines, penalties or damages are paid due to supervisory actions as persons other than the supervisor may institute legal action against a bank. However, not all disputes are settled as private settlements either. It is possible that a dispute ends in litigation and is not settled. It is also possible to end a legal dispute by means of an *ex gratia* payment. The definition also lacks reference to the sources of legal risk, which are based on a jurisdiction's legal

70 Basel Committee *Basel II* 130, 144.

71 Basel Committee *Basel II* par 187.

72 Basel Committee *Basel II* 171.

73 Basel Committee *Basel II* 244.

system.⁷⁴ Legal risk in a mixed legal system may arise out of virtually any aspect of the international law or the particular jurisdiction's public, private or formal law, which is not necessarily contained in legislation the way it would be in a civil law system. The source of the legal risk in a mixed legal system may be any aspect of the law applicable to a bank. This aspect is explored in chapter 4.

Based on the criticism highlighted above, the Basel Committee definition of legal risk is inadequate for a mixed legal system, and in an attempt to understand what is meant by the term "legal risk" the ordinary meaning of the words as found in a reputable dictionary may be of value. According to the Oxford Dictionary,⁷⁵ the word "legal" means relating to, or required by, or permitted by the law. In turn it explains the word "law" as a rule or system of rules recognised by a country or community as regulating the actions of its members and is enforced by the imposition of penalties. Moreover, it may be that such rules are the subject of study or as the basis of the legal profession; it is statute law and the common law; it is a rule that controls correct behaviour in a sport; it is a statement of fact that a particular natural or scientific phenomenon always occurs if certain conditions are present; it is something that has binding force or effect; or it is the police.⁷⁶ According to the ordinary dictionary meaning of the words "legal" and "law", the former is therefore what is permitted by the law, and for current purposes the law is the system of rules recognised by a country, regulating the actions of its citizens (members), enforced by the imposition of penalties or claims and it is both statutory law and common law.

Alexander⁷⁷ describes legal risk as the risk of loss due to a transaction that proves unenforceable in law or has been inadequately documented. This includes legal uncertainties around the legal capacity of banks' counterparties to

74 The distinction between a common law and civil law system is discussed in chapter 2.

75 Oxford Dictionary 593.

76 Oxford Dictionary 588.

77 Alexander *Operational Risk* 76, 77, 90.

enter into the transactions; the legality of the transactions and/or the recognition and effectiveness of specific arrangements in certain jurisdictions; or the effectiveness of collateral arrangements in insolvency. This definition is too narrow because it focuses only on the law of contract and does not include any other aspect of a legal system. Alexander also provides a wider definition of legal risk, which is that any risk affecting a bank can be construed as a legal risk. This definition might be technically accurate, but is too wide to be useful for the purposes of this thesis. The appropriate description of legal risk probably lies somewhere between these two extremes.

Bessis⁷⁸ defines legal risk within the context of credit risk, as the risk that guarantees cannot be enforced when they are used. This definition is correct, but is once again too narrow because it limits the application of legal risk not only to the law of contract, but also to credit agreements, sureties or guarantees.

Carter and Demczur⁷⁹ use the term “legal risk” without defining it. They provide a checklist for managing legal risk from which it is deduced that legal risk may arise from the nature of the organisation (for example is it a charity organisation or a bank?); the organisational documentation (thus highlighting the need to develop an inventory of key documents and maintain a central location for key documents); and legal documentation (leases, deeds, mortgages, joint venture and licence agreements). Although Carter and Demczur do not define legal risk, their work is helpful in that they indicate some possible sources of legal risk. For example, there may be an administrative or regulatory requirement based on the type of organisation and there may be risks in contracts and other documents with legal implications.

78 Bessis *Risk management in banking* 97.

79 Carter *Checklist* 1.

Feder⁸⁰ defines legal risk as the risk that certain provisions of a contract will not be enforceable. It includes the risk that the law will change during the life of the contract and the risk that attaches to the counterparty, for instance the counterparty may not have the legal capacity to enter into the contract. Similar to Alexander, Feder's definition does not include all aspects of a jurisdiction's legal system, and is inadequate because it is limited to the law of contract.

According to Gopinath⁸¹ legal risk primarily arises either due to a lack of clarity in documentation of the product or due to an act of a counterparty. It may also arise from changes in the legal environment (legislative changes), court interpretations and proceedings, non-enforceability of contracts or incorrect documentation. Legal risks materialising may result in claims against the institution, fines, penalties, punitive damages, unenforceable contracts and loss of institutional reputation. Gopinath further states that the starting point when entering into any financial transaction is the legal capacity to contract, which becomes complex to interpret in respect of today's innovative financial instruments, because laws and regulators have not kept pace with financial innovation.⁸² Gopinath's definition of legal risk is more comprehensive because it refers to many aspects of the legal system. However, it lacks reference to the procedural aspects of the law, public law and international law. In addition, not all aspects of private law, for example delict, are included.⁸³

Johnson⁸⁴ describes legal risk as the risk that a court may not enforce a contract due to inadequate documentation, counterparties not being authorised to enter into the transaction and general legal uncertainty. This definition is not the most helpful because it identifies contract risk as a form or source of legal risk before

80 Feder *Derivatives* 728.

81 Gopinath *Legal risks in the financial sector* 1.

82 Gopinath *Legal risks in the financial sector* 2.

83 Also refer to chapter 4.

84 Johnson *Bank finance* 21.

attempting to formulate a catch-all statement for the remainder of the legal framework. While the law may be certain, the parties may choose not to adhere to the law. This would introduce legal risk not covered by Johnson's definition.

Jooste⁸⁵ states that legal risk refers to unforeseen events that will result in legal liability to the business and which could have been prevented if appropriate measures had been taken. Factors that may increase legal risk are the increased complexity of doing business, an increasingly aggressive regulatory environment, new legislation, alternative dispute resolution and new enforcement techniques, as well as greater consumer awareness.⁸⁶ Legal risk arises out of:⁸⁷

- Competition laws;
- Contracts;
- Products;
- Regulatory laws and interventions;
- Money laundering;
- Health and safety;
- Intellectual property;
- Data protection;
- Tax and accounting; or
- Governance.

The only criticism that I have against Jooste's definition is that legal risk does not necessarily arise from unforeseen events. For example, an organisation might foresee the legal risk, yet it could be unable or unwilling to mitigate it, consciously choosing to suffer the consequences should the risk materialise. I therefore

85 Jooste *Establishment of a legal risk forum.*

86 Jooste *Establishment of a legal risk forum.*

87 Jooste *Establishment of a legal risk forum.*

agree with Jooste, but would test the sources of legal risk against the framework of laws applicable to a specific jurisdiction.

Jorion⁸⁸ defines legal risk as the risk of reputational or financial damage as a result of fraud. This definition is inadequate because it only includes one kind of criminal activity and not any other aspect of the law.

McCormick⁸⁹ mentions that the Financial Services Authority in the UK defines legal risk as the risk that the law operates in a way adverse to the interests or objectives of the bank; where the bank did not consider the law's effect; believed its effect to be different; or operated with uncertainty with regard to its effect. Although quite accurate, this definition is rather wide. It would probably be completely correct and preferred when legal risk is a well-established, -defined and -managed concept, which has already been shown not to be the case. Until then, I remain of the opinion that because legal risk is a relatively new concept, and it often needs to be applied either by legal advisors, who are not well versed in risk management, or by risk managers without the requisite legal expertise. Legal risk therefore needs to be defined or described more clearly in order to assist these persons in fulfilling their duties. McCormick⁹⁰ also mentions that the Bank of England defines legal risk as the risk that an unexpected interpretation of the law or legal certainty will leave the payment system or its members with unforeseen financial exposures and possible losses. This definition is once again too narrow, because it links legal risk only to one specialised part of the legal system, which is the role of a central bank in maintaining a national payment system. McCormick⁹¹ further mentions that the International Institution for the Unification of Private Law (UNIDROIT) defines legal risk as a situation where the applicable law does not provide for a predictable and sound solution. This is

88 Jorion *Risk Manager Handbook* 669.

89 McCormick *Legal risk* 105-113.

90 McCormick *Legal risk* 105-113.

91 McCormick *Legal risk* 105-113.

accurate because it importantly touches upon the subject of legal uncertainty; however, it does not deal with other aspects of the law, for example in instances where the law might be clear, yet an organisation may choose to disregard the law and be wilfully non-compliant.

McCormick⁹² mentions two further definitions of legal risk used by banks. The first is that legal risk in a financial institution is the risk of having legal action taken, or a legal sanction enforced, against that institution, or the institution is unable to enforce a legal right, arising directly or indirectly out of the legal relationship between the institution and a contractual counterparty, a third party, or a governmental or non-governmental authority. This definition addresses the various consequences of legal risk materialising, and is wide enough to be applied to any legal system.

The second definition mentioned by McCormick⁹³ is that legal risk is the failure to understand and/or act in accordance with the legal environment, including any legislation, law, contracts and duties, relevant to the bank's rights, obligations or assets that may be detrimental to the achievement of the bank's strategic and business objectives. While this definition is correct, the reference to assets seems misplaced, because an asset causes certain rights and obligations to attach to the legal subject who owns the asset. The definition refers to the causes of legal risk, namely the failure to understand or act in accordance with the legal environment. A combination of the two above-mentioned definitions of legal risk used by banks would accurately describe legal risk, because it would include both the sources or causes of legal risk as well as the consequences of such risks materialising.

92 McCormick *Legal risk* 105-113.

93 McCormick *Legal risk* 105-113.

Merna and Al-Thani⁹⁴ regard legal risk as a source of risk. They state that legal risk, as a source of risk, is the risk associated with changes in legislation, specifically from both EU directives and UK legislation. It is clear that this definition is intended for a specific jurisdiction, therefore this definition is too narrow for a mixed legal system where the law is more than legislation.

Moosa⁹⁵ defines legal risk as the risk that a transaction proves unenforceable in law or that it has been inadequately documented. Once again, this definition is too restricted because it only focuses on a contract committed to in writing. It does not deal with verbal agreements, nor does it deal with other aspects of the law, such as non-adherence to supervisory and regulatory requirements, criminal liability, delictual liability, or formal or international law.

Olson and Wu,⁹⁶ regard legal risk as a type of external risk, which in turn is a form of operational risk. Olson and Wu further classify four specific risks as part of legal risk, namely compliance, litigation, contractual obligations and fiduciary risk. The starting point of their definition is incorrect, because many legal risks do not arise externally but may arise internally, such as labour disputes, fraud, failure to comply with the law, inadequate contractual terms, and not fulfilling fiduciary responsibilities. Their definition also excludes reference to public law, international law and formal law.

Pigott⁹⁷ points out that credit risk as per the Basel Committee's definition includes legal risks such as the taking of collateral, netting arrangements and guarantees. Put differently, the risk mitigant introduced for credit risk management purposes may introduce legal risk, which may result in the credit risk mitigant being ineffective. Legal risk may also overlap with reputational risk.

94 Merna and Al-Thani *Corporate risk management* 16.

95 Moosa *Operational risk* 14.

96 Olson and Wu *Enterprise Risk Management* 35.

97 Pigott *Legal Risk* 3-4.

For example, accepting deposits linked to money laundering may lead to a criminal penalty for the bank, yet the reputational damage incurred following such a conviction may far outweigh the legal sanction imposed.⁹⁸ Pigott's assertion that legal risk may overlap with credit or reputational risk is therefore valid.

Schmedlen⁹⁹ defines legal risk as the risk of loss due to a contract that is legally unenforceable. This includes risks arising from insufficient documentation, insufficient capacity or authority of a counterparty, uncertain legality and unenforceability due to bankruptcy or insolvency. This definition is also too narrow because it focuses only on contract risk in a context of a credit agreement.

Trzaskowski,¹⁰⁰ a respected author on the topic of legal risk, mentions that legal risk management is not clearly defined and it relates to more established concepts such as corporate governance and compliance. Moreover, Trzaskowski states that risk is the potential harm that may arise from a present process or from a future event, and it combines the probability of a negative event occurring with how harmful it would be. In this context, he defines legal risk as the potential harm or detriment that may be caused in connection to a legal relation and which may be imposed by enforcement through the judiciary. He defines a legal relation as one which encompasses rights and obligations which may be enforced through the judiciary. He uses examples such as pecuniary or custodial sanctions, injunctions issued, and the deprivation of the rights of a legal or natural person, such as claiming performance or invoking remedies in a contractual relation. Trzaskowski further distinguishes between legal relations based on contract and those that are not. In a contractual relation, the parties have freedom to contract and negotiate a well-balanced contract. For all other legal relations, norms are settled by law as interpreted by the judiciary and

98 Pigott *Legal Risk* 3-4.

99 Schmedlen *Derivative Transactions* 1451-1452.

100 Trzaskowski *Legal Risk* 1-2.

without the same flexibility as within contracts. Non-contractual relations are enforced through law enforcement.¹⁰¹ Trzaskowski further states that businesses are, or at least they should be, interested in both legal and contractual relations. For Trzaskowski, the interest in law enforcement is the extent to which the law can be enforced on the business and what the business can do to mitigate or eliminate the risk of enforcement.¹⁰² Trzaskowski's description of legal risk might be adequate for the purposes of this study because although he takes it to the level of enforceable rights and obligations, it is still wide enough to include all aspects of a legal system. He is also the only author who links legal risk and compliance in this manner. Trzaskowski¹⁰³ states that corporate governance and compliance are measures taken under legal risk management. I agree that corporate governance, legal risk and compliance are related concepts.

Another author who has defined legal risk is Turing,¹⁰⁴ who describes legal risk as the risk of loss when a party to a contract is unable to enforce its rights against or rely on obligations incurred by a counterparty in the event of default or a dispute. Legal risk also includes property rights, as well as duties and rights under delict, statute and criminal law. This description of legal risk might be adequate, but it would need to be tested in specific jurisdictions to ensure that all aspects of the relevant country's legal framework are included. It is not clear whether Turing would, for example, include international and formal law into the category of risk that deals with the law.

Whittaker¹⁰⁵ is of the opinion that there is no standard definition when talking about legal risk, and that it may in fact not be very helpful to produce a definition either. He describes legal risk in a very wide sense as the risk that lawyers can

101 Trzaskowski *Legal Risk* 2.

102 Trzaskowski *Legal Risk* 2.

103 Trzaskowski *Legal Risk* 5.

104 Turing *Operational risk* 260-261.

105 Whittaker *Lawyers as Risk Managers* 5-7.

help to identify or mitigate, and points out that it overlaps with other forms of risk. Whittaker's definition is clearly too wide, because a lawyer may be employed by a bank to do anything *but* legal work or legal risk management. He distinguishes between two kinds of legal risk: the first is the risk to a specific organisation or its objectives based on their implementation of the law; and the second is the risk that the law itself gives rise to an unplanned and unwelcome result. Whittaker's first type of legal risk is, for example, where the organisation acted unlawfully; where contracts do not reflect the commercial objectives of the contract; or the organisation is involved in litigation due to some dispute. He attributes this part of legal risk to the organisation's own operational risk controls being inadequate. Examples of Whittaker's second type of legal risk are when the law changes or develops; clarity is provided on ambiguous or unclear law; or the law is clear but widely misunderstood, misinterpreted or ignored. This kind of legal risk tends to be wide ranging and potentially impacts general law, not only one organisation's operations. It may also crystallise quickly when the law is amended, or a court ruling provides clarity or punishes non-compliance. Whittaker regards legal risk as a type of environmental risk found within operational risk. His reasoning for including it in environmental risk is because individual organisations are able to mitigate the risk at an individual or micro level, while public authorities can mitigate the risk at a macro level, which might be outside the control of an individual organisation. Whittaker's two types of legal risk may overlap. The only criticism against Whittaker's definitions is that it does not take wilful non-compliance with the law into account.

Young¹⁰⁶ defines legal risk as the risk from violations of or non-compliance with laws, rules, regulations, prescribed policies and ethical standards. He further states that it is the risk that laws or rules governing products or activities of an organisation's customers are untested or unclear. Non-compliance can expose an organisation to fines, financial penalties, payment of damages and the voiding

106 Young *Operational risk* 4.

of contracts. It could also lead to reputational damage, reduced franchise value, limited business opportunities, restricted developments and unenforceable contracts. Because legal risk may lead to financial losses, it is regarded as a type of operational risk. Young¹⁰⁷ is of the opinion that operational risk may be caused by external events, and that one such external event may be legal litigation. The objection to Young's definition is that he does not take a lack of consensus into account. For example, litigation may arise out of a contractual dispute, where there is complete adherence to the law, but the parties involved in the contract fail to deliver on the provisions of the agreement.

The International Bar Association (IBA)¹⁰⁸ defines legal risk as the risk of loss to an institution that is primarily caused by a defective transaction; a claim, defence to a claim or counterclaim being made that results in a liability; failing to take appropriate measures to protect assets owned by the institution; or a change in law. This definition does not deal with regulatory and supervisory actions, adherence to legislation or international law and thus needs to be expanded. Although I agree that a loss may result from a defective transaction or a claim, the root cause of the defective transaction or claim needs to be established. For example, a sale of land in South Africa may result in a loss due to a defective transaction, and the root cause of the defect in the transaction may be that the agreement was not reduced to writing, as is required by section 2 the *Alienation of Land Act*.¹⁰⁹

The Operational Risk Exchange Organisation (ORX) defines legal risk as the risk of loss resulting from exposure to:

- (1) non-compliance with regulatory and/or statutory responsibilities and/or

107 Young *Operational risk* 17.

108 McCormick *Legal risk* 105-113.

109 *Alienation of Land Act* 68 of 1981.

(2) adverse interpretation of and/or unenforceability of contractual provisions.

This includes the exposure to new laws as well as changes in interpretations of existing law(s) by appropriate authorities and exceeding authority as contained in the contract.¹¹⁰

The ORX's definition is not comprehensive because it limits legal risk to statutory requirements and contracts. The remainder of the body of law that applies to a bank is disregarded.

The Financial Stability Board¹¹¹ defines legal risk as the risk that unenforceable contracts, lawsuits, adverse judgements or other legal proceedings will disrupt or adversely affect the operations or condition of a bank. It can arise from broad legal or jurisdictional issues to a missing provision in an otherwise valid agreement. This definition does not take the risk of financial loss or damage to reputation into account.

In the UK the Combined Code of the Committee on Corporate Governance¹¹² requires directors to review their organisation's system of internal controls and report to the shareholders annually. The system of control includes identifying and assessing legal risk in relation to the financial system infrastructure.¹¹³ The committee unfortunately does not define or describe legal risk. It is, however, agreed that internal controls should include aspects that would assist in mitigating legal risk.

The Financial Law Panel started a project in 2001,¹¹⁴ which aimed to promote a common understanding of what legal risk is and how it relates to other risk types. The Financial Law Panel, which was subsequently closed in 2002, is quoted as

110 ORX ORSS 11.

111 Financial Stability Board *FSI Connect*.

112 FRC *Combined Code on Corporate Governance* 39.

113 Exchanges, settlement, payment and clearing systems.

114 McCormick *Legal risk* 105-113.

stating that legal risk arises from organisational legal risk (the risk connected to the maintenance of a bank's assets and property and internal affairs of the bank); legal methodology risk (the risk that the methods and steps to protect a bank's assets against claims by others or to protect it against the liability to pay damages or compensation to others are inadequate); or conduct of business legal risk (the risk that during the conduct of commercial operations a bank will incur obligations or liabilities that were not foreseen, are greater than were foreseen or that its rights and claims prove to be fewer, or of a lower value, than was expected). This definition is relatively comprehensive, because it refers to many aspects of the private law applicable to organisations. However, it does not deal with adherence to legislation and the adverse consequences that may flow from non-adherence. Nor does it deal with the relationship between government and the organisation (public law) or international law.

Solvency II,¹¹⁵ similar to the Basel Committee, includes legal risk into the definition of operational risk. The Solvency II definition of operational risk is the risk of loss arising from inadequate or failed internal processes, personnel or systems, or from external events, and operational risk shall include legal risk and exclude risks arising from strategic decisions and reputational risk.¹¹⁶ Unfortunately, Solvency II does not define legal risk.

As already mentioned in chapter 1, regulation 67 of the *Banks Act*¹¹⁷ defines legal risk in the context of operational risk:

...including legal risk such as exposure to fines, penalties, or punitive damages resulting from supervisory actions and private settlements, but does not include strategic or reputational risk.

115 European Union *Solvency II* 252.

116 European Union *Solvency II* 100.

117 *Banks Act* 94 of 1990.

This definition is copied almost verbatim from the Basel Committee definition and the same criticism is raised, namely that the definition is too narrow. While the definition should include damages paid under a court order, not all fines, penalties or damages are paid due to supervisory actions, other persons may institute legal action against a bank, which does not necessarily result in a private settlement.

I propose that a definition or description of legal risk should be established taking the jurisdiction(s) within which the relevant bank operates into account. This should include all aspects of the legal system as well as all possible losses or damages that could be suffered. It should include both the causes and results of the risk materialising.¹¹⁸ Legal risk cannot be confined to adherence to legislative requirements in all jurisdictions. In uncodified, common law and mixed legal systems, as a minimum I propose that legal risk be defined as the risk of financial loss or reputational damage due to non-adherence to legal requirements, which may stem from private, public, procedural or international law. Legal risk should include codified and uncodified law, as well as industry or organisational standards, rules and policies.¹¹⁹ These aspects are discussed in more detail in chapter 4.

The next concept which needs to be defined for the purposes of this study is “compliance”.

118 Similar to the definition of operational risk, where the result is financial loss or reputational damage, caused by people, processes or external events.

119 It is accepted that all risk types may result not only in financial losses or reputational damage, but also loss in business opportunity, disqualification, debarment, denial of a license or tender, be subject to boycott or similar action.

2.4.2 Compliance

According to the Oxford Dictionary¹²⁰ the word “comply” has its origins in the Latin word *complere*, which translates to “fulfil” or “fill up”. “To comply” is to act in accordance with a request or order or meet specified standards. The word “compliance” means the action of obeying an order, rule or request, or obedience to, observance of, adherence to, conformity to, respect for, acquiescence, agreement, assent, consent or acceptance. Compliance, in the context of the law, in the ordinary dictionary¹²¹ meaning of the word is therefore obedience, acquiescence, agreement, submission, amenability, passivity, or falling in line with the law.

With regard to compliance in banks, the Basel Committee published a document on the compliance function in banks in 2005, which unfortunately does not define the word “compliance”.¹²² The Basel Committee has not defined the term “compliance” in any other publication, but has defined “compliance risk”, which is dealt with in the next section of this chapter.

According to Baumann,¹²³ compliance includes all laws, regulations and internal policies or codes of conduct as well as compliance issues raised by third parties, such as clients and service providers. I agree with this description of compliance, because it is wide enough to encompass all aspects of a legal system.

Driver¹²⁴ states that the core of compliance, at least within the context of the financial services industry, is the cornerstone of a compliance culture. He looks at risk identification and assessment in the context of new products and services. One should look at compliance in the “initial dialog” when new products are

120 Oxford *Dictionary* 195-196.

121 Oxford *Dictionary* 195-196.

122 Basel *Compliance* 7.

123 Baumann *Corporate Compliance* 17.

124 Driver *High price of non-compliance* 23.

launched and new markets are accessed as opposed to only looking at compliance once the product is being traded. Risk assessment is a component of compliance and a risk assessment should be done when moving into a new market, acquiring a business, or changes in the legal or regulatory environment occur. The compliance officer should at least ask the business whether there is an impact on the control environment, on policies and procedures, or how risks are understood and reported.¹²⁵ I agree with Driver; however, she believes that this description is better suited to “compliance risk” and not specifically to “compliance”. This illustrates that there is a lack of uniformity in legal terminology usage.

Fenn¹²⁶ states that banks are faced with the decision of whether or not to comply with given regulatory standards. A decision not to comply would be seen as wilful non-compliance and in the context of current world events regarding corporate ethics, this cannot be supported. I cannot agree with this description, because the law is more than merely regulatory requirements. Fenn’s definition disregards primary and tertiary legislation and, in mixed legal systems, the rest of the legal system.

Hoyman¹²⁷ is of the view that it should be kept in mind that compliance with the law is achieved through three processes, namely a voluntary process (compliance is initiated and sustained through a voluntary process); a bureaucratic process (compliance is initiated and sustained through mechanisms of bureaucracy); and a legal process (compliance is as a direct result of a change in the law). This is philosophical and speaks to the human motivation for compliance with the law, but it does not describe what compliance is. I therefore propose that this description be disregarded for current purposes.

125 Driver *High price of non-compliance* 23.

126 Fenn *Business Response to Regulation* 245.

127 Hoyman *Policy Compliance* 78.

Ronconi¹²⁸ states that the term “compliance” is not easily defined. In Argentine legislation, all employers must comply with various universally applicable norms, such as registering employees, providing a healthy and safe work environment, complying with collective bargaining agreement provisions, paying minimum wages, and making contributions to the social security system. Ronconi has done some work on measuring or quantifying compliance. Given the fact that Ronconi's work is done in the limited area of labour law, his description is relatively accurate because he refers to universally applicable norms, which may include all aspects of a legal system.

Sagemueller¹²⁹ describes compliance as the “conformity of an actor's behaviour with explicit treaty rules”. Compliance theory generally distinguishes between two theoretical approaches in responding to non-compliance: the “soft” managerial approach and the “hard” enforcement approach.¹³⁰ In my opinion, this limits compliance to adherence only to treaty rules, which is too narrow as it does not deal with any other rules or practices that need to be adhered to.

The legal concept and the necessity of compliance are accepted according to Sidhu.¹³¹ This does not define compliance, but does imply that organisations accept that they need to adhere to some rule(s) if the ordinary dictionary meaning is attached to the word.

In Denmark, Trzaskowski¹³² states that “compliance” refers to systems used to ensure that personnel are aware of and take steps to comply with relevant laws and regulations. Compliance is measures taken under corporate governance.

128 Ronconi *Labor regulations* 722.

129 Sagemueller *“Soft” Approach* 165.

130 Sagemueller *“Soft” Approach* 163.

131 Sidhu *Anti-corruption compliance* 1351.

132 Trzaskowski *Legal Risk* 5.

Again, I agree with Trzaskowski, but I believe that this description is better suited to a “compliance risk” process.

A survey conducted within the compliance community by the Corporate Compliance Committee states that compliance consists of an organisation's code(s) of conduct, policies, and procedures designed to achieve compliance with applicable legal regulations.¹³³ The same survey states that compliance is a wide concept, and that whenever an employer instructs employees about the law, the employer performs a compliance function.¹³⁴ I cannot agree with this statement, because it implies that only second-tier legislation (regulation) needs to be adhered to, along with internal organisational arrangements. This leaves a gap regarding primary legislation, third-tier legislation and, in a mixed legal system, every part of the law that is not codified. I do, however, agree that compliance is a wide concept because, in the ordinary meaning of the word, it can mean adherence to almost any kind of law or standard.

The Corporate Compliance Committee's survey further identified various types of compliance,¹³⁵ including hortatory, incentive-based and legally required compliance standards. Hortatory compliance standards are normally principles-based¹³⁶ standards and there is no sanction or penalty for ignoring them, nor is there an official reward for following the letter or spirit thereof.¹³⁷ The reward for compliance is more esoteric. An effective compliance programme will help an organization to prevent wrongdoing, detect misconduct early and cooperate with the government.¹³⁸

133 Corporate Compliance Committee *Survey* 1759.

134 Corporate Compliance Committee *Survey* 1759.

135 Corporate Compliance Committee *Survey* 1762-1763.

136 Similar to a parent telling a child to eat his vegetables “because it is good for you”.

137 An example of a hortatory compliance standard in South Africa would be the King Code on Corporate Governance.

138 Corporate Compliance Committee *Survey* 1762-1763.

The Corporate Compliance Committee states that incentive-based government standards¹³⁹ offer a promise from the government to an organisation with a qualifying ethics and compliance programme. A qualifying compliance programme will be where the organisations follow the relevant regulator's compliance standards. The incentives may include complete amnesty from punishment, no referral for criminal prosecution and reduced civil fines. It is important that the government has made a credible commitment. This commitment may not necessarily always be legally binding.¹⁴⁰ An example in South African law would be where a party cooperates with the Competition Commission¹⁴¹ in prosecuting other wrongdoers within the same case, in doing so obtaining complete amnesty from prosecution and penalties for the relevant party's own wrongful acts. My opinion is that this description may be accurate, but is too narrow, because it only focuses on areas supervised by a regulator.

The Corporate Compliance Committee further states that legally required compliance standards are those required by an applicable statute, regulation, or case law, and where a failure to maintain a qualifying compliance programme triggers civil or criminal sanction.¹⁴² This definition of compliance, in my opinion, is closer to what compliance is, namely adherence to all laws and internal rules.

In the USA, in the context of taxation, compliance is described as the timely filing and paying of tax obligations for which one is responsible.¹⁴³ I am of the opinion that this is a narrow view of compliance, but similar to Ronconi's definition, accurate in the narrow context to which it refers.

139 Also referred to as a "carrot" approach.

140 Corporate Compliance Committee *Survey* 1762-1763.

141 *Competition Act* 89 of 1998.

142 Corporate Compliance Committee *Survey* 1762-1763.

143 *IRS Disciplinary Actions* 13.

Solvency II¹⁴⁴ states that compliance shall include advising the administrative, management or supervisory body on compliance with the laws, regulations and administrative provisions adopted in terms of the Solvency II directive. It shall include an assessment of the possible impact of any changes in the legal environment on the operations of the undertaking concerned. I am of the opinion that the first part of the description is accurate in the narrow context of Solvency II implementation. The second part, which refers to changes in the legal environment, is accurate but should not only refer to changes but also to correcting the interpretation and application of the existing law.

The *Banks Act*,¹⁴⁵ in the form BA 002, uses the term “compliance” as a category of risk, by referring to “compliance” under the heading “risk” along with other risk types such as solvency and liquidity. The word “compliance” is used amongst other risk types, and following the *sui generis* (like with like) rule of interpretation of statutes, it cannot be the intention of the legislator to use “compliance” as a verb. My opinion is that “compliance risk” is therefore the meaning intended by the legislator. “Compliance” as used in the *Banks Act* is therefore discussed in section 2.4.3 below under the heading “Compliance risk”.

The King III Code¹⁴⁶ acknowledges the international use of the word “comply”, yet substitutes it with the word “apply”, denoting that “comply” is a much stronger word which should be reserved for adhering to statutes. I am in favour of such a distinction, firstly because the King Code refers to primary legislation, namely statutes, and secondly because it is clear that the King Code demonstrates an understanding that there is a distinction between various types of “law”.

144 European Union *Solvency II* 164.

145 Form BA 002 *Banks Act* 94 of 1990.

146 *King Report III* 6.

Young¹⁴⁷ concurs with the King II Report's view that risk management should provide assurance on compliance with applicable laws and that the board is responsible for compliance with applicable regulations. I agree with this, except it should be noted that the board is responsible for compliance with all applicable law, and not only with regulations.

The Compliance Institute of South Africa¹⁴⁸ defines compliance as "obedience or adherence to applicable laws, rules, codes and standards". I agree with the definition of the Compliance Institute because it is wide enough to cover all possible aspects of a legal system.

Therefore, for the purposes of this thesis, compliance with the law is a wide, sometimes vague, concept. It is a verb (i.e. comply with the law), and in the ordinary meaning of the word, it is adherence or obedience to something. This "something" may include adhering to legislation and the common law. It may even include adherence to industry standards and codes, as well as internal organisational standards, codes and policies. Compliance, for the purposes of this study, will be the act of obeying or adhering to the law, whether statutory or common law, industry codes and standards, as well as internal organisational standards, codes and policies.

2.4.3 Compliance risk

As referred to in section 2.4.2 above, the Basel Committee, in Basel II¹⁴⁹ defines compliance risk as:

the risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to

147 Young *Operational risk* 21.

148 CISA *The Profession*.

149 Basel Committee *Compliance 2005 7*;
Basel Committee *Compliance function* 3.

comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities.

Specifically within the context of South Africa, however, I am not in favour of this definition of compliance risk because of the reference to legal sanctions in general, as well as regulatory sanctions. In the Basel Committee's definition "laws" is wide enough to encompass regulations and rules. However, if regulations are mentioned, then surely the primary law, being legislation or acts needs to be mentioned. The failure to adhere to laws should either be expanded to include statutes, or the word "regulation" should be omitted. If the Basel Committee's documentation is read as a whole, it includes applicable laws, rules and standards into compliance risk. This includes the prevention of money laundering and terrorist financing, the conducting of business (conflicts of interest), privacy and data protection, consumer credit, employment and tax law. The Basel Committee acknowledges that there are various sources of compliance risk, such as primary legislation, rules and standards issued by supervisors, market conventions, codes of practice promoted by industry associations, and internal codes of conduct applicable to staff.¹⁵⁰ A compliance failure may attract a significant risk of legal or regulatory sanction, material financial loss, or loss to reputation.¹⁵¹ It is therefore clear that the Basel Committee's intention is to include all aspects of law into compliance risk. This may be problematic in a mixed legal system, because traditional risk management and specifically compliance risk management processes do not easily lend themselves to the management of all aspects of the law, especially uncodified law.

In contrast to the above, the Basel Committee states that the legal and compliance departments may be separate departments. The legal department

¹⁵⁰ Basel Committee *Compliance function (2003)* 3.

¹⁵¹ Basel Committee *Compliance function (2005)* 10.

may be responsible for advising management on compliance with laws, rules and standards and for preparing guidance to staff, while the compliance department may be responsible for monitoring compliance with policies and procedures, and reporting to management.¹⁵²

I agree with the Basel Committee to a certain extent. I agree that legal and compliance may be separate departments; however, compliance staff should look at adherence to all legislation, policies and procedures, and not only at policies and procedures. The legal department, as the Basel Committee points out, should give advice on the law, but its role should be wider than merely giving advice and preparing guidance. The legal department should also manage the risks not covered by the compliance staff, for example functions such as the drafting of contracts, ensuring that contracts are properly effected, keeping a record of such agreements and actively managing these (for example by alerting management timeously to renewal dates) are the role of the legal department and not a compliance officer.

Bundy, Scanlan and Purdon¹⁵³ describe compliance risk in a bank in terms of the risk of legal or regulatory sanctions, financial loss, or damage to reputation or franchise value, which may result from an organisation's failure to comply with laws, regulations, standards, or codes of conduct of self-regulatory organisations that apply to the bank's business activities and functions. Financial services institutions are regulated entities, which must adhere to a multitude of rules and regulations. Many of these rules and regulations require banks to design, implement and manage a structure and process to ensure that compliance is achieved. Some rules and regulations provide a statutory basis for compliance management and expressly mandate banks to establish an official compliance programme which is approved and regularly reviewed by its board of directors or

152 Basel Committee *Compliance 2005* 13.

153 Bundy Scanlan and Purdon *Compliance Program Management* 742.

to designate a specific individual, such as a chief compliance officer, with overall responsibility for compliance. The chief compliance officer will report to the board of directors. Requirements of this type are relatively recent developments in the compliance environment, reflecting the increased focus by all players in the industry on compliance risk management. There have been numerous industry developments on effective compliance management and the banking regulators are actively focusing on compliance issues. For example, the former Federal Reserve Board Governor, Mark Olson,¹⁵⁴ stated that the Federal Reserve Board was taking a greater interest in the ability of banking institutions to manage their compliance risk.¹⁵⁵ The description provided by Bundy, Scanlan and Purdon is adequate in a codified legal system. However, in a mixed system, as will be discussed in chapter 5, it may not be possible to manage all aspects of the legal system within the context of a jurisdiction with a mixed legal system. The process and skills necessary to manage the risk that the law as a whole poses in a mixed legal system are different to the process that has proven effective in a codified system or those parts of a mixed legal system which has been codified.

Driver¹⁵⁶ states that the cornerstone of compliance in the financial services industry is the basics of a compliance culture. He looks at risk identification and assessment in the context of new products and services. One should look at compliance in the product planning phase, or “initial dialog” when new products are launched and new markets are accessed as opposed to looking at compliance risks once the product is being traded. He calls it a “compliance minefield” which needs to be navigated. Risk assessment is the core component of compliance. An internal compliance risk assessment is triggered by accessing a new market; the acquisition of business; or legal or regulatory amendments.¹⁵⁷ Although Driver does not define or describe compliance risk itself, his description

154 Olsen served on the Federal Reserve Board from 2001 to 2006.

155 Bundy, Scanlan and Purdon *Compliance Program Management* 735-736.

156 Driver *High price of non-compliance* 23.

157 Driver *High price of non-compliance* 23.

of compliance risk management offers some clues as to what he deems compliance risk to be. The reference to legal or regulatory amendments suggests that compliance risk can only be introduced by changes in the law. Similar to other authors, Driver also neglects primary legislation. There is the reference to the law in its entirety (“legal amendments”) and then the reference to regulatory amendments. I maintain the position that “legal” requirements are those requirements imposed by the entire body of law in a legal system, be such requirements codified or not. By contrast “regulatory” requirements only refer to one specific aspect of the law, being secondary legislation.¹⁵⁸ It is recommended that the word “regulatory” be replaced by “statutory” or “legislative” because the inclusion of the primary source of law would by default include all sources of law subordinate to the primary source. I acknowledge that this view is an application of the South African perspective, and that my intention is to include all aspects of the law rather than a narrow definition or interpretation.

As indicated in chapter 2, Moorcroft¹⁵⁹ describes compliance risk as the risk that processes and procedures, implemented by a bank to ensure compliance with relevant statutory, regulatory and supervisory requirements, are not adhered to or are inefficient and ineffective. Two elements of compliance risk are identified, namely regulatory risk and reputational risk. I find Moorcroft’s description acceptable, because of the reference to primary legislation. It is also clear that regulatory risk forms part of compliance risk and is not synonymous with compliance risk as compliance risk is a wider concept.¹⁶⁰ This approach is advisable, because the primary source of law, that is the statute, is what compliance risk is. Just as a jurisdiction’s statute is the primary source of law and given that regulation is a secondary source of law, in the same manner I would argue that compliance risk is a primary risk category and regulatory risk is a

158 Botha *Statutory Interpretation* 7.

159 Moorcroft *Banking Law* 10-1.

160 Although Moorcroft clarifies the distinction between “compliance risk” and “regulatory risk”, it is not clear what is meant by “legal risk”.

secondary risk category. It may even be argued that the primary risk category is legal risk, the secondary risk category is compliance risk and the tertiary risk category is regulatory risk.¹⁶¹

Moosa¹⁶² defines compliance risk as the operational risk of regulatory sanctions or financial losses resulting from failure to comply with laws, regulations and internal policies, processes and controls. Again, I am not in favour of a description that omits statutes.

Young¹⁶³ mentions that the events that may lead to legal risk or regulatory risk are non-compliance with standards, changes in regulatory standards and contractual failures. I find this description to be inadequate firstly because it is not structured in a hierarchy that is plausible in the framework of the law: standards are not law – they merely provide guidance. Secondly, the term “regulatory standards” is not familiar to the legal fraternity and I propose that it would be more appropriate to refer to regulatory requirements, bearing in mind that reference to primary legislation is omitted. Thirdly, as will be demonstrated in chapter 4, contractual failures may be a significant source of risk, but they are not the only source of risk within the law. Many other parts of the law, such as delict or intellectual property, may also lead to risks materialising.

CISA defines compliance risk as:

the current and prospective risk of damage to the organisation’s business model or objectives, reputation and financial soundness arising from non-adherence with regulatory requirements and expectations of key stakeholders such as customers, employees and society as a whole.¹⁶⁴

161 See also sections 2.4.1 and 2.4.6 for a discussion on legal risk and compliance risk.

162 Moosa *Operational risk* 14.

163 Young *Operational risk* 7.

164 CISA Framework Definitions;

This definition, again, does not refer to primary legislation, but to “regulatory requirements”. As has been explained earlier in this section, I am of the opinion that a reference to statutes would be advisable and preferred over a reference to the subordinate legislation.

The *Banks Act* refers to compliance risk in regulation 39(3)(b) as follows:

The conduct of the business of a bank entails the on-going management of risks, which may arise from the bank’s on-balance sheet or off-balance sheet activities and which may include, among others, the following types of risk:
... (b) compliance risk...¹⁶⁵

The legislator does not define compliance risk, although reference is made to it.

ABSA Bank Limited¹⁶⁶ defines compliance risk as the risk that the implemented processes to comply with applicable laws, regulations and supervisory requirements are not followed, inadequate or ineffective. A failure to manage compliance risk may result in financial penalties (corporate and/or personal liability); criminal prosecution and imprisonment of directors; executive officers, management and employees; public reprimands and the associated reputational damage; greater regulatory scrutiny and intervention; or retraction of licences. ABSA clearly does not include everything within a mixed legal system into its definition of compliance risk, despite the reference to “laws”. The reason for this conclusion is that ABSA reports on legal proceedings separately and outside the context of compliance risk.¹⁶⁷ My criticism against ABSA’s definition is that the concept of “laws” is wide enough to encompass the entire legal system, and then a logical jump is made to regulatory requirements. It would be advisable for

CISA *The Profession*.

165 Reg 39(3)(b) *Banks Act* 94 of 1990.

166 ABSA *Annual Report* 181.

167 ABSA *Annual Report* 451.

ABSA to describe legal risk to include both compliance risk and those risks the rest of the mixed legal system poses to ABSA's business, for example litigation.

In summarising this section, for the purposes of this study, compliance risk will be taken to mean the risk of financial, reputational or other loss as a result of non-adherence to the codified law in a mixed legal system. This includes statutory requirements, which includes legislation, regulation or other guidance (such as best practices) issued by the relevant regulators or in terms of industry or company codes, standards and policies.

2.4.4 Legal compliance

The term "legal compliance" refers to the process of ensuring that an organisation follows the relevant laws, regulations and business rules, such as ethical codes of conduct within an organisation or profession. The role of legal compliance is to self-monitor the behaviour of an organisation in so far as obedience to the law and internal rules is concerned.¹⁶⁸ The use of the term "legal compliance" is not common in the banking industry in South Africa. It is more frequently used in the retail, manufacturing and mining industries and in general refers to adherence to environmental, labour, and health and safety legislation by way of legal risk registers, which refer to checklists for the various requirements imposed in terms of the legislation.¹⁶⁹

168 http://www.nmsbvi.k12.nm.us/Records/records_def.htm.

169 <http://www.tfg.co.za/governance/legal.asp>;
https://www.sasolethics.com/downloads/8736_Sasol_Ethics_Guides.pdf;
http://www.woolworthsholdings.co.za/investor/annual_reports/ar2006/sr/social.asp;
<http://www.implerx.co.za/>;
<http://www.legalcompliance.org/>.

2.4.5 Regulatory compliance

FirstRand Bank Limited¹⁷⁰ uses the term “regulatory compliance” in the context of its regulatory risk management function, which is defined as the risk of statutory or regulatory sanction and material financial loss or reputational damage as a result of a failure to comply with any applicable laws, regulations or supervisory requirements. As was highlighted in section 2.4.3 above, I find the reference to “regulatory” in the title of the category of risk unacceptable because regulations are subordinate to statutes. Taking the definition of FirstRand into account, a more accurate term would be “statutory compliance” or even “legislative compliance”.

Mynhardt¹⁷¹ also refers to “regulatory compliance” which he describes as:

...a new science that concerns itself with compliance laws, rules and standards. These laws, standards and rules cover issues such as observing proper standards of market conduct, managing conflicts of interest, treating customers fairly, and ensuring the suitability of customer advice. Also included are areas such as the prevention of money laundering and terrorist financing. Any bank participating in transactions could be exposed to compliance risk.

It is unclear what “compliance law” is, but given the additional information mentioned by Mynhardt, it is clear that he regards compliance risk and regulatory risk as synonyms.

No other references to the term “regulatory compliance” were obtainable. Therefore, it is proposed that the term “regulatory compliance” be regarded as meaning “compliance risk” for the purposes of this thesis.

170 FirstRand *Annual Report* 200.

171 Mynhardt *Regulatory compliance* 161.

2.4.6 Regulatory risk¹⁷²

The Basel Committee,¹⁷³ in Basel II, classifies legal risk and regulatory risk under the political and legal environment in its supervisory rating grades for object finance exposures in specialised lending. The Basel Committee does not provide any clarity on what is meant by “regulatory risk”. Jurisdictions with a mixed legal system often have a three-tier legislative framework. The first tier is legislation or statute, the second tier is regulation and the third tier is rules, self-regulation and codes of conduct.¹⁷⁴ If the Basel Committee’s wording is applied to such a legal system, then the word “regulation” could be interpreted as secondary legislation. Once again, the problem with such an interpretation is that parts of the law within a mixed legal system are disregarded. This was probably not the intention of the Basel Committee. The Basel Committee¹⁷⁵ distinguishes between legal liability (judgements, settlements and other legal costs) and regulatory and compliance (fines, or the direct cost of any other penalties, such as licence revocations).

Regulation 49(1) of the *Banks Act*,¹⁷⁶ refers to an:

independent compliance function [which] shall ensure that the bank continuously manages its regulatory and supervisory risks, that is, the risk that the bank does not comply with applicable laws and regulations or supervisory requirements...

Because the legislator limits the definition by stating it is regulatory and supervisory risks before attempting to widen it by referring to all applicable

172 Risk regulation and regulatory risk should not be confused. Risk regulation is the legislative, regulatory and other statutory instruments that regulate risk management, for example regulation 23 of the *Banks Act* 94 of 1990. In contrast, regulatory risk is the risk inherent in regulation and would include, but not be limited to, risk regulation.
Bessis *Risk management in banking* 3rd ed 8-10.

173 Basel Committee *Basel II* 244.

174 LAWSA Vol 25(1);
Kleyn and Viljoen *Beginners Guide* 43-95;
Botha *Statutory interpretation* 11-26.

175 Basel Committee *Operational risk* 23.

176 *Banks Act* 94 of 1990.

“laws”, banks have interpreted this to include only those “laws” imposed by regulators or supervisors. Put differently, if the interpretation of statute *eiusdem generis*-rule is applied to this section of the *Banks Act*, then a compliance function, as imposed by regulation 49(1) includes only the three tiers of legislation and not the rest of the law. This is not necessarily correct, because the law of South Africa applicable to banks is wider than just statute and regulation, it also includes common law. In a broader context, the legislator defines corporate governance and various risk types. A bank is expected to manage any risk that it regards as material to its business. The intention of the legislator would therefore have been to include all aspects of the law and not only statute.

The *Banks Act*¹⁷⁷ refers to regulatory risk in regulation 23(11)(d)(iii)(C)(iii) as a risk driver in object finance. This is aligned to the wording used by the Basel Committee¹⁷⁸ in a similar context, but does not assist in defining or describing “regulatory risk”.

Nedbank Limited¹⁷⁹ uses the term “compliance and regulatory risk” and defines it as:

...the risk of legal or regulatory sanctions, material financial loss, or loss to reputation that the group may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking and other activities.

Given the context of the Basel Committee and the *Banks Act* within which Nedbank operates, I regard its reference to compliance risk and regulatory risk as synonyms, or at least aspects of the same risk type, being non-adherence to legislative requirements. Again, the criticism is raised that the wording is not as exact as it perhaps should be. A “legal sanction” is extremely wide, yet if the rest

177 Reg 23 of the *Banks Act* 94 of 1990.

178 Basel Committee *Basel II* 292.

179 Nedbank Group Ltd *Integrated Report* 177.

of the Nedbank report is taken into account, it becomes clear that its “compliance and regulatory risk” definition refers to “compliance” as defined in section 2.4.3.

Fenn¹⁸⁰ asks the question: Why do *businesses* chose to adhere to regulatory requirements? What determines the extent of their implementation of the regulatory requirements (and subsequently the success of the regulator?) There will be a level of natural compliance with the regulation: profit-driven banks in a competitive market will provide stakeholders with information, improve the working conditions of employees in order to improve productivity and revenue, and generally act in a manner to protect their reputation, and decrease their liability in delict. Each bank needs to decide whether it is going to increase expenditure in order to achieve compliance, or whether it will pay the penalties imposed for non-compliance and incur the resultant reputational risk. It is possible to achieve negotiated compliance, where the regulator, supervisor or enforcement agency negotiates with the firm on the definition or level of compliance required, rather than prosecuting. Fenn is of the opinion that firms will only comply if the penalty is higher than the cost of compliance. I cannot fully agree with this statement, because banks will not only look at the possible penalty, but also at the possible reputational damage which may result from non-compliance. Her experience is that banks will often comply in order to avoid reputational damage. Further, the statement that banks will act in a manner that will decrease their delictual liability is too limiting. It stands to reason that it is not logical that a bank would choose to decrease its delictual liability and not any other aspect of the law. It is suggested that Fenn’s definition be expanded.

Merna and Al-Thani¹⁸¹ regard regulatory risk and fiscal risk as synonyms. This is partly correct, because governmental fiscal policy may indeed lead to new regulations or amendments to existing regulations. However, not all regulatory

180 Fenn *Business Response to Regulation* 243-247.

181 Merna an Al-Thani *Corporate risk management* 23.

changes are driven by fiscal policy; many regulatory changes are because of general country political policies. Also, regulations are secondary to legislation, and one often finds that government policy leads to legislation rather than regulation, or at the very least, to both. In another definition by Merna and Al-Thani,¹⁸² regulatory risk is defined as potential changes in the environment. This definition is also inadequate, because regulatory risk is more than only potential changes. The reference to changes in the environment is too wide as it should be limited to the legal, financial services or banking environment. It should also include adherence to current regulation and actual changes to current legislation. The point has already been made that regulation is a form of subordinate legislation and that primary legislation should be considered prior to focusing on regulation.

According to the Compliance Institute of South Africa,¹⁸³ compliance risk comprises regulatory risk and reputational risk. Regulatory risk is described as:

...the risk that a business does not comply with regulatory requirements or excludes provisions of relevant regulatory requirements from its operational procedures.

Moorcroft¹⁸⁴ defines regulatory risk as the risk that financial institutions do not comply with applicable laws and regulations or supervisory requirements, or the risk that provisions of relevant legislation will be excluded from operational procedures. I disagree with Moorcroft because he states that regulatory risk is a part of compliance risk, as discussed in section 2.4.3, yet in this statement he attempts to widen it by distinguishing between laws and statutes. My opinion is that “laws” are wider than “statutes” and therefore this definition by Moorcroft does not hold up to more stringent scrutiny.

182 Merna and Al-Thani *Corporate risk management* 131-132.

183 CISA Framework *Definitions*.

184 Moorcroft *Banking Law* 10-1.

When all of the above definitions and descriptions of regulatory risk are read together, it is evident that the standard-setting bodies, South African banking legislator and numerous authors quoted intend to include what is described as “compliance risk” in this thesis when they refer to “regulatory risk”. “Compliance risk” and “regulatory risk” will accordingly be regarded as synonymous for current purposes.

3 Conclusion

It is difficult for all researchers to involve all aspects and legal risk management thus calls for multidisciplinary cooperation in research.¹⁸⁵

The research presented in this chapter indicates that operational risk includes legal risk and compliance risk. This is not questioned, and it is accepted that this is correct. It is noted that there is some overlap between operational risk and other risk categories such as credit risk, market risk and reputational risk. It is extrapolated that the same would apply to legal risk and compliance risk. For example, inadequate documentation in a credit agreement may simultaneously be a legal risk and a credit risk (and compliance risk in countries such as South Africa and Australia,¹⁸⁶ where there are legislative requirements regarding credit agreements).

Based on the descriptions provided of the relevant terms in sections 2.4.1 to 2.4.6, it is recommended that legal risk be regarded as a distinct component of operational risk, and that legal risk includes the risks posed by all aspects of the legal system in which the risk is managed. Legal risk therefore is the risk of financial, reputational or other losses incurred due to the non-adherence to legal

185 Trzaskowski *Legal Risk* 6.

186 *National Credit Act* 34 of 2005;
(Australian) *National Consumer Credit Protection Act* 2009.

requirements of all aspects of the law, including private, public, procedural or international law. It includes the codified and uncoded aspects of a mixed legal system.

It is further posited that compliance risk, specifically in a mixed legal system, is a part of legal risk, because compliance risk deals only with statutory or legislative requirements, and not with the uncoded aspects of the law. Therefore, compliance risk is the risk of financial, reputational or other losses as a result of non-adherence to statutory requirements, which include legislation, regulation, other guidance issued by the regulators as well as industry and organisational standards, rules and policies.

Lastly, it is postulated that use of the term “regulatory risk” be discontinued and replaced by “compliance risk”. The reasoning for this proposal is that “regulatory” or “regulation” may have a very specific meaning in jurisdictions with a three-tier legislative framework. Regulation is a form of subordinate legislation, which excludes primary legislation (statutes) and tertiary legislation (directives, guidance notes, circulars, codes of conduct and the like). It is acceded that “regulation” and “regulatory” may have a broad meaning, which refers to the act of guiding or controlling.

My hypothesis is that legal risk is not synonymous with compliance and that it is incorrect that a definition of legal risk, as included in the definition of operational risk, creates the assumption that it is synonymous with compliance risk. I am of the opinion that it is indeed adequate that a definition of operational risk includes legal risk, which in turn also includes compliance risk. However, the language should be used carefully in order not to exclude the parts of legal risk that are not covered by compliance risk.

In this chapter, it was established that legal risk and compliance risk developed in the context of risk management principles set by the Basel Committee. Some of

the risk categories which apply to a bank are credit risk, market risk, liquidity risk and operational risk, definitions of which were also provided.

It was also established that operational risk is defined as the risk of failure or loss resulting from a human act or negligence, or system failure, which includes failure to adhere to company policies, procedures or processes, external events, or legal risk. Moreover, compliance refers to an action of adherence to the law in a wide sense. It was further established that legal risk and compliance risk are complementary, yet distinct concepts, thus partly validating my hypothesis. It was further established that the term “regulatory risk” is inadequate for a mixed legal system, because it refers to only the second tier of legislation. Legal compliance and regulatory compliance was established to have limited or no use in the banking industry of South Africa and the use of these terms will therefore be avoided for the purposes of this thesis in order to avoid confusion.

It has also been argued in this chapter that in a civil law legal system, it is possible that legal risk and compliance risk could be interchangeable terms. However, in a mixed legal system, specifically that of South Africa, compliance risk is a narrower concept than legal risk. Legal risk encompasses the entire legal system, whereas compliance risk only deals with the codified part of the legal system. There is some overlap between legal risk and compliance risk. Legal risk therefore includes compliance risk; however, compliance risk does not include the entire body of law that may pose legal risk.

Chapter 4 will be used to apply the terms “legal risk” and “compliance risk” to the law of South Africa applicable to banks.

CHAPTER 4

Legal risk and compliance risk in the banking industry in South Africa

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1 Introduction

It was concluded in chapter 3 that compliance risk in a bank is a component of legal risk, which in turn is a component of operational risk in a bank operating in a mixed legal system such as South Africa. It was also established that while legal risk includes compliance risk, the reverse is not true as compliance risk does not include all aspects of legal risk, nor are the two concepts synonymous in the South African context. The purpose of this chapter is to apply these concepts to banking law in South Africa.

An outline for the law of South Africa is set out in section 2 of this chapter. This structure represents all possible legal risks, including compliance risk. The possible risk subcategories to legal risk are public, private, formal and procedural, and international law. This outline is then used to provide a discussion of the law which is merely descriptive. The intention is not to interrogate any aspect of the law, but merely to provide the broad framework of the law of South Africa as it applies to a bank. This broad descriptive framework is then used to develop a legal risk management framework in the next chapter.

It has already been established that South Africa has a mixed legal system, as opposed to a civil law legal system. For banking, this means that banks are not only regulated by the *Banks Act*,¹ *Mutual*,² and *Co-operative*³ *Banks Acts* and its regulations, directives, circulars and guidance notes issued by either the Minister of Finance or the Registrar of Banks, but also by precedent and custom⁴ Increasingly there is a trend to restate the common law in statute.⁵ Examples of

1 *Banks Act* 94 of 1990.

2 *Mutual Banks Act* 124 of 1993.

3 *Co-operative Banks Act* 40 of 2007.

4 The *Dedicated Banks Bill* will also apply once it is enacted.

5 *King Report III* 7.

where South Africa has followed this trend are the *National Credit Act*,⁶ *Consumer Protection Act*⁷ and the *Companies Act*.⁸ However, South Africa still has a mixed system and hence not all law is codified.

The banking industry in South Africa includes both government and the private sector. The Reserve Bank, a government agency, houses the Bank Supervision Department, which is both the legislator responsible for the *Banks Act*⁹ and the regulations relating thereto, and the regulator that supervises banking activities. The private banking sector is constituted by the registered banks and their stakeholders.¹⁰ Regulators also face legal risks,¹¹ which may arise from the regulator's international contracts with other regulators, contracts arising out of its own operations and the risk that regulatory sanctions may be overthrown by the courts.¹² However, this aspect of legal risk is not dealt with in detail as the focus is specifically on commercial banks.

The *Banks Act*¹³ requires banks to establish a compliance function, but the manner in which it is worded leads to an interpretation that only codified law needs to be considered. My view is that this has led to the practice among South African banks to manage compliance risk only (although they may refer to it as legal risk). Therefore a distinction is made between the compliance risk and legal risk in this chapter. Because compliance risk and the management thereof are well established in the commercial banks in South Africa, I do not believe it needs significant focus in this thesis. I have rather opted to focus on finding a suitable distinction between legal risk and compliance risk. In this chapter legal risk is defined as the part of the law not already managed in terms of the compliance

6 *National Credit Act* 34 of 2005.

7 *Consumer Protection Act* 68 of 2008.

8 *Companies Act* 71 of 2008.

9 *Banks Act* 94 of 1990.

10 Bank Supervision Department *Annual Report* 1-2.

11 Gopinath *Legal risks in the financial sector* 5.

12 Gopinath *Legal risks in the financial sector* 5.

13 *Banks Act* 94 of 1990.

risk process. References to compliance risk are only to provide context and for completeness, but the intricacies thereof are not discussed.

2 Context of the *Banks Act*

The *Banks Act*¹⁴ is the primary statute applicable to banks in South Africa and the legislator uses the word "compliance" with both a general¹⁵ and a specific meaning in the *Act* and its related regulations, directives, circulars and guidance notes. Examples of the use of the word "compliance" with a general meaning are:¹⁶

Regulation 1(1):

The objective of these Regulations is to provide for the establishment of basic principles relating to the maintenance of effective risk management by banks and controlling companies, with due allowance for the ancillary objective that the benefits derived by banks and controlling companies for compliance with these Regulations exceed the costs entailed by such compliance. (My emphasis.)

Regulation 4(1):

Irrespective whether a return is rendered on a prescribed form or by means of an electronic facility, the chief executive officer, chief accounting officer and executive officer responsible for the relevant reporting bank or controlling company's compliance with the *Financial Intelligence Centre Act, 2001* (Act No. 38 of 2001), as amended (FICA), shall sign and certify the prescribed Form BA 099 in respect of each return indicated on the said form. (My emphasis.)

14 S49(4) and form BA 002 *Banks Act* 94 of 1990.

15 Ordinary dictionary meaning.

16 The general meaning of the word is discussed in chapter 3.

Regulations 36, 39 and 49 of the *Banks Act*¹⁷ establish and set specific requirements for a compliance risk management function, but do not expressly define compliance risk. The legislator does, however, define regulatory and supervisory risk management as the risk that a bank does not comply with laws and regulations or supervisory requirements.¹⁸

The regulations relating to banks¹⁹ use the term "compliance" as a category of risk, by referring to "compliance" under the heading "risk", along with other risk types such as solvency and liquidity.²⁰ In other words, the word "compliance" also has a specific meaning, for example in regulation 49(1) where the legislator refers to:

an independent compliance function [which] shall ensure that the bank continuously manages its regulatory and supervisory risks, that is, the risk that the bank does not comply with applicable laws and regulations or supervisory requirements. (My emphasis.)

The manner in which it is worded implies that regulatory and supervisory risks are defined as the risk that a bank does not comply with applicable laws, regulations and supervisory requirements. This may lead to an interpretation that "laws" refer to primary legislation (statutes); regulations refer to secondary legislation; and supervisory requirements refer to directives, circulars and guidance notes. As already mentioned in chapter 3, given the fact that the legislator limits the definition to "regulatory and supervisory risks" before attempting to widen it by referring to all applicable "laws", banks have interpreted this to include only those laws imposed by regulators or supervisors. Put differently, if the interpretation of statute *eiusdem generis*-rule is applied to this section, then a compliance function as imposed by the above-quoted regulation 49(1) includes only the three tiers of legislation and not the rest of the

17 *Banks Act* 94 of 1990.

18 Ss 49(1) and 49(2)(c) *Banks Act* 94 of 1990.

19 Form BA002 *Banks Act* 94 of 1990.

20 Reg 39(3)(b) of the *Banks Act* 94 of 1990.

law. This is not necessarily correct, because the law of South Africa applicable to banks is wider than just statute and regulation: it also includes common law. In a broader context, the legislator defines corporate governance and various risk types. A bank is expected to manage any risk that it regards as material to its business. Therefore the conclusion is drawn that the intention of the legislator should have been to include all aspects of the law and not only statute. It is also possible to interpret the above-mentioned regulation to refer to the entire legal system, including common law, because of the reference to "applicable laws". As was discussed in chapter 3, this is not the manner in which banks in South Africa have historically interpreted the role of an independent compliance function. Such functions focus on statutory compliance and not on adherence to the law in general.

In regulation 49(3)(g) it is stated that a bank's compliance function-

(g) shall establish a line of communication to line management, in order to monitor continuously compliance with laws and regulations or supervisory requirements by the bank...

When this regulation is read in isolation, it includes all aspects of the legal system. However, because of the other sections and regulations mentioned above, this has not been the *de facto* interpretation in the South African banking industry.

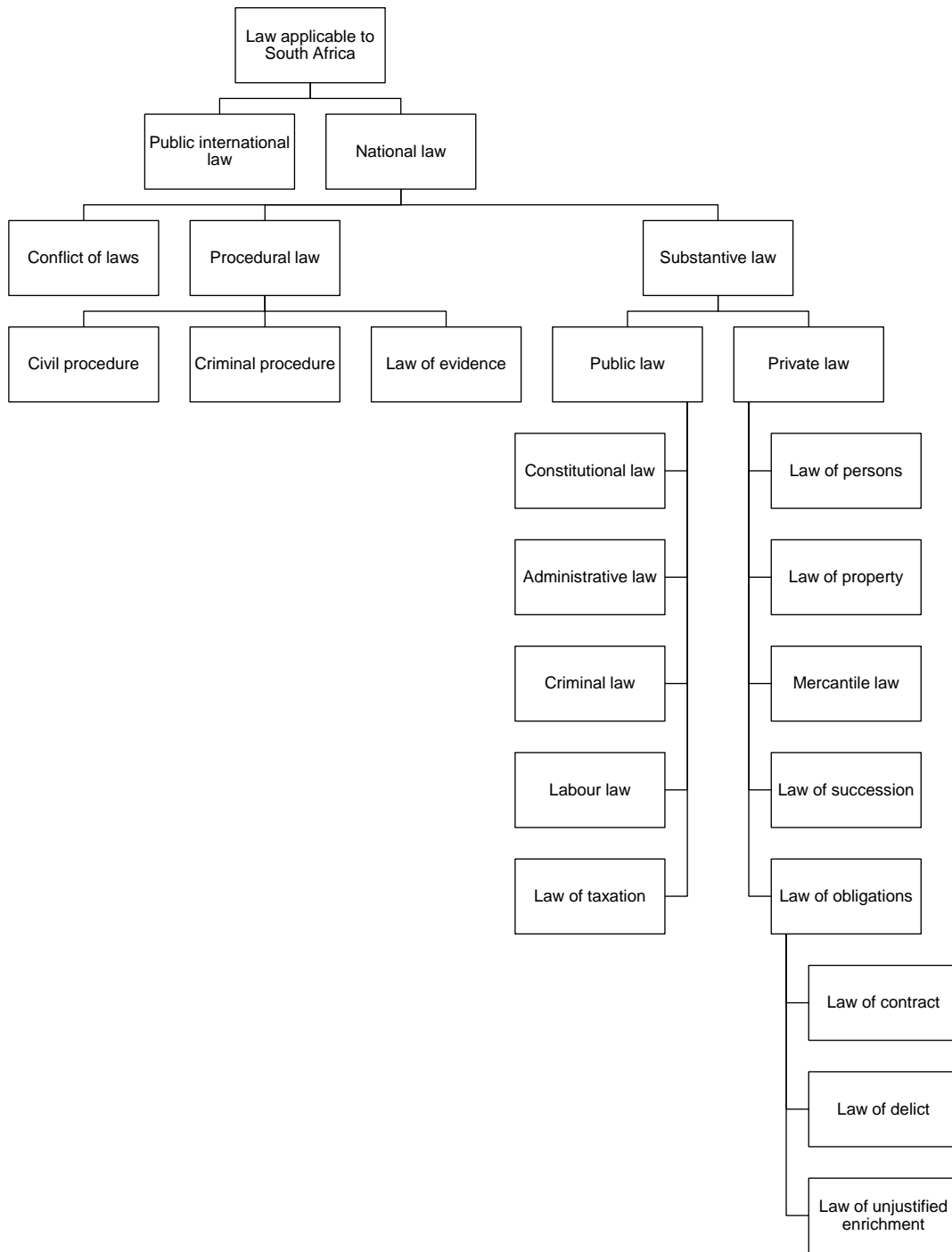
3 Outline of the South African legal system

A broad outline of the South African legal system is provided in this section, whereafter a more detailed outline of the law applicable to banks will be discussed.

Kopel²¹ divides the law of South Africa into the categories stipulated in figure 1.

21 Kopel *Business law* 9; 71.

Figure 1 - Kopel's structure of the law applicable to South Africa

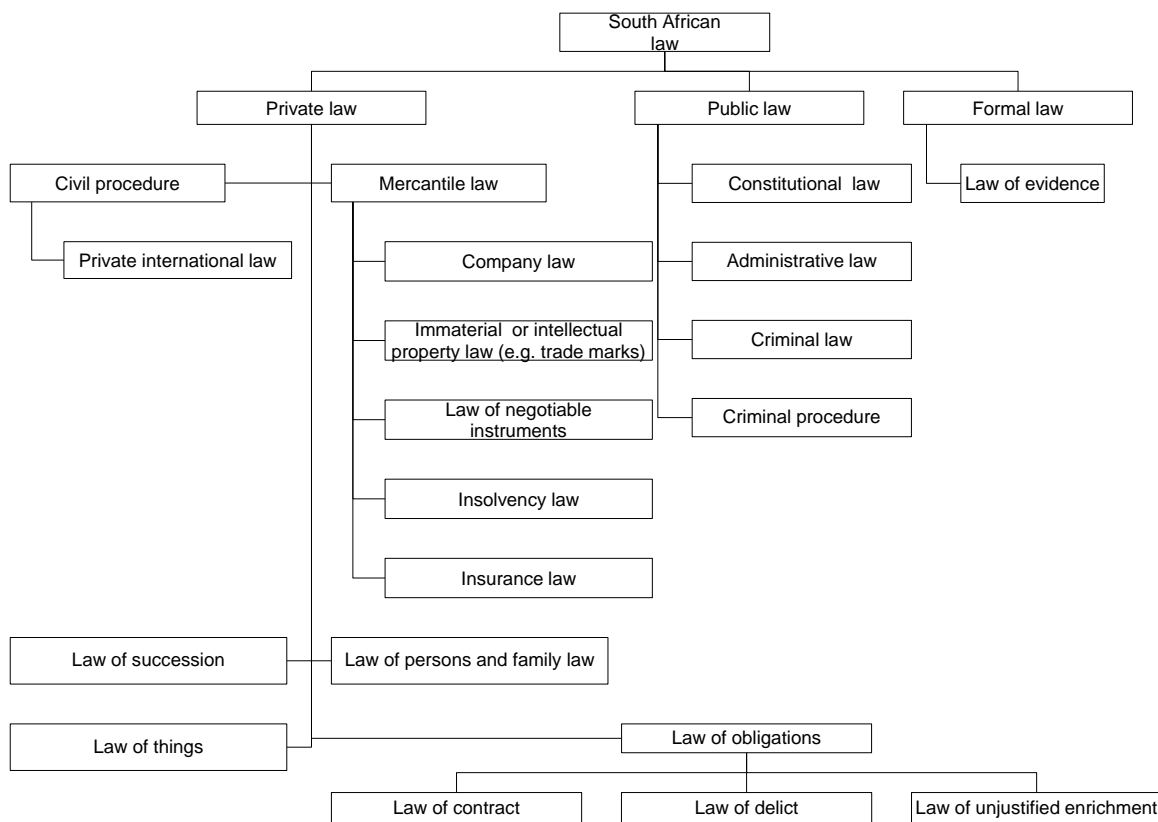


As can be seen from Kopel's structure of South African law, he does not identify banking law as a distinct aspect of the South African legal system. Banking law appears to consist of rules relevant to banks and the bank-customer relationship.

The relevant rules are found in these areas of law, but also drawn from relevant areas of public law, such as criminal law.

Hosten²² structures the South African legal system as follows:

Figure 2 - Hosten's structure of the law applicable to South Africa

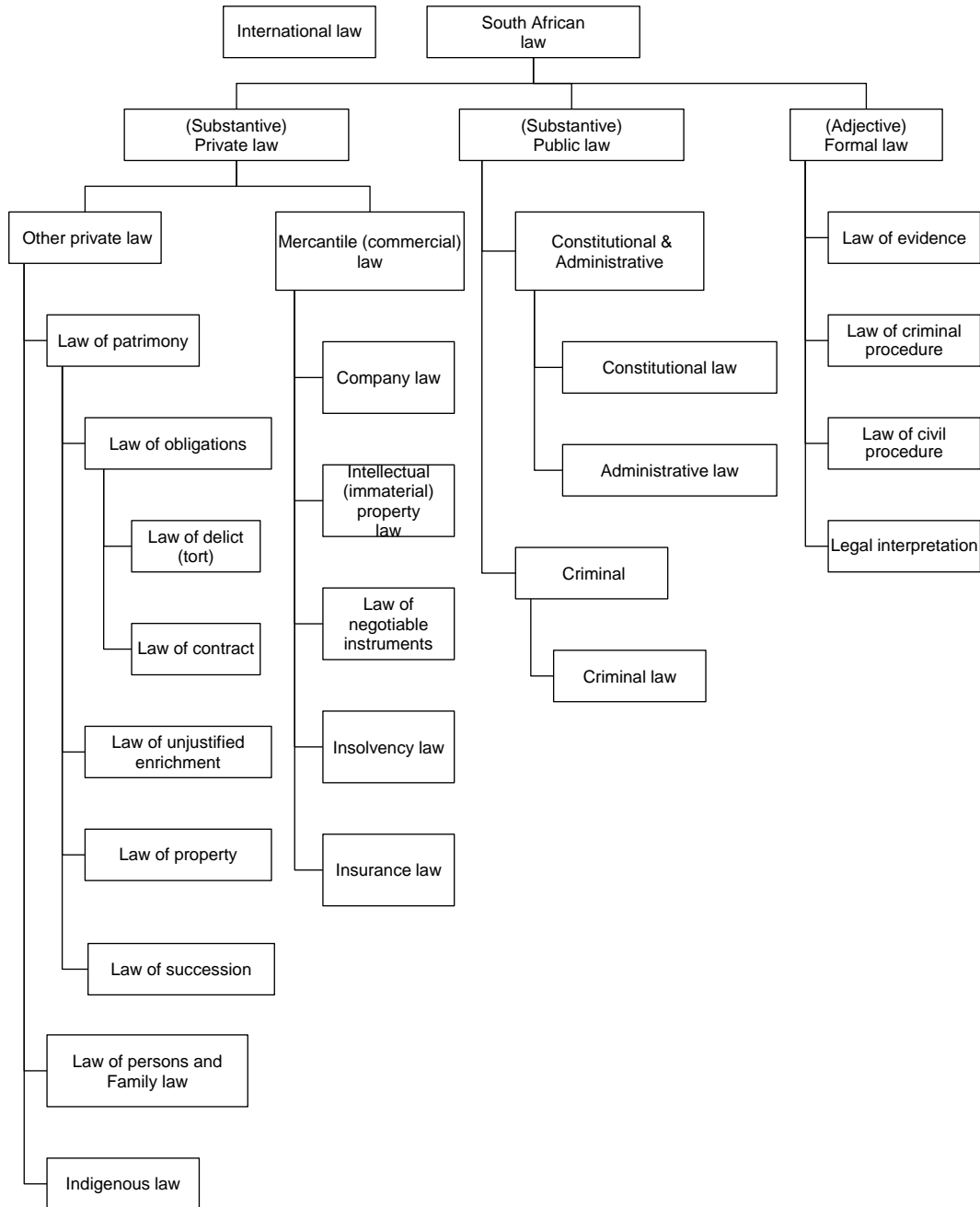


Hosten mentions banking law as part of the law of negotiable instruments.²³ As will be discussed later in this chapter, modern banking is more than only bills of exchange, cheques and promissory notes.

²² Hosten *South African Law* 492.

Kleyn and Viljoen's²⁴ structure of the law of South Africa is as follows:

Figure 3 - Kleyn and Viljoen's structure of South African law



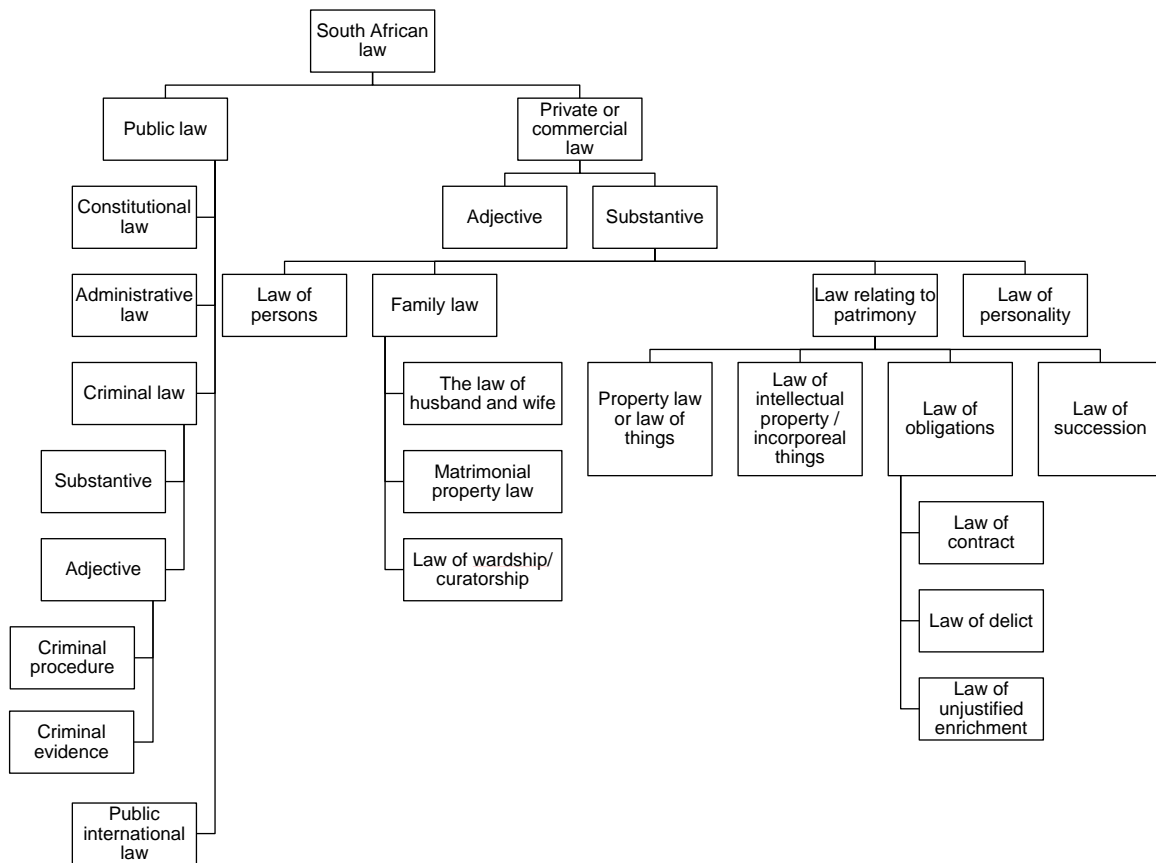
23 Hosten *South African Law* 908.

24 Kleyn and Viljoen *Beginners' Guide* 97.

It is interesting to note that while Kleyn and Viljoen do not identify banking law either, they do identify insurance law, amongst others, as the components of mercantile or commercial law.

Du Plessis²⁵ structures the law of South Africa as follows:

Figure 4 - Du Plessis's structure of the law applicable to South Africa



25 Du Plessis *Introduction to law* 130-206.

As can be seen from the above figure, Du Plessis does not classify banking law either.

Willis²⁶ does not provide an outline of the entire South African legal system, but does mention that the relationship between a banker and a customer arises out of contract law. As mentioned in chapter 2, banking law is not a discrete area of law such as the laws of contract or delict; it is a collection of legal principles that govern the relationship between a depositor and a bank, as well as the relationship between a bank and the state.²⁷ Moorcroft²⁸ states that banking law is part of private law, specifically mercantile law and the law of negotiable instruments.

I propose that banking law (which includes deposit-taking and other aspects of banking, as will be discussed later in this chapter) be regarded as a form of commercial law for classification purposes. This is similar to the classification of insurance law used by Kleyn and Viljoen.²⁹ The business of a bank touches on many aspects of the law, not only pure commercial law. Banks do not operate in isolation; they are run as profit-driven businesses, and all possible areas of the law apply to banks.

Therefore, for the purposes of this study, the law of South Africa is divided as follows:

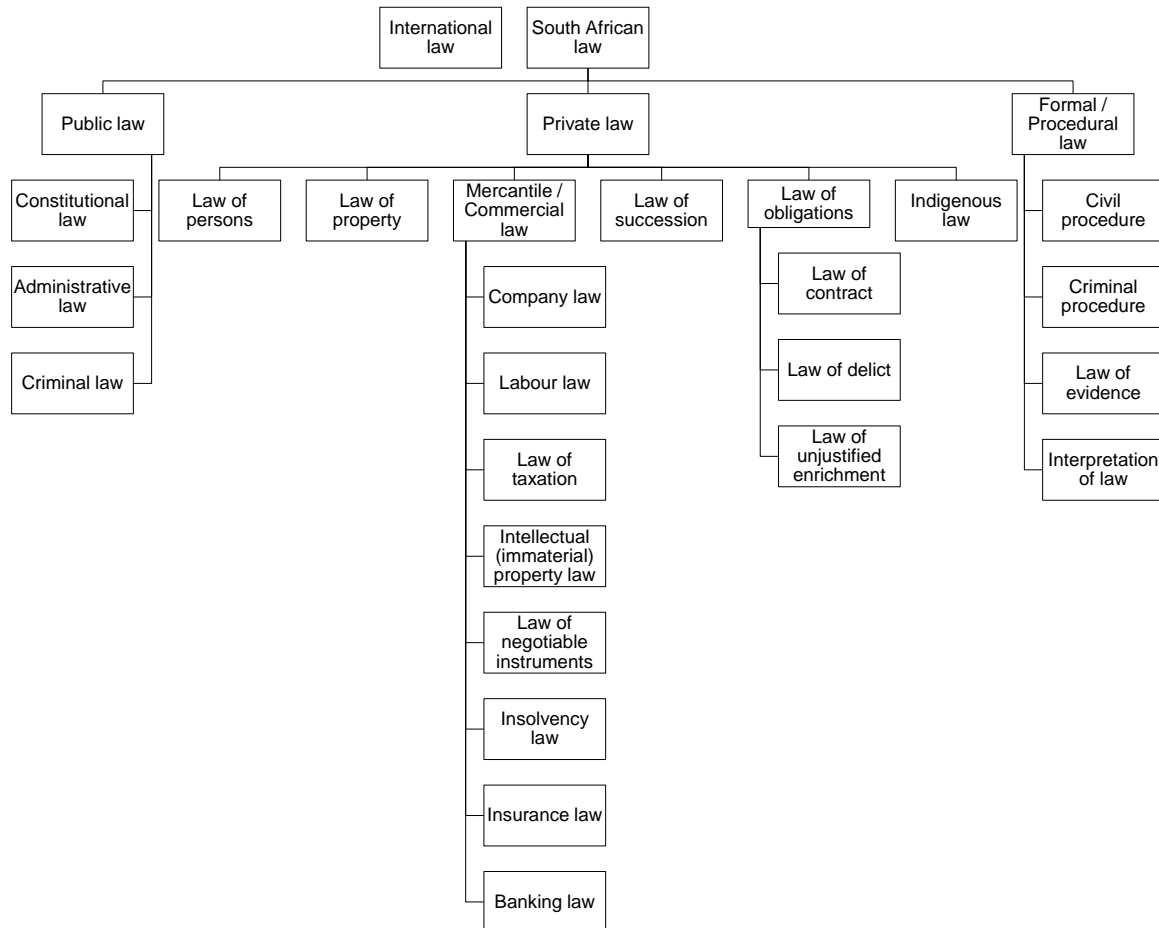
26 Willis *Banking* 24.

27 Wentworth *Banking Law* 1;
Moorcroft *Banking Law* 1-2 – 1-3.

28 Moorcroft *Banking Law* 1-2.

29 Kleyn and Viljoen *Beginners' Guide* 97.

Figure 5 - Proposed structure of South African law



Legal risk, as previously defined in this study, is not actively regulated, supervised and consequently managed by banks in the same level of detail as compliance risk. The remainder of this chapter is devoted to identifying those legal risks applicable to a bank in South Africa. Where relevant, the legal risks applicable to the central bank are also indicated, but this is not the focus of this chapter. The structure for the remainder of this chapter follows the proposed structure of South African law set out in Figure 5.

As was indicated in chapter 3, legal risk, for the purposes of this study, includes all aspects of the law applicable to a business or transaction, which may lead to a risk of financial loss or reputational damage. Compliance risk is a component of legal risk which focuses on the risk of financial loss or reputational damage which may result from non-adherence to statutory requirements.

4 Legal risk and compliance risk applicable to a bank

The legal risk and compliance risk applicable to a bank operating in South Africa relates to the business of the bank and the relations with parties outside the bank.³⁰ It also relates to internal risks with regard to its employees and physical infrastructure. This section is used to list the principles of the law and demonstrate how they can have an effect on legal risk and compliance risk.

4.1 Public law

Public law is where the state is a party to the legal relationship. It includes all the rules necessary for the running of the state and for the general order of the community.³¹ Public law is divided into constitutional, administrative and criminal law. Each of these subcategories of private law and their application to banks in particular are discussed below.

4.1.1 Constitutional law

Constitutional law is that part of the public law that governs the exercising of state authority, defines the principle organs of the state and regulates the relationship amongst those organs of state, as well as between individual subjects and organs of state.³² The supreme law of South Africa is the *Constitution*,³³ meaning

30 Third party stakeholders.

31 Devenish *South African Constitution* 3;
Wiechers *Staatsreg* 8;
Hosten *South African Law* 491-493.

32 Devenish *South African Constitution* 3;
Wiechers *Staatsreg* 8;
Hosten *South African Law* 946.

33 *Constitution of the Republic of South Africa*, 1996.

that the *Constitution* is the highest law in the country and that all other law is subject thereto. Certain fundamental human rights are entrenched in the *Constitution*, such as the Bill of Rights.³⁴ The Bill of Rights is binding on all natural or juristic persons in terms of section 8 of the *Constitution*.³⁵ A bank is a juristic person and therefore the Bill of Rights applies to banks. The rights protected in the Bill of Rights relate to:

- equality;
- human dignity;
- life;
- freedom and security of the person;
- freedom from slavery, servitude and forced labour;
- privacy;
- freedom of religion, belief and opinion;
- freedom of expression;
- assembly, demonstration, picket and petition;
- freedom of association;
- political rights;
- citizenship;
- freedom of movement and residence;
- freedom of trade, occupation and profession;
- labour relations;
- environment;
- property;
- housing;
- health care, food, water and social security;
- children;
- education;

34 Devenish *South African Constitution* 43-104.

35 Also called horizontal application.

- language and culture;
- cultural, religious and linguistic communities;
- access to information;
- just administrative action;
- access to courts; and
- arrested, detained and accused persons also have rights.³⁶

A juristic person is entitled to the rights entrenched in the Bill of Rights and may not infringe on these rights of another person named in the Bill of Rights,³⁷ except under circumstances where the rights may be restricted in terms of sections 36 and 37 of the Bill of Rights.³⁸ If a bank does infringe on any of these rights of another person, it would constitute a compliance risk to a bank, because it would not only be non-adherence to the *Constitution*, but also a legal risk, because an aggrieved person may approach the court in terms of section 38 of the *Constitution*. For example, if a bank has a policy not to employ Sesotho-speaking people, it may be regarded as discrimination based on language and therefore unconstitutional under the equality clause, chapter 2 of the *Constitution*. It could potentially lead to legal risk because an aggrieved person may enter into litigation with the relevant bank.³⁹

Commercial banks should also adhere to the Bill of Rights, for example all South Africans have a right to housing,⁴⁰ which may impact on a bank's ability to use international credit risk-rating methodologies when approving housing bonds. Non-adherence will introduce compliance risk to both the Reserve Bank as well as commercial banks. It may also result in litigation, which will introduce legal risk.

36 S9-35 *Constitution*, 1996.

37 S38 *Constitution*, 1996.

38 *Constitution*, 1996.

39 Keep in mind that a compliance risk is by default also a legal risk. In this context a narrower definition of legal risk is applied. Legal risk is that aspect of the law not already covered by compliance risk.

40 S26 *Constitution*, 1996.

The *Constitution* regulates various aspects of the public sector, in particular the Reserve Bank as the central bank of South Africa, which is established in terms of section 223 of the *Constitution*.⁴¹ Since the Second World War, there has been an international practice of state ownership and control of the central bank of a country.⁴² It is a constitutional obligation⁴³ to regulate the central bank in terms of an Act of Parliament. This Act is the *South African Reserve Bank Act*.⁴⁴ Section 224 of the *Constitution* sets the primary objective for the central bank, namely to protect the value of the currency in the interest of balanced and sustainable economic growth in the country. The Reserve Bank has to perform its functions independently, without fear, favour or prejudice, but within a context of regular consultation between the Governor and the Minister of Finance.⁴⁵ The powers and functions of the Reserve Bank are wide and encompass all those powers and functions customarily exercised and performed by central banks and these powers and functions must be determined by, exercised in terms of, or performed subject to conditions prescribed in terms of the *South African Reserve Bank Act*.⁴⁶ In this context, it is possible for the Reserve Bank to be non-compliant with these requirements if it does not adhere to the *Constitution* and the *South African Reserve Bank Act*. This would lead to compliance risk due to non-adherence to legislation, as well as possible legal risk due to litigation as a result of such alleged non-compliance.

This constitutional mandate given to the Reserve Bank⁴⁷ is embodied in the *Constitution*⁴⁸ The *South African Reserve Bank Act* established the Reserve

41 S223 *Constitution*, 1996;
Moorcroft *Banking Law* 21-1.

42 *Banco de Moçambique v Inter-Science Research & Development Services (Pty) Ltd* 1982 (3) SA 330 (T) 338;
Moorcroft *Banking Law* 21-1.

43 S223-224 *Constitution*, 1996.

44 *South African Reserve Bank Act* 90 of 1989.

45 S224 *Constitution*, 1996.

46 S224 *Constitution*, 1996.

47 *South African Reserve Bank Act* 90 of 1989.

Bank as a juristic person, with the primary objective to protect the value of the rand and conduct inflation targeting in line with the constitutional mandate.⁴⁹ The powers and duties of the Reserve Bank are set out section 10 of the *South African Reserve Bank Act*. These include, for example, that only the Reserve Bank may produce, issue and destroy banknotes and coins; and establish and maintain clearing or settlement systems.

The *Broad-Based Black Economic Empowerment Act* and the *Employment Equity Act*⁵⁰ are aimed at correcting some of the injustices introduced by apartheid by increasing the level of meaningful participation in the economy by black people, women, youths, people with disabilities and people living in rural areas. These *Acts* will be applicable to banks in general and non-adherence will lead to compliance risk. These *Acts* partly gives effect to the right to equality as provided for in the *Constitution*.

Therefore, constitutional law is applicable to banks in South Africa and presents both legal risk and compliance risk.

4.1.2 Administrative law

The second category of public law applicable to a bank is administrative law. Administrative law is that part of public law that deals with the organisation, powers and duties of government administration.⁵¹ This part of the law may be applicable to the Reserve Bank in its capacity as a government agency. Both legal risk and compliance risk may materialise from administrative law where the

48 *South African Reserve Bank Act* 90 of 1989.

49 S224(2) of the *Constitution*, 1996;
S3 of the *South African Reserve Bank Act* 90 of 1989;
Moorcroft Banking Law 21-1.

50 *Kopel Business Law* 339-343;
Broad-Based Black Economic Empowerment Act 53 of 2003;
Employment Equity Act 55 of 1998.

51 *Aman Administrative law* 1.
Gellhorn Administrative law 87;
Wiechers Administratiefreg 2.

Reserve Bank may be taken on review for transgressing either a legislative or common law requirement. An example would be where a decision of the Registrar of Banks is taken on review, such as the case of *Ban Konsult (Pty) Limited v Kruger NO and Others*,⁵² where the decision of the Registrar of Banks not to allow the registration of this bank was challenged but upheld by the court.

Administrative law is therefore applicable to the Reserve Bank and introduces both legal risk and compliance risk. Compliance risk is introduced because various administrative requirements are legislated and the Reserve Bank needs to ensure that it adheres to these requirements. For example, the *Banks Act*, in sections 11 to 35, stipulates the administrative requirements for the registration of a bank. Legal risk is introduced because courts interpret the law, and a bank's interpretation of a legislative requirement may not be the same as the interpretation of a court. In the event of a dispute, the bank will need to approach the court, albeit for a declaratory order.

Administrative law is applicable to a commercial bank, for example when a commercial bank applies for a licence or when it disputes a decision of the Registrar of Banks and takes such a decision on review.

4.1.3 Criminal law

The third type of public law applicable to a bank is criminal law. A crime or offence is an unlawful human act which is punishable by the state. Criminal law deals with what type of human behaviour constitutes a crime and what the punishment for such a crime should be.⁵³ Criminal law is similar to the law of delict and the same act will very often constitute both a crime and a delict. Criminal law is aimed at punishing the offender and protecting the interests of the

52 *Ban Konsult (Pty) Limited v Kruger NO and Others* (48088/2008) [Unreported 2009] ZAGPPHC 135 (5 November 2009).

53 Snyman *Strafreg* 1-2;
Hosten *South African Law* 1083.

community. A civil action (based on the delict) is aimed at compensating the plaintiff for damages suffered. Most crimes have been legislated and those would fall within the realm of compliance risk. However, common law crimes would fall within the realm of legal risk. The common law crimes that still exist in South Africa are crimes against the state (high treason, sedition⁵⁴ and public violence), crimes against the administration of justice (contempt of court, defeating or obstructing the course of justice, and perjury), crimes against human life (murder and culpable homicide), crimes against the person (assault, indecent assault, kidnapping, *crimen inuria* and criminal defamation), crimes against the community (incest and abduction), crimes against property (theft, robbery, receiving stolen property, malicious injury to property and arson), fraud and related crimes (fraud and theft by means of false pretence) and extortion.⁵⁵

A bank may incur criminal liability through the actions of its employees and representatives. This may be for transgressing either an Act of Parliament or the common law. A transgression of an Act of Parliament is not *per se* a crime, but it is in instances where the penalty for such non-compliance is a criminal sanction. Some examples of how criminal law poses either legal risk or compliance risk to a bank are detailed below. These examples are not exhaustive and depending on the specific nature of the business of a particular bank, these may or may not be applicable.

Theft of credit was not originally recognised in the common law; only theft of physical objects, such as cheques, bills, notes and coins, was recognised.⁵⁶ Today, theft of an incorporeal right to money, such as a credit balance in a bank account, is recognised as a form of theft.⁵⁷ If an employee of a bank steals

54 The unlawful and intentional gathering of a number of people in order to challenge, defy or resist the authority of the state.

55 Snyman *Strafreg* 1-2;
Burchell *Criminal Law* 1;
Hosten *South African Law* 1122-1125.

56 Moorcroft *Banking Law* 35-2 – 35-5.

57 Moorcroft *Banking Law* 35-2 – 35-5;

money or credit from a client, that employee will be held criminally liable. This normally manifests in the form of fraud perpetrated by the employee. This would not pose a legal risk to the bank; however, it may pose a legal risk to the bank if the employee stole in the course of fulfilling his/her duties (which is unlikely). In this instance the bank will be criminally liable in terms of the common law. This would therefore constitute a legal risk to a bank.

In terms of the *Banks Act*,⁵⁸ sections 91 and 91A, a bank or other person (for example a person taking deposits without a banking licence⁵⁹) who contravenes the provisions of the *Banks Act* may be liable for a fine of up to R10 000 000 per day or imprisonment up to ten years. With regard to criminal liability, section 91A(8) states:

The imposition of an administrative penalty shall not be regarded as a conviction in respect of a criminal offence, but no prosecution for contravention or non-compliance in respect of this Act shall thereafter be competent.

The effect of section 91A(8) is that a bank and/or its officers cannot be prosecuted twice (administratively and criminally) for the same offence. Such contraventions would result in compliance risk materialising.

The potential criminal liability of directors and officers should also be managed in a bank in terms of section 332 of the *Criminal Procedure Act*.⁶⁰ A bank may be held vicariously liable for crimes committed by directors and officers acting within

Miller v Trust Bank of South Africa 1965 2 SA 447 (T);

Miller v Muller 1965 4 SA 458 (C);

Minister of Community Development v SA Mutual Fire & General Insurance Co Ltd 1978 1 SA 1020 (W).

58 *Banks Act* 94 of 1990.

59 This is referred to as illegal deposit-taking in terms of section 1 and section 11 of the *Banks Act*.

60 *Criminal Procedure Act* 51 of 1977.

the scope of their employment or authority, or while furthering the interests of the bank.⁶¹

Another example of how criminal law may be applicable to a bank is money laundering. Money laundering is an activity that has or is likely to have the effect of concealing or disguising the nature, source, origin, location, disposition or movement of the proceeds of unlawful activities.⁶² The term "kiting"⁶³ is essentially fraud and refers to a form of money laundering where money is obtained by means of cheques being passed through banks without value being deposited against the bank.⁶⁴ South Africa is a member of the international Financial Action Task Force ("FATF"), which aims to combat terrorist financing and combat money laundering. The FATF has adopted 40 core principles, plus an additional 9 principles, known as the 40 plus 9 principles.⁶⁵ South Africa has adopted and implemented the 40 plus 9 principles in the *Banks Act*,⁶⁶ *Prevention of Organised Crime Act*,⁶⁷ *Financial Intelligence Centre Act*,⁶⁸ and *Protection of Constitutional Democracy against Terrorist and Related Activities Act*⁶⁹ in an attempt to address the crimes of financing terrorist activities and money laundering. The role of banks in combating terrorism and preventing money

61 Borg-Jorgensen and Van der Linde *Corporate criminal liability* 452.

62 S1 of the *Financial Intelligence Centre Act* 38 of 2001.

63 Also known as cross-firing, kite-flying or merry-go-round forms.

64 *S v Rosenthal* 1980 (1) SA 65 (a) 89 E-H;
S v Ostilly and Others 1977 (2) SA 104 (D);
S v Ressel 1968 (4) SA (A) 232 E-F;
R v Alexander and Others 1936 AD 445, 457;
S v Heller and Another 1964 (1) SA 524 (W) 445H;
S v Hugo 1976 (4) SA 536 (A) 540 F-H;
S v Heller 1971 (2) SA 29 (A) 52H-53D;
R v Alberts 1959 (3) SA 404 (A);
Corporation Agencies Ltd v Home Bank of Canada 1927 AC 318 (PC) 320;
S v Judin 1969 (4) SA 425 (A) 431A, 435D;
Moorcroft Banking Law 35-1.

65 Financial Action Task Force *40 Recommendations*;
Financial Action Task Force *40 + 9 Recommendations*.

66 *Banks Act* 94 of 1990.

67 *Prevention of Organised Crime Act* 121 of 1998.

68 *Financial Intelligence Centre Act* 38 of 2001.

69 *Protection of Constitutional Democracy against Terrorist and Related Activities Act* 33 of 2004.

laundering is to ensure that they know their clients and have determined the source of their clients' funds.⁷⁰ It is a criminal offence for a bank not to comply with these requirements.⁷¹ If a bank does not take reasonable measures to combat money laundering and adhere to the above legislation, that bank may be exposed to compliance risk.

As mentioned earlier, due to international influences, legal risk and compliance risk have become interchangeable terms. This has resulted in a large area of the law not being managed as part of the risk management process. In general, criminal law will introduce mainly compliance risk to a bank, because many criminal transgressions are legislated in South Africa. It is, however, possible that certain common law crimes, such as theft, have not been legislated and these may also be applicable. This could lead to legal risk.

It is not foreseen that criminal law will introduce legal risk to a bank where the bank was the victim of crime. However, the civil claim that a bank may have as a result of being a victim of crime may introduce legal risk. Where a bank is the transgressor and not the victim, it will be exposed to compliance risk in so far as the criminal act is prohibited by legislation and to legal risk for common law crimes. If a bank failed to take reasonable steps to prevent a crime from being perpetrated, it may incur legal risk. Put differently, compliance risk would be introduced if a bank does not adhere to specific legislative and regulatory requirements. Legal risk is introduced by all aspects of the law, in this specific instance criminal law.

70 Moorcroft *Banking Law* 8-1 – 9-13;
R v Van Heerden 1958 (3) SA 150 (T) 152D-E;
Bredenkamp and Others v Standard Bank of South Africa Ltd and Another 2009 (6) SA 277 (GSJ) 61;
Bredenkamp and Others v Standard Bank of South Africa Ltd 2010 (4) SA 468 (SCA) 64.

71 Moosa is of the opinion that both domestic and international regulation in itself is a risk due to cost and pressure from the regulators and a failure to establish effective cross-border regulation. Money laundering is a risk, not only because of the act of laundering money, but also because of the overregulation of money laundering, which dilutes traditional bank secrecy.

Sections 3.1.1 to 3.1.3 above set out some possible forms of legal risk and compliance risk which may be introduced to a bank by the application of public law. Section 3.2 will deal with private law and how legal risks or compliance risks may be introduced to a bank through the application of private law. However, the law of taxation will be discussed first.

4.1.4 Law of taxation

The law of taxation is that part of the law that provides for the collection of revenue in the state. The state is the tax collector and the citizens of the country are the taxpayers.⁷² Because the state is always a party to taxation, it is part of public law.⁷³ The law of taxation applies to banks in South Africa, because they are profit-driven public companies and corporate citizens. All tax law in South Africa would appear to be codified and would therefore primarily introduce compliance risk to a bank. It should be noted that courts interpret legislation, which may introduce legal risk to a bank. Tax law applies in various ways, for example income tax,⁷⁴ value added tax,⁷⁵ air passenger tax,⁷⁶ capital gains tax (CGT), estate duty, excise and levies, retirement funds tax, stamp duty and transfer duty.

A peculiarity with regard to statutory interpretation was introduced during 2010. As a general rule, legislation of one sovereign state is not applicable to another sovereign state. Exceptions to this have to be effected by means of international treaties and other forms of cooperation agreements. The US has a controversial approach to extraterritorial application of some of its laws, especially where it

72 Stiglingh *et al Income Tax* 534;
Goodall and King *Tax & Investments* 3;
Hosten *South African Law* 494.

73 There is also the opinion that taxation law is private commercial law. I disagree with this notion and regard taxation law as part of public law.

74 *Income Tax Act* 58 of 1962.

75 *Value Added Tax Act* 89 of 1991.

76 Where employees or officers of a bank travel by air for the business of the bank.

concerns acts by its citizen. An example of this is the *Foreign Account Tax Compliance Act*.⁷⁷ This act states that all counterparties have to comply with its provisions if the transaction has or may have a connection with a US citizen. The wording of the above-mentioned *Act* is wide and entails that the US government will be able to introduce penalties and take enforcement action against other sovereign states and their citizens.

My experience and opinion is that, although tax risk is codified in South Africa, it is a specialist field and best managed by a dedicated team. This team should, in my view, consist of experts in tax structuring in order to have tax efficient corporate structures and tax compliance. The tax compliance may be done by the bank's compliance team or by the tax department, where monitoring occurs on whether all tax returns were submitted timeously.

In general, tax law in South Africa is codified and would therefore introduce compliance risk to a bank. Should the law be unclear or interpretation difficulties arise, it is possible for the matter to be heard by a court. This would introduce legal risk to a bank.

4.2 Private law

The second category of the law that is discussed is private law. Private law in South Africa comprises all the rules necessary for the resolution of disputes among private citizens (juristic or natural persons).⁷⁸ The body of private law consists of mercantile law, the law of property, persons, succession, obligations and indigenous law. Each of these is discussed in greater detail in the sections following below.

77 The US *Foreign Account Tax Compliance Act* is a part of the *Hire Act* of 2010.; Doyle *Extraterritorial Application*39.

78 Thomas *South African Private Law* 25;
Hosten *South African Law* 493.

4.2.1 Mercantile law

Mercantile law is also called commercial or business law⁷⁹ and is simply a convenient classification of all national law that caters for the field of commerce.⁸⁰ This includes company law, labour law, taxation law, intellectual property law, insolvency law, insurance law, banking law and the law on negotiable instruments. The relevance of each of these to a bank is elaborated on in sections 3.2.1.1 to 3.2.1.7 below.

4.2.1.1 Company law

Company law in South Africa has been codified to a large degree.⁸¹ A bank is a public company, registered both in terms of the *Companies Act*⁸² and the *Banks Act*.⁸³

The *Companies Act*⁸⁴ refers to interrelated or controlling relationships. Banks in South Africa are often owned by a controlling company or in turn have various subsidiaries. Related parties are those who directly or indirectly control the juristic person. If the related party is another juristic person, then it is known as a “holding company”.⁸⁵ The provisions of the *Companies Act* apply to banks to the extent that they are not inconsistent⁸⁶ with any provision of the *Banks Act*.⁸⁷ Not only do banks, as juristic persons, face possible litigation, but their directors may

79 Sharrock *Business transactions law* 1;
Nagel *Business Law* 3;
Hosten *South African Law* 493.

80 Countries with codified legal distinguish commercial law from private law. In South African law we regard commercial law as a component of private law.

81 Cassim *Contemporary Company Law* 3.

82 *Companies Act* 71 of 2008.

83 *Banks Act* 94 of 1990.

84 *Companies Act* 71 of 2008.

85 Kopel *Business law* 310.

86 Currently such inconsistencies do exist and the *Banks Act* is in the process of being amended in order to align to the 2008 *Companies Act*.

87 Moorcroft *Banking Law* 5-1;

S v Swartz and Another 2001 (1) All SA 252 (C) 256;

Du Preez v Garber: In re Die Boere Bank Bpk 1963 (1) SA 806 (W) 811 E-F.

also personally face legal action for breach of their fiduciary duties.⁸⁸ This may flow from either legal risk or compliance risk materialising. The common law duties of directors have been incorporated into the *Companies Act*,⁸⁹ which is aligned with international trends.⁹⁰ There is an increasing trend to hold directors accountable for the actions of a bank and the board of directors may now incur personal liability.

All instances of non-compliance should be reported to the governance structures of the bank, the board of directors and the appropriate regulatory bodies.⁹¹ Regulations 39(3)(b) and (m)⁹² of the *Banks Act* include compliance and operational risk under risk management, which in turn forms part of the corporate governance in a bank. Regulation 49(3)(c)⁹³ further prescribes that the compliance officer of a bank needs to report non-compliance with laws, regulations or supervisory requirements to the chief executive officer, the board of directors and the audit committee of the bank. Not reporting non-compliance will in itself pose a compliance risk to a bank.

4.2.1.1.1 *Corporate governance*

Corporate governance has developed as a specific aspect of company law over the past two decades. Corporate governance is the manner in which business is conducted and includes various aspects such as ethics, sound risk management practices and combined assurance. Simplistically put, corporate governance is simply doing the right thing even if nobody is looking. The corporate governance standard for South Africa is King III.⁹⁴ This is a voluntary code, but the JSE Listing Requirements have made it compulsory for all listed entities, some of which may be banks. Corporate governance includes strategy, risk management,

88 Carter *Checklist* 1.

89 *Companies Act* 71 of 2008.

90 King *Report III* 7.

91 Moorcroft *Banking Law* 10-6.

92 *Banks Act* 94 of 1990.

93 *Banks Act* 94 of 1990.

94 King *Report III* 11.

performance and sustainability.⁹⁵ The King III Code⁹⁶ introduces information technology ("IT") governance as a type of operational risk to South African organisations. An example of IT governance risk would be where an organisation outsources its IT to a third party, whereby it increases its information security risk because confidential information is held outside the company.⁹⁷ In some instances, the legislator has attempted to include international IT governance standards into legislation or proposed legislation, for example the OECD Eight Data Protection Principles.⁹⁸ Companies should also protect the fundamental right to privacy.⁹⁹ The *Consumer Protection Act*,¹⁰⁰ *Protection of Personal Information Bill*¹⁰¹ and the *Protection of State Information Bill*¹⁰² have been introduced to assist in protecting privacy. Many aspects of the *Consumer Protection Act*,¹⁰³ *Protection of Personal Information Bill*¹⁰⁴ and the *Protection of State Information Bill*¹⁰⁵ are aimed at enforcing improved IT risk management in order to protect privacy. This introduces an overlap between IT governance risk and compliance risk in a bank, because non-compliance with the acts would imply that an IT risk has materialised.

95 Also referred to as "integrated reporting";
King *Report III* 11.

96 King III Code 19;
King *Report III* 15.

97 For example, the standards issued by the IT Governance Institute, ISACA (which issues the Control Objectives for Information and Related Technology (COBIT) and offers various qualifications in information security, such as Certified Information System Auditor, Certified Information Security Manager, and Certified in the Governance of Enterprise IT), the International Organization for Standardization (ISO), and the Open Compliance and Ethics Group (OCEG).

98 Chapter 3 Part A *Protection of Personal Information Bill*;
OECD *Guidelines Protection of Personal Data* Part 2.

99 S14 *Constitution*, 1996.

100 *Consumer Protection Act* 68 of 2008.

101 *Protection of Personal Information Bill*.

102 *Protection of State Information Bill*.

103 *Consumer Protection Act* 68 of 2008.

104 *Protection of Personal Information Bill*.

105 *Protection of State Information Bill*.

Regulations 49(1) and (3) of the *Banks Act*¹⁰⁶ state that the board of directors is ultimately responsible for an effective process of corporate governance, which includes risk management.

Company law may therefore introduce legal risk, compliance risk and reputational risk to a bank. It may also overlap with other risk types such as IT governance risk. But the converse is not correct, corporate governance is not merely an aspect of company law.

4.2.1.2 Labour law

The second part of the private law in South Africa that may introduce legal risk or compliance risk to a bank is labour law. Labour law is the rules, principles and guidelines that govern the relationship between individual employers and their employees.¹⁰⁷ It is that part of South African private law that deals with the employment relationship. Employment is divided into the letting and hiring of services and the letting and hiring of work in South Africa. The letting and hiring of services refer to the relationship between an employer and employee, whilst the letting and hiring of work are where an independent contractor is hired to perform a piece of work. Services are subject to labour law and legislation, because the employee is under the control and supervision of the employer. In the case of an independent contractor, the employer and contractor negotiate as equals and are not protected by labour law. Employment is essentially a contract.¹⁰⁸

106 *Banks Act* 94 of 1990.

107 Grogan *Labour law* 1.

108 Du Toit *Labour Relations law* 76-77;
Basic Conditions of Employment Act 75 of 1997;
Labour Relations Act 66 of 1995;
Employment Equity Act 55 of 1998;
Jack v Director-General Department of Environmental Affairs [2003] 1 BLLR 28 (LC) para. 17-19;
Kopel *Business law* 202, 208-210.

Labour law in South Africa has largely been codified. It is regulated mostly by the *Basic Conditions of Employment Act*,¹⁰⁹ *Labour Relations Act*,¹¹⁰ *Code of Good Practice: Who is an Employee*, issued in terms of sections 200A and 203 of the *Labour Relations Act*¹¹¹, the *Employment Equity Act*¹¹², the *Occupational Health and Safety Act*¹¹³, the *Compensation for Occupational Injuries and Diseases Act*¹¹⁴, the *Unemployment Insurance Contributions Act*¹¹⁵, the *Income Tax Act*¹¹⁶, the *Employment Equity Act*¹¹⁷, the *Skills Development Act*¹¹⁸ and *Skills Development Levies Act*.¹¹⁹

If an employee commits a delict whilst seeking to advance the interests of the employer, then the employer may be held vicariously liable. For this to occur, there must be an employment relationship and the delict must have been committed by the employee whilst performing his/her duties.¹²⁰

Despite various legislative requirements, which may introduce compliance risk to a bank, employment is primarily a contract, which introduces legal risk.¹²¹ My conclusion is that labour law also poses an internal risk to a bank, in that third parties are not involved. The risk lies in the contracts and labour practices in place between the bank as a legal entity and its employees.

109 *Basic Conditions of Employment Act* 75 of 1997.

110 *Labour Relations Act* 66 of 1995.

111 S200A and S203 of the *Labour Relations Act* 66 of 1995;
Code of Good Practice: Who is an employee (Notice 1774 of 2006).

112 *Employment Equity Act* 55 of 1998.

113 *Occupational Health and Safety Act* 85 of 1993.

114 *Compensation for Occupational Injuries and Diseases Act* 130 of 1993.

115 *Unemployment Insurance Contributions Act* 2 of 2002.

116 *Income Tax Act* 58 of 1962.

117 *Employment Equity Act* 55 of 1998.

118 *Skills Development Act* 97 of 1998.

119 *Skills Development Levies Act* 9 of 1999.

120 Landis *Employment and the Law* 180;

Jack v Director-General Department of Environmental Affairs [2003] 1 BLLR 28 (LC) para. 17-19; There are other and better authority see law of delict
Kopel *Business law* 202, 208-210.

121 Van Niekerk *Law@work* 19.

4.2.1.3 Intellectual property law

Intellectual, immaterial or industrial property rights refer to the right that a person may have to non-tangible creations of the mind, inventions, literary works and computer coding.¹²² Banks have such intellectual property which they may wish to protect, for example copyright on websites, patents in cellphone and internet banking, and trade marks in the form of logos and branding. In this regard, the *Patents Act*,¹²³ *Copyright Act*,¹²⁴ *Trade Marks Act*,¹²⁵ *Merchandise Marks Act*,¹²⁶ *Designs Act*¹²⁷ and *Counterfeit Goods Act*¹²⁸ are applicable to banks. Banks may also not encroach upon the intellectual property of another. This may introduce compliance risk to a bank, because the bank will need to ensure that it has processes and procedures in place to ensure adherence to these pieces of legislation. In the event of a dispute, a bank wishing to protect its intellectual property may face legal risk, because the courts will interpret the legislation and apply it to the specific case.

4.2.1.4 Law of negotiable instruments

A negotiable instrument is a document which itself embodies a cause of action.¹²⁹ It is furthermore a written contract and it contains an order or a promise for the payment of money. A negotiable instrument is negotiable in that the document and the rights contained therein are easily transferred from one person to another. When it is transferred, it gives rise to an obligation to make payment. On transfer the *bona fide* transferee obtains all the rights apparent in the

122 Ramsden *Intellectual Property Law* 1;
Hosten *South African Law* 545.

123 *Patents Act* 57 of 1978.

124 *Copyright Act* 98 of 1978.

125 *Trade Marks Act* 194 of 1993.

126 *Merchandise Marks Act* 17 of 1941.

127 *Designs Act* 95 of 1993.

128 *Counterfeit Goods Act* 37 of 1997.

129 Thomas *Mercantile and Company Law* 445;
Malan and De Beer *Wisslreg en tjekreg* 3;
Cowen *Negotiable Instruments* 1;
Hagood *Paget's Law of Banking* 546.

document, even if the rights of the transferor are lacking. If the transferee is not *bona fide*, then he/she will not obtain more rights than what the transferor had.¹³⁰ A holder for value can obtain a good title notwithstanding defects in the title of his/her transferor. A negotiable instrument is suitable for a pledge, because the person in possession of it has the rights embodied in it.¹³¹ The law of negotiable instruments is applicable to banks, specifically the *Bills of Exchange Act*.¹³²

In South Africa, a negotiable instrument is defined as:¹³³

A document of title embodying rights to the payment of money, or as security for money, which, by custom or legislation, is (a) transferable by delivery (or by endorsement and delivery) in such a way that the holder *pro tempore* may sue on it in his own name and in his own right, and (b) a *bona fide* transferee *ex cause eronus* may acquire a good and complete title to the document and the rights embodied therein, notwithstanding that his[/her] predecessor had a defective title or no title at all.

The most commonly used negotiable instruments are notes, cheques and traveller's cheques.¹³⁴ It could be argued that signoirage¹³⁵ has become a negotiable instrument, because the actual value of the paper or coin is no longer the same as the value it represents.¹³⁶ One of the tests of negotiability is that the instrument needs to be transferable like cash.¹³⁷ In terms of the *Bills of Exchange Act*, all banks, mutual banks, the Reserve Bank and the Postbank are regarded as banks. Banks are afforded some protection by the *Bills of Exchange Act* when acting in good faith, without negligence and according to instructions, in which case the bank cannot be held liable.¹³⁸

130 Van Jaarsveld *Suid-Afrikaanse Handelsreg* 1-2;
Sharrock and Kid *Understanding cheque law* 4-5.

131 Hapgood *Paget's Law of Banking* 546.

132 *Bills of Exchange Act* 34 of 1964.

133 Hosten *South African Law* 907.

134 Kopel *Business law* 367.

135 Notes and coins.

136 Also refer to chapter 2.

137 Hosten *South African Law* 908.

138 Hapgood *Paget's Law of Banking* 546;

The *Bills of Exchange Act* defines a bill of exchange in section 2 as:

an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to a specified person, or his order, or to bearer.

The same *Act* defines a cheque as:

a bill of exchange drawn on a banker payable on demand.

A cheque is a specific kind of bill of exchange in that the parties are the same as with any bill of exchange, but the drawee is always a bank.¹³⁹

The *Bills of Exchange Act*, in section 87(1), defines a promissory note as:

an unconditional promise in writing made by one person to another, signed by the maker, and engaging to pay on demand or at a fixed price or determinable future time, a sum certain in money, to a specified person or his order, or to bearer.

Although a bill of exchange and a promissory note are similar, the difference is that a bill of exchange is an order given by one person to another to pay a third party, while a promissory note is a promise by the maker to pay a specified

Froman v Robertson 1971 (1) SA 115 (A);
Saambou-NasionaleBouvereniging v Friedman 1979 (3) SA 978 (A);
Natal Bank (Ltd) v Ismail Cassim 189213 NLR 152;
Venter v Smit 1913 TPD 231;
Moti & Co v Cassim's Trustee 1924 AD 720;
Estate Wege v Strauss 1932 AD 76;
Standard Bank of SA Ltd v Sham Magazine Centre 1977 (1) SA 484 (A);
Nedbank Ltd v Window Press Pty (Ltd) 1987 (3) SA 761 (SE);
National Housing Commission v Cape of Good Hope Savings Bank Society 1963 (1) SA 230 (C) 234A-235H;
Standard Bank of SA Ltd v Minister of Bantu Education 1966 (1) SA 229 (N) 239A-241D;
Moorcroft Banking Law 34-1 – 34-10.

¹³⁹ Hosten *South African Law* 908.

person (the drawee). The drawee may become the endorser and the note may be made payable to bearer.¹⁴⁰

A negotiable instrument that is made payable to bearer may be transferred by simply physically transferring the instrument as long as the intention to transfer the rights is apparent on the face of the instrument to the transferee. If the instrument is made payable to a specific person, then the transferor has to endorse the document before the rights embodied in the document can be transferred. A transferee may become a transferor simply by delivering a bill made payable to bearer to another person. A bill may be endorsed or drawn up in such a way that it is not negotiable and only payable to a specific person.¹⁴¹ Unless a cheque or note has a forged endorsement or is crossed "not negotiable", the pledgee will acquire an independent title and right to sue and hold the instrument against the true owner until his/her debt is satisfied. Bills of exchange may be pledged or discounted. Discounting a bill effectively means purchasing it, normally with a right of recourse and for a sum less than its face value. The discountee may then deal with the instrument as he/she pleases. Discounting is a way of raising money, but it is not a loan as is the case with a pledge.¹⁴²

A client also has certain duties towards a bank. The *Bills of Exchange Act*¹⁴³ requires clients who are also required by law to have their financial statements audited in terms of the *Auditing Profession Act*¹⁴⁴ to exercise reasonable care in the custody of cheque forms and in the reconciliation of bank statements. These requirements do not apply to other clients.¹⁴⁵ These requirements introduce

140 Hosten *South African Law* 909.

141 Hosten *South African Law* 909;
Hapgood *Paget's Law of Banking* 547.

142 Hapgood *Paget's Law of Banking* 546.

143 S72B of the *Bills of Exchange Act* 34 of 1964.

144 S37 of the *Auditing Profession Act* 26 of 2005.

145 Moorcroft *Banking Law* 15-24.

compliance risk, because cheques introduce a legislative requirement which needs to be adhered to.

Negotiable instruments are a part of the core business of a bank, and have been for many decades. Banks therefore manage such instruments well. Not all aspects of negotiable instruments have been codified, therefore they introduce both legal risk in terms of common law and compliance risk in so far as the law of negotiable instruments is codified.

4.2.1.5 Insolvency law

The law of insolvency deals with situations where a debtor is unable to repay his/her debts because his/her liabilities exceed his/her assets.¹⁴⁶ The law of insolvency and the *Insolvency Act*¹⁴⁷ affect banks mainly in two ways: firstly in terms of the insolvency of a debtor and secondly in terms of the insolvency of the bank itself. The insolvency of either a debtor or the bank itself is regulated primarily by the *Insolvency Act* and secondarily by the *Banks Act* and *National Credit Act*. Regulatory reform regarding debtor and bank insolvency is under way in the form of the Unified Insolvency Bill and the Financial Regulatory Reform project.¹⁴⁸ Under the current *Banks Act*,¹⁴⁹ the Minister of Finance may appoint a curator if the Registrar of Banks is of the opinion that the bank will be unable to meet its obligations.¹⁵⁰ Not all aspects of insolvency law is codified, therefore insolvency will introduce both legal risk and compliance risk to a bank.

146 De Clerq *Insolvent Estate* 1.
Hosten *South African Law* 895.

147 *Insolvency Act* 24 of 1936.

148 National Treasury *A Safer Financial Sector to serve South Africa Better* 2011.

149 *Banks Act* 94 of 1990.

150 *Alpha Bank Bpk en Andere v Registrateur van Banke en Andere* 1996 (1) SA 330 (A) 347G-348F;

Ex Parte Registrar of Banks 1968 (3) SA 300 (C) 301H;

Registrar of Banks v New Republic Bank Ltd 1999 2 All SA 459 (D) 459, 466;

Moorcroft Banking Law 14-1, 15-18 – 15-21.

4.2.1.6 Insurance law

One of the ways in which risk may be mitigated is by transferring the risk. This may be done by way of insurance.¹⁵¹ Insurance law deals with the relationship between an insurer and an insured party where cover is provided in order to prevent financial loss which results when, for example, an asset is damaged or destroyed.¹⁵² Both the *Long-Term Insurance Act*¹⁵³ and the *Short-Term Insurance Act*¹⁵⁴ may apply to banks. Both these *Acts* contain policyholder protection rules which provide consumer protection. The *Long-Term Insurance Act* may, for example, be applicable where a bank requires credit life insurance to be taken out by the consumer where credit is granted under the *National Credit Act* or by selling assistance business policies¹⁵⁵ to consumers. Similarly, the *Short-Term Insurance Act* may, for example, be applicable where a bank insists that the consumer insures the asset affected by a credit agreement. A bank often enters into a binder agreement¹⁵⁶ with an insurer in order to sell these products to consumers. A bank may also be the policyholder of an insurance policy. Examples would be where policies are taken out against the risks of key person dependency, damage to or destruction of assets and retirement policies for employees. Insurance introduces both legal risk and compliance risk to a bank. Legal risk is introduced because insurance is a form of contract, while compliance risk is introduced because the bank needs to comply with the insurance legislation.

4.2.1.7 Banking law

As could be expected, banking law is applicable to banks in South Africa. Banking law in its broadest sense refers to the law relevant to banks and the banker-customer relationship. Banking law has traditionally only dealt with the

151 Reinecke *Insurance Law* 2.

152 Hosten *South African Law* 912-913.

153 *Long-Term Insurance Act* 52 of 1998.

154 *Short-Term Insurance Act* 53 of 1998.

155 For example, a funeral policy.

156 Essentially a form of a partnership agreement; regulated by *Directive* 159.

relationship between banker and depositor. However, the increased complexity in the financial services industry has led to other fields of the law, such as company law, tax law and labour law also becoming relevant to banks. It has already been mentioned that banking law is codified by way of the *South African Reserve Bank Act*,¹⁵⁷ the *Banks Act*,¹⁵⁸ the *Mutual Banks Act*,¹⁵⁹ the *Co-operative Banks Act*,¹⁶⁰ and the *South African Postbank Limited Act*.¹⁶¹

Banks and persons conducting the business of a bank¹⁶² in South Africa are primarily regulated by the *Banks Act*.¹⁶³ There are exceptions, for example the Reserve Bank (established by the *Constitution*¹⁶⁴), the Land Bank, mutual banks, cooperative banks and dedicated banks are excluded from the *Banks Act*. Banks have to apply for registration and be licensed prior to carrying out the business of a bank.¹⁶⁵

Foreign institutions may conduct the business of a bank in South Africa with the prior written approval of the Registrar of Banks. They conduct such business as a branch of the foreign bank in South Africa. Foreign institutions may also establish representative offices in South Africa; however, these may not conduct the business of a bank.¹⁶⁶

The Reserve Bank may acquire shares in a company in order to attain the objects of the *South African Reserve Bank Act*,¹⁶⁷ accept money on deposit and pay interest; grant loans and advances under specific circumstances; trade in

157 *South African Reserve Bank Act* 90 of 1989.

158 *Banks Act* 94 of 1990.

159 *Mutual Banks Act* 124 of 1993.

160 *Co-operative Banks Act* 40 of 2007.

161 *South African Postbank Limited Act* 9 of 2010.

162 S1 of the *Banks Act* 94 of 1990.

163 *Banks Act* 94 of 1990.

164 *Constitution*, 1996.

165 S11 – S14 of the *Banks Act* 94 of 1990;
Moorcroft *Banking Law* 3-1.

166 S18A and 18B of the *Banks Act* 94 of 1990;
Moorcroft *Banking Law* 6-1 – 6-5.

167 *South African Reserve Bank Act* 90 of 1989.

bills of exchange, promissory notes and financial instruments; issue interest-bearing securities for purposes of monetary policy; deal in bullion; and appoint two audit firms to audit the bank.¹⁶⁸ There are various other procedural and administrative duties placed on the Reserve Bank in terms of the *South African Reserve Bank Act* and non-adherence to these may introduce compliance risk. If the Reserve Bank fails to comply with the *South African Reserve Bank Act* or its regulations, then the Minister of Finance may require the Reserve Bank's board of directors ("Board") to remedy the non-compliance within a specified time. The Minister of Finance may approach the High Court for an order that the Board must make good or remedy the default.¹⁶⁹

The Reserve Bank is the government's banker, and the relationship between the Reserve Bank and the state is a client-banker relationship in the ordinary understanding of a client-banker relationship. All the privacy and confidentiality aspects that are normally part of the client-banker relationship in a commercial bank apply to the Reserve Bank.¹⁷⁰ The Reserve Bank may also be faced with legal risk such as any other commercial bank, for example contractual risk in relationships with service providers.

In terms of section 88 of the *Banks Act*,¹⁷¹ if the employees, officers, registrars, governors or members of the Reserve Bank's Board act in good faith, whether in their personal or official capacity within the course of their duties, then neither the Reserve Bank nor these persons can be held liable, except for gross negligence.

168 Ss1, 10, 10A, 11, 12, 14, 15(1), 15(2), 21(1), 21(3), 21(4), 22(1), 22(2), 22(3), 23(1), 23(2), 24, 25(1), 25(2), 25(3), 26(1), 26(2), 27(2), 28(1), 28(2), 29(1), 29(2), 30(1), 30(2), 31, 32(1), 33(1), 33(2), 34(1) 35, 36, 37(1), 37(2), 38(1), 38(2), 38(3), 38(4) of the *South African Reserve Bank Act* 90 of 1989;
S v White 1973 (4) SA 174 (W);
South African Reserve Bank v Khumalo and Another 2010 (5) SA 449 (SCA);
S v Magidson 1984 (3) SA 825 (T);
S v Makhanya and Another 2002 (3) SA 201 (N).
Moorcroft Banking Law 21-7 – 21-14.

169 S37 of the *South African Reserve Bank Act* 90 of 1989.

170 *Moorcroft Banking Law* 21-1 – 21-2;
Hagood Paget's Law of Banking 7.

171 *Banks Act* 94 of 1990.

This may lead to legal risk for a commercial bank if it enters into a dispute with the regulator and the regulator believes that it acted in good faith, and the commercial bank alleges that the regulator was grossly negligent.

A mutual bank is registered in terms of the *Mutual Banks Act* 124 of 1993. Mutual banks are governed in a manner similar to other banks and the Registrar of Banks, in terms of section 4 of the *Banks Act*, is also the Registrar of Mutual Banks. A mutual bank may accept deposits and grant loans, advances or other credit in South Africa but may not issue negotiable certificates of deposit or conduct cross-border transactions.¹⁷² The *Mutual Banks Act* will introduce compliance risk to a bank. If any person acts as a mutual bank without being registered as such, they may incur both legal risk and compliance risk.

Another aspect of the Reserve Bank which applies to commercial banks in South Africa, which may introduce legal risk and/or compliance risk to a bank is the national payment system.¹⁷³ The national payment system is regarded as central to the financial stability in a country. South Africa's national payment system encompasses the entire payment process from the moment an end-user issues an instruction to pay another person, up to the final interbank settlement of the transaction. The national payment system in South Africa is the responsibility of the Reserve Bank¹⁷⁴ and is regulated by the *National Payment System Act*.¹⁷⁵ Disputes between settlement system participants and the Reserve Bank need to be settled in accordance with this *Act*.¹⁷⁶ This will introduce compliance risk to a bank.

A domestic real-time gross settlement system is used for high-value transactions and in South Africa this system is called the "South Africa Multiple Option

172 Moorcroft *Banking Law* 22—1 – 22-7.

173 A detailed discussion of the payment system is beyond the scope of this thesis.

174 Moorcroft *Banking Law* 33-1.

175 *National Payment System Act* 78 of 1998.

176 Moorcroft *Banking Law* 33-8.

Settlement System" ("SAMOS"). It is owned and operated by the Reserve Bank and allows banks to settle their obligations on a real-time basis. Two message carriers are used, the Society of Worldwide Interbank Financial Telecommunication ("SWIFT") for international transactions and SARBLink for local transactions. Access to SARBLink is via SWIFT. The Continuous Linked Settlement ("CLS") system is also a designated settlement system in South Africa used by six South African banks. These six banks provide the funding for the rand in the CLS system. It is linked to the CLS system in London.¹⁷⁷ This may lead to legal risk to a bank, because non-adherence to the CLS system rules may lead to litigation between the relevant domestic commercial bank, the Reserve Bank, and other commercial domestic and international banks.

Although access to information, competition law, conflicts of interest, insider trading and consumer protection is not banking law, it has such a significant impact on banks that they are discussed in the next subsections under banking law.

4.2.1.7.1 Access to information

Banks have an obligation to preserve confidentiality of client information. However, this obligation is not absolute.¹⁷⁸ For example when a person holds a beneficial interest in the shares of a company, that person has certain rights to

¹⁷⁷ Moorcroft *Banking Law* 33-3 – 33-4.

¹⁷⁸ *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd (in liquidation)* 1998 (1) SA 811 (A) 823B;
Burg Trailers SA (Pty) Ltd and Another v ABSA Bank Ltd and Others 2004 (1) SA 284 (A) para. 13;
Densam (Pty) Ltd v Cywilnat (Pty) Ltd 1991 (1) SA 100 (A);
Tournier v National Provincial and Union Bank of England [1924] 1 KB 461 (CA);
Abrahams v Burns 1914 CPD 452 456;
Cambanis Buildings Pty Ltd v Gal 1983 (2) SA 128 (NC) 137F;
GS George Consultants and Investments (Pty) Ltd and Others v Datasys (Pty) Ltd 1988 (3) SA 726 (W) 736F-G;
FirstRand Bank Ltd v Chaucer Publications (Pty) Ltd 2008 (2) SA 592 (C) para. 20;
Pharaon and Others v Bank of Credit and Commerce International SA (in liquidation) (PriceWaterhouse (a firm) intervening), PriceWaterhouse (a firm) v Bank of Credit and Commerce International SA (in liquidation) and Others [1998] 4 All ER 455 (Ch);
Moorcroft Banking Law 15-7.

company information under the *Companies Act*¹⁷⁹ and under the *Promotion of Access to Information Act*.¹⁸⁰ If a bank then fails to provide such information it will be non-compliant and face compliance risk. If a bank refuses to provide the information because it believes the person is not entitled to the information, then that may lead to litigation, which constitutes legal risk.

4.2.1.7.2 Competition law

Competition law is probably a part of the law of delict, but in my opinion it has become such an integral part of the manner in which a commercial bank in South Africa is run, that I categorise it as banking law. Competition law deals with unlawful competition. Freedom of trade means that simply by competing, one is not necessarily acting wrongfully. There are, however, aspects of competition which are unlawful, for example passing off (pretending to be linked to an entity, where by law, there is no link).¹⁸¹ The *Competition Act*¹⁸² has codified competition law in South Africa to a large extent. Both the Competition Commission and the Registrar of Banks have jurisdiction with regard to mergers and acquisitions involving banks.¹⁸³ In terms of section 21 of the *Competition Act*,¹⁸⁴ a banking enquiry was established by the Competition Commission in 2006 to investigate the level and structure of bank charges. The objective of the enquiry was to increase transparency and competition in the banking industry.

179 *Companies Act* 71 of 2008.

180 *Promotion of Access to Information Act* 2 of 2000;
King Report III 7.

181 Fox *Competition law and policy* xv;
Kopel *Business law* 297.

182 *Competition Act* 89 of 1998.

183 Competition Tribunal: *The Standard Bank of SA Real Equity Trust and Stellenbosch Vineyards* Case no 2002Jul131;
Competition Tribunal: *FirstRand Bank Holdings Ltd and Saambou Bank Ltd* Case no. 2002 Aug 161;
Competition Tribunal: *WesBank and Barloworld Leasing* Case no. 2002 Nov 300;
Moorcroft *Banking Law* 2-29 – 2-30;
S37 of the *Banks Act*,
Chapters 2 and 3 of the *Competition Act* 89 of 1998.

184 *Competition Act* 89 of 1998.

The enquiry made specific recommendations with regard to ATMs,¹⁸⁵ payment cards and interchange fees, EFT¹⁸⁶ payments, EDO¹⁸⁷ transactions, barriers to accessing the national payment system, minimum disclosure standards for products and price information, the role of BASA in improving transparency and consumer education, measures to facilitate switching between banks, the establishment of a payment system ombud and the expansion of the role of the Ombudsman for Banking Services.¹⁸⁸ The banking enquiry is an example of a combination of legal risk, compliance risk and reputational risk. Legal risk materialised due to the nature of the enquiry¹⁸⁹, compliance risk due to the non-adherence to the *Competition Act*¹⁹⁰ and reputational risk due to the damage to the relevant banks' corporate image.

4.2.1.7.3 *Conflicts of interest*

Similar to competition law, conflicts of interest have become such an integral part of banking that I chose to categorise it here. However, a purist might view it as a form of delict and given the extent to which it has been legislated, it is a criminal offence. The potential for conflict of interest between the interests of a bank and the interests of a client may arise when:¹⁹¹

- The bank is also a customer of the client;
- The bank is likely to make a financial gain or avoid a financial loss at the expense of the client;
- The bank may receive an inducement (other than normal fees, charges and commission) in relation to the service provided to the client;
- There is a financial incentive to favour the interests of one client over another; or

185 Automated teller machines.

186 Electronic fund transfer.

187 Early debit order.

188 Moorcroft *Banking Law* 2-26 – 2-29.

189 It may have resulted in civil litigation.

190 It may have resulted in fines.

191 Moorcroft *Banking Law* 12-1.

- One department obtains confidential information relating to a client, which may be of interest to another department in the banking group.

This may be, for example, when the bank becomes aware of a planned warning about a client's profitability; the bank is considering a management buy-out, merger or acquisition; the bank is in possession of price-sensitive information that is not in the public domain and could affect investment decisions; or the bank supports more than one client in bidding for the same contract.¹⁹² Depending on the circumstances, it may be best to disclose in writing the conflict of interest or potential conflict of interest to the client. Even if the bank is of the opinion that it will be able to manage the conflict, it is advisable to obtain the client's written consent.¹⁹³ A conflict of interest will generally lead to legal risk.

4.2.1.7.4 Insider trading

Insider trading is prohibited in South Africa by way of section 73 of the *Securities Services Act*.¹⁹⁴ The *Securities Services Act* was enacted, amongst other reasons, to specifically prohibit insider trading. If an insider deals directly or indirectly for his/her own account in securities in a regulated market, based on inside information, that insider is committing an offence. If this occurs within a bank, the bank will be exposed to compliance risk.¹⁹⁵ Given the developments in corporate governance and the emphasis on ethical leadership,¹⁹⁶ insider trading will introduce reputational risk.

4.2.1.7.5 Consumer protection

One aspect of the South African law which has seen increased emphasis since the late 1990s is the protection of consumer rights. The earliest explicit statement on consumer rights was made on 16 March 1962 by President John F Kennedy

192 Moorcroft *Banking Law* 12-1 – 12-2.

193 Moorcroft *Banking Law* 12-2.

194 *Securities Services Act* 36 of 2004. This act will be replaced by the *Financial Markets Bill*.

195 Moorcroft *Banking Law* 12-1.

196 King Report III 8.

in the US.¹⁹⁷ In South Africa, various government departments and agencies are tasked with the protection of consumer rights. This has in turn resulted in legislation that aims to give effect to these rights.¹⁹⁸

The *Consumer Protection Act* applies to every transaction for the supply of goods or services in South Africa, subject to certain exclusions. The definition of "service" in section 1 of the *Consumer Protection Act* includes any banking, banking-related or similar financial service. It excludes advice and intermediary services, which are regulated by the *Financial Advisory and Intermediary Services Act*,¹⁹⁹ the *Long-term Insurance Act* and the *Short-term Insurance Act*.²⁰⁰

The National Consumer Commission (previously the Consumer Affairs Committee) was established in terms of section 85 of the *Consumer Protection Act*²⁰¹ and a part of its role is to promote consumer awareness in terms of section 3(1)(e) of the said *Act*. Certain fundamental consumer rights are now included in chapter 2 of the *Consumer Protection Act*.²⁰² Banks are exempt from section 14 (expiry and renewal of fixed-term agreements) of this *Act*.²⁰³ This entails that the normal consumer rights will not be applicable where a consumer has a fixed-term deposit with a bank. The reason for this exemption is to protect systemic financial stability in the event of a run on a bank. The remainder of the *Consumer Protection Act* is, however, applicable to banks. Because these consumer rights are legislative requirements which a bank needs to adhere to, it introduces compliance risk.

197 United Nations *Guidelines for Consumer Protection* 1.

198 Kopel *Business law* 407.

199 *Financial Advisory and Intermediary Services Act* 37 of 2002.

200 Moorcroft *Banking Law* 37-1 – 37-5;
Long-Term Insurance Act 52 of 1998; and
Short-Term Insurance Act 53 of 1998.

201 *Consumer Protection Act* 68 of 2008.

202 Moorcroft *Banking Law* 37-8.

203 Gen Not 980 in GG 32408 of 16 July 2009.

The *Consumer Protection Act*²⁰⁴ protects consumers against receiving inferior goods and services.²⁰⁵ According to Parker and Lehman²⁰⁶ in Australia, the implementation of trade practice compliance systems is partial, symbolic and half-hearted. Nevertheless, enforcement action by the Australian Competition and Consumer Commission improves the level of implementation of compliance systems. In South Africa, the situation was probably similar under the *Consumer Affairs (Unfair Business Practices) Act*,²⁰⁷ however, the *Consumer Protection Act*, along with the Treating Customers Fairly²⁰⁸ initiative, has resulted in increased awareness and focus on consumerism.

The *Consumer Affairs (Unfair Business Practices) Act*²⁰⁹ prohibits any business practice that may directly or indirectly harm the relations between businesses and consumers, unreasonably prejudice any consumer, deceive any consumer or unfairly affect any consumer. Put differently, this means that the National Consumer Commissioner, which is part of the Department of Trade and Industry, may investigate business practices in a bank and may take various enforcement actions. For example, the National Consumer Commissioner may enter into an undertaking with a bank, in terms of which the bank will commit to taking certain actions, such as including a five-day cooling off period into its agreements. Such an undertaking may be published in the *Government Gazette*.²¹⁰ The *Consumer Affairs (Unfair Business Practices) Act* is still in force, but has been largely superseded by the *Consumer Protection Act*.²¹¹ Non-adherence to the *Consumer Protection Act* may lead to compliance risk in a bank because penalties and fines may be incurred. It may also result in civil litigation, which constitutes legal risk.

204 *Consumer Protection Act* 68 of 2008.

205 Kopel *Business law* 415-417.

206 Parker and Lehmann *Do businesses take compliance systems seriously?* 441.

207 *Consumer Affairs (Unfair Business Practices) Act* 71 of 1988.

208 FSB *Treating Customers Fairly: The Roadmap*, 2011 6-7.

209 *Consumer Affairs (Unfair Business Practices) Act* 71 of 1988.

210 GN 980 of 2009 GG 32408 of 16 July 2009.

211 *Consumer Protection Act* 68 of 2008.

The *National Credit Act*²¹² also provides a level of consumer protection and introduces compliance risk to a bank.

The *Financial Advisory and Intermediary Services Act*²¹³ applies to banks and affords a level of consumer protection to consumers. A bank may provide financial advice to a client, for example which kind of long-term investment to deposit money into. A bank also provides intermediary services in respect of various products. Only a few of the aspects of the relationship between a bank and its client with regard to financial advice and intermediary services are based on contract or other common law requirements. The *Financial Advisory and Intermediary Services Act* therefore introduces compliance risk to a bank.²¹⁴

4.2.2 Law of obligations

The second type of private law that applies to a bank is the law of obligations. This has its roots in Roman law, in the concept of *obligare* (obligation).²¹⁵ An obligation is a juristic relationship between two persons where the one is legally bound to perform something. Put differently, it is a relationship between two persons where the one person has a right to performance and the other person has a duty to perform. The duty to perform may be positive (the party has to do something) or negative (the party has to refrain from doing something).²¹⁶ Various subcategories of the law of obligations have developed and these are discussed in items 3.2.1.7.5 and 3.2.2.1 below.

212 *National Credit Act* 34 of 2005.

213 *Financial Advisory and Intermediary Services Act* 37 of 2002.

214 The proposals by the Financial Services Board around Treating Customers Fairly may introduce both legal and compliance risk in a bank.

215 Van der Merwe *Kontraktereg* 1.

216 Thomas *South African Private Law* 213-214.
Hosten *South African Law* 700-701.

4.2.2.1 Law of contract

A contract is an obligation to do what one has promised to do.²¹⁷ The law of contract deals with a bilateral juristic act amongst legal subjects, which creates an agreement.²¹⁸ A contract is a form of obligation in terms of which certain rights and duties (obligations) are created.²¹⁹ The basis of any contract is consensus and in the absence thereof no contract can be established.²²⁰ A bank is not obliged to enter into a contract with a client.²²¹ A bank may cancel the contract with the client unilaterally, and this is normally contained in the standard terms and conditions of the bank's special contract. The bank is not bound to supply the service stipulated in the contract, for example, where a client draws a cheque on the bank, but there are insufficient funds in the account, then the bank is not obliged to pay on presentation of the cheque.²²²

As a general rule, no formalities are required for the formation of a valid contract. Valid contracts may be made orally, in writing or even by conduct.²²³ Written contracts are easier to prove and in some instances, the law requires contracts to be in writing.²²⁴ Statute²²⁵ or the parties may require certain formalities, for

217 Kerr *Law of Contract* 19.

218 Hosten *South African Law* 701;
Van der Merwe *Kontraktereg* 1.

219 Van der Merwe *Kontraktereg* 7.

220 Van der Merwe *Kontraktereg* 11.

221 *Siman & Co (Pty) Ltd v Barclays National Bank Ltd* 1984 (2) SA 888 (A) 907A, 907H, 910B, 910H;

Duvenhage v Eerste Nasionale Bank van SA Bpk [2005] 4 All SA 41 (N) 54;

First National Bank of South Africa v Duvenhage 2006 (5) SA 319 (A) paras 17, 18, 20;

Great Karoo Eco Investments (Edms) Bpk h/a Grobbelaarskraal Boerdery v ABSA Bank Bpk 2003 (1) SA 222 (W) para. 33;

National Vehicle Refurbishers CC v Nedcor Bank Ltd t/a Nedbank [2000] 1 All SA 651 (T) 657;

African Life Assurance Co Ltd v NBS Bank Ltd 2001 (1) SA 432 (W) 441E-G;

Moorcroft *Banking Law* 18-10;

Hapgood *Paget's Law of Banking* 159.

222 Moorcroft *Banking Law* 15-25;

Hapgood *Paget's Law of Banking* 159.

223 Kopel *Business law* 71.

224 Kopel *Business law* 72.

225 For example, the *Alienation of Land Act* 68 of 1981;

Property Time-sharing Control Act 75 of 1983;

example that the contract must be in writing, signed by the parties, signed by witnesses, notarial execution and registration with a government department.²²⁶

There are certain minimum or essential criteria²²⁷ that must be agreed upon for the particular type of agreement to be binding or for the formation of a valid contract. These essential criteria for a valid contract to come into existence are that there has to be consensus between the parties; the parties must have the capacity to contract; performance must be possible; the contract must be legal and if there are any formalities that need to be adhered to, these must be fulfilled.²²⁸

There are certain terms that automatically form part of a contract through the operation of the law. Such terms are natural consequences²²⁹ of certain categories of contract, and the parties do not need to specifically include these clauses because they are automatically included, for instance that the buyer will accept delivery. Additional terms may be agreed upon.²³⁰ A contract may be void or voidable if it is not valid.²³¹ A void contract has a fatal defect that is so severe

Sale and Service Matters Act 25 of 1964;
Housing Consumer Protection Measures Act 95 of 1998;
Deeds Registries Act 47 of 1937;
National Credit Act 34 of 2005.

226 Kopel *Business law* 72-73.

227 *Essentialia*.

228 Hosten *South African Law* 702-719.

229 *Naturalia*.

230 *Incidentalialia*.

231 Kopel *Business law* 74-75;

Moorcroft Banking Law 17-1;

First National Bank of Southern Africa Ltd v Bophuthatswana Consumer Affairs Council 1995

(2) SA 853 (B) 856G-H;

Conradie v Rossouw 1919 AD 105 287-288, 297;

Saambou-Nasionale Bouvereniging v Friedman 1979 (3) SA 978 (A) 993F;

Manna v Lotter and Another 2007 (4) SA 315 (C) paras 22-26;

Goldblatt v Freemantle 1920 AD 123 128;

Bird v Somersville 1960 (4) SA 395 (N);

Sewpersadh and Another v Dookie 2008 (2) SA 526 (D);

Sewpersadh and Another v Dookie 2008 (4) SA 127 (D);

Alfred McAlpine & Son (Pty) Ltd v Transvaal Provincial Administration 1974 (3) SA 506 (A)

531E-H and 532G-H;

that it is as if the contract never came into existence.²³² A voidable contract has a flaw that entitles the aggrieved party to choose whether he/she wishes to treat the contract as valid or not.²³³

The risks attached to contracts are that they are unlawful. Generally all contracts are lawful, unless if prohibited by common law²³⁴ or statute, in which case such contracts would be void.²³⁵

It must be physically and legally possible to perform the terms agreed in the contract. If performance becomes impossible after the contract was entered into, then the contract is voidable.²³⁶ Physical impossibility is either objectively impossible²³⁷ or supervening impossible.²³⁸ If performance is objectively impossible²³⁹ at the point of inception and it will render the contract void. If it becomes impossible after inception then it is supervening impossibility and the contract is voidable.²⁴⁰ If, however, the impossibility arises due to the deliberate or negligent act or acts of one of the parties, then the contract remains binding.²⁴¹ Legal impossibility is when a contract is illegal,²⁴² immoral or contrary to public policy. Non-compliance with a statute will not necessarily lead to invalidity of a contract.²⁴³

City of Cape Town (CMC Administration) v Bourbon-Leftley NNO 2006 (3) SA 488 (A) para. 19;

Van Nieuwkerk v McCrae 2007 (5) SA 21 (W) 26E-F, 27C-E, 28H;

Nedcor Bank Ltd v SDR Investment Holdings Co (Pty) Ltd and Others 2008 (3) SA 544 (A) paras 9-12.

232 Kopel *Business law* 75.

233 Kopel *Business law* 75.

234 Against public policy or good morals (*contra bonos mores*).

235 Kopel *Business law* 79.

236 Kopel *Business law* 121.

237 For example, a contract to buy a house is entered into after it has burned down.

238 This may be due to an act of God (*vis major*), an act of the State, or an irresistible force beyond the control of either party (*causa fortuitus*).

239 For example, a contract to buy a house is entered into after it has burned down.

240 This may be due to an act of God (*vis major*), an act of the State, or an irresistible force beyond the control of either party (*causa fortuitus*).

241 Kopel *Business law* 121-122.

242 Namely agreements to commit crimes, delicts or break the law.

243 Kopel *Business law* 122-124.

There are various types of contracts applicable to banks in South Africa. Generally the principles set out above would apply, but there are exceptions, for example there are generally no formalities to sales contracts, except in terms of the *Alienation of Land Act*,²⁴⁴ the *Sectional Titles Act*,²⁴⁵ the *Share Blocks Control Act*,²⁴⁶ the *Property Time-sharing Control Act*,²⁴⁷ and the *National Credit Act*,²⁴⁸ which Acts require that an agreement to sell land must be in writing and signed. The *Insolvency Act*²⁴⁹ has specific requirements with regard to the sale of a business. The *Merchandise Marks Act*²⁵⁰ also sets specific requirements with regard to merchandising.²⁵¹ Other specific types of contract that may introduce legal risk to a bank are contracts of lease and occupancy,²⁵² agency agreements,²⁵³ insurance contracts,²⁵⁴ joint ventures,²⁵⁵ electronic banking (including the *Electronic Communications and Transactions Act*,²⁵⁶ which will introduce compliance risk)²⁵⁷ credit and debit cards,²⁵⁸ and ATMs.²⁵⁹ Restraint of trade agreements puts into conflict the principles of freedom of trade and sanctity of contract. In South Africa restraint of trade agreements are valid if they are reasonable under the circumstances.²⁶⁰ This may be relevant to a bank that

244 *Alienation of Land Act* 68 of 1981.

245 *Sectional Titles Act* 95 of 1986.

246 *Share Blocks Control Act* 59 of 1980.

247 *Property Time-sharing Control Act* 75 of 1983.

248 *National Credit Act* 34 of 2005.

249 *Insolvency Act* 24 of 1936.

250 *Merchandise Marks Act* 17 of 1941.

251 Kopel *Business law* 155-156.

252 Kopel *Business law* 180-181;
Hosten *South African Law* 784.

253 Kopel *Business law* 250;
Hosten *South African Law* 730-734.

254 Kopel *Business law* 264;
Hagood *Paget's Law of Banking* 40-43;
Hosten *South African Law* 912.

255 Kopel *Business law* 293.

256 *Electronic Communications and Transactions Act* 25 of 2002.

257 Kopel *Business law* 367.

258 Moorcroft *Banking Law* 20-11.

259 Moorcroft *Banking Law* 20-1.

260 Kopel *Business law* 124-125.

wishes to retain key employees and to prevent them from joining a competing bank.

Where contractual rights are transferred, it is called a “cession”. A cession is a transfer of a personal right, that is a claim or a debt, by way of an agreement between the old and the new creditor.²⁶¹ A bank uses cession frequently as collateral against credit risk.

The law of contract, with some exceptions, has not been codified in South Africa. Therefore the law of contract will introduce mainly legal risk to a bank.

4.2.2.2 Law of delict

The law of delict forms part of the law of obligations.²⁶² The law of delict regulates the legal relationship between legal subjects. The elements of a delict are that there needs to be conduct or an act by the wrongdoer; the act needs to be wrongful (meaning that a right has been infringed either intentionally or negligently); there has to be fault (*culpa*); there has to be a causal link between the conduct and the harm suffered; and there has to be damage²⁶³ or impairment of personality.²⁶⁴

A bank may be held delictually liable for the conduct of its employees, for example if an employee discloses information about a client, thereby breaching the client’s constitutional right to privacy, or by providing inaccurate information. Another example may be where a collecting bank (the bank that acts on behalf of

261 Scott *Law of Cession* 1;
Hosten *South African Law* 906. Find a better source.

262 Thomas *South African Private Law* 357-358;
Burchell *Principles of Delict* 1;
Loubser *Deliktereg* 7;
Moorcroft *Banking Law* 18-1.

263 Patrimonial loss.

264 Thomas *South African Private Law* 357-358;
Burchell *Principles of Delict* 23-35;
Loubser *Deliktereg* 22-31;
Hosten *South African Law* 801, 806-829.

its customer to collect the proceeds of a cheque from a paying bank) may have a duty of care towards third parties who are not clients when a non-transferable cheque is paid into the account of someone other than the named payee. The duty of care is not affected in instances where the collecting bank is also the paying bank. The duty of care is also not affected when a bank appoints another bank as its collecting agent, nor does it matter whether the client has a savings account or a current account.²⁶⁵

A breach of contract may lead to both delictual and contractual action brought against the wrongdoer. If a party to a contract is harmed due to the negligent or intentional breach of a contract, that party may claim both in terms of the breach of contract and in terms of the delict.²⁶⁶ This would also apply to a bank. The contract between the bank and its client will need to be studied in order to determine the rights and duties of the parties. A bank that fails to carry out a client's mandate, or acts outside that mandate (for example by paying the incorrect beneficiary) shall be liable. A bank may also owe a beneficiary a duty of care, even though there is no contract between the bank and the beneficiary.²⁶⁷

A party who institutes legal action based on breach of contract aims to be put in the position he/she would have been in had the counterparty performed. A party

265 *Rhostar (Pvt) Ltd v Netherlands Bank of Rhodesia Ltd* 1972 (2) SA 703 (R) 715B;
Bank of Credit and Commerce Zimbabwe Ltd v UDC Ltd 1991 (4) SA 82 (Z) 87A-B;
First National Bank of SA Ltd v Quality Tyres(1970) (Pty) Ltd 1995 (3) SA 556 (A) 568A-B;
Energy Measurements (Pty) Ltd v First National Bank of SA Ltd 2001 (3) SA 131 (W) paras 14, 122;
Strydom NO v ABSA Bank Bpk 2001 (3) SA 185 (T) 193G-H, 194D;
Standard Bank of SA Ltd v Harris and Another NNO (JA du Toit intervening) 2003 (2) SA 23 (A) paras 11, 12, 17;
Columbus Joint Venture v ABSA Bank Ltd 2000 (2) SA 491 (W) 510F-G, 511F-G;
Powell and Another v ABSA Bank Ltd t/a Volkskas Bank 1998 (2) SA 807 (SE) 821H-J;
Netherlands Bank of South Africa v Stern NO and Another 1955 (1) SA 667 (W) 669G-H;
Rosen v Barclays National Bank Ltd 1984 (3) SA 974 (W) 978E;
African Life Assurance Co Ltd v NBS Bank Ltd 2001 (1) SA 432 (W) 443J-444B;
Moorcroft Banking Law 19-1, 19-21 – 19-22.

266 *Kopel Business law* 429.

267 *National Westminster Bank Ltd v Barclays Bank International Ltd* [1974] 3 All ER 834 (QB) 844d-e;
Moorcroft Banking Law 20-15.

who institutes legal action based on delict, however, wishes to recover the loss sustained due to the wrongful conduct of another.²⁶⁸ It is possible for a person to claim based on reputational damage incurred without having to prove the actual loss incurred.²⁶⁹

The situations under which damages can be claimed are:²⁷⁰

- contractual damages may be claimed for breach of contract;
- in delict a plaintiff may claim for pain and suffering; or
- a plaintiff may also claim under the law of delict for impairment of the plaintiff's person, dignity or reputation when the damage is inflicted intentionally and wrongfully.

The test for liability due to negligence is:

- whether a reasonable person in the position of the defendant:
 - would foresee the reasonable possibility that his conduct may cause loss to another person; and
 - would take reasonable steps to guard against such loss; and
- whether the defendant failed to take such steps.²⁷¹

A bank is not necessarily negligent if it allows an account to be opened with a name similar to that of an existing client. Trading names for registered entities are common practice, but it does lead to a multiplicity of names which may lead

268 *Trotman and Another v Edwick* 1951 (1) SA 443 (A) 449B-C;
Erf 1026 Tygerberg CC t/a Aspen Promotions SA v Pick 'n Pay Retailers (Pty) Ltd 2005 (6) SA 527 (C) para. 10;
Moorcroft Banking Law 17-2.

269 *Freeman v Standard Bank of South Africa Ltd* 1905 TH 26 34;
Moorcroft Banking Law 17-4.

270 *Victoria Falls and Transvaal Power Co Ltd v Consolidated Langlaagte Mines Ltd* 1915 AD 1 22;
Moorcroft Banking Law 17-3 – 17-4.

271 *Energy Measurement (Pty) Ltd v First National Bank of SA Ltd* 2001 (3) SA 131 (W).

to confusion. This confusion can be abused by criminals.²⁷² The introduction of section 21 of the *Financial Intelligence Centre Act*²⁷³ imposes a duty on banks to know their client. In practice, this has led to banks only allowing bank accounts in the registered name of the entity and no longer allowing "trading as" variants of a name. A bank has a duty of care towards the true owner of a cheque, when the bank is the payee of a cheque induced by fraud.²⁷⁴

Banks always act through humans, therefore the decisions and actions of a bank's staff are those of the bank. Because a bank acts through individuals, the bank may be held vicariously liable for the delicts committed by its employees and agents.²⁷⁵ Negligence and vicarious liability should be distinguished. Where the bank owes the public a duty of care to safeguard certain assets, and its management fails to put adequate safeguards in place, then the bank itself is negligent, or rather the negligence of the human beings employed by the bank is attributed to the bank. However, where it is management, or more junior employees acting in the course and within the scope of their employment with the bank, then the bank may be held vicariously liable for their actions.²⁷⁶

In terms of section 1 of the *Apportionment of Damages Act*,²⁷⁷ a plaintiff's delictual claim may be reduced, should it be found in a delictual claim that the bank or an employee for which the bank is vicariously liable was negligent as well as the plaintiff, then a court will order apportionment in a claim by that bank.²⁷⁸

272 Moorcroft *Banking Law* 18-10;

Siman & Co (Pty) Ltd v Barclays National Bank Ltd 1984 (2) SA 888 (A) 910B;
AfricanLife Assurance Co Ltd v NBS Bank Ltd 2001 (1) SA 432 (W) 441E-G.

273 *Financial Intelligence Centre Act* 38 of 2001.

274 *African Life Assurance Co Ltd v NBS Bank Ltd* 2001 (1) SA 432 (W).

275 Moorcroft *Banking Law* 18-11.

276 *Ess Kay Electronics Pte Ltd and Another v First National Bank of Southern Africa Ltd* 1998 (4) SA 1102 (W).

Moorcroft Banking Law 18-11 – 18-12.

277 *Apportionment of Damages Act* 34 of 1956.

278 Moorcroft *Banking Law* 18-14;

ABSA Bank Ltd v Bond Equipment (Pretoria) (Pty) Ltd 2001 (1) SA 372 (A) para. 9. If the bank as plaintiff was negligent an apportionment will like wise be made.

Misrepresentation may give rise to a claim for loss or damages suffered as a result of the misrepresentation. This will occur when there is negligent or intentional misrepresentation by someone with a legal duty not to make such a misrepresentation, or by an agent of such a person. Intentional or fraudulent misrepresentation is committed when the representer knows that the representation is false. A negligent misrepresentation is when it can be shown that a reasonable person would have ascertained the true facts before making such a misrepresentation.²⁷⁹

There are three forms of delictual liability that may lead to legal action:²⁸⁰

- patrimonial loss, or pure economic loss;²⁸¹
- intentional, wrongful impairment of a person's dignity or reputation;²⁸² and
- wrongful, culpable impairment of psychological and physical integrity, causing pain and suffering.²⁸³

Patrimonial or pure economic loss actions are more common in banking than claims for damage to dignity, reputation, psychological or physical integrity.²⁸⁴ The latter two of the above-mentioned actions are not impossible, and may for example occur when an employee commits such an act intentionally or negligently in the course of his/her employment during the normal course of

279 Moorcroft *Banking Law* 18-16 – 18-20

Nedcor Bank Ltd t/a Nedbank v Lloyd-Gray Lithographers (Pty) Ltd 2000 (4) SA 915 (A) para. 9;

Ex parte Lebowa Development Corporation 1989 (3) SA 71 (T) 103H-I;

Standard Bank of South Africa Ltd v Coetzee 1981 (1) SA 1131 (A) 1134H-1135D;

ABSA Bank Ltd v Fouche 2003 (1) SA 176 (A) para. 10;

Great Karoo Eco Investments (Edms) Bpk h/a GrobbelaarskraalBoerdery v ABSA Bank Bpk 2003 (1) SA 222 (W) paras 19-41;

Standard Bank of South Africa Ltd v Supa Quick Auto Centre 2006 (4) SA 65 (N).

280 Moorcroft *Banking Law* 18-1.

281 *Actio legis Aquilia*.

282 *Actio iniuriarum*.

283 Action for pain and suffering.

284 Moorcroft *Banking Law* 18-1;

Telematrix (Pty) Ltd t/a Matrix Vehicle Tracking v ASA SA 2006 (1) SA 461 (A) para. 12.

business. The burden of proof in a legal action based on delict is on a balance of probabilities. The onus of establishing a defendant's negligence on a balance of probabilities lies with the plaintiff.²⁸⁵

The standard of care that a bank should adhere to is that which is reasonably expected of a professional banker. This standard is similar to the reasonable person test. A court will not measure a bank against its highest level of skill and competence, but against a degree of skill that could reasonably be expected of a professional banker.²⁸⁶

A bank has a duty of care towards certain third parties. For example, when a bank account is used to facilitate fraudulent transactions, the bank should notice peculiarities of the account and take appropriate action.²⁸⁷

Banks are also required to examine a presentation (of documents) to determine if it constitutes a valid presentation which should be acted upon in terms of the International Chamber of Commerce's Uniform Customs and Practice for Documentary Credits.²⁸⁸ Failure to comply with a statutory duty will be relevant to determine wrongfulness, but it does not provide proof of or a basis for delictual liability.²⁸⁹

In the eyes of the public, a bank's personnel, especially a branch manager, are the bank itself. The branch manager is assumed to be authorised to speak for the

285 Moorcroft *Banking Law* 18-2;
Liebenberg v ABSA Bank Ltd [1998] 1 All SA 303 (C) 311.

286 Moorcroft *Banking Law* 18-3.

287 *Commissioner, South African Revenue Service and Another v ABSA Bank Ltd and Another* 2003 (2) SA 96;
Moorcroft *Banking Law* 18-7.

288 Moorcroft *Banking Law* 32-10 – 32-11.

289 Moorcroft *Banking Law* 18-8;
Commissioner, South African Revenue Service and Another v ABSA Bank Ltd and Another 2003 (2) SA 96

bank and that he/she will act within the limits of his/her powers.²⁹⁰ Estoppel²⁹¹ may apply, because a bank manager and bank officials are authorised to perform certain functions in terms of their appointment and seniority. The authority is either expressed or implied and may be actual or ostensible.²⁹² Third parties may assume that the official has the usual authority of a person in his/her position. Ostensible authority overlaps and may even exceed the official's actual authority. A bank may therefore be liable for damages, because it cannot rely on internal restrictions placed on the bank manager which are unknown to a third party. If a litigant relies on estoppel, all the essential elements of estoppel have to be proven, namely there was an intentional or negligent misrepresentation; this misrepresentation was relied on by the litigant; and the misrepresentation was the cause of the litigant acting to his/her detriment.²⁹³

A bank may incur delictual liability in respect of its clients or third parties. Delictual liability will arise out of a wrongful culpable²⁹⁴ act that causes harm to another person.²⁹⁵

Delicts are distinguished from criminal activities. One action may result in both delictual action and criminal prosecution. Delictual litigation is aimed at

290 Moorcroft *Banking Law* 18-9;

Duvenhage v Eerste Nasionale Bank van SA Bpk[2005] 4 All SA 41 (N).

291 Creating the impression that person may act on your behalf, when in fact they may not, then you are precluded from relying on the true situation and will be bound by the impression created.

292 Apparent.

293 Moorcroft *Banking Law* 29-1 – 29-6;

NBS Bank Ltd v Cape Produce Co (Pty) Ltd and Others 2002 (1) SA 396 (A) paras 25-26;

South African Eagle Insurance Co Ltd v NBS Bank Ltd 2002 (1) SA 560 (A);

Glofinco v ABSA Bank Ltd t/a United Bank 2002 (6) SA 740 (A) para. 14;

African Life Assurance Co Ltd v NBS Bank Ltd 2001 (1) SA 432 (W);

NBS Bank Ltd v Cape Produce Co (Pty) Ltd and Others 2002 (1) SA 396 (A);

Jonker v Boland Bank PKS Bpk 2000 (1) SA 542 (O);

IPF Nominees (Pty) Ltd v Nedcor Bank Ltd (Basfour 130 (Pty) Ltd, Third Party) 2002 (5) SA 101 (W);

Big Dutchman (SA) (Pty) Ltd v Barclays National Bank Ltd 1979 (3) SA 267 (W).

294 Intentional or negligent.

295 Moorcroft *Banking Law* 18-1.

compensating the victim, while criminal prosecution is aimed at punishing the wrongdoer.²⁹⁶

Delictual actions by the employees of a bank may result in legal risk if the aggrieved person chooses to take legal action against the bank.

4.2.2.3 Law of unjustified enrichment

The purpose of unjustified enrichment law is to restore economic benefits to the impoverished or plaintiff, at whose expense the economic benefit was obtained by another person, and where the other person has no legal justification for the retention of the benefit.²⁹⁷ Unjustified enrichment gives rise to an obligation in terms of which the enrich²⁹⁸ed party has a duty to restore the impoverished party to the extent that he/she was enriched, and the impoverished party has a corresponding right to claim that the enrichment be restored to him/her.²⁹⁹ It is possible that the law of unjustified enrichment could be applicable to a bank, for example where a third party erroneously pays money to the bank, or when the bank erroneously pays money to a third party. It is also possible that a bank could be the conduit for unjustified enrichment, for example where a third party pays money into the incorrect bank account of a client of the bank. In the latter example, the bank will not incur any obligation or liability. However, it will nevertheless lead to legal risk in a bank.

In general, and in conclusion to section 3.2.2, the law of obligations will introduce legal risk to a bank, except to the extent where it has been codified. Codified law of obligations introduce compliance risk.

296 Kopel *Business law* 429.

297 Visser *Unjustified enrichment* 4.

298 A detailed discussion of unjustified enrichment is beyond the scope of this thesis.

299 Hosten *South African Law* 848.

4.2.3 Law of persons

The law of persons is that part of the law that deals with anyone or any entity that has the legal capacity to be the bearer of rights and duties.³⁰⁰ A bank is an entity with the capacity to be a bearer of rights and obligations because it is a public company. As such a bank is therefore able to incur both legal risk and compliance risk. The only instance where I foresee that the law of persons may introduce legal risk to a bank is when the legal status of the bank are being challenged or the legal status of its client is being disputed.

4.2.4 Law of property

The law of property³⁰¹ mainly deals with real rights or the right to independent corporeal objects external to humans that may be subjected to human control and are of use and value to humans.³⁰² The law of property has, to a large degree, been codified.³⁰³ These include the *Alienation of Land Act*,³⁰⁴ the *Sectional Titles Act*,³⁰⁵ the *Share Blocks Control Act*,³⁰⁶ the *Second-Hand Goods Act*,³⁰⁷ the *Property Time-sharing Control Act*,³⁰⁸ and the *Housing Consumers Protection Measures Act*.³⁰⁹ These would introduce compliance risk to a bank.

It is also possible for the law of property to introduce legal risk to a bank by way of real and personal securities. In providing credit to a third party, there is always the risk that the person will not repay the credit. In order to minimise the creditor's losses, the creditor will obtain security against the debt. This security may be in

300 Neethling *Law of Personality* 11;
Kruger *Law of Persons* 11;
Hosten *South African Law* 542-543.

301 Also called the law of things.

302 Mostert *Law of Property* 5.

303 Kopel *Business law* 411.

304 *Alienation of Land Act* 68 of 1981.

305 *Sectional Titles Act* 95 of 1986.

306 *Share Blocks Control Act* 59 of 1980.

307 *Second-Hand Goods Act* 6 of 2009.

308 *Property Time-sharing Control Act* 75 of 1983.

309 *Housing Consumers Protection Measures Act* 95 of 1998.

the form of real or personal security. Examples of real security held against credit risk are mortgages, notarial bonds, cession, pledge, lien and tacit hypothec. A suretyship is a personal security.³¹⁰ Credit extension is an example of an overlap between credit risk, legal risk and compliance risk. The security is held in order to mitigate credit risk. However, there is the risk of disputes and civil legal action, which will lead to legal risk. There is also the risk of non-adherence to legislative requirements, such as the *National Credit Act*,³¹¹ which may lead to compliance risk.

4.2.5 Law of succession

The law of succession regulates what happens to a person's estate or his/her assets and liabilities after his/her death.³¹² Banks may offer a service to clients by drafting wills for clients and administering their deceased estates. The *Wills Act*³¹³ and the *Estate Duty Act*³¹⁴ will need to be complied with and will therefore lead to compliance risk. It is possible for third parties to institute legal action against a bank in its capacity as the executor of a deceased estate, which will lead to legal risk. This may, for example, be in instances where a bank was appointed as executor and did not follow the formalities for the execution of the estate, or it may be that the executor incorrectly interpreted the will.³¹⁵ A bank will only face a risk if it has been appointed as executor in a will. I therefore cannot foresee how the law of intestate succession will be applicable to a bank.³¹⁶

310 Kopel *Business law* 386-404;
Moorcroft *Banking Law* 26-1 – 26-14;
Bisnath NO and Others v Absa Bank Ltd, Absa Bank Ltd v Bisnath NO and Others 2008 (4) SA 92 (A) para. 24.

311 *National Credit Act* 34 of 2005.

312 Van der Merwe and Rowland *Erfreg* 1;
De Waal *Law of Succession* 1;
Hosten *South African Law* 660.

313 *Wills Act* 7 of 1953.

314 *Estate Duty Act* 45 of 1955.

315 De Waal *Law of Succession* 29-142.

316 De Waal *Law of Succession* 1.

4.2.6 *Indigenous law*

Indigenous law, in South Africa's instance African law, is the unwritten customary law of small and static societies and it is the real customary law exercised by the people living under this system.³¹⁷ Indigenous or customary law adds another dimension to South African private law. Any court may take judicial notice of customary law when the existence thereof can be ascertained, as long as it is not against natural justice or public policy.³¹⁸ Indigenous law has an influence on the business of a bank, for example in determining whether a person is married in community of property or not when assessing his/her credit risk, or determining which persons will have rights to claim against a deceased estate where the bank acts as executor. In some instances, African indigenous law is recognised by statute, for example "stokvels" in section 1 of the *National Credit Act*.³¹⁹ The *National Credit Act* would introduce compliance risk to a bank. However, the bulk of indigenous or customary law is not statutory and hence could introduce legal risk to a bank.

There are various aspects of private law that introduce both legal risk and compliance risk to a bank. These risk types may overlap with other risk types such as credit risk, IT governance risk and reputational risk. The next section deals with formal or procedural law and how it has an impact on the legal risk and compliance risk in a bank.

4.2.7 *Private international law*

Private international law will apply to banks in so far as it relates to the relationship between a bank and another natural or juristic person in another jurisdiction.³²⁰ Put differently, if there is an element of foreign law applicable, then private international law will determine which legal system needs to be applied.

317 Thomas *South African Private Law* 8.

318 Hosten *South African Law* 1248-1249.

319 *National Credit Act* 34 of 2005.

320 Cheshire *Private International Law* 5.

Private international law applies when enforcing rights and obligations between private individuals across borders, for example in foreign trade and in the enforcement of contracts.³²¹

4.3 Procedural law

Formal, procedural or adjective law prescribes the procedures which need to be followed when a material or substantive rule requires enforcement, or where a material or substantive rule has been transgressed and redress is sought.³²² The narrow definition of procedural law is that it is that part of the law which applies when a person, a bank in our instance, enters into litigation.

4.3.1 Civil procedure law

Civil procedure law is the body of legal rules that determines the extent to which rights and duties are protected and enforced in a society.³²³ Civil procedure law is there to ensure that justice is served between the relevant parties.³²⁴ There are certain principles in civil procedure law and these include:

- everyone should have access to an impartial and independent judiciary;
- the principle of *audi alteram partem*³²⁵ should be adhered to;
- The parties decide whether they want to litigate and what evidence they choose to lead;
- *Viva voce* (oral) evidence is allowed;
- Court proceedings are generally held in public;
- The court must consider evidence on objective and rational grounds;
- The court must deliver a fair and judicially sound judgement; and

321 Forsyth *Private International Law* 5; 107-108.

322 Hosten *South African Law* 1129.

323 Paterson *Principles of Civil Procedure* 6;
Van Heerden *Siviele Prosesreg* 2-3;
Harms *Civil Procedure* 5.

324 Paterson *Principles of Civil Procedure* 6.

325 Hear both sides of the story.

- The decision of the court is final and binding.³²⁶

Although civil procedure applies to commercial banks in South Africa, alternative dispute resolution is also an option. One aspect of alternative dispute resolution would be governed by BASA. With the exception of the Reserve Bank, all banks registered in South Africa are members of BASA.³²⁷ BASA is mandated to represent its membership in liaising with government and other stakeholders, guiding transformation, and conducting research and development.³²⁸ An example of such representation of its membership is the Financial Sector Charter, which was adopted by the Banking Association and other private sector organisations in the financial services industry in October 2003.³²⁹ The *Broad-Based Black Economic Empowerment Act*³³⁰ introduced Codes of Good Practice in 2007. An amended draft *Financial Sector Charter* was submitted to the Department of Trade and Industry in 2010. Until such time as it is approved, banks will need to comply with the generic Codes of Good Practice. The Codes, and in due course the *Charter*, may result in compliance risk to a bank.

Although the representation of banks is the primary role of BASA, it also plays a role in civil procedure. When a dispute arises between a bank and its client, the client must first submit his/her complaint to the bank. A client who is not satisfied with the outcome after the bank has attempted to resolve the complaint may lodge a complaint with the Ombudsman for Banking Services; the Ombud for Financial Services Providers³³¹ or the National Consumer Tribunal.³³²

326 Van Heerden *Siviele Prosesreg* 2-3.

327 Moorcroft *Banking Law* 13-1.

328 Moorcroft *Banking Law* 13-1;
<http://www.banking.org.za>.

329 Moorcroft *Banking Law* 13-2.

330 *Broad-Based Black Economic Empowerment Act* 53 of 2003.

331 Part I of the *Financial Advisory and Intermediary Services Act* 37 of 2002.

332 Moorcroft *Banking Law* 13-4;
S1 of the *Consumer Protection Act* 68 of 2008.

When summonses are issued or a complaint is received by an ombud, prescription is interrupted until the case is settled, judgement has been handed down or the complaint has been withdrawn or determined.³³³

Incorrect application of, or not following civil procedure rules, will also introduce legal risk. For example incorrect serving of pleadings.³³⁴

During a civil procedure the parties will present evidence, and this aspect of procedural law is discussed in section 3.3.3.

4.3.2 *Criminal procedure law*

Bekker states that:

Crime is a reality of life, especially in South Africa; and each country needs rules, principles, mechanisms and state structures to prevent, detect, cope with and control criminal behaviour. Criminal procedure rules play a pivotal role in this regard.³³⁵

Criminal procedure law deals with how the state deals with perpetrators of the criminal law. The *Criminal Procedure Act*³³⁶ will apply to criminal proceedings where the bank or one of its officers may be a witness or an accused. Directors and officials who fail in their fiduciary duties, may lead to the bank being held criminally liable.³³⁷

The bank is not compelled to produce accounting records unless the court orders that such records be produced.³³⁸

Due to limited resources, regulators are unable to detect and prosecute all non-compliance. They therefore employ other means to perform the monitoring of

333 Moorcroft *Banking Law* 13-7.

334 *Sebola v Standard Bank*.

335 Joubert *Criminal Procedure* 5.

336 *Criminal Procedure Act* 51 of 1977.

337 S332 of the *Criminal Procedure Act*.

338 Moorcroft *Banking Law* 30-6.

adherence to regulatory requirements and report thereon.³³⁹ In South Africa this is done by means of compliance officers employed by banks, which is a requirement in terms of *Banks Act* regulation 49. Fenn³⁴⁰ calls this a negotiated enforcement strategy.

Criminal procedure will lead to both legal risk and compliance risk in a bank. The compliance risk is introduced by means of the *Criminal Procedure Act*,³⁴¹ whilst legal risk is introduced by the mere fact that there is litigation involved, based on court rules as well as common law.

4.3.3 Law of evidence

The law of evidence deals with the way in which facts are presented or proved in a court of law. Substantive law determines what has to be proven in order to be successful in a legal proceeding.³⁴² When banks are involved in legal disputes, they will need to comply with the *Criminal Procedure Act*,³⁴³ the *Civil Proceedings Evidence Act*³⁴⁴ and the *Electronic Communications and Transactions Act*.³⁴⁵ These Acts may introduce compliance risk to a bank.

In the event that a bank is a plaintiff or a defendant in a court case, the bank will be allowed to lead relevant, admissible evidence. This may be in the form of the testimony of witnesses, real evidence,³⁴⁶ and documentary evidence.³⁴⁷

South Africa subscribes to the International Chamber of Commerce's Uniform Rules for Collections and the Uniform Customs and Practice for Documentary

339 Fenn *Business Response to Regulation* 248.

340 Fenn *Business Response to Regulation* 248.

341 *Criminal Procedure Act* 51 of 1977.

342 Schmidt *Bewysreg* 1;
Hosten *South African Law* 1229.

343 *Criminal Procedure Act* 51 of 1977.

344 *Civil Proceedings Evidence Act* 25 of 1965.

345 *Electronic Communications and Transactions Act* 25 of 2002.

346 This is normally physical evidence, for instance a firearm used to commit a crime.

347 Moorcroft *Banking Law* 30-1.

Credits. South African banks are required to act in good faith and exercise reasonable care in collections.³⁴⁸

Alternative dispute resolution is becoming increasingly important in doing business, especially in a world that is flat and borderless as far as capital flows are concerned. Electronic communication has expedited the process of concluding contracts and mediation is being used as both a dispute resolution mechanism and as a management tool.³⁴⁹ The King Report cites as an example that a mediation expert will be called in upon finalisation of a contract to “build a bridge”, because the mediation expert will be able to add clauses that will avoid disputes or amend clauses that normally lead to disputes. If a dispute does arise, the mediation expert is called in, and will be more likely to arrive at innovative solutions quickly, efficiently, effectively and with a cost saving.³⁵⁰

Alternative dispute resolution is seen as an important element of good governance, because directors and senior management should preserve business relationships. Unnecessary litigation will destroy relationships, which is neither desirable nor sustainable.³⁵¹

Evidence is generally part of legal proceedings and will therefore pose a legal risk to a bank.

4.3.4 Interpretation of the law

The meaning of the law has to be discovered for it to be applied. The juridical understanding of legislation and other legal texts follow certain rules and principles to construct the meaning of the legislative provisions to be applied in practice.³⁵² In order to discover the law, there are various rules to interpreting it.

348 Moorcroft *Banking Law* 32-1 – 32-3.

349 *Electronic Communications and Transactions Act* 25 of 2002.

350 King Report III 13.

351 King Report III 13.

352 Botha *Statutory Interpretation* 1;

The *Constitution* is the first part of the law that needs to be taken into account when interpreting the law.³⁵³ Various common law rules and the *Interpretation Act*³⁵⁴ apply to the interpretation of law in South Africa. The common law rules to the interpretation of law stipulate that the intention of the legislature needs to be ascertained, whereby both the language of the enactment and the context are taken into account. In determining the intention of the legislature, the literal construction approach may be used, whereby the ordinary meaning of the words are used, except if that would lead to absurdity. The context or subject matter of the law needs to be taken into account when interpreting the law. The background or history to a statute may also be important and used in interpreting the law. In other words, the primary rule to the interpretation of statute is to determine the intention of the statute. The subrules are to use the ordinary grammatical meaning of the words in the statute and the *eiusdem generis*-rule is that when general words follow specific or narrow words, then the general words must be narrowed down to those specific words.³⁵⁵

The *Interpretation Act*³⁵⁶ deals with consolidating the laws relating to the interpretation and the shortening of the language of statutes.

Regulation is analysed through normative (namely the desirability, cost and benefits of the proposed reform) or positive (the effects of the regulations on the regulated) analysis. Put differently – what are the intended and unintended consequences of regulation?³⁵⁷

Steyn *Uitleg van Wette* 1;

Nerhot *Law, writing, meaning* 1.

353 Klug *Constitution of South Africa* 78-79.

354 *Interpretation Act* 33 of 1957

355 Hosten *South African Law* 449-469.

356 *Interpretation Act* 33 of 1957.

357 Fenn *Business Response to Regulation* 244.

Interpretation of the law may also include the interpretation of other non-statutory aspects of the law, such as contracts.³⁵⁸ The interpretation of the law may introduce both legal and compliance risk to a bank. Compliance risk is introduced when the statute is interpreted incorrectly by the compliance officer or legal advisor, which leads to non-compliance. Legal risk is introduced when a matter is considered certain or correctly interpreted, but nevertheless ends up in a dispute.

4.4 International law

International law is the body of rules and principles (normally conventions and protocols agreed to amongst states) that governments observe in their relations with each other, and which are binding upon the governments and their relation with one another.³⁵⁹ It includes the law applicable to international organisations or institutions and the law relating to non-state entities in so far as the rights or duties of such individuals and non-state entities are the concern of the international community.³⁶⁰ Anti-money laundering and the combating of terrorist activities have links to international law, because perpetrators who finance these activities or oppressive regimes, may be prosecuted for crimes against humanity.³⁶¹ Non compliance with international conventions also has implications for state parties and perpetrators in international law.

Banks registered in terms of chapter III and section 52 of the *Banks Act*³⁶² need to obtain the approval of the Registrar of Banks prior to establishing businesses outside of South Africa. Foreign banks wishing to establish their business in South Africa may do so by way of representative offices or branches, with the prior approval of the Registrar of Banks. This may result in a domestic compliance risk if these sections of the *Banks Act* are not adhered to. It may also

358 Hosten *South African Law* 728-729.

359 Dugard *International law* 1.

360 Shearer *International law* 3;
Dugard *International law* 1;
Hosten *South African Law* 1272.

361 Article 7, Rome Statute of the International Criminal Court.

362 *Banks Act* 94 of 1990.

have an adverse effect on the relationship between South Africa and foreign jurisdictions if South African banks operate in such jurisdictions without the necessary regulatory approvals, and *vice versa*.

There are also international agreements, standards and guidance, such as the pronouncements of the Basel Committee and the FATF 40 plus 9 recommendations which would also apply to banks and their supervisors.³⁶³ Technically this will not introduce a legal risk to South Africa, because South Africa does not have a legal obligation to adhere to these international standards. However, moral suasion would. This may introduce legal risk to a bank in the event of a dispute, but is more likely to lead to compliance risk because the guidance has been incorporated into South African statutes.

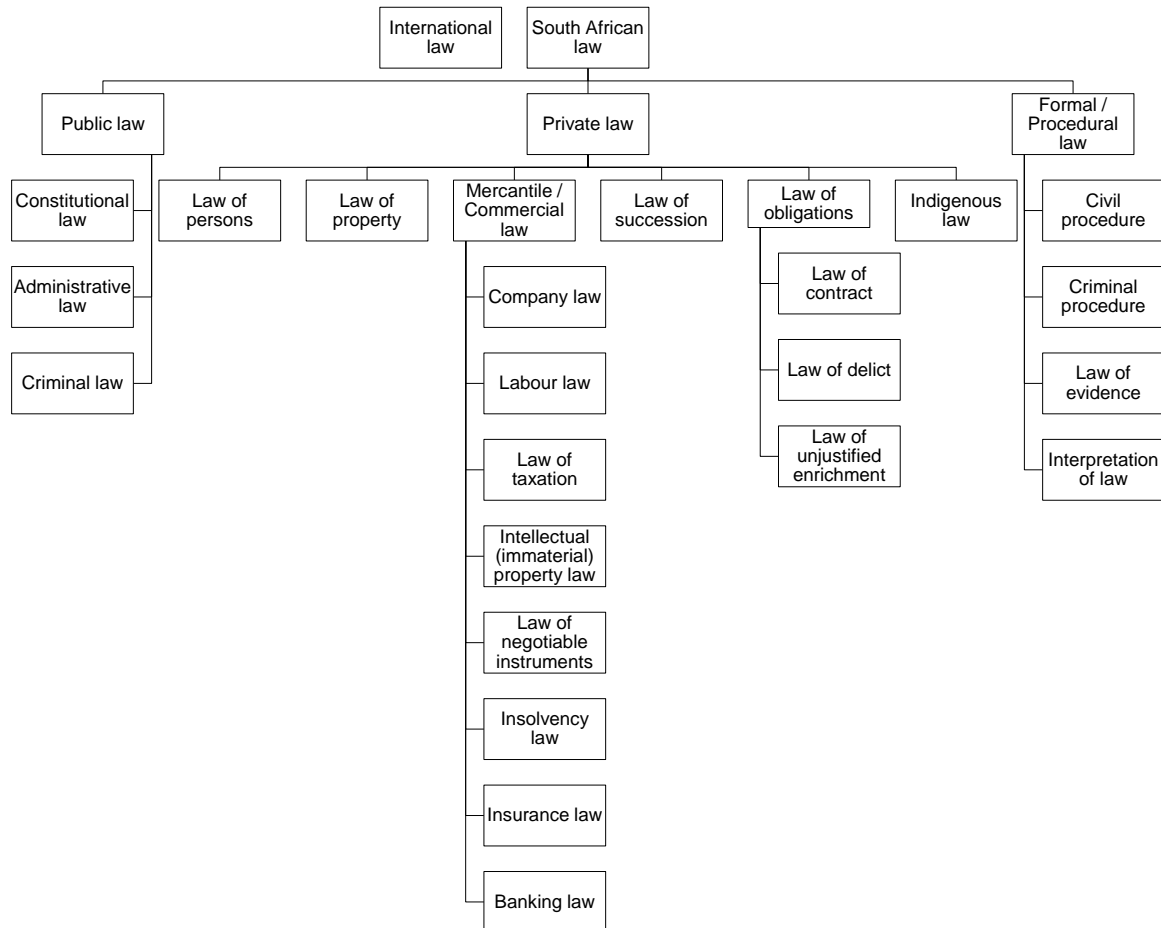
5 Conclusion

This chapter provided the context of the *Banks Act*³⁶⁴ within which legal risk and compliance risk are managed in the banking industry of South Africa. This included providing a structure within which the risks posed by South African law may be managed by a bank. This structure may be depicted as follows:

363 Financial Action Task Force *40 Recommendations*;
Financial Action Task Force *40 + 9 Recommendations*.

364 *Banks Act* 94 of 1990.

Figure 6 - Structure of South African law



This structure was used in identifying possible legal risks and compliance risks applicable to a bank operating in South Africa. The findings of this chapter may be summarised as set out in Table 1 - Summary of chapter 4 findings.

Table 1 - Summary of chapter 4 findings

| Category of law | Possible legal risks (excluding compliance risk) | Possible compliance risks ³⁶⁵ |
|--|---|---|
| Public law | - | - |
| <ul style="list-style-type: none"> • Constitutional law | Infringing on fundamental human rights entrenched in the Bill of Rights of the <i>Constitution</i> | <i>Broad-Based Black Economic Empowerment Act</i> <i>Employment Equity Act</i> |
| <ul style="list-style-type: none"> • Administrative law | Review of decisions of the Registrar of Banks | Various acts of Parliament applicable to a bank may impose administrative penalties (e.g. for late submission of returns to the Bank Supervision Department) |
| <ul style="list-style-type: none"> • Criminal law | Theft Fraud | <i>Banks Act</i> <i>Financial Intelligence Centre Act</i> <i>Prevention of Organised Crime Act</i> <i>Protection of Constitutional Democracy Against Terrorism and Related Activities Act</i> <i>Companies Act</i> <i>Occupational Health and Safety Act</i> Various other acts of Parliament applicable to a bank, where a criminal penalty is imposed |
| Private law | - | - |
| <ul style="list-style-type: none"> • Law of persons | Matrimonial regime of the client (third party) | <i>Matrimonial Property Act</i> <i>National Credit Act</i> <i>Pension Funds Act</i> |
| <ul style="list-style-type: none"> • Law of property | Security | <i>Alienation of Land Act</i> <i>Sectional Titles Act</i> <i>Share Blocks Control Act</i> <i>Property Time-sharing Control Act</i> <i>National Credit Act</i> <i>Housing Consumers Protection Measures Act</i> <i>Second-hand Goods Act</i> |
| <ul style="list-style-type: none"> • Mercantile/commercial law <ul style="list-style-type: none"> ○ Company law | Corporate governance Common law fiduciary responsibilities King III (quasi-legal) Conflicts of interest Litigation/disputes | <i>Companies Act</i> <i>Competition Act</i> <i>Consumer Affairs (Unfair Business Practices) Act</i> <i>Banks Act</i> <i>Securities Services Act (Insider trading)</i> <i>(Protection of Personal Information Bill)</i> <i>(Protection of State Information</i> |

365 Items listed in (brackets) represent policies or draft legislation.

| Category of law | Possible legal risks (excluding compliance risk) | Possible compliance risks ³⁶⁵ |
|--|--|--|
| | | <i>Bill)</i> |
| ○ Labour law | Law of contract | <i>Basic Conditions of Employment Act Employment Equity Act Labour Relations Act Unemployment Insurance Contributions Act Skills Development Act Skills Development Levies Act Compensation for Occupational Injuries and Diseases Act Code of Good Practice: Who is an employee</i> |
| ○ Law of taxation | Disputes regarding interpretation of the taxation legislation | <i>Income Tax Act Value Added Tax Act Foreign Account Tax Compliance Act (US)</i> |
| ○ Intellectual (immaterial) property law | Litigation to protect intellectual property | <i>Patents Act Copyright Act Trade Marks Act Merchandise Marks Act Designs Act Counterfeit Goods Act</i> |
| ○ Law of negotiable instruments | - | <i>Bills of Exchange Act</i> |
| ○ Insolvency law | - | <i>Insolvency Act Banks Act National Credit Act (Unified Insolvency Bill) (Financial Regulatory Reform)</i> |
| ○ Insurance law | Law of contract | <i>Long-term Insurance Act Short-term Insurance Act Policyholder Protection Rules National Credit Act</i> |
| ○ Banking law | Review of decisions of the Registrar of Banks | <i>South African Reserve Bank Act Banks Act Mutual Banks Act Co-operative Banks Act South African Postbank Limited Act National Payment System Act</i> |
| • Law of succession | Litigation against a bank acting as executor of an estate | <i>Wills Act Estate Duty Act Pension Funds Act Long-term Insurance Act</i> |
| • Law of obligations | Litigation against or by a bank in terms of aspects of the law of obligations not codified | <i>Consumer Protection Act Consumer Affairs (Unfair Business Practices) Act (Treating Customers Fairly) National Credit Act</i> |
| ○ Law of contract | Essential criteria for a valid contract Remedies available require legal | <i>Financial Advisory and Intermediary Services Act Alienation of Land Act</i> |

| Category of law | Possible legal risks (excluding compliance risk) | Possible compliance risks ³⁶⁵ |
|---|--|---|
| | action to enforce the remedy Contractual penalties Risks attached to a specific kind of contract (e.g. credit agreement, insurance, joint venture, agency, electronic banking) | <i>Sectional Titles Act</i> <i>Share Blocks Control Act</i> <i>Property Time-sharing Control Act</i> <i>National Credit Act</i> <i>Insolvency Act</i> <i>Merchandise Marks Act</i> <i>Financial Services Schemes Act</i> <i>Payment Card Industry Data Security Standard</i> <i>Electronic Communications and Transactions Act</i> <i>Code of Banking Practice (Protection of Personal Information Bill)</i> |
| <ul style="list-style-type: none"> ○ Law of delict | Liability based on negligence or intentional act | None identified |
| <ul style="list-style-type: none"> ○ Law of unjustified enrichment | Erroneous payment to incorrect party | None identified |
| <ul style="list-style-type: none"> • Indigenous/customary law | African Traditional Law (Stokvels) Hindu law Islam | <i>National Credit Act</i> |
| Formal/procedural law | - | - |
| <ul style="list-style-type: none"> • Civil procedure | None identified | <i>Civil Proceedings Evidence Act</i> Ombudsman for Banking Services Ombudsman for Financial Services Providers National Consumer Tribunal Magistrates Court Rules High Court Rules |
| <ul style="list-style-type: none"> • Criminal procedure | None identified | <i>Criminal Procedure Act</i> |
| <ul style="list-style-type: none"> • Law of evidence | None identified | <i>Electronic Communications and Transactions Act</i> <i>Criminal Procedure Act</i> <i>Civil Proceedings Evidence Act</i> |
| <ul style="list-style-type: none"> • Interpretation of law | None identified | <i>Interpretation Act</i> |
| International law | Contracts | International treaties and standards |

It is evident from the discussion in this chapter that nearly all aspects of South African law are applicable to banks and that all these aspects may pose either legal risk or compliance risk or both to a bank. The law itself is not interrogated in this chapter, but serves as the basis for developing a legal risk management framework. A proposal on how to manage practically the legal risks in a bank, based on the discussion above, will be dealt with in chapter 5.

It is therefore imperative to understand that if risk management is only limited to compliance risk, a substantial part of the legal risk that a bank is exposed to is not considered. This may expose the bank to various other types of risk, such as credit risk, reputational risk and financial risk.

CHAPTER 5

A proposed legal risk management framework

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1 Introduction

As was demonstrated in chapters 3 and 4, regulations 33, 34 and 49 of the *Banks Act*¹ prescribe that a bank in South Africa shall have risk management and compliance functions in order to manage its legal risk and compliance risk. It has also been highlighted that these regulations are not wide enough to include all aspects of the law applicable to South African banks. Therefore, this chapter is dedicated to providing a practical proposal on how to manage legal risks in a bank in the South African context. Compliance risk is not dealt with specifically in this chapter, as this research has already been conducted by Mynhardt² and the Compliance Institute of South Africa.³

For reasons stipulated in chapters 3 and 4, it is proposed that legal risk be managed in a manner similar to compliance risk. It is further suggested that it is imperative that such a legal risk management framework and methodology should include establishing a legal risk management function; assigning specific responsibilities to the various stakeholders in the bank, which may include

1 Reg. 33, 34 and 49 of the *Banks Act* 94 of 1990.

2 Mynhardt *Compliance Risk*.

3 CISA *Generally Accepted Compliance Framework*.

appointing legal risk managers; identifying the legal risk universe applicable to South African banks; and implementing controls to mitigate identified legal risk, which may include the monitoring of, and the provision of training and reporting on, legal risk. This process must be continuous.⁴ The proposed legal risk management framework and methodology will be discussed in this chapter. The first aspect that will be discussed is the current South African practice regarding legal risk management.

2 Current South African application of legal risk management

The *Banks Act*⁵ requires a bank to manage its legal risk, yet it does not provide any further clarity on the matter.⁶ This has led to the definitions, terminology and language regarding legal risk and compliance risk being inconsistent in the South African banking industry.⁷ This is probably due to the South African legislator adopting the Basel text, which was developed in a codified legal system, almost *verbatim* into the South Africa legal framework without taking the fact that South Africa has a mixed legal system into account. The annual reports of the five largest South African banks (as determined by the Bank Supervision Department of the South African Reserve Bank's *Annual Report*⁸ 2011, based on asset value) illustrate this statement. The most relevant details in this regard of each of these five banks are summarised below.

ABSA's⁹ annual report implies that compliance is adherence to laws, rules, codes, principles and standards. ABSA mentions the term "legal risk" in the

4 McCormick *Legal Risk* 232;
Mynhardt *Compliance Risk* 164;
CISA *Generally Accepted Compliance Framework* part 3 standard 1;
Banks Act 94 of 1990.

5 *Banks Act* 94 of 1990.

6 Refer to chapter 3.

7 Refer to chapters 3 and 4.

8 BSD 2011 *Annual Report* Appendix 2.

9 ABSA *Annual Report 2010* 47;
ABSA *Annual Report 2011* 61.

context of operational risk, but does not elaborate thereon.¹⁰ This does not provide any indication whether ABSA is in fact managing its legal risk, and if so, how it is being done.

FirstRand states that compliance relates to legislation and the bank's code of ethics.¹¹ FirstRand defines regulatory risk¹² as:

...the risk of statutory or regulatory sanction and material financial loss or reputational damage as a result of a failure to comply with any applicable laws, regulations or supervisory requirements.

The FirstRand definition of regulatory risk is synonymous with compliance risk as discussed in chapter 3. As was also discussed in previous chapters, this does not include any other part of the legal system; it only includes codified law.

Investec uses the term "compliance" in the context of internal policies, international standards and legislation.¹³ Investec therefore does not regard uncodified aspects of the legal system as something that needs to be complied with.

Nedbank¹⁴ uses the terms "legal risk", "compliance risk" and "regulatory risk" in its *Annual Report*. Nedbank describes legal risk as the risk that:

...arises from the necessity that the group conducts its activities in conformity with the business and contractual legal principles applicable in each of the jurisdictions where the group conducts its business. The possibility of a failure to meet these legal requirements may result in unenforceable contract disputes,

10 ABSA *Annual Report 2011* 131.

11 FirstRand *Annual Report 2010* 81;
FirstRand *Annual Report 2011* 87, 200.

12 FirstRand *Annual Report 2011* 121.

13 Investec *Annual Report* 87, 111, 118, 172.

14 Nedbank *Integrated Report* 177.

litigation, fines, penalties or claims for damages or other adverse consequences. Legal risk includes, but is not limited to, exposure to fines, penalties or punitive damages resulting from supervisory actions, as well as private settlements.

From the above quote it appears as if Nedbank regards legal risk to be all risks posed by the legal system in the jurisdiction where it chooses to do business. Nedbank¹⁵ further describes compliance and regulatory risk as:

...the risk of legal or regulatory sanctions, material financial loss, or loss to reputation that the group may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking and other activities

It is clear that these definitions are extracts of the Regulations relating to Banks.¹⁶ I find it encouraging that Nedbank did not merely stick to the letter of the law, but went further to define legal risk as a wider concept than compliance and regulatory risk.

Standard Bank uses the term “compliance” in the context of adherence to regulations and legislation.¹⁷ Similar to most other banks, this does not address the risks posed by the rest of the legal system.

From the above it is clear that there is a lack of consistency in the South African banking industry with regard to the terminology that describes the risks that may arise from non-adherence to the law. Some banks use the definitions contained in the Regulations relating to Banks,¹⁸ whilst others developed their own definitions, probably because the definitions contained in the regulations are inadequate in a mixed legal system. A consistent definition or description of the

15 Nedbank *Integrated Report* 177.

16 Reg 67 *Banks Act* 94 of 1990.

17 Standard Bank *Annual Report* 15.

18 Reg 67 *Banks Act* 94 of 1990.

various terms, including legal risk, is advisable.¹⁹ It is recommended that the definitions of legal risk and compliance risk in the Regulations relating to Banks be replaced with the proposed definitions of legal risk and compliance risk proposed in chapter 3, namely that legal risk (in a common law system) is the risk of financial loss or reputational damage due to non-adherence to legal requirements, which may stem from private, public, procedural or international law, and include codified and uncodified law as well as industry or organisational standards, rules and policies. And compliance risk is the risk of financial, reputational or other loss as a result of non-adherence to the codified law in a common law legal system. The remainder of this chapter is dedicated to developing a framework and methodology to implement this description of legal risk in banks in South Africa.²⁰

3 Proposed legal risk management framework for banks in South Africa

It is clear from the 2008 global financial crisis that legal risk management in international banks prior to the crisis was inadequate.²¹ Some of the key legal risks faced by entities in the aftermath of the 2008 global financial crisis relate to bankruptcy risks, mis-selling of complex derivatives, enforceability of contracts and agreements, cross-border transactions in general, backing over the counter (OTC) transactions across jurisdictions, repurchase transactions, tripartite agreements and securities lending.²² All these examples have one thing in common: they constitute various types of legal risk. None of these aspects were covered in traditional compliance risk management programmes and therefore the risks were not managed.²³

South Africa was relatively safe from the downturn in the world economy during the financial crisis. My opinion is that South Africa remained largely unscathed

19 Chapter 3, sections 2.3.1 and 4.

20 These proposals may be adapted to manage the legal risk faced by the Reserve Bank.

21 Gopinath *Legal risks in the financial sector 2*.

22 Gopinath *Legal risks in the financial sector 2*.

23 Gopinath *Legal risks in the financial sector 2*.

due to a combination of adequate exchange control and strict regulations imposed on banks. The Regulations relating to Banks state that reputational risk²⁴ and collateral²⁵ may be sources of legal risk. The *Banks Act* places an obligation on banks to manage their legal risks pertaining to collateral.²⁶ Yet the South African banking regulator loosely uses the terminology in the *Banks Act* and the regulations.²⁷ Put differently, the regulations prescribe that banks should manage their legal risk, but then only define compliance risk. This, in my opinion, corresponds with Botha,²⁸ who points out that there seems to be a "sad" decline in the quality of legislation:

One of the reasons for the dismal state of statutory interpretation in South Africa is the lack of a sound theoretical basis for the discipline, resulting in a hotchpotch of conflicting rules and principles.²⁹

This is not easy to address because the statutory framework for banking, will have to be amended, because legal risk is not defined and the current *Banks Act* definition of compliance risk is inadequate to also cover legal risk. However, the process of amending the *Banks Act*, regulations, directives, circulars and guidance notes will be cumbersome and time-consuming. As a result it is up to the individual institutions to do what is in their own best interest, which in turn will be in the interest of the country and the maintenance of financial stability. This will include managing not only those risks prescribed by the Regulations relating to Banks, but also those that pose a real business risk. Banks should protect themselves by defining what legal risk means to their business and then follow a risk management process, similar to a compliance risk management process. It is not to say that the legislation will never be amended, but legislation generally lags industry best practice. In my opinion a difficulty that will remain is that

24 Reg 67 *Banks Act* 94 of 1990.

25 Reg 23(7)(b)(iii)(B)(vi) *Banks Act* 94 of 1990.

26 Reg 23(7)(b)(iii)(B)(vi)(dd)(ii) *Banks Act* 94 of 1990.

27 Reg 67 *Banks Act* 94 of 1990.

28 Botha *Statutory Interpretation* 47.

29 Botha *Statutory Interpretation* 47.

probably only legal experts will understand the difference between legal risk and compliance risk; however, lawyers are not generally drawn to risk management positions in banks where they will be able to rectify the situation. I am therefore of the opinion that the average legal advisor is not interested in managing legal risk, compliance risk or any other risk type. They prefer "traditional" legal work, such as drafting contracts and managing litigation.

Risk management has historically focused on other areas of risk. For example, banks assess credit risk by checking the counterparty's ability to repay and monitor their own exposure to bad debts. Legal risk may be an insignificant, obscure risk at the outset, which may end up growing and overshadowing the initial risks identified.³⁰ Whittaker³¹ describes it as:

..outlying risks, risks on the horizon "no bigger than a man's hand".

Valsamakis³² proposes that a common framework for risk will enable managers to identify and prioritise all the risks to the organisation, develop a common understanding of risk and should capture all sources and classifications of risk.

In order to determine how to develop and establish a legal risk management framework for banks in South Africa, it is necessary to consider international standards and literature on the topic.

The Basel Committee states that legal and compliance functions may be housed in separate departments. The legal department may be responsible for advising management on compliance with laws, rules and standards, and for preparing guidance to staff, while the compliance department may be responsible for monitoring compliance with policies and procedures, and reporting to

30 Whittaker *Lawyers as Risk Managers* 5-7.

31 Whittaker *Lawyers as Risk Managers* 5-7.

32 Valsamakis *Risk management* 93-95.

management.³³ This implies that the Basel Committee does indeed acknowledge that there is a distinction between legal risk and compliance risk, although this distinction is not apparent in the other Basel Committee documents on the topic. My view is that it does not matter in which department in a bank the two functions reside, what is important is to manage the risk.

According to Trzaskowski,³⁴ legal risk is managed in three layers, which I presume follows after the risk itself has been identified. The first layer is organisation theory and deals with the practical implementation of legal risk management strategies (e.g. compliance programmes). This is probably the day-to-day management of legal risk by the legal advisors in the business. The second layer is economic theory and deals with the economic rationale behind decision making. In practice this would probably be the decision by a bank to either develop or expand a specific product line, or alternatively to discontinue a product line based on the economic viability of the product given the legal risk inherent in the product. The third layer is legal theory and deals with the assessment of legal risk and finding alternative legal strategies. This would entail legal advice as to how to structure products in order to minimise the legal risk, yet still be economically viable. I do not see the three layers of legal risk management as mutually exclusive or as a hierarchy. I regard this as three aspects of legal risk management which need to be applied to a given set of circumstances after the legal risk has been identified.

Trzaskowski³⁵ argues that business should apply a cost-benefit analysis to managing legal risk. This may manifest itself in two ways: the first would entail breaking the law if it is more profitable than complying with the law, while the second is the choice between using an in-house (general) legal advisor or an external specialist. The external specialist will be more expensive, but the legal

33 Basel Committee *Compliance function* 13.

34 Trzaskowski *Legal Risk* 5-6.

35 Trzaskowski *Legal Risk* 4.

advice probably more accurate. I cannot agree with the first statement, because the reputational risk attached to being wilfully non-compliant with the law is too great. It is also unethical. A bank needs the law to survive, and it cannot expect clients to adhere to the law, for example contracts, and not do so themselves. The second situation is more palatable, and is probably what happens in practice. If a bank perceives the legal risk to be a threat to its core business, it will be more inclined to seek specialist advice. This analysis should ideally be done shortly after the legal risk has been identified.

Trzaskowski³⁶ further states that the courts change the law progressively, incrementally and develop existing principles. They do not make sudden changes in direction. This simultaneously eases and burdens the legal risk manager's duties. Because the law is unlikely to be changed suddenly (other than through legislation), the legal risk manager should be able to implement processes to manage specific legal risks. The added burden on a legal risk manager is that he/she should continually keep abreast of the latest rulings (even unreported cases) as far as the cases pertain to the business of a bank. My opinion is that given the current volume of rulings handed down by the courts, it is necessary for legal advisors in banks to subscribe to automated tools to assist them to keep abreast of such rulings. This would form part of the process to manage a bank's legal risks.

Gopinath³⁷ is of the opinion that a legal audit function should be established, which would review agreements with custodians, counterparties, service providers and agents. It should also review legal title to foreign assets and liabilities under both the common law and civil law. Such a legal audit function will probably address one aspect of managing legal risk, being monitoring, but it is not enough. This legal audit function will need to be expanded to first identify

36 Trzaskowski *Legal Risk* 5-6.

37 Gopinath *Legal risks in the financial sector* 6.

the legal risk applicable to a bank, implement controls to mitigate it and only thereafter monitor and report on the relevant legal risk.

In the UK, the Financial Markets Law Committee was established as part of the Bank of England, which aims to address legal uncertainties and establish common views regarding various aspects of the law in the commercial world. The Financial Services Authority in the UK attempts to provide as much clarity as possible in the regulatory system through the issuance of guidance. The Financial Services Authority states that legal risk needs to be managed, not only on a transaction-by-transaction basis, but generally also. Legal risk should be part of the overall strategy as well as the risk management process of an organisation.³⁸ Various steps may be taken to mitigate legal risk, which include the training of staff and clients, improved product design, improved disclosure, assessing product efficiency, identifying classes of customers for whom the products are unsuitable, or establish complaint-handling procedures. I agree with the FSA and Bank of England as I too am of the view that legal risk should be managed by training and implementing various controls with regard to products.

Whittaker³⁹ is of the opinion that lawyers have a key role in managing legal risk because they have a direct understanding of the organisation as a whole. Lawyers are independent and they can provide proactive legal support through advice and training on the law in general or on specific legal aspects of the business. They can act as gatekeepers to ensure that legal approval is given at predetermined stages in a project. They are part of multidisciplinary teams trying to identify risk. Lawyers may also provide advice to internal audit or report to a risk committee on identified legal risks.

The established risk management and compliance risk management processes already embedded in a bank could be useful to establish a legal risk

38 Whittaker *Lawyers as Risk Managers* 5-7.

39 Whittaker *Lawyers as Risk Managers* 5-7.

management process. It is proposed that the basic elements of specifically a compliance risk management framework, which is based on both internal audit and risk management processes, be utilised for developing a legal risk management framework. A compliance framework or policy usually contains a compliance risk management process which includes the identification, measurement, management or mitigation of the risk (which includes training), as well as the monitoring and reporting thereof.⁴⁰ Each of these elements is elaborated on in the sections that follow.

4 Establishment of and responsibility for a legal risk management function

In compliance risk management, the first matter that is normally addressed is the strategy of the compliance function. Such a strategy is normally embodied in a framework.⁴¹ If a compliance risk management framework is taken as the basis from which to establish a legal risk management framework, the first step would be to assign responsibility for the establishment of such a compliance risk framework.

A compliance function is normally assigned to a chief risk officer or a chief compliance officer of an organisation.⁴² Because of the nature of legal risk, as discussed above,⁴³ it is proposed that a legal risk management function be assigned to either the chief risk officer, chief compliance officer or legal advisor of an organisation. The group or at least a senior legal advisor is probably best placed to fulfil such a role. The nature of the role of legal advisor currently employed by a bank is already an unstructured form of legal risk management. With the advice, assistance and guidance of the chief risk officer and chief

40 Moorcroft *Banking Law* 10-4 – 10-6.

41 Sometimes referred to as a charter or policy.

42 Mynhardt *Compliance Risk* 167-172;
Merna and Al-Thani *Corporate risk management* 201, 265-266.

43 Chapter 3 and section 2 of this chapter.

compliance officer, the legal advisor can easily enhance existing processes in the existing legal function to also encompass legal risk management.

Once the responsible person has been identified, this person can establish a legal risk management framework. Again, the basic elements of a compliance risk management framework may be used. These elements are to establish a compliance risk management function; assign responsibility to stakeholders; identify the compliance risk universe; implement controls; do compliance monitoring; and do reporting.⁴⁴ These principles may be applied to legal risk management.

Within a compliance risk management function, compliance is regarded as the responsibility of every employee in a bank and the compliance function has the duty to monitor compliance.⁴⁵ Similarly, it is proposed that legal risk management should be the responsibility of every employee in a bank and that the legal risk manager is responsible for monitoring adherence to the law. This is in itself a daunting task, but a framework, and training and reporting mechanisms will go some way in raising awareness and assisting in operating a bank within the confines of the law.

I agree with Mynhardt⁴⁶ that making compliance part of budgets and strategic initiatives, and including it on the agenda of board meetings will raise it to a more strategic level. Specific risk responsibility should be assigned to the executive management of the organisation.⁴⁷ The responsibility for operational risk management and compliance risk management is considered to be the duty of

44 Mynhardt *Compliance* 164;
CISA *Generally Accepted Compliance Framework* part 3 standard 1.
Banks Act 94 of 1990.

45 Mynhardt *Compliance* 163;
Valsamakis *Risk management* 106-121.

46 Mynhardt *Compliance* 163.

47 Merna and Al-Thani *Corporate risk management* 62-65.

every employee, officer, manager, executive or director of a bank.⁴⁸ Due to the fact that legal risk is classified as operational risk, it should follow that the responsibility and accountability for legal risk management should also vest with every employee, officer, manager, executive or director of a bank. It may be advisable to have a person or function overseeing and coordinating the management of legal risk in a bank. Specific responsibilities may also be assigned to specific persons. A legal risk manager should keep abreast of changes to the law, especially precedent because this provides insight into the direction in which the law is developing. Such insight will allow the legal advisor to adjust internal legal risk management strategies in order to protect the bank against such legal risks. A legal risk manager should also take cognisance of legislative changes, but this would be the primary responsibility of the compliance officer. The reason for assigning this to a compliance officer is a practical consideration. Compliance risk management in a bank is well established and the processes to track and implement new or amended legislation are already in place.

It is suggested that management information systems on compliance matters be implemented to provide timeous, relevant information to the board and executive management. It could be extrapolated that the processes and strategies to ensure compliance proposed by Mynhardt could be utilised to ensure that legal risks are managed. Ronconi⁴⁹ has done work in Argentina that might be of use in measuring and quantifying legal risk. The work done by Mynhardt⁵⁰ on compliance in South Africa is also of value in managing legal risk. The principles of Ronconi and Mynhardt's work form the basic outline of the rest of this section.

A risk management function should be aligned to the goals, objectives and mission of the organisation as a whole. The objectives of a risk management

48 Reg 49 *Banks Act* 94 of 1990.

49 Ronconi *Labor regulations* 722.

50 Mynhardt *Compliance* 163.

function should be described in a risk management policy.⁵¹ It is advisable to establish a legal risk management function similar to the manner in which a general, enterprise, operational risk or compliance function is established.⁵² It is not advisable to include legal risk in the compliance risk management function. However, the reverse may be acceptable. The reason for including compliance risk in legal risk is that legal risk encompasses the entire legal system in a common law jurisdiction such as South Africa.⁵³ Compliance risk only entails the legislative aspects of the law in the jurisdiction. Depending on the sophistication of a bank, it might not be feasible to establish a separate legal risk management function. In such an instance it would be acceptable to establish a framework for managing legal risk, and assigning such responsibility to the legal advisor. The legal advisor would then act as a legal risk manager. Based on size and complexity concerns, a bank may also choose to appoint dedicated legal risk managers.

Once responsibility for legal risk management and the framework within which legal risk in a bank will be managed has been established, the legal risk manager needs to perform the next step, namely identifying the legal risk universe applicable to the bank.

Therefore it is proposed that a legal risk management framework should include:

- establishing a legal risk management function in the bank;
- assigning specific responsibilities to the various stakeholders in the bank, which may include appointing legal risk managers;
- identifying the legal risk universe applicable to South African banks;
- implementing controls to mitigate identified legal risks;

51 Valsamakis *Risk management* 14.

52 CISA *Generally Accepted Compliance Framework* part 3 standard 4;
Valsamakis *Risk management* 15;
McCormick *Legal risk* 232.

53 See chapter 3.

- monitoring legal risks; and
- reporting on legal risks.

If these principles are applied to a bank, the bank may choose to establish a legal risk management function as part of its existing legal advice function, or as part of an enterprise risk management function. The first option is probably appropriate for smaller organisations with resource constraints, while the latter option might be advisable for larger banking groups.

After the legal risk management function has been established, the responsibility for legal risk management needs to be assigned. Similar to compliance,⁵⁴ it is not advisable for the legal risk manager to assume responsibility for legal risk. Ultimately, the board and executive management still need to remain directly responsible for legal risk. The legal risk manager can facilitate a process to ensure that the legal risk is managed by the bank.

Once the function has been established, the legal risks applicable to the bank need to be identified. A basic outline of the law of South Africa, such as the proposal in chapter 4 (private law, public law and international law, with all its sub-categories), together with a legal register, may be used in order to ensure that categories of the law are not accidentally left out. Thereafter, controls may be implemented to mitigate the identified legal risks. There are various ways in which the legal risks may be mitigated. For example, a bank may spend a significant amount of time, effort and money in agreeing and signing a contract, but then neglect subsequently managing the terms of the contract. This risk may be mitigated by the implementation of an automated contract management system.

54 Mynhardt *Compliance* 164;
CISA *Generally Accepted Compliance Framework* part 3 standard 1;
Banks Act 94 of 1990.

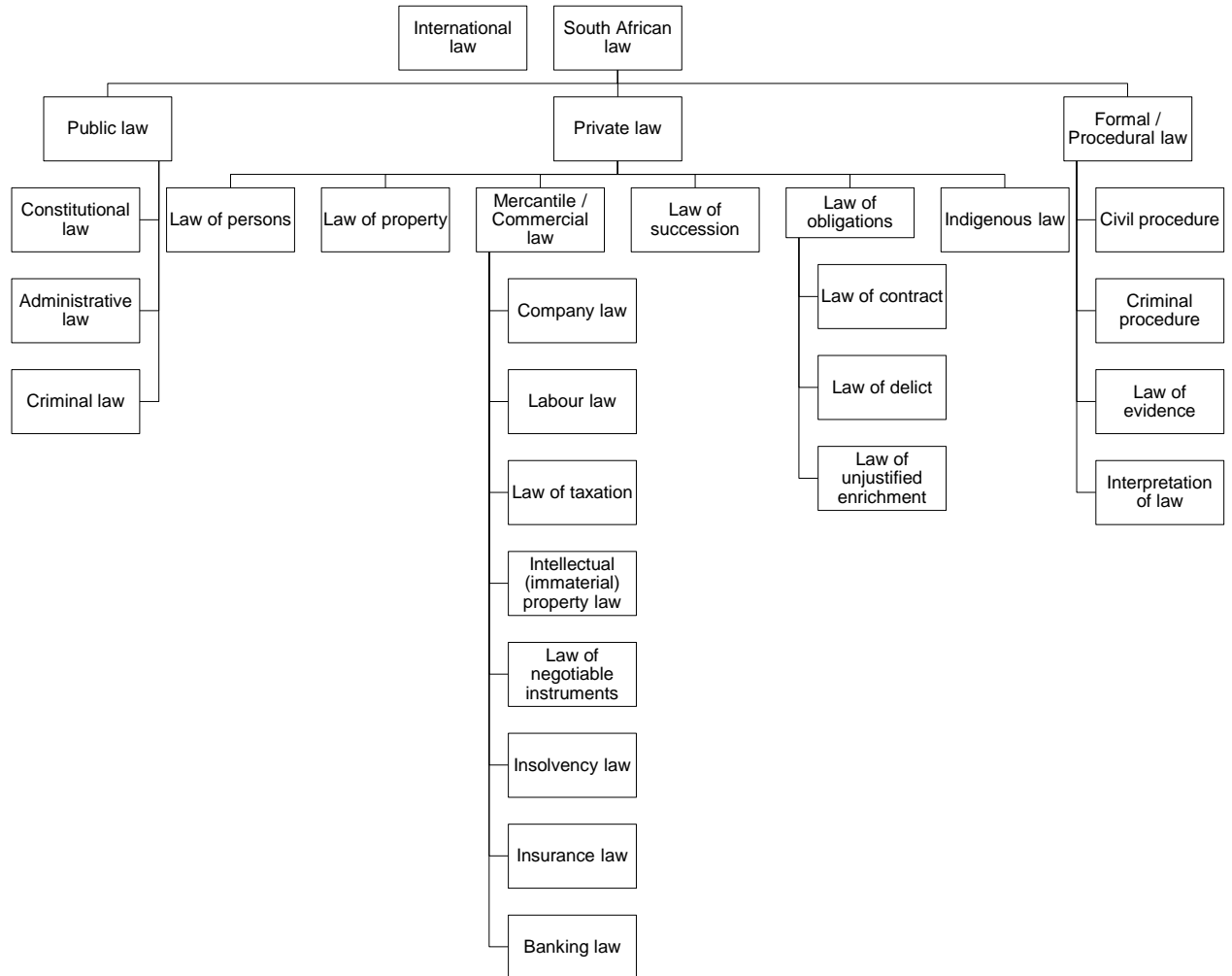
Similar to other risk disciplines, legal risk needs to be monitored. Put differently, legal risk needs to be audited. However, this need not be an elaborate process. By way of example, checking that all contracts have been loaded into a contract management system will be a form of monitoring.

5 Identification of the legal risk universe applicable to South African banks

Similar to any other risk management function, the source of the risk must be identified before it can be managed.⁵⁵ Once a legal risk management function has been established, it should then manage the risks. It is proposed that the structure used in chapter 4 be applied to identify legal risks for banks in South Africa. The legal risk universe applicable to banks in South Africa is set out in figure 1 below.

55 Valsamakis *Risk management* (2010) 15;
Valsamakis *Risk management* 14;
Merna an Al-Thani *Corporate risk management* 44-50;
Olson and Wu *Enterprise Risk Management* 50-51.

Figure 1 - Legal risk universe applicable to a bank in South Africa



One peculiarity that may be noted with regard to legal risk is that it is also a form of sovereign risk or country risk.⁵⁶ Sovereign risk is the risk that a foreign central bank will alter its foreign exchange policy. This may result in foreign exchange contracts losing value. Contracts are a type of legal risk. Therefore legal risk is

56 http://www.moodysanalytics.com/microsites/erm/2011/New-methods-for-modeling-sovereign-risk-and-contagion-in-credit-portfolios?gclid=CO_EIYyPxrACFYwQfAodbGMDVw

broader than sovereign risk.⁵⁷ The strength and impartiality of the legal system, as well as the level of adherence to the law in that country, contribute to the level of sovereign risk or country risk faced. This aspect may be covered by the management of international law in a legal risk management framework. It is also possible that foreign law is applicable to a bank and that the bank will need to ensure that it adheres to all aspects of the relevant legal system. Such a foreign jurisdiction's legal system may be a codified, common or mixed law legal system. If the foreign jurisdiction has a codified legal system, the risks will be managed in the bank's existing compliance risk management process. However, if that country has a common law or mixed legal system, the legal risks not covered by a traditional compliance risk management process will need to be managed.

Trzaskowski⁵⁸ mentions that the treatment of risks may involve transfer, avoidance (termination), reduction (mitigation or treatment) and acceptance (tolerance) of the risk. He states that on a sliding scale with avoidance and acceptance at the extreme ends, mitigation lies somewhere in the middle. Outside of contractual relations, avoidance through compliance is the path to pursue in order not to infringe the law. Transferring legal risk (for example through insurance which is available as an acceptable risk management technique for other operational risks) is normally not an option,⁵⁹ because it is unethical to be wilfully non-compliant with the law.⁶⁰ It is probably also unacceptable to accept legal risk, because it is an acceptance of infringing the law. There probably are exceptions to this, for example accepting unfavourable contract terms. Trzaskowski is of the opinion that reduction or mitigation of legal risk is also not an acceptable option, because it also leads to infringing the law. I do not agree with Trzaskowski, because a bank may for example train its employees in order to reduce the risk of them acting in non-compliance with the

57 www.cmavision.com/learning/sovereign-risk-reports/

58 Trzaskowski *Legal Risk* 3-4.

59 An exception would be where insurance cover is taken out for negligent acts leading to delictual liability.

60 Such a decision is likely to lead to reputational risk.

law or by getting legal advice on matters where the law is unclear. It is possible that legislation changes the common law.⁶¹ In today's business world, with current complexities and volumes of business and legislation, it is impossible to avoid all types of legal risk.

Trzaskowski⁶² further rightly questions whether it is possible to comply with all law. Theoretically this is of course possible provided that no law is in conflict with any other and if human beings are infallible, which is evidently not possible in practice. It will entail that a bank employs or contracts legal advisors to ensure that every step taken by the business is in accordance with legal requirements. This is impractical from both a time and cost perspective. Therefore corporate governance and compliance programmes may be valuable. Another question is what the avoidance instruments available to a business are. Trzaskowski calls it a "source of wisdom" available to the business. A court decision provides an interpretation of the law, which is correct, if it is not overruled by a higher ranking judgement. Unfortunately courts do not give advice. Businesses may use in-house or other legal advisors. It is also possible to obtain assistance from public authorities such as the regulators. However, none of these "sources of wisdom" will be able to foresee how the court will eventually rule on a particular case. Because of this, there is always uncertainty associated with legal advice, and therefore it does not seem possible to eliminate the risk through legal advice as legal advice is a form of mitigation. Trzaskowski states as an alternative that risk mitigation can be seen as an accepted means of legal risk management.

It is suggested that a risk identification matrix, such as proposed by COSO,⁶³ Merna and Al-Thani,⁶⁴ and Mynhardt⁶⁵ be used to identify and risk rate legal risks. I am of the opinion that a bank's internal risk management methodology

61 For example, the common law *in duplum* rule is amended by the *National Credit Act*.

62 Trzaskowski *Legal Risk* 3-4.

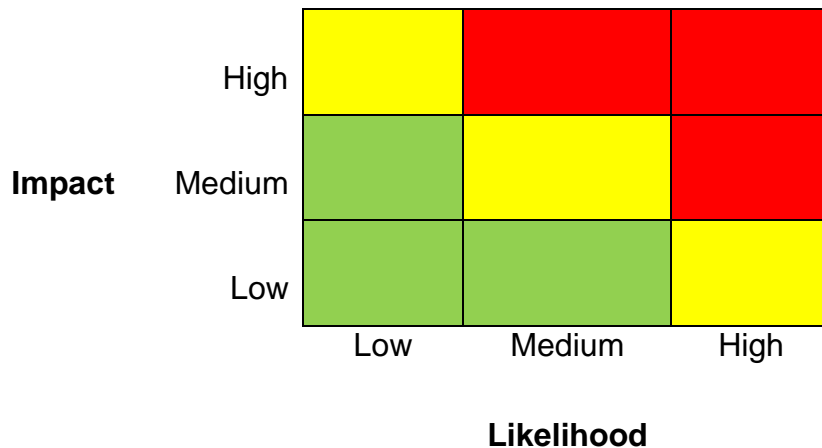
63 Mestchian et al *COSO* 21.

64 Merna and Al-Thani *Corporate risk management* 374.

65 Mynhardt *Compliance* 175

would be ideal, but in lieu thereof, it is suggested that the elements proposed by Mynhardt and COSO be used in order to establish a similar matrix for legal risk. An example of such a risk identification matrix is set out in figure 2 below.

Figure 2 - Risk identification matrix



The terms “impact” and “likelihood” on the different axes can be defined as follows, and banks may choose to link these to quantitative measures they deem appropriate:⁶⁶

Impact:

- High risk refers to events of legal risk which may result in disputes, litigation, or offences resulting in substantial damages, costs, fines and/or jail terms, or severe reputational damage.
- Medium risk refers to events of legal risk which may result in disputes, litigation, or offences resulting in moderate damages, costs, fines and/or jail terms, or reputational damage.

66 Mynhardt *Compliance Risk* 175-180.

- Low risk refers to events of legal risk which may result in disputes, litigation, or offences resulting in limited damages, costs, fines or minor reputational damage.

Likelihood or probability:

- High - It is almost certain that the legal risk event will occur.
- Medium - There is some chance that the legal risk event will occur, but a greater or equal chance that it will not occur.
- Low - There is a very limited chance that the legal risk event will occur.

The colour coding used in the abovementioned matrix is as follows:

- Red - These events are serious in nature and require immediate attention from a bank's board and management. It also indicates that there should be immediate communication and engagement with the relevant authority in order to resolve the matter. Contact with the media may be necessary.
- Yellow - These events are less serious in nature and require attention from the bank's board and management, but only on a routine basis. It also indicates that there should be communication and engagement with the relevant authority in order to resolve the matter.
- Green - These events are not serious and require no additional attention from the bank's board and management. It also indicates that there is no need for additional communication and engagement with the relevant authority other than that required by the authority on a routine basis.

If a specific risk is not applicable to a bank or business unit in the bank, then another colour such as white or blue could be used.

It is advisable to create a legal register or implement a similar tool which is updated and alerts the legal risk manager on the latest developments and

judgements pertaining to the business of a bank. This register should ideally be structured according to the legal risk management framework implemented in the bank. This will assist in timeously identifying potential legal risks. An aspect that a bank may wish to consider in developing its legal risk management framework is to distinguish between internal legal risks (employment contracts or renting, occupying or owning buildings), external legal risks (the business of a bank, relationships with clients and other banks) and regulatory risk (the relationship with the regulators).

It is therefore recommended that a bank identify all its legal risks, and assign a risk rating to each legal risk in a manner suggested above or as per the bank's previously established operational risk or compliance management framework.

6 Implementing controls to mitigate identified legal risks

Once the legal risks have been identified, these risks need to be evaluated and assessed. In evaluating each legal risk, it should ideally be quantified as far as possible and the potential impact on the bank should be determined. Put differently, the risk needs to be quantified and analysed.⁶⁷ This should include an evaluation of the loss severity and likely frequency. The next step is to minimise the risk through the implementation of a risk management programme in order to reduce the magnitude of the exposure, reduce the frequency of loss-producing events, dealing with loss-producing events once they have occurred and recovering from such events.⁶⁸

There are various techniques available to analyse risk. These include qualitative and quantitative methods. Some examples of qualitative techniques are:⁶⁹

67 Merna and Al-Thani *Corporate risk management* 50-51.

68 Valsamakis *Risk management* 16.

69 Merna and Al-Thani *Corporate risk management* 69-76.

- brainstorming;⁷⁰
- assumption analysis;⁷¹
- Delphi;⁷²
- interviews;
- hazard and operability studies;⁷³
- failure modes and effects criticality analysis;⁷⁴
- checklists;
- prompt lists;⁷⁵
- risk registers;⁷⁶
- risk mapping;⁷⁷
- probability-impact tables;⁷⁸ and
- project risk management roadmapping.⁷⁹

Some examples of quantitative techniques are:⁸⁰

- decision trees;⁸¹
- controlled interval and memory techniques;⁸²

70 A creativity technique is where possible solutions, conclusions to a specific problem or a list of ideas are gathered from a group. It usually involves spontaneous contributions.

71 All assumptions are documented on a one-on-one basis, whereafter the risks that exist as a result of each assumption and possible inaccuracies are identified.

72 A group of experts are asked to make a forecast, initially independently and then thereafter by consensus.

73 An examination of a process to identify problems that may either put people in danger or prevent efficient operations.

74 A bottom-up, inductive analytical method which may be performed at either the functional or piece-part level.

75 Similar to a checklist, but usually more aimed at guidance than compliance.

76 A central repository for all risks identified within the risk category it pertains to.

77 A visual (diagrammatic) representation of a risk register, usually per risk category and not per individual risk.

78 A table, usually colour coded, that illustrates risk by impact and probability/likelihood on the respective x and y axes. Also called a risk matrix chart.

79 Essentially the desired end state is defined, whereafter the steps to reach that end state are deconstructed into small achievable goals.

80 Merna and Al-Thani *Corporate risk management* 76-84.

81 A tree-like graph, model or picture that depicts possible decisions and their outcomes or consequences.

82 These are used in modelling rare or tail events.

- Monte Carlo simulation;⁸³ and
- sensitivity analysis.⁸⁴

Any of these techniques might be useful in analysing legal risk. The choice of technique would differ based on the level of risk sophistication that the bank has already reached. However, the very nature of legal risk makes it difficult to quantify. The operational risk quantification methodology, which is based on historical loss data, might be of use in so far as legal risk has translated into actual losses. I recommend that the legal risk management methodology be aligned to the operational risk methodology, or in lieu thereof,⁸⁵ the enterprise risk methodology already used by the relevant bank.

There are four possible responses to control risk, also referred to as the “Four Ts” approach. These are to tolerate (accept or retain), treat (mitigate or reduce), transfer and terminate (avoid) the risk.⁸⁶ Some authors also regard training (not part of one of the Four Ts approach) as a form of risk control.⁸⁷

As was discussed in chapter 4, it may not be possible or advisable to have a zero tolerance for legal risk. It may be too expensive to eliminate all legal risks. It may also be impossible to ensure that there is total legal certainty, or doing so may result in costly delays to all transactions. Each bank will need to utilise the expertise of its legal risk manager to assess which approach is the most appropriate for the individual legal risks identified. It may be advisable to manage

83 These are a class of computational algorithms. It relies on repeated random sampling in order to compute the results.

84 This is a study of how robust the model is. By investigating the uncertainty in the output of a model, it can be apportioned to different sources of uncertainty in the model input.

85 Banks following the basic indicator approach [you’ll have to briefly indicate what this entails as I believe this is the first mention] to quantify their operational risk capital charge will not have a sophisticated operational risk management framework, but all banks are required to manage their risks and will therefore at least have an enterprise risk management process.

86 Valsamakis *Risk management* (2010) 17;
Merna and Al-Thani *Corporate risk management* 51-55;
Olson and Wu *Enterprise Risk Management* 35.

87 Valsamakis *Risk management* 15-16.

certain risks on an automated basis, for example credit agreements or agreements for the procurement of services may be managed with automated contract management systems, which would go some way in addressing the risks by for example setting e-mails reminders to alert the relevant persons timeously of actions needed in terms of the agreements.⁸⁸

Each area within a bank should implement appropriate controls, automated as far as possible, to ensure that identified legal risks are mitigated. These processes should be similar to operational risk management processes implemented by the bank.⁸⁹ For example, due to the risk of false identification documents being used by clients, the bank may choose to implement a control that validates the identity number against certain preset criteria when the bank employee enters that number into the system. Similarly, a bank may choose to manage its contract risk by making certain fields in a contract management system compulsory. Such a field might be a date for renewal of the contract, which is linked to an automated e-mail.

Once a process has been established to manage legal risk, it will need to be monitored and reported on. This aspect is discussed in the next section.

7 Monitoring and reporting legal risks

After a risk has been identified, it needs to be managed, monitored and reported on. Similar to any other risk in a bank, legal risk should also be monitored. Legal risk monitoring is an examination of business activities to assist management and the board to understand whether business is conducted in accordance with the law applicable to that bank.⁹⁰

88 McCormick *Legal risk* 105.

89 Valsamakis *Risk management* (2010) 134-150;
Olson and Wu *Enterprise Risk Management* 35.

90 CISA *Generally Accepted Compliance Framework* 81.

Legal risk cannot be eliminated, therefore it is necessary to implement a reporting process for legal risks, which should ideally include key risk indicators⁹¹ and a stated risk tolerance or appetite by either the board or at least senior management.⁹² In general, risks cannot be entirely eliminated, and therefore one of the steps in the risk management process is risk financing.⁹³ The rationale for monitoring and reporting legal risk would be the same as the reasons for monitoring and reporting any other risk type, which is to ensure that timeous corrective action can be taken if the risk falls outside the bank's risk appetite.⁹⁴

The Regulations relating to Banks, in regulation 33(8)(b)(ii)(A) requires a bank to report on all operational risk as part of the operational risk management process. This would therefore include legal risk and it is accordingly advisable to report on legal risks on a regular basis, for example quarterly at the board meetings or at board committees, such as the board risk committee. However, based on the key risk indicators and risk tolerance of a specific bank, risks may arise that require immediate reporting to the board. This should ideally be done within the operational or legal risk management framework and not be left to the personal preferences of the bank's legal risk manager.

There are a number of methods available to compliance officers to monitor compliance. These are based on auditing techniques and similar techniques can be utilised in monitoring legal risk.⁹⁵ These are risk management plans, meeting attendance and research.⁹⁶ A risk management plan is exactly what its name implies: a plan to manage the risk. It provides a tool to plan and forecast, which tool facilitates the analysis of actual against planned results, and provides an indication of forecasted risk levels.⁹⁷ Such a plan is a systematic document which

91 Valsamakis *Risk management* (2010) 146.

92 Valsamakis *Risk management* (2010) 146.

93 Valsamakis *Risk management* 16-17.

94 Valsamakis *Risk management* (2010) 134-151.

95 Also refer to chapter 2.

96 Mynhardt *Compliance Risk* 180-183.

97 Bessis *Risk management in banking* 43.

stipulates which aspects of the risk will be scrutinised or monitored (effectively it is audited) on a regular basis. I recommend a risk management plan as set out in figure 3. This suggested template for a legal risk management plan is broadly based on the format for a compliance risk management plan suggested by the Compliance Institute of South Africa.⁹⁸ The inherent risk rating column is completed and represents my view of the inherent risk faced by a bank with regard to a specific risk type.

98 CISA *Generally Accepted Compliance Framework* 59.

Table 1 - Suggested legal risk management plan (template)

| Legal risk category | Risk description | Inherent risk rating [High/ Medium/ Low] | Controls implemented | Residual risk rating [High/ Medium/ Low] | Management option [Tolerate/ Treat/Transfer/ Terminate/ Train] | Action required (if applicable) | Responsible person | Due date |
|---|-------------------------|--|-----------------------------|--|---|--|---------------------------|-----------------|
| Private law - law of persons | | Medium | | | | | | |
| Private law - law of property | | Medium | | | | | | |
| Private law - law of succession | | Medium | | | | | | |
| Private law - law of obligations | | | | | | | | |
| Contracts | | High | | | | | | |
| Delict | | Medium | | | | | | |
| Unjustified enrichment | | Medium | | | | | | |
| Private law - mercantile / | | | | | | | | |

| Legal risk category | Risk description | Inherent risk rating [High/ Medium/ Low] | Controls implemented | Residual risk rating [High/ Medium/ Low] | Management option [Tolerate/ Treat/Transfer/ Terminate/ Train] | Action required (if applicable) | Responsible person | Due date |
|---|-------------------------|--|-----------------------------|--|---|--|---------------------------|-----------------|
| commercial law | | | | | | | | |
| Company law | | High | | | | | | |
| Immaterial or intellectual property law | | High | | | | | | |
| Labour law | | High | | | | | | |
| Law of taxation | | High | | | | | | |
| Law of negotiable instruments | | High | | | | | | |
| Insolvency law | | High | | | | | | |
| Insurance law | | Low | | | | | | |
| Banking law | | High | | | | | | |
| Public law - constitutional and administrative law | | | | | | | | |

| Legal risk category | Risk description | Inherent risk rating [High/ Medium/ Low] | Controls implemented | Residual risk rating [High/ Medium/ Low] | Management option [Tolerate/ Treat/Transfer/ Terminate/ Train] | Action required (if applicable) | Responsible person | Due date |
|----------------------------------|-------------------------|--|-----------------------------|--|---|--|---------------------------|-----------------|
| Public law - criminal law | | | | | | | | |
| Criminal law and procedure | | Medium | | | | | | |
| Formal / procedural law | | | | | | | | |
| Law of evidence | | Medium | | | | | | |
| International law | | | | | | | | |
| Public international law | | Medium | | | | | | |

Once legal risk monitoring has been conducted, it needs to be reported on. It is suggested that legal risk, similar to the establishment of compliance risk practices, be reported on either an immediate or regular basis, as appropriate, to the boards of directors, audit and risk committees, senior management and other relevant stakeholders in the bank. It may be advisable to develop quantifiable key risk indicators where possible, for example the number of cases lodged against the bank in line with its overall risk appetite. It would also be advisable to align the bank's risk methodology with its overall risk methodology. In the suggested reporting matrix depicted below, the inherent and residual risk ratings are aligned with the risk identification matrix.⁹⁹ The inherent risk rating would refer to the risk without any implemented controls. The residual risk rating would reflect the risk given the controls implemented to mitigate the risk. Depending on the risk maturity of the bank, it may be advisable to look simply at the residual risk rating. The management options available to the bank are to tolerate, treat, transfer or terminate the risk. The suggested legal risk reporting matrix is as follows:

Table 2 - Suggested legal risk reporting matrix

| Legal risk category | Inherent risk rating [High/Medium/Low/Not applicable] | Residual risk rating [High/Medium/Low/Not applicable] | Management option [Tolerate/Treat/Transfer/Terminate] |
|---|---|---|---|
| Private law - Law of persons | | | |
| Private law - Law of property | | | |
| Private law - Law of succession | | | |
| Private law - Law of obligations | | | |
| Contracts | | | |
| Delict | | | |
| Unjustified enrichment | | | |
| Private law - Mercantile / | | | |

⁹⁹ Figure 2 - Risk identification matrix

| Legal risk category | Inherent risk rating [High/Medium/ Low/Not applicable] | Residual risk rating [High/Medium/Low/ Not applicable] | Management option [Tolerate/Treat/ Transfer/ Terminate] |
|---|--|---|---|
| commercial law | | | |
| Company law | | | |
| Immaterial or intellectual property law | | | |
| Labour law | | | |
| Law of taxation | | | |
| Law of negotiable instruments | | | |
| Insolvency law | | | |
| Insurance law | | | |
| Banking law | | | |
| Public law - Constitutional and administrative law | | | |
| Public law - Criminal law | | | |
| Criminal law and procedure | | | |
| Formal / Procedural law | | | |
| Law of evidence | | | |
| International law | | | |
| Public international law | | | |

A bank may choose to add a comments column. The legal risk category in the suggested reporting matrix is aligned with the structure of the law of South Africa provided in chapter 4. The inherent risk rating is the absolute or pure risk to the bank. This reflects a worst-case scenario if the risk materialises. The residual or current risk rating refers to the inherent risk taking the mitigation controls into account. For example, labour law might be an inherently high risk to a bank, but because sound human resource and industrial relations processes have been implemented in the bank, the risk is reduced to a low risk. The management option refers to the decision on how to manage the risk. As mentioned above, there are four options available to the bank: (a) the risk may be treated, which means the risk is managed and controls are implemented to reduce the risk; (b)

the risk may be transferred, which normally refers to outsourcing that aspect of the business to another entity; (c) the risk may be terminated, meaning that the bank chooses not to pursue a specific business line or product due to the risks involved; or (d) a bank may choose to tolerate a risk, which is normally done where a new business line is entered into and the bank does not have adequate resources to manage all risks. The inherent risk might also be low enough for the bank to decide to accept it, because it falls within its risk appetite.

The legal risk management process is continuous and does not end when the risk has been reported on. The legal risk manager will need to carry on identifying possible legal risks, implementing controls in order to manage them, and monitoring and reporting on the identified risks.

The benefit of an approach such as the one proposed in this chapter is that legal risk management could simply be included in the compliance risk management process by expanding the latter.

8 Conclusion

This chapter dealt with the lack of consistency in the use of the language related to legal risk and compliance risk within the South African banking industry, specifically with regard to the largest five banks. While these banks' definition of legal risk and compliance risk is generally aligned with the Basel Committee's standards, such definition is not ideal for a mixed legal system such as South Africa. The result is that certain banks simply adopted the Basel Committee and *Banks Act* wording, whilst others developed the wording to suit their own needs. This chapter accordingly resulted in two proposals being made. Firstly, it was proposed that the South African legislator itself should deviate from the exact Basel Committee wording in order to provide more appropriate definitions of legal risk and compliance risk for a common law or mixed legal system. Failing this, it was secondly suggested that banks should manage their legal risk, despite the

exact wording contained in the Basel Committee's standards and the regulations relating to the *Banks Act*.

In conclusion, this chapter makes several proposals and recommendations on managing legal risk in a bank. This includes the establishment of a legal risk management function and allocating responsibility for the management of legal risk, identification of the legal risk universe applicable to the bank, implementing controls in order to mitigate identified legal risks, monitoring and reporting on legal risks.

CHAPTER 6

Conclusion

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1 Overview of findings

As explained in chapter 1, this study was borne out of my need to find an appropriate language and process applicable to compliance risk and legal risk management specifically in the South African context. The research problem of this study emanated from the fact that the Basel Committee defines legal risk, but that its definition is too narrow for a common law or mixed legal system such as South Africa. A theoretical background of all the concepts was accordingly provided, including the definitions, theory and principles of and need for risk management, operational risk, the Basel Committee and, in as far as could be established, legal risk and compliance risk. I also set out to establish whether South African banking law is aligned with the Basel Committee's principles and whether or not a strict alignment with the Basel Accord creates confusion and could lead to misinterpretation. The aim of the research was to determine if it is advisable to follow the Basel principles regarding legal risk and compliance risk verbatim, or whether there is a more appropriate alternative for the mixed South African legal system. The aim of the study was not only to compare South African law to international standards and similar jurisdictions, but also to arrive at a suggestion as to how to improve South African law in this regard. To this end, a legal risk management framework has been proposed.

The hypothesis formulated for this study was that the Basel Committee's definition of operational risk includes legal risk, which is accepted by the Basel Committee to be compliance with legislative provisions. It was argued that legal risk and compliance risk are related, yet distinctly separate concepts in the South African banking industry. It was shown that legal risk is not synonymous with compliance risk, and it was accordingly found that legal risk in a bank in South Africa entails more than mere adherence to the legislative provisions for the banking sector because operational risk also includes legal risk and compliance risk in South Africa.

This thesis dealt with the lack of consistency in the use of the language related to legal risk and compliance risk within the South African banking industry. The legal language used was found to be generally aligned with the Basel Committee's standards, but not to be ideal for a mixed legal system such as South Africa. The result is that certain banks simply adopted the Basel Committee and *Banks Act* wording, whilst others developed the wording to suit their own needs. The main objective of this thesis was therefore twofold: firstly, it was to determine whether the South African legislator deviates from the exact Basel Committee wording in order to provide more appropriate definitions for legal risk and compliance risk for a mixed legal system; and secondly it was to suggest that banks manage their legal risk despite the exact wording contained in the Basel Committee's standards and the regulations relating to banks. In conclusion, this thesis made several proposals and recommendations on managing legal risk in a bank. These proposals and recommendations include the establishment of a legal risk management function and the allocation of responsibility for the management of legal risk, the identification of the legal risk universe applicable to the bank, the implementation of controls in order to manage identified legal risks, and the monitoring and reporting of legal risks.

This thesis provided a practical framework and methodology within which to manage legal risk in a bank operating in South Africa. The basis of the study was the work done by the Basel Committee with regard to operational risk management, which was adopted into legislation in South Africa through the *Banks Act*.¹ As indicated in chapter 1, a comprehensive study of all legal risks was beyond the scope of this study and it was therefore limited to the banking industry in South Africa.

The literature review comprised a comprehensive review of relevant textbooks, articles, case law, and conference notes. It was found that research material on legal risk is limited because it is a relatively new concept, especially in the banking industry in South Africa. This study did not deal with banking or the law of banking in detail as the main focus was placed on legal risk and compliance risk within the context of a bank in the South African context.

The study was broken down into four substantive chapters. Chapter 2 dealt with the historical background to legal risk and compliance risk in banks specifically in South Africa. Chapter 3 provided definitions of terminology, including credit risk, market risk, liquidity risk, operational risk, legal risk, compliance, compliance risk, legal compliance, regulatory compliance and regulatory risk. In chapter 4 the definitions of legal risk and compliance risk were applied to the law of South Africa as it pertained specifically to a bank, while in chapter 5 a practical recommendation was made on how to manage legal risk in a bank in South Africa.

A brief history of compliance risk management was provided in chapter 2, which revealed that it is a form of risk management which in turn developed out of gambling in an attempt to predict mathematically the future. Moreover, risk management is considered to form part of corporate governance, although corporate governance only emerged during the 1990s.

1 *Banks Act* 94 of 1990.

A historical background was provided to the law in general, banking law specifically, internal audit and risk management, as well as the interrelationship between these. It was shown that the law, internal audit and risk management developed separately but converged during the 20th century to form a separate discipline, namely compliance risk and/or legal risk management.

It was also established that the concept that the law needs to be adhered to (or complied with) is as old as the Code of Hammurabi. The origin of the law of South Africa was traced back to a combination of common law (Roman, Roman-Dutch and English law), legislation, precedent, customary law, indigenous law, the works of modern authors and the *Constitution*.

In chapter 3 the basic risk types applicable to a bank were identified, such as credit risk, market risk, liquidity risk and operational risk, the latter including legal risk and compliance risk. It was established that within the context of legal risk and compliance risk, the legal language used in South Africa is convoluted and confusing, especially to non-lawyers and even to a South African lawyer. One of the causes of this confusion is the fact that there are no uniform definitions or perhaps even a common understanding of what compliance, compliance risk, legal risk, legal compliance, regulatory compliance and regulatory risk are.

Compliance risk management was defined as a combination of the law, internal audit and risk management. It was found that the law needs to be adhered to, and the manner in which banks ensure adherence to the law is by using a risk management process (identification, management, monitoring and reporting). The monitoring conducted in a compliance risk management process is based on auditing techniques. Therefore, compliance risk was defined as the risk of financial, reputational or other losses as a result of non-adherence to statutory requirements, which included legislation, regulation, other guidance issued by the regulators as well as industry and organisational standards, rules and policies.

Legal risk includes compliance risk, which in turn is based on adherence to the law. The manner in which banks ensured adherence to the law is based on risk management principles, with the addition of monitoring techniques. These monitoring techniques are essentially internal audit principles.

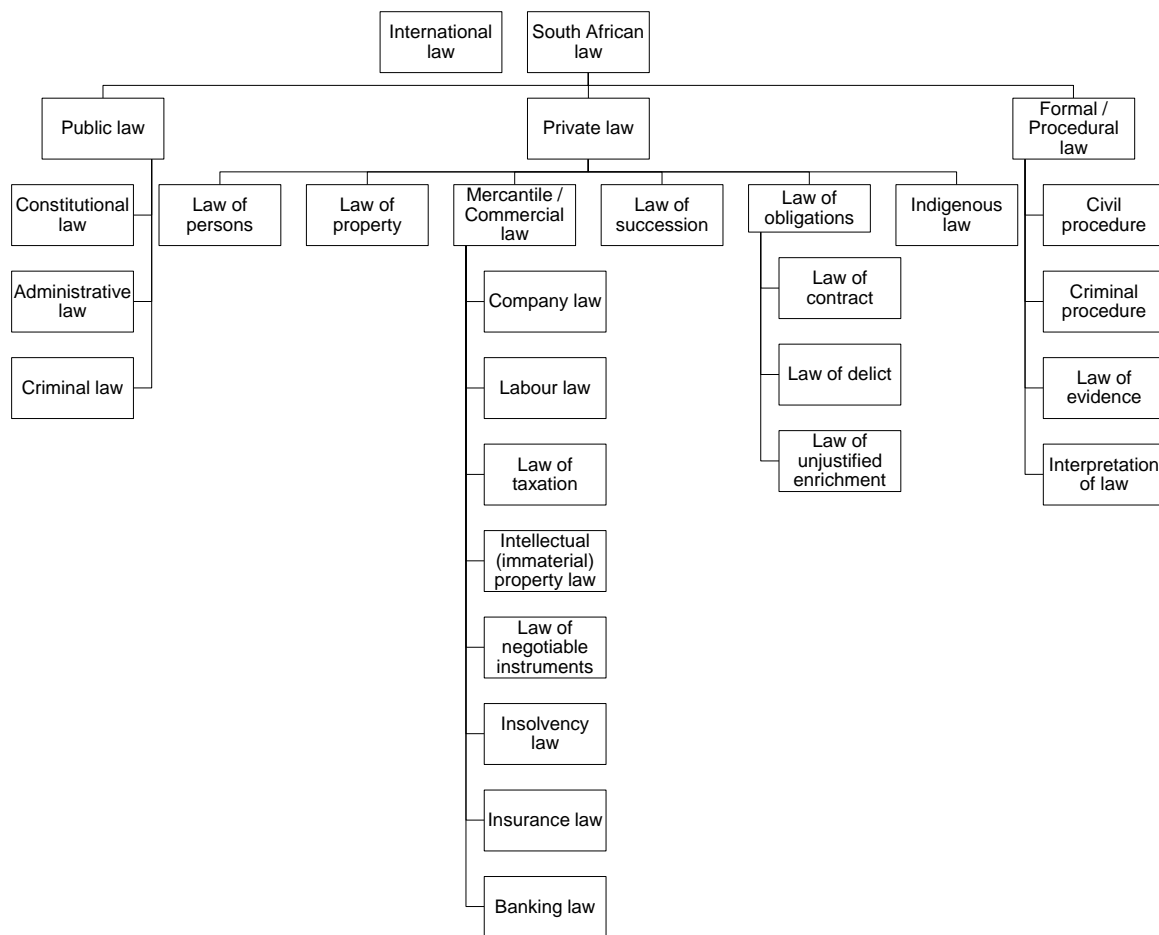
In chapter 3 the concepts of legal risk and compliance risk within the context of risk management, narrowed down, where possible, to banking, were discussed.

The aim of the research was to determine if it is advisable to follow the exact Basel principles regarding legal risk and compliance risk, or whether there is a more appropriate alternative for the South African legal system. The Basel Committee defines operational risk, but its definition includes legal risk. The inference was therefore drawn that legal risk includes, or is synonymous with, compliance risk. It was explained in chapter 3 that in a mixed legal system, the law is wider than only legislation. The Basel Committee's wording in its definition of legal risk refers to laws and regulations, which implies that "laws" are primary legislation or statute, because "regulation" is secondary legislation. As detailed in chapter 3, the objection I raised with regard to this interpretation is that the Basel Committee's definition is too narrow for a common law or mixed legal system such as South Africa.

After considering all the information mentioned above, it was concluded that compliance risk in a bank is a component of legal risk, which in turn is a component of operational risk in a bank operating in a mixed legal system such as South Africa. While legal risk therefore includes compliance risk, the reverse is not true as compliance risk does not include legal risk, nor are the two concepts synonymous in the South African legal context. The narrow definition of legal risk suggested by this study in chapter 3 is that it is all the aspects of the legal system not already managed as part of the compliance risk management process.

In chapter 4 an outline of the law of South Africa was established and used as the basis for the identification of all the potential legal risks a bank could face. This structure represents all possible legal risks, including compliance risk, and the possible risk categories that could have an impact on a bank, namely public, private, formal and procedural law, and international law. These risk categories are repeated below for ease of reference.

Figure 1 - Structure of South African law



It was shown that South Africa has a mixed legal system, as opposed to a codified or civil law legal system, meaning that banks are not only regulated by the *Banks Act*,² the *Mutual Banks Act*,³ and the *Co-operative Banks Act*⁴ and its regulations, directives, circulars and guidance notes issued by either the Minister of Finance or the Registrar of Banks, but also by precedent, custom and the writings of legal experts.⁵

It was indicated that the *Banks Act*⁶ requires banks to establish a compliance function, but the manner in which it is worded leads to an interpretation that only codified law needs to be managed by banks. This has led to the practice for South African banks to manage only compliance risk (although banks may refer to it as legal risk). Therefore a distinction was made between the two risk types in chapters 3 and 4 respectively. Because compliance risk is a well-established legal concept, I did not deem it necessary to focus on it significantly in this thesis. I therefore opted for a distinction between legal risk and compliance risk, with legal risk having been defined as the part of the law not already managed in terms of the compliance risk process.

Chapter 4 indicated that both government and the private banking sector face legal risk. Regulations 33, 34 and 49 of the *Banks Act*⁷ prescribe that a bank in South Africa shall have risk management and compliance functions in order to manage its compliance risks. It was also highlighted that these regulations are not wide enough to include all aspects of the law applicable to banks. A practical proposal on how to manage legal risks in a bank has accordingly been proposed based on the outline of the law of South Africa.⁸

2 *Banks Act* 94 of 1990.

3 *Mutual Banks Act* 124 of 1993.

4 *Co-operative Banks Act* 40 of 2007.

5 The *Dedicated Banks Bill* will also apply once it is enacted.

6 *Banks Act* 94 of 1990.

7 Reg. 33, 34 and 49 of the *Banks Act* 94 of 1990.

8 CISA *Generally Accepted Compliance Framework*.

Compliance risk was shown to be a type of legal risk and therefore it was proposed that legal risk be managed in a manner similar to compliance risk. It was further suggested that such a legal risk management framework and methodology should include the establishment of a legal risk management function, which should assign specific responsibilities to the various stakeholders in a bank. Such responsibilities may include appointing legal risk managers; identifying the legal risk universe applicable to South African banks; and implementing controls to mitigate identified legal risks, which may include training and reporting on, and monitoring of, legal risks. This was shown to be a continuous process in chapter 5.⁹

I anticipated that it would be practically difficult for anyone except legal specialists to understand and apply the difference between legal risk and compliance risk. Unfortunately lawyers are not necessarily employed in risk management positions in banks. Therefore I propose a practical legal risk management framework to be implemented in banks.

2 Conclusion

It has been shown that legal risk and compliance risk developed out of the law, internal audit and risk management, and that the law of South Africa is not entirely codified. There are thus aspects of the law that are not legislated. The banking law in South Africa is influenced by the Basel Committee and South Africa is implicitly bound to follow the Basel Committee's recommendations, one of which relates to the definition of operational risk, which includes legal risk. The application of this definition is problematic in South Africa, because the Basel Committee regards legal risk and compliance risk as synonymous.

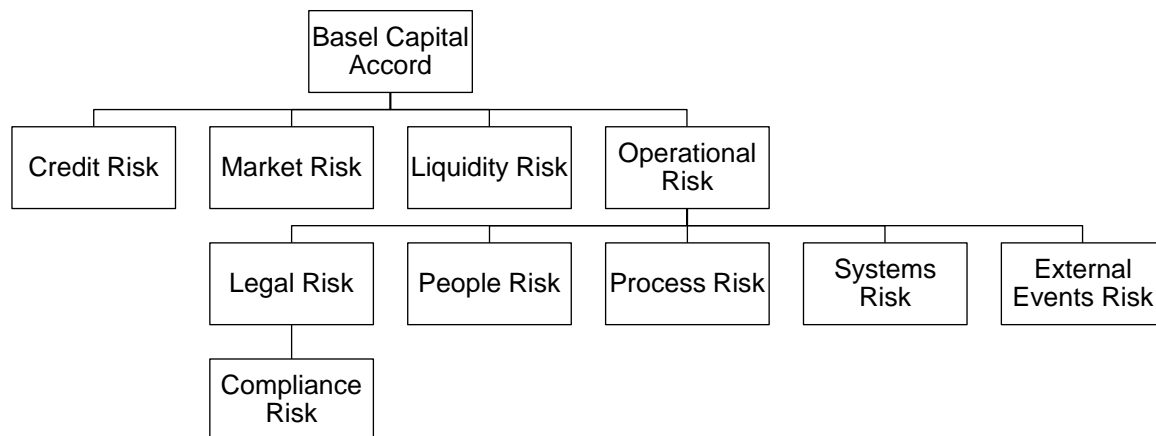
9 McCormick *Legal Risk* 232;
Mynhardt *Compliance Risk* 164;
CISA *Generally Accepted Compliance Framework* part 3 standard 1;
Banks Act 94 of 1990.

It has accordingly been recommended that legal risk be regarded as a distinct component of operational risk, and that a definition of legal risk should include the risks posed by all aspects of the legal system in which the risk is managed. Legal risk has therefore been defined in this thesis as the risk of financial, reputational or other losses incurred due to the non-adherence to legal requirements of all aspects of the law, including private, public, procedural or international law. This thesis has also recommended that both codified and uncoded aspects of a common law system be included under a definition of legal risk.

Furthermore, it has been recommended in this thesis that compliance risk, specifically in a common law system, should be construed as being a part of legal risk, because compliance risk deals only with statutory or legislative requirements, and not with the uncoded aspects of the law.

The risk categories applicable to a bank in South Africa have accordingly been identified as follows:

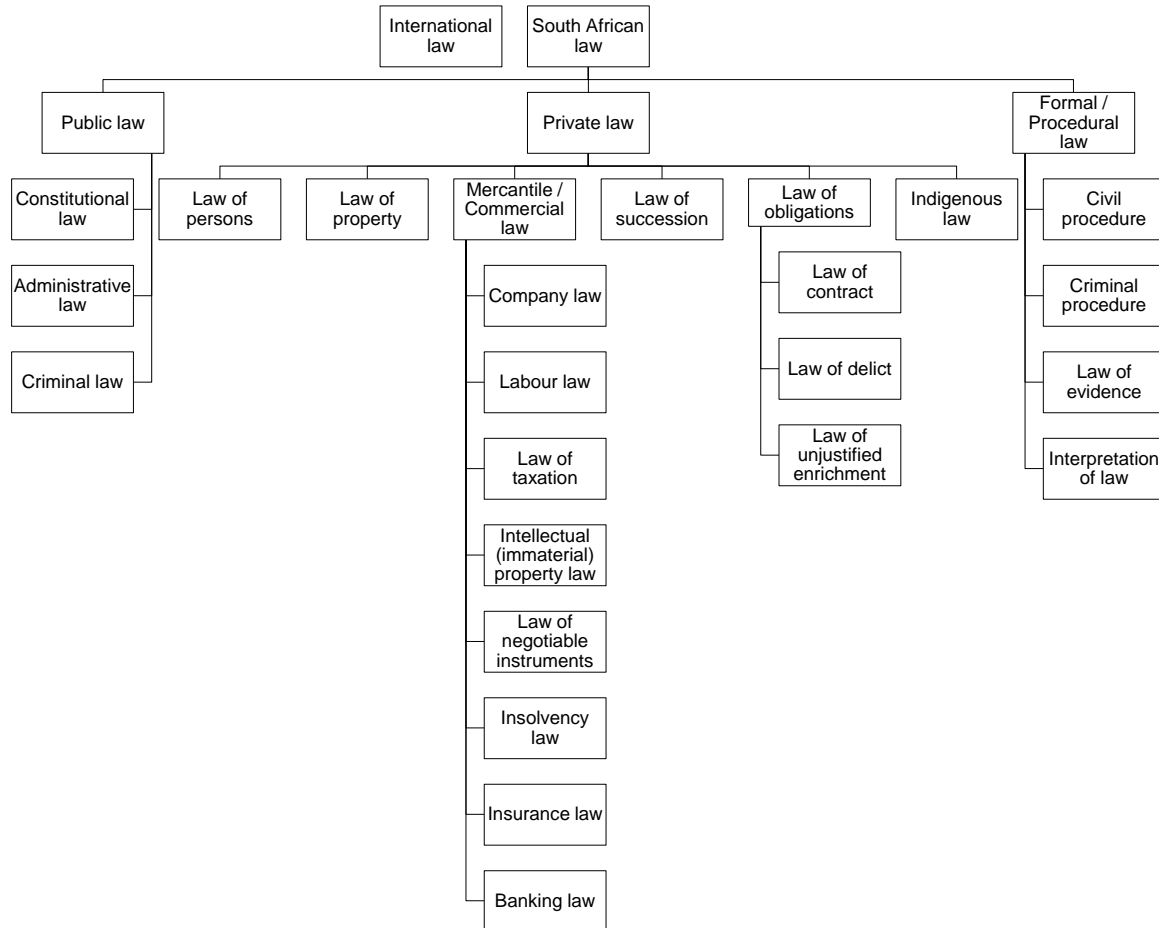
Figure 2 - Risk categories applicable to a bank in South Africa



The above-mentioned terms have been applied, at a summary level, to the law of South Africa applicable to banks, resulting in a structure within which the risks

posed by the law of South Africa may be managed by a bank. Again, this structure is as follows:

Figure 3 - Structure of South African law



This structure has been used to identify possible legal risks and compliance risks applicable to a bank. These findings, which are listed in chapter 4, are summarised as set out in Table 1 below:

Table 1 - Summary of chapter 4 findings

| Category of law | Possible legal risks (excluding compliance risk) | Possible compliance risks ¹⁰ |
|--|--|--|
| Public law | - | - |
| <ul style="list-style-type: none"> Constitutional law | Infringing on fundamental human rights entrenched in the Bill of Rights of the <i>Constitution</i> . | <i>Broad-Based Black Economic Empowerment Act</i> <i>Employment Equity Act</i> |
| <ul style="list-style-type: none"> Administrative law | Review of decisions of the Registrar of Banks | Various Acts of parliament applicable to a bank may impose administrative penalties (e.g. for late submission of returns to the Bank Supervision Department). |
| <ul style="list-style-type: none"> Criminal law | Theft Fraud | <i>Banks Act</i> <i>Financial Intelligence Centre Act</i> <i>Prevention of Organised Crime Act</i> <i>Protection of Constitutional Democracy Against Terrorism and Related Activities Act</i> <i>Companies Act</i> <i>Occupational Health and Safety Act</i> Various other Acts of parliament applicable to a bank, where a criminal penalty is imposed. |
| Private law | - | - |
| <ul style="list-style-type: none"> Law of persons | Matrimonial regime of the client (third party) | <i>Matrimonial Property Act</i> <i>National Credit Act</i> <i>Pension Funds Act</i> |
| <ul style="list-style-type: none"> Law of property | Security | <i>Alienation of Land Act</i> <i>Sectional Titles Act</i> <i>Share Blocks Control Act</i> <i>Property Time-sharing Control</i> |

¹⁰ Items listed in (brackets) represent policies or draft legislation.

| Category of law | Possible legal risks (excluding compliance risk) | Possible compliance risks ¹⁰ |
|---|---|--|
| | | <i>Act</i> <i>National Credit Act</i> <i>Housing Consumers Protection Measures Act</i> <i>Second-hand Goods Act</i> |
| <ul style="list-style-type: none"> • Mercantile/commercial law | - | - |
| <ul style="list-style-type: none"> ○ Company law | Corporate governance Common law fiduciary responsibilities King III (quasi-legal) Conflicts of interest Litigation/disputes | <i>Companies Act</i> <i>Competition Act</i> <i>Consumer Affairs (Unfair Business Practices) Act</i> <i>Consumer Protection Act</i> <i>Banks Act</i> <i>Securities Services Act (Insider trading)</i> <i>(Protection of Personal Information Bill)</i> <i>(Protection of State Information Bill)</i> |
| <ul style="list-style-type: none"> ○ Labour law | Law of contract | <i>Basic Conditions of Employment Act</i> <i>Employment Equity Act</i> <i>Labour Relations Act</i> <i>Unemployment Insurance Contributions Act</i> <i>Skills Development Act</i> <i>Skills Development Levies Act</i> <i>Compensation for Occupational Injuries and Diseases Act</i> <i>Code of Good Practice: Who is an employee</i> |
| <ul style="list-style-type: none"> ○ Law of taxation | Disputes regarding interpretation of the taxation legislation | <i>Income Tax Act</i> <i>Value Added Tax Act</i> <i>Foreign Account Tax Compliance Act (USA)</i> |
| <ul style="list-style-type: none"> ○ Intellectual | Litigation to protect intellectual | <i>Patents Act</i> |

| Category of law | Possible legal risks (excluding compliance risk) | Possible compliance risks ¹⁰ |
|---------------------------------|---|--|
| (immaterial) property law | property | <i>Copyright Act</i> <i>Trade Marks Act</i> <i>Merchandise Marks Act</i> <i>Designs Act</i> <i>Counterfeit Goods Act</i> |
| o Law of negotiable instruments | - | <i>Bills of Exchange Act</i> |
| o Insolvency law | - | <i>Insolvency Act</i> <i>Banks Act</i> <i>National Credit Act</i> <i>(Unified Insolvency Bill)</i> <i>(Financial Regulatory Reform)</i> |
| o Insurance law | Law of contract | <i>Long-term Insurance Act</i> <i>Short-term Insurance Act</i> <i>Policyholder Protection Rules</i> <i>National Credit Act</i> |
| o Banking law | Review of decisions of the Registrar of Bank. | <i>South African Reserve Bank Act</i> <i>Banks Act</i> <i>Mutual Banks Act</i> <i>Co-operative Banks Act</i> <i>South African Postbank Limited Act</i> <i>National Payment System Act</i> |
| • Law of succession | Litigation against a bank acting as executor of an estate. | <i>Wills Act</i> <i>Estate Duty Act</i> <i>Pension Funds Act</i> <i>Long-term Insurance Act</i> |
| • Law of obligations | Litigation against or by a bank in terms of aspects of the law of obligations not codified. | <i>Consumer Protection Act</i> <i>Consumer Affairs (Unfair Business Practices) Act</i> <i>(Treating Customers Fairly)</i> <i>National Credit Act</i> |
| o Law of contract | Essential criteria for a valid contract Remedies available require legal | <i>Financial Advisory and Intermediary Services Act</i> <i>Alienation of Land Act</i> |

| Category of law | Possible legal risks (excluding compliance risk) | Possible compliance risks ¹⁰ |
|---|--|---|
| | action to enforce the remedy Contractual penalties Risks attached to a specific kind of contract (e.g. credit agreement, insurance, joint venture, agency, electronic banking) | <i>Sectional Titles Act</i> <i>Share Blocks Control Act</i> <i>Property Time-sharing Control Act</i> <i>National Credit Act</i> <i>Insolvency Act</i> <i>Merchandise Marks Act</i> <i>Financial Services Schemes Act</i> <i>Payment Card Industry Data Security Standard</i> <i>Electronic Communications and Transactions Act</i> <i>Code of Banking Practice (Protection of Personal Information Bill)</i> |
| <ul style="list-style-type: none"> ○ Law of delict | Liability based on negligence or intentional act | None identified |
| <ul style="list-style-type: none"> ○ Law of unjustified enrichment | Erroneous payment to incorrect party | None identified |
| <ul style="list-style-type: none"> • Indigenous/customary law | African Traditional Law (Stokvels) Hindu law Islam | <i>National Credit Act</i> |
| Formal/procedural law | - | - |
| <ul style="list-style-type: none"> • Civil procedure | | <i>Civil Proceedings Evidence Act</i> Ombudsman for Banking Services Ombudsman for Financial Services Providers National Consumer Tribunal Magistrates Court Rules High Court Rules |
| <ul style="list-style-type: none"> • Criminal procedure | | <i>Criminal Procedure Act</i> |
| <ul style="list-style-type: none"> • Law of evidence | | <i>Electronic Communications and</i> |

| Category of law | Possible legal risks (excluding compliance risk) | Possible compliance risks ¹⁰ |
|---|---|---|
| | | <i>Transactions Act</i> <i>Criminal Procedure Act</i> <i>Civil Proceedings Evidence Act</i> |
| <ul style="list-style-type: none"> • Interpretation of law | | <i>Interpretation Act</i> |
| Public international law | Contracts | International treaties and standards |

The discussion of the above table provided in chapter 4 has revealed that nearly all aspects of the law of South Africa is applicable to banks and that all of those may pose either legal risk or compliance risk to a bank. I have accordingly proposed a framework on how to manage practically the legal risks in a bank, in terms of which legal risk is identified, managed and reported.

This thesis has made several practical suggestions on how to manage legal risk. Firstly, the risk needs to be identified and classified by utilising the risk identification matrix. In terms of the legal risk management process that I have recommended, during which the risk would be identified and classified, mitigating controls are to be implemented. A template for the legal risk management plan that I have recommend is provided in chapter 5.

It has been proposed that once the legal risks have been identified and a management plan has been implemented, the risk should be monitored according to that management plan and reported on. Such a report is recommended in chapter 5.

The implications of my findings for the banking industry of South Africa are that banks are exposed to legal risk that is not being managed adequately at the moment. I further proposed that banks should expand their risk management policies and processes to include legal risk.

The benefit of the approach proposed in this study to managing legal risk and compliance risk in South African banks is that the compliance risk management process is leveraged in order to manage legal risk.

3 Recommendations

Essentially, there are two recommendations emanating from this study. The first is to amend the *Bank Act*¹¹ and regulations. The definitions (or lack thereof) with regard to legal risk and compliance risk may be amended to the definitions of legal risk and compliance risk proposed in chapter 3, namely that legal risk is the risk of financial loss or reputational damage due to non-adherence to legal requirements, which may stem from private, public, procedural or international law. Legal risk should include codified and uncodified law, as well as industry or organisational standards, rules and policies. Compliance risk is defined as the risk of financial, reputational or other loss as a result of non-adherence to the codified law in a common law or mixed legal system. This includes statutory requirements, which includes legislation, regulation or other guidance (such as best practices) issued by the relevant regulators or in terms of industry or company codes, standards and policies. The second recommendation is to manage practically legal risk in the manner described in chapter 5, with an implemented risk management process which includes, as a minimum, the identification, management and reporting of the risk.

In lieu of consistency being provided by way of amendments to the regulations relating to banks, it is recommended that a legal risk management function and framework be established in commercial banks.

4 Implications for further research

This study did not deal with setting a risk appetite for legal risk and compliance risk in a bank. A zero tolerance approach towards compliance risk might be ethically desirable, but it may not be realistic given the complexity of banking and

11 *Banks Act* 94 of 1990.

the fact that there are various statutory requirements applicable to a bank. These statutes are not necessarily aligned and may lead to a bank (unintentionally) being non-compliant. Setting a legal risk appetite is even more difficult, because some legal risks may be acceptable. For example, in a contract, both parties may agree on terms unfavourable to themselves, but when all the terms of the contract are taken as a whole, the contract is still favourable to the bank. The setting of a risk appetite for legal risk and compliance risk may form the basis of further inquiry.

This study also did not deal with the quantification of legal risk. The Basel Committee requires banks to hold capital against operational risk. This entails that operational risk is quantified and capital is held based on such quantification. Although operational risk includes legal risk (as per the Basel Committee's definition), this study did not consider this aspect of legal risk management in detail. The assumption was made that because legal risk is regarded as synonymous with compliance risk, the latter might have been measured and quantified, but not legal risk. This may also be investigated in further studies.

5 Concluding statement

It is clear that the current language and terminology relating to legal risk and compliance risk in a bank operating in South Africa are inadequate. The *Banks Act* should therefore preferably be amended to ensure that banks adequately manage all risks. In view of the fact established in this thesis that legal risk is a wider concept than compliance risk and includes compliance risk, it is possible to expand the compliance risk management process in order to ensure that legal risk is managed adequately.

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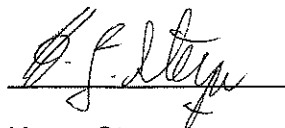
Confirmation of editing of thesis: Janet René Terblanché

I, Herco Steyn, hereby confirm that I have done the necessary language editing of the thesis of Janet René Terblanché, entitled "Legal risk and compliance risk in the banking industry in South Africa".

I am academically qualified to do such editing by virtue of the master's degree I hold in English. Moreover, my current role as Senior Linguist within the Bank Supervision Department (BSD) of the South African Reserve Bank requires me to edit official BSD correspondence on a day-to-day basis, which has afforded me relevant insight into the subject matter and context within which the above-mentioned thesis was written.

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Yours sincerely



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