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## Legislative and regulatory obstacles to mass banking

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**Legislative and regulatory obstacles to mass banking**

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## EXECUTIVE SUMMARY

This report explores the impact of certain aspects of the regulation of the banking sector on the ability of financial institutions to roll out products for the mass market. We consider legislative and regulatory obstacles that increase the cost and complexity associated with offering basic savings and transactions accounts, and transfer of value products to low income clients. We do not consider the terms of access to deposit-taking itself, access to the payments system or obstacles to the provision of credit products to the low end of the market (although the impact of the Basel II Accord could fall in this category).

We find that on the product development side, efforts to extend access to financial services fall into two categories. On the one hand, big banks have formed an Inter-Bank Task Group who is developing proposals for a basic savings account and a transfer of value product. On the other hand, a number of smaller banks and potential market entrants are developing products that aim to utilise modern technologies such as GSM networks and POS devices and third party non-financial distribution networks.

We investigate the following regulatory frameworks that will potentially impact a mass banking roll out:

- Money laundering control rules which encompass our own Financial Intelligence Centre Act (FICA) and regulations, as well as the international standards set by, inter alia, the Financial Action Task Force;
- The Financial Advisory and Intermediary Services Act (FAIS) and the draft Code of Conduct for Short-Term Deposit-Taking Business;
- Common law and statutory rules affecting the contractual capacity of minors, as well as relevant provisions of the proposed Children's Bill;
- The Stamp Duties Act;
- The Cash Reserve Requirement set by the South African Reserve Bank; and
- The Basel II Capital Accord.

We find that the implementation of FICA and its regulations presents a number of material obstacles to a mass banking roll out. These vary from the inability of poor people to provide the documentary proof required by banks to verify their residential address, to potential problems with the ability of third parties to perform

customer due diligence procedures on behalf of financial institutions. We propose a number of options to facilitate extending access to financial services, including an appropriate mass banking exemption to replace the current unworkable exemption 17.

The impact of FAIS is less pronounced than anticipated, particularly because banks are already subject to the Code of Banking Practice and have the systems in place to deal efficiently with the additional requirements. Complying with FAIS will be slightly more difficult for new entrants who propose to utilise non-financial third parties to perform account opening procedures. For such basic products a Code of Conduct-based exemption is possible.

The lack of contractual capacity of minors is a growing problem for access to financial services as the Aids pandemic causes parents to die, leaving children for whom no formal guardians have been appointed. The Children's Bill seeks to address this problem, but with ambiguous consequences for the capacity of minors to access financial services.

The Stamp Duties Act imposes a duty of 20 cents on every debit entry posted to a bank account. The impact of this duty increases proportionally as the actual fee charged by the bank for the performance of the transaction decreases. At low fee levels, such as some of the levels proposed by the new banking models, the stamp duty does become a material obstacle to the extension of access. We propose a number of exemption options, including levying stamp duty as a percentage of the fee charged, with an absolute cap.

Regarding the Cash Reserve Requirement, our view is that there is insufficient evidence that a mass banking roll out will indeed increase the cash holding requirements of banks. We therefore do not believe that it offers a material obstacle to extending access to financial services.

Finally, whereas the Basel II Capital Accord could affect banks involved in a mass banking roll out, either as regulated entities providing loans to clients in high risk categories, or as clients of larger banks receiving funding for onlending, indications are that the market has already forced institutions active in the mass market to maintain much higher capital ratios than that required by the regulator. We therefore believe that Basel II will not offer a material obstacle to a mass banking roll out.

# 1. INTRODUCTION

## 1.1. BACKGROUND AND OBJECTIVES

Extending access to financial services for the poor and financially excluded has been identified as a priority by the South African government. Not only is this important in order to meet the needs of lower income households, but it will also contribute to the sustainable long-term development of the national economy. A number of public and private processes are currently under way to advance the objective of extending access to financial services.

On the public side, negotiations are under way aimed at the creation of a Black Economic Empowerment Charter for the Financial Sector. Access to finance issues are on the agenda for inclusion in the Charter. This process was preceded by the NECLAC financial sector summit in 2002 where the banking sector made commitments to promote access to finance. Following these commitments, the major banks formed an Interbank Task Group (IBTG) with the specific objective of developing proposals for a mass banking project. At the same time various potential private entrants are gearing up to enter the mass market, at least on a pilot basis, in 2003 and 2004. All these initiatives aim to enlist market forces, as opposed to state provision, to extend access to financial services to the poor in South Africa.

The ability and appetite of the market, as opposed to the state, to extend financial services to the poor, are determined by a number of factors. One of these is the regulatory framework for the rendering of banking services. Banking is a highly regulated industry. Regulation defines the market space, shapes its development, and seeks to control the behaviour of market players. By definition the nature and content of regulation also impact the ability of the banking sector to serve the needs of low income customers.

This project explores this relationship, i.e. the extent to which certain aspects of the regulation of the banking sector impact the ability of financial institutions to extend access to financial services to low income customers and the financially excluded.

## 1.2.

## SCOPE

The project considers legislative and regulatory obstacles that increase the cost and complexity associated with offering a basic savings or transactions bank account or other transfer of value product, as well as the difficulty for a client to access such a banking service. It considers these questions as they relate to low income clients rather than clients in general.

The following potential obstacles are thus specifically excluded from the study:

- The terms of access to deposit-taking itself as well as access to the payments system; and
- Obstacles to the provision of credit products to the low end of the market.

## 1.3.

## METHODOLOGY

The environment within which issues of access to financial services are being considered is currently particularly volatile. This creates both opportunities and difficulties for a project of this nature. The methodology we used had to take account of this ever changing landscape.

*Define a mass banking account roll out:* The first step was to define what we mean by a mass banking account roll out. We focused primarily on the proposals of the IBTG and the proposed methodologies of possible new market entrants. In the latter instance we were obviously limited by issues of confidentiality. We further limited the study to business models that are capable of implementation under the current regulatory regime.

*Interviews with market participants:* We interviewed key market players, particularly those involved with compliance. Since key aspects of the Financial Intelligence Centre Act (FICA) and regulations came into force on 30 June 2003, in the middle of our project, we undertook a second round of interviews to see whether the perspectives of the banks have changed subsequent to implementation.

*Scan of relevant laws and regulations:* We undertook a scan of the relevant laws and regulations to identify the obstacles and verify the information that we received from interviews. In relation to FICA we were ably assisted by Prof Louis de Koker one of the foremost legal experts on money laundering controls in South Africa. He also undertook a comprehensive study of the international standards on money

laundrying controls. The Financial Action Task Force Revised Forty Recommendations were published in June 2003. We incorporated these in our findings and proposals.

*Assessment of the material nature of obstacles:* To assess whether obstacles would indeed have a material impact on a mass account roll out, we generally used three guidelines:

- Will the obstacle prevent the roll out of the product completely, because there is a legal principle, statutory rule or regulation that prohibits a key element of the product from being implemented?
- Will the obstacle make it difficult, impossible or unattractive for a significant section of the target market to access the product or service?
- Will the obstacle on its own, or in combination with other obstacles, make it significantly more expensive for the product to be implemented, thus potentially making it unaffordable for a significant section of the target market? Since accurate information on the cost implications of obstacles is unavailable, we use a general value chain analysis to pinpoint the incidence of cost. We link this to the FinMark model that illustrates the impact of changes in bank charges to levels of potential access.

*Proposals for the overcoming of obstacles:* In respect of material obstacles, we suggest options what would facilitate mass banking. Initial proposals were presented to a workshop of various stakeholders, including representatives from government, the banks and the SA Post Office. This greatly assisted with the development of our final proposals.

#### 1.4.

#### OUTLINE OF REPORT

The report is divided into four parts:

**Part 1 - The mass-banking context:** We describe the mass banking products that form the basis for our evaluation of the impact of regulation. We then illustrate how the cost of bank charges relates directly to the extension of market access. We present a value-chain analysis of savings and transmission banking products as a tool to think about the cost impact of regulation.

**Part 2 – Money laundering controls:** This section includes an analysis of relevant international standards for money laundering control and how these are currently

being implemented in South Africa. Since South Africa is now a member of the international standard setting body, the Financial Action Task Force, any possible changes suggested to the South African framework must comply with the international standards. We also consider applicable common law rules.

**Part 3 - Financial Advisory and Intermediary Services Act :** In this section we consider the impact of the new Financial Advisory and Intermediary Services Act (FAIS) and the draft Code of Conduct for Short-term Deposit-taking Business.

**Part 4 - Other legislative and regulatory obstacles to mass-banking:** This section deals with the position of minors, the Stamp Duties Act, the Cash Reserve Requirement and the Basel II Capital Accord.

## PART 1: THE MASS BANKING CONTEXT

### 2. MASS BANKING PRODUCTS

In this section we describe the products that could form part of a mass banking account roll out. By definition we do not deal with products currently being offered to the so-called mass market by the big banks. (They generally define the mass market as clients earning less than R5000 per month.) We consider products currently being developed by the IBTG as well as products aimed specifically at the low end of the market being developed by smaller banks and potential new entrants to the market. Where we did find existing products similar to those being developed, these are mentioned. Although not part of the formal financial sector, we do briefly refer to member-based financial institutions, since FICA and its regulations do have a particular impact on the ability of these informal institutions to open formal bank accounts.

#### 2.1. IBTG PROPOSAL – NATIONAL SAVINGS ACCOUNT<sup>1</sup>

The IBTG is working on two potential products. The first is a National Savings Account designed to nurture a savings culture in the nation. As such it aims to be affordable and to ensure capital preservation. It will be a so-called “first order saving solution” offering no additional transaction functionality besides deposits and withdrawals. The key characteristics of this product will be the following:

- A basic “no frills” card based account;
- Offered by individual banks and branded by those banks;
- The rules and standards for the product will be agreed by the banks;
- Inter-operability between the banks, i.e. you can transact against the account at any bank;
- Only deposits and withdrawals will be allowed;
- Withdrawals will be limited;
- The inter-bank relationship will be based on existing interchange methodologies.

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<sup>1</sup> This analysis is based on the IBTG proposal as of June, 2003.

## 2.2. IBTG PROPOSAL – EXCHANGE OF VALUE PRODUCT<sup>2</sup>

The second IBTG proposal is aimed at providing a banking service, universally branded across service providers, enabling point-to-point transmission of funds. It will not be an account-based product and therefore no formal banking relationship will be entered into between the user of the service and the financial institution facilitating the transfer of funds. No card based options are being considered at this stage. The “pay for use” principle will apply, it being the intention that the depositor-originator would pay for the service and that the recipient would only pay a nominal amount. Although the business model has not yet been finally developed, the IBTG envisages that the product will be able to pay for itself.

To maximise the reach of the potential distribution network, it is proposed that an agency model be used. The service will therefore be available at :

- Bank branches
- Post Office branches
- At other financial institutions such as Teba Bank, Capitec Bank and Ithala.

It is also mooted to expand the service to Lotto outlets and municipal and other government pay points.

The product would be aimed at individuals, particularly those who do not have bank accounts, as well as the provision of government transmission services to individuals for the delivery of social welfare grants and pensions.

## 2.3. NEW INNOVATIVE MASS BANKING MODELS

A number of new and innovative business models are currently being developed by various existing and new players aimed at utilising new technologies and distribution networks to deliver financial services, especially to currently unbanked customers. These models include the usage of GSM networks, POS devices and various ancillary technologies. The developments are spurred on, in part, by the promise of a new regulatory framework that will allow the creation of narrow or second tier banks. However, the driving force is the possibility of dramatically cutting the costs of delivering financial services, thereby creating the opportunity of

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<sup>2</sup> This analysis is based on the IBTG proposal as of June, 2003.

extending the market for financial services to customers who would simply not have been able to afford it in the past.

#### 2.3.1.

##### CELL PHONE BASED MODELS

Business models for the delivery of banking services via cell phone will utilize the smart card (SIM card) functionality built into the cell phone for financial transactions. Cell phone users will therefore be able to make EFTs and conduct other non-cash financial transactions from their cell phone. Cash transactions can be undertaken on a person to person basis, or at existing ATM, EasyPay and other banking networks processing cash if the product is supported by a debit card.

Much of the attractiveness and financial viability of these models lie in the marketing strategies utilized. In essence, the bank account is commoditised. The client will either receive the bank account as part of his or her cell phone package, or receive a “starter pack” containing the necessary instructions and a debit card. The account opening procedures therefore need to be undertaken at this point. The models rely on distribution networks via agents, either individuals who distribute the product by moving around in communities, or agency networks.

Due to the increased security risks of distribution models of this type, certain product developers are considering the use of biometrics to enhance security. This would involve developing a system that would capture the customer’s biometric, be it a voice biometric or fingerprint, at the account opening stage and store it in a central database. Whenever the customer wishes to contract, he or she would have to be identified against the stored biometric. Obviously, the use of fingerprints would be ruled out in models based on transacting via cell phone.

In order to be successful, these business models rely on the virtually immediate use of the product subsequent to account opening. Marketing experience in the targeted market segment shows that if the account is not used within three days of opening, its subsequent uptake drops significantly.

All of these models intend to make use of distribution networks other than traditional bank networks to distribute their products. Account opening would therefore not be effected via traditional bank branches, but via third party agents or agencies. Customers would be able to transact utilising existing infrastructure networks.

### 2.3.2. MODELS UTILISING POS DEVICES

An alternative model involves the opening of accounts and issuing and authentication of debit cards to customers using nothing more than a GSM linked modified POS device placed at the premises of a range of third party agents. Customers would be able to transact utilizing these POS devices as well as conventional banking infrastructure.

The account opening process will entail the following:

- The client approaches an accredited agent who is in possession of a POS device.
- The agent captures the necessary client information, including name, address, contact information and ID number, either by drawing the information from the database of a partner organization, or by the customer preparing a blank form.
- The client is immediately issued with a debit card and the deposit or welfare payment is captured on the card.
- The client is immediately able to transact against the account.
- The information is electronically captured on the bank's central database. The hard copies of documents, including the copy of the ID document, are forwarded by the agent to the central bank office where it is stored.

### 2.4. POST OFFICE PIN PRODUCT

The Post Office has recently launched a money transfer product. This service is (currently) only available for transfers within South Africa and can only be issued at Post Offices with on-line (Post Link) facilities. A maximum of R2000 per transaction can be transferred from a South African Post Office to another South African Post Office. Of the 1241 offices operated by SAPO, 1000 are currently on line with the rest expected to come on line before the end of the year. In order to utilise this product, the recipient and sender must have access to a SAPO branch or agency that is on line. Additionally, the recipient and sender must have access to a telephone or cell phone in order to communicate the PIN.

*The product operates as follows:*

- The sender fills in a form at a qualifying Post Office, pays the relevant amount and is given a unique PIN that identifies that transaction. The sender need not produce any other form of identification.
- The sender must then contact the recipient and communicate the PIN to him or her.
- When purchasing a money order the name and address of the sender and the recipient must be furnished. No provision is apparently made for the verification of the particulars of the sender's information or of the recipient's address. However, the recipient must produce his or her ID book when claiming the money.
- The recipient can access the funds at any online SAPO branch or agency by communicating the PIN.
- This service is not limited to natural persons and can also be used by corporate entities such as banks.
- There is no restriction on how many transfers a single person can make.

## 2.5.

### MEMBER BASED FINANCIAL INSTITUTIONS

Different types of member-based financial institutions are active in the informal financial sector. These include:

- Rotating Savings and Credit Associations (ROSCAs) (known in South Africa as stokvels);
- Burial Societies;
- Village Banks (or Financial Services Co-operatives); and
- Savings and Credit Co-operatives (SACCOs)<sup>3</sup>

Many South Africans benefit from these schemes. It is estimated that more than 8 million people invest over R 5 billion annually into stokvels and Burial Societies alone<sup>4</sup>. Stokvels offer a range of services, including rotating credit and savings facilities as well as funeral insurance. Burial societies offer funeral insurance to

<sup>3</sup> See, in general, De Koker *Money laundering trends in South Africa* (2002); Van der Merwe *Die stokvel – 'n Ondernemingsregtelike studie* 26 Tran CBL (1996); Schulze *Legal aspects of the insurance premium* 1996 LLD thesis UNISA, Government Notice 2173 of 1994 (*Government Gazette* 16167 of 14 December 1994) and Schoeman, Coetzee and Willemse "A review of the capacity, lessons learned and way forward for member based financial institutions in South Africa" 2003 report prepared by ECI Africa for the FinMark Trust.

<sup>4</sup> Presentation on stokvels in South Africa August 2002, presented by SA to for the FinMark Trust.

members. Whilst not all stokvels and burial societies use formal banks, a great many do open accounts where accumulated savings can be stored or invested. Those schemes that use accounts at formal banks usually use “group accounts”.

### 3. COST SENSITIVITY OF LOW INCOME CLIENTS

When assessing the cost impact of regulation on extending access to financial services, two aspects have to be considered. Firstly, what is the extent of the incremental cost imposed by the particular regulatory duty on a financial institution? Secondly, what is the impact of the increase in cost on the affordability of the service?

The normal methodology to determine the answer to the first question is to undertake a cost-benefit analysis of the particular regulation. Undertaking such a study falls beyond the ambit of this project. In our attempts to secure relevant information from industry sources, we found that very little information is available, certainly not enough to allow for accurate quantification of costs. It is hoped that the IBTG, in the process of developing realistic business propositions for the proposals that they are currently developing, will be able to shed some light on the subject. In order to assist with thinking through the question of cost, we constructed a value chain for a typical savings and transactions product aimed at the low end market. We discuss this in the next section.

To get some idea of the impact that a cost increase would have on affordability and access, we draw on earlier research done by FinMark and utilise the concept of an affordability frontier. We show that the impact of incremental cost changes is greater the lower the aggregate bank charges of the product involved.

#### 3.1. VALUE CHAIN ANALYSIS

A useful way of assessing the cost impact of legislation and regulation on the rendering of financial services is through a value chain analysis. An analysis of a typical savings and transmission account is shown in

Figure 1. Although the value-chain is likely to be different for different products, this analysis shows generic activities, processes, infrastructure and inputs that are likely to be common to the “mass-market” products described above.

The top row depicts the broad components of a basic banking product value chain. On the next row, the different activities that are undertaken in each of these broad components are shown. Below this we list the infrastructure and other inputs that support the activities in the value-chain. The components of the value chain impacted by the various regulatory frameworks discussed in this report are depicted on the bottom line. The purpose of this depiction is to illustrate the extent of the impact, rather than its actual cost. The cumulative impact of the various regulations is significant.

An aspect which is not included in the value chain is the cost of capital. To the extent that the Basel II Capital Accord will have cost implications for banks, it will affect the risk management component and the cost of capital.

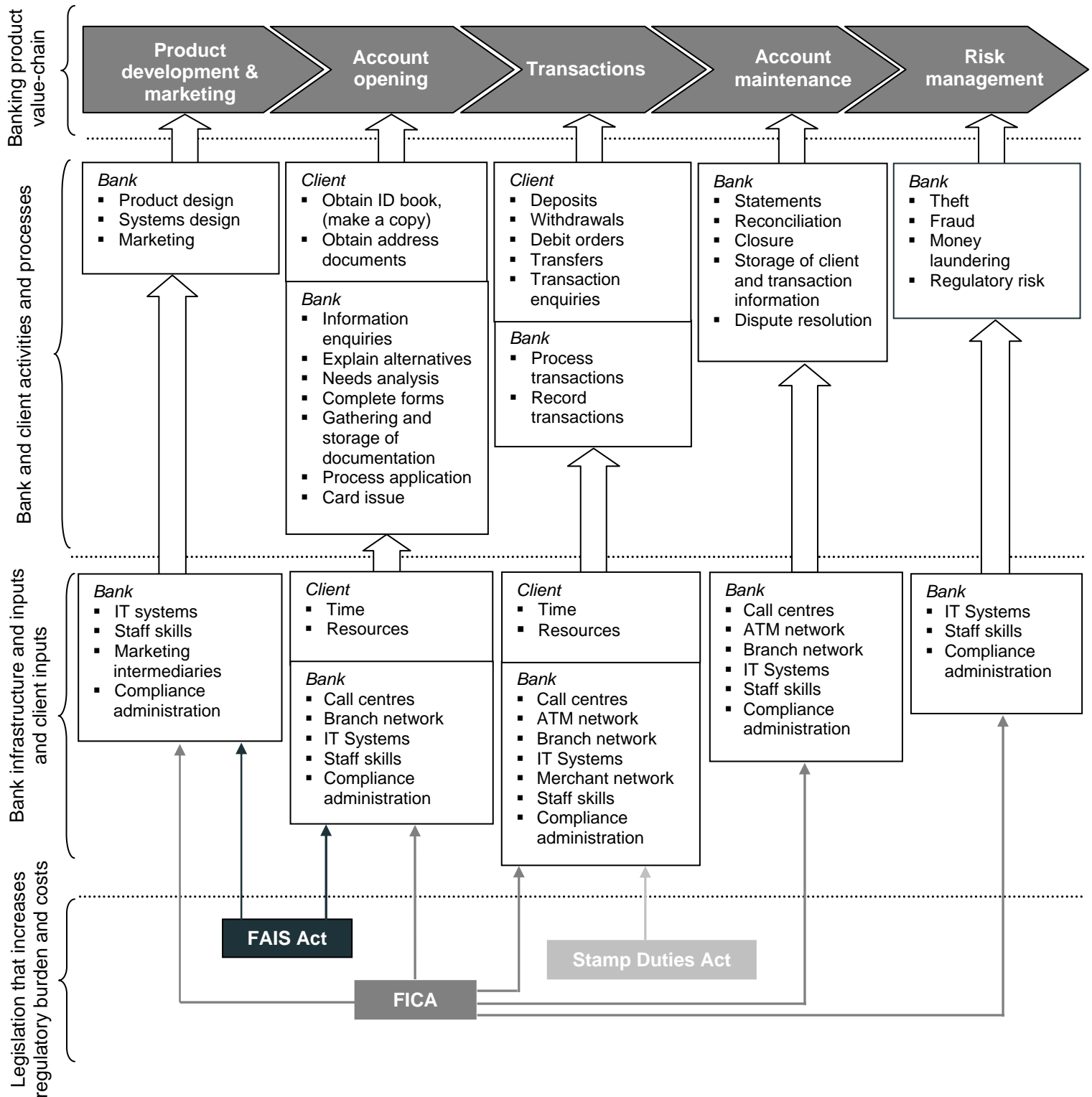


Figure 1: Value-chain analysis of a basic banking product

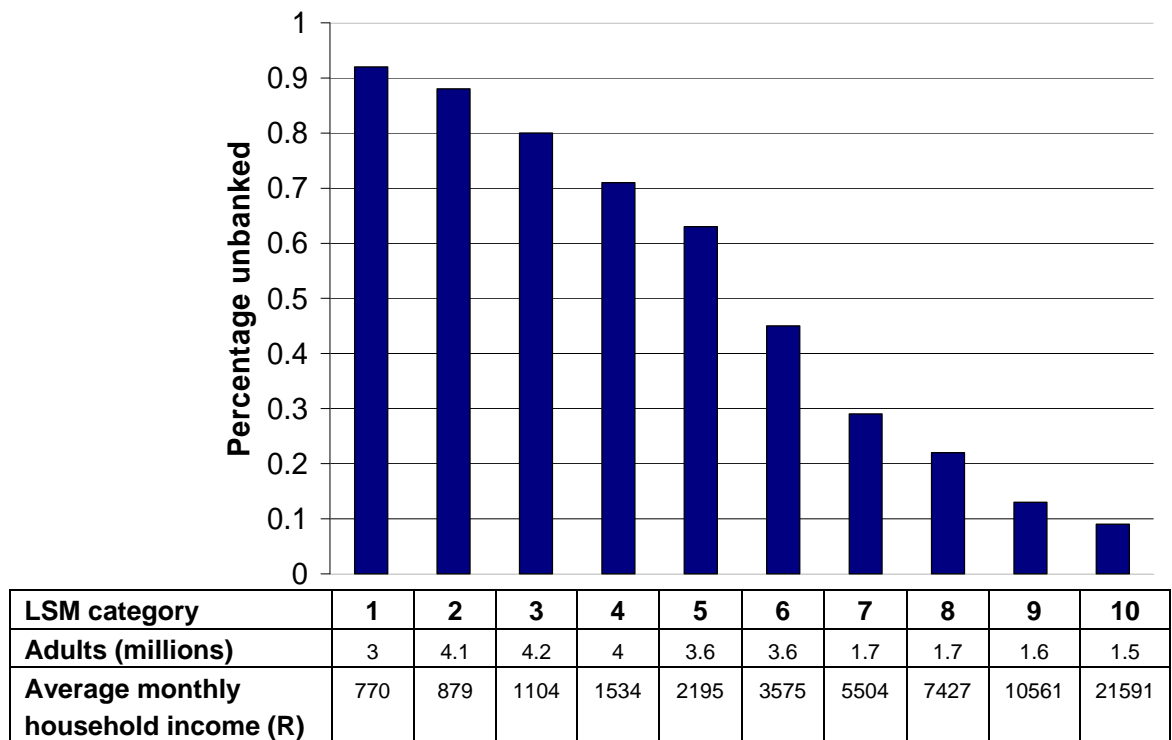
### 3.2. THE AFFORDABILITY FRONTIER

How do incremental changes in the cost of financial services affect the extension of access to financial services? To answer this question requires an understanding of the relevant market and how they are likely to respond to changes in the cost of financial services.

FinMark defines the “low-income” market as individuals falling into LSM (Living Standards Measure) categories 1 to 5<sup>5</sup>. A recent survey by SAtoZ shows that of the approximately 19 million adults falling into these categories approximately 78% (15 million adults) do not have access to banking products. The level of access to financial services is shown for each LSM category on Figure 2 overleaf. FinMark proposes that, realistically, the “mass-market” should be limited to LSMs 3-5, as households below that level of income will not be able to afford even very low costs of financial services, and households above it are no longer “low-income”. This definition includes households with a monthly income of between approximately R1100 per month and R2200 per month. The SAtoZ survey shows that 72% of these households are unbanked.

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<sup>5</sup> Individuals living in households with income of less than R2 200 per month. See Figure 2.



**Figure 2: The unbanked by LSM category (including monthly household income and number of adults)**  
Source: *FutureFact (2002) quoted in Porteous (2003)*

The FinScope survey, undertaken by FinMark, revealed that the main reason that a large segment of the mass-market is unbanked is that they cannot afford banking services<sup>6</sup>. As a result of their need, poor people can afford to spend only a small proportion of their income on bank charges. In order to illustrate the effects on affordability of incremental increases in costs of financial services, an “affordability frontier” is shown on Figure 3 below.<sup>7</sup> For the purposes of this project, the segment of the curve lying between the R24 and R44 cost range approximately captures affordability for the “mass-market”, i.e. individuals in LSM categories 3 to 5.

It is interesting to note the estimated effects of costs on affordability along this segment of the frontier. Analysis of the data shows that at an average monthly cost

<sup>6</sup> The FinScope survey shows that the main reason given by the unbanked for why people don't have bank accounts is that “people do not have enough money”. 27% of unbanked respondents, the highest proportion, gave this reply. A further 24% replied that “people are not regularly employed”. When asked what the greatest problems with banks are, 19% of unbanked respondents, the highest proportion, replied that bank charges are too high.

<sup>7</sup> This analysis is based on a model developed by FinMark. See FinMark Trust *Scenarios for Financial Services in South Africa in 2010*. The data source is SA to Z/AMPS 2002. The calculation assumes that a transaction banking service costing more than 2% of monthly income is not affordable (Based on Porteous *The landscape of access to financial services in South Africa*, Labour Markets & Social Frontiers No.3 April, PSARB (2003)), and that the current monthly cost of a transaction account is R40 (measured using the methodology described in footnote 85 below). At this cost, only households earning R2 000 or more can afford a transaction account.

close to the high end of the “affordability frontier” of R45<sup>8</sup>, a R9 reduction in the cost of banking accounts is necessary to increase the number of households able to afford bank accounts by approximately 490 000 households. At an average cost of R23 per month (close to the low-end of the frontier)<sup>9</sup>, a R2 reduction in cost will result in approximately 450 000 additional households being able to afford bank accounts.

Therefore, for the mass-market, small incremental costs generated by legislation and regulations may have a large impact on the affordability of financial services, particularly at low costs of financial services.

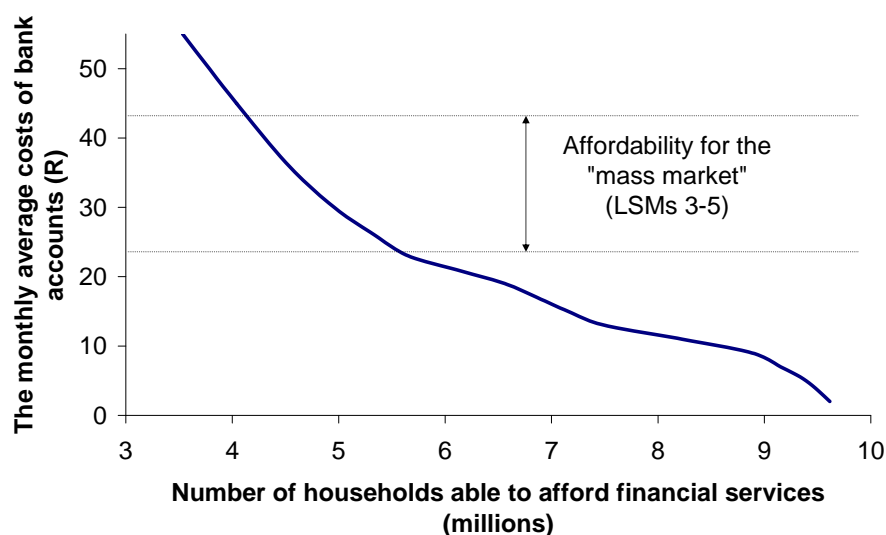


Figure 3: Affordability frontier of households for bank accounts

Source: Genesis Analytics based on “Scenarios for Financial Services in South Africa in 2010”, FinMark Trust

<sup>8</sup> The current estimated average monthly cost of an existing bank account is R40. This is based on a FinMark Trust Market Comparison that took place in 2002, which makes several assumptions about the number and value of transactions that a typical client is likely complete. The bank charges of the “typical client” are assumed to arise from: a monthly service fee, 2 debit orders, 2 ATM withdrawals--on us (w/d: R100 each), 1 ATM withdrawal--SASWITCH (w/d: R100 each), 2 Electronic payments (R100 each), 1 Statement requested – ATM, 1 Statement requested – Counter, 1 Deposit (R1,000). The FinMark Trust analysis compared 14 bank accounts at 6 existing South African banks.

<sup>9</sup> Several of the “innovator” banks aim to charge approximately R20 per month for bank accounts.

## PART 2: MONEY LAUNDERING CONTROLS

Towards the end of the last century a money laundering control system was developed by the international community. This system is aimed at preventing crime and especially organised crime. Since the 11<sup>th</sup> of September 2001 the money laundering control framework has also been employed to suppress the funding of terrorism.

The money laundering control system enlists the financial services industry as one of the key partners in crime combating. The industry is required to actively prevent its services from being abused to launder money. One of the core money laundering control duties is the duty of a financial institution to identify its customers on the basis of reliable documentation (generally referred to in this report as Customer Due Diligence or CDD).

South African banks are required by international standards to identify their customers. However, they are also compelled to do so by common law as well as legislation. The regulations under the Banks Act 94 of 1990 and FICA (the Financial Intelligence Centre Act 38 of 2001) are particularly important in this regard.

This section of the report investigates the basic international standards and the relevant laws relating to customer identification. It considers the impact that the laws may have on mass banking solutions and proposes a framework for a solution.

### 4. INTERNATIONAL STANDARDS

#### 4.1. INTRODUCTION

The main international standard-setting body in respect of money laundering control is the Financial Action Task Force (FATF). After the admission of South Africa and Russia as members, the membership of the FATF comprises 31 countries and two regional organisations. The membership of the FATF represents the major financial and political centres of the world. The FATF co-operates closely

with the World Bank, the International Monetary Fund, organs of the United Nations and several FATF-style regional bodies.

The FATF adopted a set of standards with regard to money laundering control in 1990. These standards, referred to as the Forty Recommendations, have been endorsed by more than 130 countries. The Recommendations were supplemented in 2001 with eight special recommendations relating to funding of terrorism. After an extensive review programme which was launched in 2001 a revised set of Forty Recommendations was adopted by the FATF in June 2003. Although the Revised Forty Recommendations are the currently applicable international standards, we commence this review by setting out the relevant aspects of the original (pre-2003) Forty Recommendations. The pre-2003 Recommendations are still relevant because they have influenced the South African money laundering control framework and because of the accumulated international compliance experience that has been built up in the context of those Recommendations. After that we turn to the 2001 Special Recommendations on Terrorist Financing and then to the 2003 Recommendations.

The other major international standard-setting body in relation to customer identification and verification by banks is the Basel Committee on Banking Supervision. However, unlike the FATF approach, the Basel Committee's approach to CDD (customer due diligence) is not confined to money laundering control. Rather, they see CDD as a critical element in the effective management of banking risks. We also briefly consider the Basel guidelines on CDD.

#### 4.2.

#### THE FORTY RECOMMENDATIONS (1990)

Recommendation 10 of the 1990 Recommendations addressed customer identification and record-keeping. It read as follows:

"Financial institutions should not keep anonymous accounts or accounts in obviously fictitious names: they should be required (by law, by regulations, by agreements between supervisory authorities and financial institutions or by self-regulatory agreements among financial institutions) to identify, on the basis of an official or other reliable identifying document, and record the identity of their clients, either occasional or usual, when establishing business relations or conducting transactions (in particular opening of accounts or passbooks, entering into fiduciary transactions, renting of safe deposit boxes, performing large cash transactions)."

If there were any doubts about the true identity of persons on whose behalf an account is opened or a transaction conducted, Recommendation 11 required financial institutions to take reasonable measures to obtain information about the true identity of those persons.

Amongst others, Recommendation 12 required financial institutions to keep records on customer identification (e.g. copies or records of official identification documents like passports, identity cards, driving licenses or similar documents), account files and business correspondence for at least five years after the account is closed.

Client identification and verification had to be done before a single transaction was concluded or a business relationship was established. Once a business relationship was established the customer and the account also had to be subject to ongoing due diligence procedures and scrutiny.<sup>10</sup>

#### 4.3. THE SPECIAL RECOMMENDATIONS ON TERRORIST FINANCING (2001)

In October 2001 FATF issued eight special recommendations to combat financing of terrorism<sup>11</sup>. Special Recommendations VI and VII are of particular importance for this study.

##### 4.3.1. SPECIAL RECOMMENDATION VI: ALTERNATIVE REMITTANCE

Special Recommendation VI requires of every country to take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value (including transmission through an informal money or value transfer system or network) are:

- licensed or registered; and
- subject to all the FATF Recommendations that apply to banks and non-bank financial institutions.

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<sup>10</sup> FATF The review of the Forty Recommendations – Consultation Paper 30 May 2002 par 79.

<sup>11</sup> A bill that will incorporate these Special Recommendations, the Anti-Terrorism Bill, B 12-2003, has been tabled in Parliament. It is anticipated that the bill will be amended extensively. No further comment regarding the bill will therefore be made in this document, except to point out that it will give rise to further direct or indirect duties on banks to correctly identify their customers.

In addition each country is required to ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions.

The interpretative note to this recommendation makes it clear that it is aimed at all forms of money or value transfer, particularly those traditionally operating outside the conventional financial sector. The note defines “money or value transfer service” as referring to a financial service that accepts cash, cheques, other monetary instruments or other stores of value in one location and pays a corresponding sum in cash or other form to a beneficiary in another location by means of a communication, message, transfer or through a clearing network to which the money/value transfer service belongs. Transactions performed by such services can involve one or more intermediaries and a third party final payment.

A money or value transfer service may be provided by persons (natural or legal) formally through the regulated financial system, informally through non-bank financial institutions or other business entities or any other mechanism either through the regulated financial system (for example, use of bank accounts) or through a network or mechanism that operates outside the regulated system. In some jurisdictions, informal systems are frequently referred to as “alternative remittance services” or “underground (or parallel) banking systems.”

In essence, Recommendation VI consists of three elements:

- Jurisdictions should require licensing or registration of persons (natural or legal) that provide money/value transfer services, including through informal systems;
- Jurisdictions should ensure that money or value transmission services, including informal systems, are subject to applicable FATF Forty Recommendations and the Eight Special Recommendations (in particular SR VII); and
- Jurisdictions should be able to impose sanctions on money/value transfer services, including informal systems, that operate without a license or registration and that fail to comply with relevant FATF Recommendations.

“Licensing” is defined as a requirement to obtain permission from a designated competent authority to operate a money or value transfer system and “registration” (for purposes of the interpretative note) is defined as a requirement to register with

or declare to a designated competent authority the existence of the money or value transfer service in order for the business to operate legally.

The interpretative note to Recommendation VI makes it clear that the licensing or registration requirement also applies to agents. An agent is defined as any person who provides money or value transfer service under the direction of or by contract with a legally registered or licensed remitter (for example, licensees, franchisees, concessionaires). At a minimum, the principal business must maintain a current list of agents which must be made available to the designated competent authority.

The recommendation applies to all persons (natural or legal) who conduct money or value transfers as a primary or substantial part of their business or when it is undertaken on a regular or recurring basis, including as an ancillary part of a separate business enterprise.

Countries are required to designate authorities that will grant the necessary licences or register the necessary information and will ensure that the requirements are observed. However, it is not necessary to impose these requirements on financial institutions which are licensed or registered in terms of formal requirements and which are already subject to the full range of money laundering control requirements.

#### 4.3.2.

#### SPECIAL RECOMMENDATION VII: WIRE TRANSFERS

Special Recommendation VII requires countries to take measures that will require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address and account number) on funds transfers and related messages that are sent. This information should remain with the transfer or related message through the payment chain. Countries should furthermore ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers that do not contain complete originator information.

The main objectives of Special Recommendation VII are to prevent terrorists and criminals from having unfettered access to wire transfers to move their funds and to aid detection of such abuse if it occurs. It aims to ensure that basic information on the originator is available to for purposes of identifying and reporting suspicious transactions and to facilitate the tracing of assets of terrorists and criminals.

The interpretative note to Special Recommendation VII provides the following relevant definitions:

- “Wire transfer” and “funds transfer” refer to any transaction carried out on behalf of an originator person (both natural and legal) through a financial institution by electronic means with a view to making an amount of money available to a beneficiary person at another financial institution. The originator and the beneficiary may be the same person.
- “Cross-border transfer” means any wire transfer where the originator and beneficiary institutions are located in different jurisdictions. This term also refers to any chain of wire transfers that has at least one cross-border element.
- “Domestic transfer” means any wire transfer where the originator and beneficiary institutions are located in the same jurisdiction. This term therefore refers to any chain of wire transfers that takes place entirely within the borders of a single jurisdiction, even though the system used to effect the wire transfer may be located in another jurisdiction.
- “Financial institution” is as defined by the FATF Forty Recommendations. The term does not apply to any persons or entities that provide financial institutions solely with message or other support systems for transmitting funds.
- The “originator” is the account holder, or where there is no account, the person (natural or legal) that places the order with the financial institution to perform the wire transfer.

The Special Recommendation, according to the interpretative note, covers both cross-border and domestic wire transfers. In respect of cross-border transfers, the general requirement is that it must contain:

- the name of the originator;
- the number of the account, or if that is absent, a unique reference number;
- the address of the originator, although countries may substitute the address with a national identity number, customer identification number or date and place of birth.

Domestic wire transfers must be accompanied by the same information unless that information can be made available to a beneficiary financial institution by other means. In such a case the wire transfer must include a unique identifier that allows the transaction to be traced back to the originator and the information must be disclosed promptly on request by the beneficiary financial institution.

The ordering financial institution must ensure that the relevant wire transfers contain complete originator information. They must also verify the information for accuracy and keep the relevant records as required by the Forty Recommendations.

The interpretative note to the Special Recommendation allows jurisdictions to have a *de minimis* threshold (no higher than USD 3,000) for a one-year period from publication of the interpretative note (14 February 2003). At the end of this period, the FATF undertook to review this issue to determine whether the use of a *de minimis* threshold is acceptable. Notwithstanding any thresholds, accurate and meaningful originator information must be retained and made available by the ordering financing institution.

The interpretative note to this recommendation provides the following guidance regarding the responsibilities of the ordering, intermediary and beneficiary financial institutions:

- The **ordering** financial institution must ensure that qualifying wire transfers contain complete originator information. The ordering financial institution must also verify this information for accuracy and maintain this information in accordance with the standards set out in the FATF Forty Recommendations.
- For both cross-border and domestic wire transfers, financial institutions processing an **intermediary** element of such chains of wire transfers must ensure that all originator information that accompanies a wire transfer is retained with the transfer. Where technical limitations prevent the full originator information accompanying a cross-border wire transfer from remaining with a related domestic wire transfer (during the necessary time to adapt payment systems), a record must be kept for five years by the receiving intermediary financial institution of all the information received from the ordering financial institution.
- **Beneficiary** financial institutions should have effective risk-based procedures in place to identify wire transfers lacking complete originator information. The lack of complete originator information may be considered as a factor in assessing whether a wire transfer or related transactions are suspicious and, as appropriate, whether they are thus required to be reported to the financial intelligence unit or other competent authorities. In some cases, the beneficiary financial institution should consider restricting or even terminating its business

relationship with financial institutions that fail to meet the standards of the Special Recommendation.

The interpretative note does not cover financial institution-to-financial institution transfers where the institutions are the originators and beneficiaries in their own capacity. It does not cover debit and credit card transactions either, so long as the number of the relevant card accompanies the transfer flowing from the transaction. However, when such a card is used to effect a money transfer the transaction is covered by the Recommendation.

#### 4.4. THE REVISED FORTY RECOMMENDATIONS (2003)

FATF launched a review programme of the Forty Recommendations in 2001. As part of the review programme attention was given to a clearer formulation of customer identification and verification principles.<sup>12</sup> In this process FATF paid attention to appropriate standards that were formulated by other relevant bodies. In particular it described the paper on “Customer due diligence for banks” which was published by the Basel Committee on Banking Supervision as broadly consistent with FATF standards.<sup>13</sup> In the review programme attention was also given to situations in which simplified client identification and verification may be allowed.<sup>14</sup>

The Revised Recommendations that were issued in June 2003 are in general stricter and more detailed than the 1990 Recommendations. The Recommendations were issued together with a glossary and interpretative notes that define, clarify and detail certain aspects of the Recommendations. The key Recommendations for purposes of this study are Recommendations 5-11.

##### 4.4.1. RECOMMENDATION 5 : GENERAL CUSTOMER DUE DILIGENCE (CDD)

Recommendation 5 requires financial institutions to undertake CDD measures, including identifying and verifying the identity of their customers, **when**:

- establishing business relations;

<sup>12</sup> FATF *The review of the Forty Recommendations – Consultation Paper* 30 May 2002 par 29.

<sup>13</sup> FATF *The review of the Forty Recommendations – Consultation Paper* 30 May 2002 par 36.

<sup>14</sup> FATF *The review of the Forty Recommendations – Consultation Paper* 30 May 2002 par 78.

- carrying out occasional transactions (1) above the applicable designated threshold; or (2) that are wire transfers in the circumstances covered by the interpretative note to Special Recommendation VII;
- there is a suspicion of money laundering or terrorist financing; or
- the financial institution has doubts about the veracity or adequacy of previously obtained customer identification data.<sup>15</sup>

The designated **threshold** for occasional transactions with financial institutions is defined in the interpretative notes to the Forty Recommendations as USD/Euro 15,000. Financial transactions above a designated threshold include situations where the transaction is carried out in a single operation or in several operations that appear to be linked.

Under Recommendation 5 the following **CDD measures** are to be taken:

- Identifying the customer and verifying that customer's identity using reliable, independent source documents, data or information (generally referred to as "identification data" in the Recommendations);
- Identifying the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner such that the financial institution is satisfied that it knows who the beneficial owner is. For legal persons and arrangements this should include financial institutions taking reasonable measures to understand the ownership and control structure of the customer.
- Obtaining information on the purpose and intended nature of the business relationship.
- Conducting ongoing due diligence on the business relationship and scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the institution's knowledge of the customer, their business and risk profile, including, where necessary, the source of funds.

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<sup>15</sup> According to Interpretative Note 5 financial institutions do not have to repeatedly identify and verify the identity of each customer every time that a customer conducts a transaction. An institution is entitled to rely on the identification and verification steps that it has already undertaken unless it has doubts about the veracity of that information. Examples of situations that might lead an institution to have such doubts could be where there is a suspicion of money laundering in relation to that customer, or where there is a material change in the way that the customer's account is operated which is not consistent with the customer's business profile.

Financial institutions should apply each of the above CDD measures, but may determine the extent of such measures on a **risk sensitive basis** depending on the type of customer, business relationship or transaction. The measures that are taken should be consistent with any guidelines issued by competent authorities. For higher risk categories, financial institutions should perform enhanced due diligence. In certain circumstances, where there are low risks, countries may decide that financial institutions can apply reduced or simplified measures.

Financial institutions should verify the identity of the customer and beneficial owner **before or during the course of establishing a business relationship** or conducting transactions for occasional customers.<sup>16</sup> Countries may permit financial institutions to complete the verification as soon as reasonably practicable following the establishment of the relationship, where the money laundering risks are effectively managed and where this is essential not to interrupt the normal conduct of business. Where the financial institution is unable to identify the customer or obtain information regarding the purpose and intended nature of the business relationship it should:

- not open the account, commence business relations or perform the transaction or should terminate the business relationship; and
- should consider making a suspicious transactions report in relation to the customer.

These requirements should apply to all new customers, though financial institutions should also **apply the Recommendation to existing customers on the basis of materiality and risk**, and should conduct due diligence on such existing relationships at appropriate times.

Recommendation 9 allows countries to permit financial institutions to **rely on intermediaries or other third parties** to perform the identification and verification

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<sup>16</sup> Interpretative Note 6 provide the examples of the types of circumstances where it would be permissible for verification to be completed after the establishment of the business relationship, because it would be essential not to interrupt the normal conduct of business include: The examples furnished include non face-to-face business and securities transactions that require an immediate action and transactions. The note requires financial institutions to adopt risk management procedures with respect to the conditions under which a customer may utilise the business relationship prior to verification. These procedures should include a set of measures such as a limitation of the number, types and/or amount of transactions that can be performed and the monitoring of large or complex transactions being carried out outside of expected norms for that type of relationship. Financial institutions are required to refer to the Basel CDD paper for specific guidance on examples of risk management measures for non-face to face business.

elements of the CDD process or to introduce business.<sup>17</sup> Where such reliance is permitted, the ultimate responsibility for customer identification and verification remains with the financial institution relying on the third party. However, the following criteria should be met:

- a) A financial institution that relies upon a third party should immediately obtain the necessary information concerning the identification and verification elements of the CDD process. Financial institutions should take adequate steps to satisfy themselves that copies of identification data and other relevant documentation relating to the CDD requirements will be made available from the third party upon request without delay.
- b) The financial institution should satisfy itself that the third party is regulated and supervised and has measures in place to comply with CDD requirements in line with Recommendations 5 and 10.

Recommendation 5 is detailed in a number of interpretative notes. Interpretative Notes 9 to 13, for instance, provide guidance on **simplified or reduced CDD** measures. The general rule is that customers must be subject to the full range of CDD measures, including the requirement to identify the beneficial owner. Nevertheless it is recognised that there are circumstances where the risk of money laundering or terrorist financing is lower, where information on the identity of the customer and the beneficial owner of a customer is publicly available, or where adequate checks and controls exist elsewhere in national systems. In such circumstances it could be reasonable for a country to allow its financial institutions to apply simplified or reduced CDD measures when identifying and verifying the identity of the customer and the beneficial owner. Examples of customers where simplified or reduced CDD measures could apply are furnished in Interpretative Note 10 and include the following:

- Financial institutions – where they are subject to requirements to combat money laundering and terrorist financing consistent with the FATF Recommendations and are supervised for compliance with those controls;
- Public companies that are subject to regulatory disclosure requirements; and
- Government administrations or enterprises.

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<sup>17</sup> However, the Interpretative Note to this recommendation states that it does not apply to outsourcing or agency relationships.

Simplified or reduced CDD measures could also apply to the beneficial owners of pooled accounts held by designated non-financial businesses or professions provided that those businesses or professions are subject to the FATF requirements and subject to effective systems for monitoring and ensuring their compliance with those requirements.

According to Interpretative Note 12 simplified CDD or reduced measures could also be acceptable for various types of products or transactions such as (examples only):

- Life insurance policies where the annual premium is no more than USD/Euro 1000 or a single premium of no more than USD/Euro 2500;
- Insurance policies for pension schemes if there is no surrender clause and the policy cannot be used as collateral;
- A pension, superannuation or similar scheme that provides retirement benefits to employees, where contributions are made by way of deduction from wages and the scheme rules do not permit the assignment of a member's interest under the scheme.

#### 4.4.2.

#### RECOMMENDATION 6 : POLITICALLY EXPOSED PERSONS

Financial institutions should, in relation to politically exposed persons, in addition to performing normal due diligence measures:

- Have appropriate risk management systems to determine whether the customer is a politically exposed person;
- Obtain senior management approval for establishing business relationships with such customers;
- Take reasonable measures to establish the source of wealth and source of funds; and
- Conduct enhanced ongoing monitoring of the business relationship.

The glossary defines politically exposed persons as individuals who are or have been entrusted with prominent public functions in a foreign country, for example Head of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials. The definition does not cover middle ranking or junior individuals in those categories, but does seem to extend to family members and close associates

of politically exposed persons. The Interpretative Note to Recommendation 6 encourages a country to extend the requirements of the recommendation to individuals who hold prominent public functions in their own country.

4.4.3. RECOMMENDATION 8 : NEW TECHNOLOGIES

Recommendation 8 requires financial institutions to pay special attention to any money laundering threats that may arise from new or developing technologies that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes. In particular, financial institutions should have policies and procedures in place to address any specific risks associated with non-face to face business relationships or transactions.

4.4.4. RECOMMENDATION 10 : RECORD-KEEPING

Financial institutions should maintain, for at least five years, all necessary records on transactions, both domestic and international, to enable them to comply swiftly with information requests from the competent authorities. Such records must be sufficient to permit reconstruction of individual transactions (including the amounts and types of currency involved if any) so as to provide, if necessary, evidence for prosecution of criminal activity.

Financial institutions should keep records on the identification data obtained through the CDD process (e.g. copies or records of official identification documents like passports, identity cards, driving licenses or similar documents), account files and business correspondence for at least five years after the business relationship is ended.

The identification data and transaction records should be available to domestic competent authorities upon appropriate authority.

4.4.5. RECOMMENDATION 11 : COMPLEX TRANSACTIONS

Financial institutions should pay special attention to all complex, unusual large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities and auditors.

#### 4.5. BASEL COMMITTEE ON BANKING SUPERVISION

The Basel Committee on Banking Supervision published a paper entitled “Customer due diligence for banks” in October 2001. The aim of the paper was to provide a customer identification and so-called know-your customer (“KYC”) framework that may serve as a benchmark for banking supervisors to establish national practices and for banks to design their own KYC programmes.

The Basel Committee acknowledged the importance of the FATF recommendations in respect of customer identification and expressed its support for the Forty Recommendations. However, unlike the FATF approach, the Basel Committee’s approach to CDD is not confined to money laundering control:<sup>18</sup>

“Sound KYC procedures must be seen as a critical element in the effective management of banking risks. KYC safeguards go beyond simple account opening and record-keeping and require banks to formulate a customer acceptance policy and a tiered customer identification programme that involves more extensive due diligence for higher risk accounts, and includes proactive account monitoring for suspicious activities. (par 5) The Basel Committee’s interest in sound KYC standards originates from its concerns for market integrity and has been heightened by the direct and indirect losses incurred by banks due to their lack of diligence in applying appropriate procedures. These losses could probably have been avoided and damage to the banks’ reputation significantly diminished had the banks maintained effective KYC programmes.”

The guidance provided in the paper enjoys broad international support. Participants in the 2002 International Conference of Banking Supervisors in Cape Town in September 2002 recognised the paper as the agreed standard on CDD. The participants represented banking regulators from more than 120 countries.<sup>19</sup>

<sup>18</sup> Basel Committee on Banking Supervision “Customer due diligence for banks” par 4 and 5.

<sup>19</sup> BIS press release 19 September 2002: “Key elements of the Basel Committee’s *Customer due diligence for banks* report, which ICBS attendees recognised as the agreed standard, are: thorough customer acceptance and identification practices, ongoing transactions monitoring and a robust risk management programme for banks. The report provides a benchmark for all supervisors to proceed with the work of designing or improving national supervisory practice.”

#### 4.5.1. CUSTOMER ACCEPTANCE POLICY<sup>20</sup>

The paper requires banks to develop clear customer acceptance policies and procedures, including a description of the types of customer that are likely to pose a higher than average risk to a bank. In preparing such policies, factors such as a customer's background, country of origin, public or high profile position, linked accounts and business activities should be considered. These policies and procedures should be graduated to require more extensive due diligence for higher risk customers.

The paper is **sensitive to the needs of the financially or socially disadvantaged**. It allows client acceptance policies that may require the most basic account-opening requirements for a working individual with a small account balance. The paper also stresses that "[i]t is important that the customer acceptance policy is not so restrictive that it results in a denial of access by the general public to banking services, especially for people who are financially or socially disadvantaged."

#### 4.5.2. CUSTOMER IDENTIFICATION

The paper lays down a number of general principles regarding client identification. The principles include the following:

- Banks should establish a systematic procedure for identifying new customers and should not establish a banking relationship until the identity of a new customer is satisfactorily verified;<sup>21</sup>
- The best documents for verifying the identity of customers are those most difficult to obtain illicitly and to counterfeit.<sup>22</sup>
- The customer identification process applies naturally at the outset of the relationship.<sup>23</sup>
- To ensure that records remain up-to-date and relevant, there is a need for banks to undertake regular reviews of existing records.<sup>24</sup>
- Banks need to obtain all information necessary to establish to their full satisfaction the identity of each new customer and the purpose and intended

<sup>20</sup> Basel Committee on Banking Supervision "Customer due diligence for banks" par 20.

<sup>21</sup> Basel Committee on Banking Supervision "Customer due diligence for banks" par 22.

<sup>22</sup> Basel Committee on Banking Supervision "Customer due diligence for banks" par 23.

<sup>23</sup> Basel Committee on Banking Supervision "Customer due diligence for banks" par 24.

<sup>24</sup> Basel Committee on Banking Supervision "Customer due diligence for banks" par 24.

nature of the business relationship. The extent and nature of the information depends on the type of applicant (personal, corporate, etc.) and the expected size of the account.<sup>25</sup>

The paper was not specific on general identification requirements as the Working Group on Cross-Border Banking intended to develop guidelines on essential elements of customer identification requirements. These guidelines were published in February 2003 as an attachment to the paper. The attachment is entitled "General guide to account opening and customer identification".

The guide deals with the identification requirements in respect of a host of customers. In respect of natural persons it requires the following information to be obtained, where applicable:<sup>26</sup>

- legal name and any other names used (such as maiden name);
- correct permanent address (the full address should be obtained; a Post Office box number is not sufficient);
- telephone number, fax number, and e-mail address;
- date and place of birth;
- nationality;
- occupation, public position held and/or name of employer;
- an official personal identification number or other unique identifier contained in an unexpired official document (e.g. passport, identification card, residence permit, social security records, driving licence) that bears a photograph of the customer;
- type of account and nature of the banking relationship; and
- signature.

The guide requires banks to verify this information by at least one of the following methods:<sup>27</sup>

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<sup>25</sup> Basel Committee on Banking Supervision "Customer due diligence for banks" par 27.

<sup>26</sup> "General guide to account opening and customer identification" (attachment to Basel Committee on Banking Supervision "Customer due diligence for banks") par 10. See also par 14: "From the information provided in paragraph 10, financial institutions should be able to make an initial assessment of a customer's risk profile. Particular attention needs to be focused on those customers identified thereby as having a higher risk profile and additional inquiries made or information obtained in respect of those customers to include the following: evidence of an individual's permanent address sought through a credit reference agency search, or through independent verification by home visits; personal reference (i.e. by an existing customer of the same institution); prior bank reference and contact with the bank regarding the customer; source of wealth; verification of employment, public position held (where appropriate)."

- confirming the date of birth by comparing it to an official document such as a birth certificate, passport or identity document;
- confirming the permanent address by comparing it to a document such as a utility bill, tax assessment, bank statement or a letter from a public authority;
- contacting the customer by telephone, by letter or by e-mail to confirm the information supplied after an account has been opened (e.g. a disconnected phone, returned mail, or incorrect e-mail address should warrant further investigation);
- confirming the validity of the official documentation provided through certification by an authorised person (e.g. embassy official).

The guide also formulated the following principles that are relevant to this study:

- The examples of verification documents quoted in the guide are not the only possibilities. In particular jurisdictions there may be other documents of an equivalent nature which may be produced as satisfactory evidence of customers' identity.<sup>28</sup>
- Financial institutions should apply equally effective customer identification procedures for non-face-to-face customers as for those available for interview.<sup>29</sup>
- For one-off or occasional transactions where the amount of the transaction or series of linked transactions does not exceed an established minimum monetary value, it might be sufficient to require and record only the name and address of the customer.<sup>30</sup>

It is important to note from the perspective of this study that the guide produced in February 2003 is as concerned with the protection of the financially and socially vulnerable as the main paper was in October 2001. Paragraph 16 provides the following guidance:

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<sup>27</sup> "General guide to account opening and customer identification" (attachment to Basel Committee on Banking Supervision "Customer due diligence for banks") par 11.

<sup>28</sup> "General guide to account opening and customer identification" (attachment to Basel Committee on Banking Supervision "Customer due diligence for banks") par 12.

<sup>29</sup> "General guide to account opening and customer identification" (attachment to Basel Committee on Banking Supervision "Customer due diligence for banks") par 13.

<sup>30</sup> "General guide to account opening and customer identification" (attachment to Basel Committee on Banking Supervision "Customer due diligence for banks") par 15.

“It is important that the customer acceptance policy is not so restrictive that it results in a denial of access by the general public to banking services, especially for people who are financially or socially disadvantaged.”

The Basel principles and guidelines in this regard were formulated before 2003 FATF Forty Recommendations were finalised.<sup>31</sup> They influenced the drafting of the Recommendations, but unfortunately the Recommendations did not follow their lead by expressly providing safeguards for the interests of the financially and socially vulnerable.

#### 4.6.

#### CONCLUSION

The international standards in respect of customer identification and verification by banks are strict. The purpose of these procedures is not merely to prevent money laundering and combat funding of terror. Banks must manage the risks posed by their customers and these risks can only be properly appreciated and managed if the banks know with whom they are dealing.

South African law is largely compliant with the 1990 and 2003 FATF Recommendations. However, the domestic law has not yet been brought in line with the Special Recommendations on Terrorist Financing and some aspects of the with the 2003 FATF Recommendations will also have to be addressed. These international standards limit the ability of the government to freely provide a money laundering regulatory system which is conducive to mass banking products. However, there are international examples of FATF member countries that have tailored their money laundering controls and the supervision of these controls so as not to make it too difficult for the financial excluded to access banking services. We now briefly look at some of the general practices and, in particular the UK approach.

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<sup>31</sup> The Committee's processes in this regard are continuing. On 30 October 2003 the Committee released a consultative document entitled "Consolidated KYC risk management."

## 5. INTERNATIONAL SUPERVISORY RESPONSES TO MONEY LAUNDERING CONTROL CHALLENGES

South Africa's implementation of the 1990 FATF Forty Recommendations is a recent phenomenon, with banks being required to perform full CDD on new customers only since 30 June 2003. From a supervision and compliance point of view, we count our experience in months rather than years. It is therefore useful to consider international supervisory responses to the introduction of money laundering controls. For the purposes of this study we focus primarily on the move towards risk-based or risk-sensitive supervision, and the introduction of measures in the UK to ensure access to financial services for the financially excluded.

### 5.1. RISK-BASED SUPERVISION AND COMPLIANCE

Risk-based supervision and risk-based compliance are flip sides of the same coin. We proceed to deal with each in turn.

#### 5.1.1. RISK-BASED SUPERVISION

The traditional understanding of banking regulation and supervision is of prudential supervision, the objective of which is to ensure that the banking system is safe and sound. By safe and sound we mean, financially safe and sound. The objective of regulation and supervision in a money laundering control context is obviously different, i.e. to ensure that the financial system is not used for money laundering, other organised criminal activities or the financing of terrorism. Whereas the objectives of supervision differ in these two contexts, the approaches to supervision can be the same.

During the past two decades, in response to ever more complex and globally connected financial systems, new and more dynamic approaches to supervision had to be developed. In particular there has been a move away from traditional forms of supervision to so-called risk-based supervision. Key differences between

these two types of approaches to supervision of banks are summarised as follows by Robert Vogel and Thomas Fitzgerald in “Moving towards risk-based supervision in developing economies”.<sup>32</sup>

“At the risk of oversimplifying the differences in approaches to supervision, traditional supervision focuses more on *quantifying problems and minimizing risks* in individual financial institutions, while risk-based supervision focuses more on the *quality of risk-management systems* and the *recognition of systemic risks to the banking system caused by the economic environment*. ... Traditional supervision often results in quantifying problems, correcting symptoms of problems, and instructing banks to *avoid* risks that seem too high. Risk-based supervision assesses the quality of risk-management practices, addresses causes of problems, and makes recommendations that give banks options on how to minimize the adverse consequences of risk-taking.” ... The traditional approach tends to limit a bank’s ability to serve the economic community’s needs by limiting the risks a bank can take, whereas risk-based supervision allows banks to take risks as long as the banks demonstrate the ability to manage and price for risk. ... Traditional supervision tends to apply a cookie-cutter approach to supervision in which all banks are treated alike, often at the lowest common denominator. Risk-based supervision treats banks differently depending on each bank’s demonstrated ability to manage risks. It does not penalize well-managed banks by making them operate under standards designed to keep weak, poorly managed banks solvent.”

Fitzgerald and Vogel trace risk-based supervision back to a supervision strategy that the Multinational Banking Division of the Office of the Comptroller of the Currency formulated in the USA in 1980.<sup>33</sup> International advances in this approach to banking supervision are linked to the adoption of the Basle Capital Accord in July 1988, the adoption of the Core Principles for Effective Banking Supervision, the CAMEL regulatory rating system (Capital, Asset Quality, Management, Earnings and Liquidity) and the realisation that collateral-based lending is not necessarily low-risk lending.

<sup>32</sup> Briefing note for Consulting Assistance on Economic Reform II (CAER II) Discussion Paper No 66 (2000) <http://www.cid.harvard.edu/caer2/htm/content/papers/bns/dp66bn.htm> (25 July 2003).

<sup>33</sup> Fitzgerald and Vogel “Moving towards risk-based supervision in developing economies” CAER II Discussion Paper No 66 (2000) <http://www.cid.harvard.edu/caer2/htm/content/papers/paper66/paper66.htm> (4 August 2003).

The Financial Services Authority of the UK embraced a risk-based approach to supervision when it was formed in the late 1990s:<sup>34</sup>

“The FSA will adopt a flexible and differentiated risk-based approach to setting standards and to supervision, reflecting the nature of the business activities concerned, the extent of risk within particular firms and markets, the quality of the firms’ management controls and the relative sophistication of the consumers involved. The FSA will ensure that appropriate distinctions are made between the regulation of wholesale and retail business, reflecting the varying expertise of consumers and their relative need for protection.”

Risk-based supervision reviews four basic components of a risk-management system to assess the ability of management to manage risks:<sup>35</sup>

- Identification of risks;
- Measurement of risks;
- Controlling risks; and
- Monitoring changes in risk profiles or changes in the corresponding controls.

Risk-based supervision further focuses on the areas of highest risk and incorporates an assessment of management’s ability to deal with risks beyond the control of management.

Whereas risk-based supervision in the financial management field is well established, risk-based supervision in the money laundering control arena is still being shaped. Moreover, it offers challenges very different to those in the financial risk management field. Foremost amongst these is the difficulty to obtain the requisite information that allows management to assess the risks and enables the supervisor’s to assess the management of the risk. Whereas most of the information required to assess financial risks can readily be obtained either from clients or in the public domain, information about money laundering, terrorist financing and organised crime in general is by definition primarily to be found in the nefarious domain. It is for this reason that FATF and the Egmont Group of financial intelligence units, amongst others, have taken to preparing and distributing typologies of standard or regularly occurring money laundering practices. These

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<sup>34</sup> FSA *Financial Services Authority: an outline* (October 1997)” 31.

<sup>35</sup> Briefing note for Consulting Assistance on Economic Reform II, CAER II Discussion Paper No 66 (2000) <http://www.cid.harvard.edu/caer2/htm/content/papers/bns/dp66bn.htm> (25 July 2003).

assist banks with the development of their own systems. In addition, the Revised FATF Recommendations draw heavily on practical experience with money laundering control over the past 12 years.

A prime example of legislative facilitation of the risk-based approach in the anti-money laundering field, is to be found in section 326 of the USA Patriot Act which was signed into law by President Bush on 26 October 2001. The section deals with the identification and verification of bank accountholders. Subsections (1) and (2) of section 326 provides as follows:

“Identification and verification of accountholders-

- (1) IN GENERAL – Subject to the requirements of this subsection, the Secretary of the Treasury shall prescribe regulations setting forth the minimum standards for financial institutions and their customers regarding the identity of the customer that shall apply in connection with the opening of an account at a financial institution.
- (2) MINIMUM REQUIREMENTS – The regulations shall, at a minimum, require financial institutions to implement, and customers (after being given adequate notice) to comply with, reasonable procedures for –
  - (A) verifying the identity of any person seeking to open an account to the extent reasonable and practicable;
  - (B) maintaining records of the information used to verify a person's identity, including name, address, and other identifying information; and
  - (C) consulting lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency whether a person seeking to open an account appears on any such list.”

On 23 July 2002 the Secretary of the US Treasury (together with other relevant regulatory authorities) published a draft set of regulations under section 326 for comment. Extensive comment was received and processed, resulting in the final regulations being published on 9 May 2003, for implementation by 1 October 2003.

In essence, the Treasury proposed that each bank should design and implement its own customer identification programme, tailored to the bank's specific size, location and type of business. The Treasury also emphasised that banks should focus their limited resources on relationships that pose a higher risk of money laundering and terrorism. The Treasury therefore adopted a risk-based approach and amended the original draft regulations in line with this approach. For example, certain lower risk products (e.g. regulated retirement funding accounts with direct payroll deductions) were exempted from the definition of "account" in the final regulations.

#### 5.1.2.

#### RISK-BASED COMPLIANCE

Risk-based compliance is an approach to managing compliance that has taken root in the new culture created by risk-based supervision. Instead of merely maintaining a satisfactory set of systems determined by whether a set of rules were being complied with, risk-based compliance actively manages a business's legal risks of non-compliance with regulation.<sup>36</sup> In terms of this approach, a financial institution will take the following steps:

- *Establish which laws apply to the company, its directors and its employees.*

Laws that may be of general relevance to all corporate financial institutions include company law, banking law, labour laws, tax laws and laws relating to competition and money laundering. Each institution will, in addition, have laws that apply to it on account of factors such as its nature, business or location.

- *Assess the current level of compliance with those laws.*

The business practices of the institution must be considered to ascertain the current level of compliance with each of the laws.

- *Compile a management plan to ensure compliance.*

The plan will outline what has to be done, will allocate responsibility for the specific actions that must be taken and will provide for the monitoring of those actions. Such a plan will often include training and awareness programmes for employees that will alert them to the particular duties and enable them to

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<sup>36</sup> See, in general Bazley, Haynes and Blunden *Risk-based compliance* (2001).

comply with the law. The plan will obviously also address the resource needs for the implementation of the programme.

- *Adopt and implement the plan.*

The implementation should be monitored. A mechanism should be created that will ensure a regular revision of the plan to provide for changes and additions to the law.

When the institution initially assesses its compliance levels, it may find that it is contravening a host of laws. Such an institution may lack the ability to immediately ensure compliance with all of those laws. It will be sensible for an institution in such a predicament to first focus attention on improving compliance with the laws that may have the most serious impact on the institution. For example, compliance with a law that provides for crippling fines or for the loss of a business licence will then be addressed before a law with less serious penalties. That should not mean that the institution resigns itself to non-compliance with the laws with lesser penalties. A well-governed institution is a responsible corporate citizen that should comply with all the laws that apply to it. The institution's objective should therefore be to address all its compliance failures. However, in the process of addressing such failures, it is sensible to first devote attention to critical issues before less critical matters are attended to.

The risk-based approach is now well-entrenched in compliance. This philosophy is also evident in the 2003 FATF Recommendations which, for instance, allows firms to follow a more limited customer due diligence procedure in respect of low risk customers and a more comprehensive procedure in respect of high risk customers. A risk-based approach is also evident in the Exemptions that were granted under FICA.

## 5.2.

### THE UK SCHEME IN RESPECT OF THE FINANCIALLY EXCLUDED<sup>37</sup>

The United Kingdom is also struggling with the provision of financial services to all within its borders, although the problem is of a much smaller scale than in South

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<sup>37</sup> This discussion is based on De Koker "Money laundering control and the financially excluded", a paper delivered as part of a workshop entitled "The balancing act: human rights and the control of money laundering" *Twentieth International Symposium on Economic Crime* Cambridge (11 September 2002).

Africa. The NOP Financial Research Survey which was conducted in 2002 in the United Kingdom showed that 15% of the population did not have a current account. Research published by the Financial Services Consumer Panel in 2002 showed that:

- 9% of adults do not have any bank or building account of any kind; and
- one third of households have no savings or investment products.<sup>38</sup>

Those more likely to be without personal finance services are concentrated both geographically and among certain groups of people such as single parents, those on low wages, ethnic minorities, people with disabilities and the unemployed. They are therefore members of vulnerable groups in society.

Those who are financially excluded are disadvantaged by their isolation from the financial system. They face the financial risks associated with cash, their access to normal consumer credit is limited and their general inability to save threatens their financial security. According to the Financial Services Consumer Panel the impact of the financial isolation of these members of society extends to being unable to access cheaper bills through direct debiting. For example, UK DTI figures show that electricity and gas bills could be as much as 9% lower for those paying by monthly direct debit than those paying by pre-payment meter.

The UK government has tackled what it describes as “the scourge of financial exclusion”. One of the effects of their campaign against financial exclusion was the increased development of basic accounts and facilities that would provide access to direct debit services, bill payment and debit cards, but normally would not carry an overdraft facility. However, despite the increased availability of these accounts, they are not being taken up at the rate that was expected. A Spring 2002 study published by the Financial Services Consumer Panel shows that a lack of information as well as the stringency of money laundering identification requirements were major stumbling blocks.<sup>39</sup>

A group of applicants for these basic accounts were surveyed. Of these, 19% were rejected due to strict ID requirements. One of them recounted the following:

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<sup>38</sup> Foreword to Financial Services Consumer Panel *Basic banking research* (Spring 2002).

<sup>39</sup> Financial Services Consumer Panel *Basic banking research* (Spring 2002).

"They asked me for ID. The ID I could provide was my marriage licence and my housing agreement. They weren't enough. It was a driving licence or passport. Well I don't go abroad and I don't drive. But they were the only two proofs of ID they were willing to take, so that's it."

A second unsuccessful applicant told the following:

"They said 'Are you working?' I said no, I'm looking for work now. 'Any identification?' I said I've got my medical card that's all I've got. They said I need three forms of identification before they can do anything for me. Like a driving licence, passport, birth certificate. Which I haven't got."

The UK Treasury was reported in the Complinet news service (25 April 2002) as blaming banks for merely using the money laundering regulations as an excuse not to take on the poor. According to Complinet these accounts are viewed as not very lucrative for banks. A reluctance to open such accounts may therefore be understandable. However, banks are also required to identify their clients and they are not allowed to open an account unless satisfactory proof of identity is furnished.

It is not possible to judge whether HM Treasury's accusation is in fact correct or whether banks are simply being over-cautious. However, the FSA has certainly attempted to ease the identification requirements in respect of the financially excluded.

Chapter 3 (Identification of the client) of the FSA Handbook relating to money laundering<sup>40</sup> stipulates as follows in respect of the financially excluded:

**"3.1.5** The guidance in ML 3.1.5 G to ML 3.1.7 G aims to help relevant firms ensure that, where people cannot reasonably be expected to produce detailed evidence of identity, they are not denied access to financial services. Although a relevant firm must always take reasonable steps to check who its client is, relevant firms will sometimes be approached by clients who are at a disadvantage, or who otherwise cannot reasonably be expected to produce detailed evidence that helps to confirm identity. An example could be where a person does not have a passport or driving licence, and whose name does not appear on utility bills.

**ML 3.1.6** If a relevant firm has reasonable grounds to conclude that an

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<sup>40</sup> Release 018, April 2003.

individual client is not able to produce detailed evidence of his identity and cannot reasonably be expected to do so, the relevant firm may accept as identification evidence a letter or statement from a person in a position of responsibility who knows the client that tends to show that the client is who he says he is, and to confirm his permanent address if he has one.

**ML 3.1.7** Examples of persons in a position of responsibility include solicitors, doctors, ministers of religion, teachers, hostel managers and social workers.”

When a bank concluded that it should treat a customer as financially excluded for purposes of these rules, ML 7.3.2 requires of the bank to keep a record of its reasons for doing so.

In a recent report on anti-money laundering and countering of terrorism which was completed as part of an IMF Financial Stability Assessment of the United Kingdom<sup>41</sup> it was stated that there was scope for enhancing the UK legal anti-money laundering framework that applies to financial institutions. In particular, it was said that consideration could be given to limiting the circumstances in which financial institutions could temporarily accept funds from applicants before satisfactory evidence of identity is obtained, and to defining more precisely the FSA’s “financial exclusion” exception to customer identification requirements. In addition, given the important exceptions to the CDD requirements, the report continued, consideration should be given to ensuring that financial institutions keep records of the basis on which a particular customer or transaction was considered to be exempt from the otherwise applicable requirements.<sup>42</sup>

The UK responded to these comments in general by saying that it will give consideration to the suggestions, but that the basis will be whether they can be justified on cost-benefit principles given the extent of the vulnerability in these areas.<sup>43</sup>

This evaluation is important from a South African perspective. Although the clarity of the financial exclusion exception has drawn some negative comment from the IMF assessment team, the exception itself was not attacked. It is also interesting that the negative comments did not illicit a particular response from the United

<sup>41</sup> IMF Country Report No 03/46, February 2003.

<sup>42</sup> Par 291 of the IMF Country Report No 03/46, February 2003.

<sup>43</sup> Par 298 of the IMF Country Report No 03/46, February 2003.

Kingdom. This seems to indicate that the United Kingdom was not considering toning or watering the exception down in view of the criticism.

## 6. THE FINANCIAL INTELLIGENCE CENTRE ACT (FICA)

### 6.1. INTRODUCTION

The money laundering control framework in South Africa was developed over time. The first statutory money laundering offences were introduced by the Drugs and Drug Trafficking Act, 140 of 1992. Currently the money laundering control framework is provided by the Prevention of Organised Crime Act 121 of 1998 and FICA.

The first administrative requirements regarding CDD were enacted under the **Banks Act** 94 of 1990. Regulation 48 promulgated in terms of the Banks Act compels banks to implement and maintain policies and procedures to guard against the bank being used for purposes of market abuse and financial fraud, including insider trading, market manipulation and money laundering. As a minimum, Regulation 48 requires these policies and procedures to also be adequate to identify customers and, in particular, recognize suspicious customers.

The most detailed statutory requirements regarding client identification and verification, however, are set out in FICA. The intention with FICA is to implement the requirements of the 1990 FATF Forty Recommendations. Sections 21 and 22 of FICA create general client identification, verification and record-keeping obligations for so-called accountable institutions. These institutions, which include banks, are listed in Schedule 1 of FICA.

FICA should not be interpreted in isolation. Further rules regarding the client identification, verification and record-keeping duties are contained in the regulations under FICA. These regulations are of key importance in the interpretation of FICA. In addition, the impact of exemptions that were granted by the Minister of Finance under FICA must also be considered. The Act also allows

the FIC to issue formal guidance notes regarding compliance with FICA, but no such notes have not yet been released.

## 6.2. DUTY TO IDENTIFY CLIENTS

Section 21 of FICA provides that an accountable institution may not establish a business relationship<sup>44</sup> or conclude a single transaction<sup>45</sup> with a client unless the accountable institution has taken the steps prescribed in the regulations to establish and verify the identity of the client. If the client is acting on behalf of another person, the institution must establish and verify the identity of that other person and the client's authority to establish the business relationship or to conclude the single transaction on behalf of that other person. Similarly, if another person is acting on behalf of the client the institution must establish and verify the identity of that other person and that other person's authority to act on behalf of the client.

The detailed requirements regarding customer identification and verification are set out in regulations under FICA.<sup>46</sup> The relevant regulations differentiate amongst the following types of clients:

- Natural South African citizens and residents;
- Natural foreign nationals;
- Close corporations and South African companies;
- Foreign companies;
- Other legal persons;
- Partnerships; and
- Trusts.

From the perspective of mass banking, the requirements relating to natural South African citizens and residents are of prime importance. These requirements are set out in Regulations 3 and 4. In view of their importance for the study, the relevant regulations and exemptions are quoted verbatim:

<sup>44</sup> "Business relationship" is defined in section 1 of FICA as an arrangement between a client and an accountable institution for the purpose of concluding transactions on a regular basis.

<sup>45</sup> A "single transaction" is defined in section 1 of FICA as a transaction other than a transaction concluded in the course of a business relationship. "Transaction" is, in turn, defined in section 1 as a transaction concluded between a client and an accountable institution in accordance with the type of business carried on by that institution.

<sup>46</sup> Chapter 1-3 of the FICA regulations. Regulation 28 also allows for relevant guidance notes to be issued by the FIC.

“3(1) An accountable institution must obtain from, or in respect of, a natural person who is a citizen of, or resident in, the Republic, that person’s—

- (a) full names;
- (b) date of birth;
- (c) identity number;
- (d) income tax registration number, if such a number has been issued to that person;<sup>47</sup> and
- (e) residential address.

(2) In the case where the accountable institution is aware or ought reasonably to be aware that the person referred to in sub-regulation (1) does not have the legal capacity to establish a business relationship or conclude a single transaction without the assistance of another person the accountable institution must, in addition to obtaining the particulars referred to in sub-regulation (1), obtain from, or in respect of, of that other person—

- (a) his or her full names;
- (b) his or her date of birth;
- (c) his or her identity number;
- (d) his or her residential address; and
- (e) his or her contact particulars.”

“4(1) An accountable institution must verify the full names, date of birth and identity number of a natural person referred to in regulation 3 (1) (a), (b) or (c), or 3 (2) (a), (b) or (c) by comparing these particulars with—

- (a) (i) an identification document of that person; or
- (ii) in the case where that person is, for a reason that is acceptable to the institution, unable to produce an identification document, another document issued to that person, which, taking into account any guidance notes concerning the verification of identities which may apply to that institution, is acceptable to the institution and bears—

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<sup>47</sup> Institutions are currently exempted from obtaining and verifying the tax numbers, but it is believed that the exemption is only temporary in nature.

- (aa) a photograph of that person;
  - (bb) that person's full names or initials and surname;
  - (cc) that person's date of birth, and
  - (dd) that person's identity number; and
- (b) any of these particulars with information which is obtained from any other independent source, if it is believed to be reasonably necessary taking into account any guidance notes concerning the verification of identities which may apply to that institution.

(2) An accountable institution must verify the income tax registration number referred to in regulation 3 (1) (d) by comparing this number with a document issued by the South African Revenue Service bearing such a number and the name of the natural person.

(3) An accountable institution must verify the residential address referred to in regulation 3 (1) (e) or 3 (2) (f) by comparing these particulars with information which can reasonably be expected to achieve such verification and is obtained by reasonably practical means, taking into account any guidance notes concerning the verification of identities which may apply to that institution."

These two regulations stipulate the basic information that must be obtained by a bank in respect of its customers. However, whenever it is reasonably necessary (taking into account any guidance notes concerning the verification of identities or the reporting of suspicious and unusual transactions which may apply to the bank) Regulation 21 compels the bank to obtain further information:

- concerning a business relationship or single transaction which poses a particularly high risk of facilitating money laundering activities; or
- to enable the accountable institution to identify the proceeds of unlawful activity or money laundering activities.

The information which the bank must obtain in these circumstances must be adequate to reasonably enable the institution to determine whether the relevant transactions are consistent with the bank's knowledge of that client and that client's business activities and must include particulars concerning:

- (a) the source of that client's income; and
- (b) the source of the funds which that client expects to use in concluding the single transaction or transactions in the course of the business relationship.

In short, therefore, the scheme requires the following information to be obtained in respect of a customer who is a South African citizen or resident and who does not require legal assistance and is not providing assistance to another:

- Full names
- Date of birth
- Identity number
- Income tax number (if issued)
- Residential address.

The information must be verified in the following way:

- The full names, date of birth and identity number must be compared with:
  - an identification document of the person (defined in relation to a South African citizen or resident as an official identity document);<sup>48</sup> or
  - if the person is, for a reason which is acceptable to the bank, unable to produce a identity document, another document which is acceptable to the bank (taking into regard any guidance notes that may be applicable) and which bears:
    - a photograph of the person;
    - the person's full names or initials and surname;
    - the person's date of birth; and
    - the person's identity number.
- If it is believed to be necessary taking into account any relevant guidance notes, any of these particulars must be compared with information which is obtained from any other independent source.
- The income tax number must be compared to a document issued by SARS bearing such a number and the name of the person.
- The residential address must be compared to information that can reasonably be expected to achieve verification of the particulars and can be obtained by reasonably practical means (taking into regard any relevant guidance notes).

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<sup>48</sup> Regulation 1.

In terms of Regulation 19 “an accountable institution must take reasonable steps in respect of an existing business relationship, to maintain the correctness of particulars which are susceptible to change and are provided to it under this chapter.”

These duties came into effect on 30 June 2003. Accountable institutions are then given a year to identify the clients and related role-players with whom they had business relationships on that date, and to verify their particulars in accordance with FICA.<sup>49</sup>

### 6.3. DUTY TO KEEP RECORDS

Whenever an accountable institution establishes a business relationship or concludes a transaction with a client, whether the transaction is a single transaction or concluded in the course of a business relationship which that accountable institution has with the client, the accountable institution must keep record of:<sup>50</sup>

- (a) the identity of the client;
- (b) if the client is acting on behalf of another person -
  - (i) the identity of the person on whose behalf the client is acting; and
  - (ii) the client's authority to act on behalf of that other person;
- (c) if another person is acting on behalf of the client -
  - (i) the identity of that other person; and
  - (ii) that other person's authority to act on behalf of the client;
- (d) the manner in which the identity of the person(s) referred to in paragraphs (a), (b) and (c) was established;
- (e) the nature of that business relationship or transaction;
- (f) in the case of a transaction -
  - (i) the amount involved; and
  - (ii) the parties to that transaction;
- (g) all accounts that are involved in -
  - (i) transactions concluded by that accountable institution in the course of that business relationship; and
  - (ii) that single transaction;

<sup>49</sup> Section 21(2) read with section 82(2)(b) of FICA. In addition, section 21(2)(d) requires them to trace all accounts at that institution that are involved in transactions concluded in the course of that business relationship.

<sup>50</sup> Section 22 of FICA.

- (h) the name of the person who obtained the information referred to in paragraphs (a), (b) and (c) on behalf of the accountable institution; and
- (i) any document or copy of a document obtained by the accountable institution in order to verify a person's identity in terms of section 21(1) or (2).

Regulation 20 stipulates certain requirements to be met by an accountable institution that appoints a third party to keep the records mentioned above on its behalf. These requirements are limited to keeping records of formal contact details and contact persons.

#### 6.4.

#### DUTY TO REPORT

FICA imposes various reporting duties on accountable institutions. The most important of these duties is contained in section 29. In terms of this section all businesses (the duty is not limited to accountable institutions only) and employees of businesses who knows or suspects that, amongst others:

- the business has received or will receive the proceeds of unlawful activities;
- a transaction to which the business is a party “may be relevant to the investigation of an evasion or attempted evasion of a duty to pay any tax”; or
- the business has been or is about to be used for money laundering purposes, must report the knowledge or suspicion and the required particulars to the Financial Intelligence Centre in the prescribed manner. This is the duty the report so-called suspicious and unusual transactions.

Other reporting duties imposed on accountable institutions include the following (although these reporting duties have not yet taken effect):

- The duty to report payment to a client or receipt from a client of an amount of cash in excess of a prescribed limit<sup>51</sup>; and
- The duty to report electronic transfers in excess of a prescribed amount out of the country and receipts of money in excess of a prescribed amount from outside the Republic on behalf of third parties.<sup>52</sup>

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<sup>51</sup> Section 28

<sup>52</sup> Section 31

## 6.5. COMPLIANCE MEASURES

Accountable institutions must perform the following internal tasks to ensure compliance with FICA:

- Formulate and implement internal rules concerning, *inter alia*, the establishment and verification of the identity of persons whom the institution must identify<sup>53</sup>;
- Provide training to its employees to enable them to comply with the provisions of the Act<sup>54</sup>; and
- Appoint a compliance officer with the responsibility to ensure compliance by the accountable institution and its employees with FICA<sup>55</sup>.

## 6.6. EXEMPTIONS UNDER FICA

The scheme created by FICA and the regulations must be read in conjunction with the relevant exemptions that were made by the Minister. For instance, Exemption 6(2) relieves accountable institutions from the obligation to obtain and verify the tax numbers of these individuals, although this exemption is probably only temporary in nature.

Part 7 of the Exemptions contains three exemptions relating to banks and similar institutions. The first exemption (Exemption 15) relates to unsecured loans not exceeding R15 000, 00 and relieves banks from compliance with client identification, verification and record-keeping obligations. Exemption 16 relates to international banking. However, for purposes of this study project Exemption 17 is of particular importance and it is quoted in full:

“Every accountable institution which performs the functions of an accountable institution referred to in items 6, 7, 14 and 16 of Schedule 1 to the Act is exempted, in respect of those functions, from compliance with the provisions of regulations 3 (1) (d), 3 (1) (e), 3 (2) (d), 3 (2) (e), 4 (2) and 4 (3) of the Regulations, and of section 22 (1) (a), 22 (1) (b), 22 (1) (c),

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<sup>53</sup> Section 42

<sup>54</sup> Section 43(a)

<sup>55</sup> Section 43(b)

(22 (1) (d), 22 (1) (e), 22 (1) (h) and 22 (1) (i) of the Act concerning the particulars referred to in those regulations, in respect of every business relationship with a natural person who is a citizen of, or resident in, the Republic, in terms of which that person holds an account which—

- (a) enables the account holder to withdraw or transfer or make electronic payments from that account to an amount not exceeding R15 000,00 over a 24 hour period;
- (b) enables the account holder to receive a deposit, or a series of deposits over a period of 24 hours, into that account not exceeding—
  - (i) on more than one occasion in a calendar month, an amount of R5 000,00; and
  - (ii) at any time, an amount of R20 000,00;
- (c) enables the account holder to maintain a balance in that account not exceeding R25 000,00; and
- (d) does not enable the holder of that account to transfer funds out of that account to any destination outside the Republic,

subject to the conditions that such an account does not remain dormant for a period exceeding 180 days and that the same person does not hold more than one such account with the same institution at any time.”

This exemption is highly structured and conditional. In essence, it allows the following: If an account and a customer meets the specific conditions of the exemption, the bank may open that account after only obtaining the following particulars in respect of a natural person who is a citizen of, or resident in, South Africa and who does not require legal assistance.<sup>56</sup> The person’s:

- Full names;
- Date of birth; and
- Identity number.

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<sup>56</sup> Exemption 17 makes provision for similar particulars to be obtained in respect of a person who assists another who lacks legal capacity.

Compared to non-exempted accounts for similar customers, the exemption therefore exempts a bank from obtaining the person's:

- Income tax number (if issued);<sup>57</sup> and
- Residential address.

However, the bank must still verify the full names, date of birth and identity number as prescribed by the regulations.<sup>58</sup>

In addition, the bank is exempted from keeping record in terms of section 22 of FICA of the following:

- Identity of the customer;
- Identity of a legal assistant of the customer or of a person who receives such assistance;
- Manner in which identity was established;
- Nature of the business relationship;
- The name of the person who obtained the information; and
- Any document or copy of a document obtained to verify a person's identity.

In essence, therefore, the only information that must be recorded in respect of these accounts are the following:

- The amount involved in a transaction and the parties to that transaction;
- All accounts involved in transactions concluded by the bank in the course of the business relationship.

It is important to appreciate that Exemption 17 does not exempt banks from Regulation 21.<sup>59</sup> Under the circumstances envisaged in Regulation 21 (essentially relating to suspicions of possible money laundering), the bank will therefore have to take reasonable steps to establish the source of the customer's income and funds.

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<sup>57</sup> This exemption is not currently of particular importance as Exemption 6(2) currently relieves all accountable institutions from the obligation to obtain and verify the tax numbers of these individuals. However, Exemption 6(2) appears to be temporary in nature and, once it falls away, this exemption will be of great benefit.

<sup>58</sup> See Section 6.2 above.

<sup>59</sup> See Section 6.2 above.

## 6.7.

## CONCLUSION

The duty of banks to identify their customers is not simply a duty created by FICA. This duty is enshrined in international practice and standards and South African common law. It is also echoed in other laws. These standards and laws are not merely aimed at preventing money laundering, but also aim to ensure financial stability and market integrity.

Further obligations will need to be added to the current system to ensure that South Africa meets its international requirements in respect of combating of terrorist financing and the 2003 FATF Recommendations. Main areas of development that are relevant from a mass banking perspective include the following:

**FATF Special Recommendation VI**

Persons who provide money or value transfer services will have to be licensed or registered and regulated to ensure that they apply the FATF standards. These persons are also “financial institutions” for purposes of the FATF Recommendations. They will therefore have the general money laundering control duties including the identification of customers and the verification of their particulars.

**FATF Special Recommendation VII**

Electronic funds transfers must be accompanied by meaningful information of the originator (name, account or other unique reference number and identity number, address or date of birth).

**Revised FATF Recommendation 5**

Financial institutions must carry out CDD and, in particular, understand the ownership and control of legal persons.

**Revised FATF Recommendation 6**

Financial institutions will need appropriate risk management systems to determine whether the customer is a politically exposed person; obtain senior management approval for establishing business relationships with such

customers; take reasonable measures to establish the source of wealth and source of funds; and conduct enhanced ongoing monitoring of the business relationship.

### **Revised FATF Recommendation 8**

Financial institutions must pay special attention to any money laundering threats that may arise from new or developing technologies that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes. In particular, financial institutions should have policies and procedures in place to address any specific risks associated with non-face to face business relationships or transactions.

The current duties under FICA are stringent and onerous and it is clear that they will have to be amplified. However, the FATF framework is tempered by common sense and the principle of reasonableness. Internationally there is a sensitivity to protect the financially excluded and socially vulnerable from the exclusionary impact that a strict approach may have. The United Kingdom furnishes an example of a leading jurisdiction with a robust identification exemption in respect of the financially excluded. A similar approach can be discerned in Exemptions 15 and 17 to FICA.

There are also some provisions in the Revised FATF Recommendations that may be used to facilitate access to financial services for the financially and socially vulnerable. The 2003 Recommendations allow for instance that simplified CDD may be followed in respect of occasional transactions under \$/Euro 15000. It furthermore allows simplified CDD to be followed where there are low risks of money laundering. The FATF examples of customers that pose a low risk unfortunately do not include mass banking customers, but the application of the general principle may be broadened through argument to mass banking. It is also helpful that the Recommendations allow CDD to be performed by third parties. However, the requirement regarding regulation and supervision of such third parties limit its use in respect of mass banking solutions.

## 7. COMMON LAW DUTY OF CARE IN RESPECT OF STOLEN CHEQUES

Parallel to and independent of the development of CDD rules within the anti-money laundering field, our courts have developed a duty of care owed by banks to the owners of stolen cheques. In terms of this duty, banks are required to take reasonable steps to ensure that accounts are not opened fraudulently in false names. If a stolen cheque is paid into an account and the bank failed to take the reasonable steps, the bank will be liable in terms of the common law to the owner of the stolen cheque. This onerous duty was endorsed by the Supreme Court of Appeal in 2002.

In *Indac Electronics (Pty) Ltd v Volkskas Bank Ltd*<sup>60</sup> the Appellate Division (as it then was) held that a collecting banker owes the owner of a cheque a duty of care not to collect its proceeds negligently on behalf of one not entitled to payment. As stolen cheques are paid into accounts that are fraudulently opened in false names, it was held in a number of judgments that this duty encompassed an obligation to take reasonable care when receiving and processing an application to open a new banking account through which cheques belonging to another are subsequently collected for payment. This obligation was confirmed by the Supreme Court of Appeal in *Columbus Joint Venture v ABSA Bank*.<sup>61</sup> In essence, this obligation requires of a bank to take reasonable steps to ascertain and verify the identity of the prospective customer.<sup>62</sup>

This duty entails, amongst others, the duty to “properly consider all the documentation that is placed before (the bank) and to apply their mind thereto.”<sup>63</sup> In *Energy Measurements (Pty) Ltd v First National Bank of SA Ltd*<sup>64</sup> the bank was held accountable because, amongst others, the bank failed to notice that the credit record of the prospective customer reflected that he concluded a few transactions in South Africa during a period which he said he was in the USA. In *Columbus Joint Venture v ABSA Bank*<sup>65</sup> the Supreme Court of Appeal allowed banks to differentiate between existing and new customers and to require greater diligence

<sup>60</sup> 1992 1 SA 783 (A).

<sup>61</sup> 2002 1 SA 90 (SCA).

<sup>62</sup> *Energy Measurements v FNB of South Africa Ltd* 2001 3 SA 132 (W).

<sup>63</sup> *Columbus Joint Venture v ABSA Bank* 2002 1 SA 90 (SCA) 97A.

<sup>64</sup> *Energy Measurements v FNB of South Africa Ltd* 2001 3 SA 132 (W).

<sup>65</sup> 2002 1 SA 90 (SCA).

in respect of new customers as they would already have a measure of information about existing customers who may wish to have a further account.

However:<sup>66</sup>

“If circumstances should put a bank on inquiry in extending new facilities to an existing customer or creating facilities for a new customer, the necessary inquiries should be made, and fear of offending the customer cannot inhibit performance of that duty”

There are indications that the legal duty may extend to continuing CDD and monitoring of accounts. In *Commissioner for SARS v ABSA Bank Ltd*<sup>67</sup> Van der Nest AJ held as follows:<sup>68</sup>

“In my view, society’s notion of justice demands that a bank should not turn a blind eye to the possibility that a customer may be using an account concluded with it for criminal purposes. Where large VAT refunds are received and large cash amounts are withdrawn immediately (one may pause to consider how long it would take the second defendant to count out and hand R7 million to its customer), whilst, to the knowledge of the second defendant, no genuine trading transactions took place on the account, society would not expect that the bank can stand back with impunity. The pattern of receipt of VAT refunds and their almost immediate withdrawal, including cash withdrawals, is a warning light that the funds are being received and dealt with in a criminal manner.”

The above comment was made in relation to an exception and the matter was referred to trial for more thorough argument. Further developments are therefore being awaited.

For purposes of this study it must be noted that any exemption from CDD requirements under FICA will not exempt a bank from the common law duty of care it owes to the owners of stolen cheques deposited into accounts held or opened by that bank (or from any other such legal duties that it may be held to owe to third parties).

<sup>66</sup> *Columbus Joint Venture v ABSA Bank* 2002 1 SA 90 (SCA) 102E.

<sup>67</sup> 2003 2 SA 96 (W).

<sup>68</sup> *Commissioner for SARS v ABSA Bank Ltd* 2003 2 SA 96 (W) par 46.7.

## 8. OBSTACLES TO MASS BANKING PRESENTED BY FICA

In this chapter we assess the likely impact of the money laundering control framework on the extension of access to financial services to low income clients in South Africa. We not only consider the impact of FICA and its regulations, but also those aspects of the FATF Special Recommendations and Revised Forty Recommendations that have not yet been implemented in South African law and which we are obliged to implement as a member of FATF. We limit our consideration to those existing and new products described in Chapter 2.

### 8.1. CDD FOR LOW INCOME CLIENTS

Applying the CDD requirements set out in FICA to low income clients, presents particular challenges.

*Inability to produce an ID document:* A number of potential clients do not have the requisite ID document. The Department of Home Affairs estimates that about 1.5 million persons who are entitled to be issued with official identity documents are not in possession of such documents.<sup>69</sup> Most of these persons would fall in the low income category. It is safe to assume that they would also not be able to produce acceptable alternative forms of identification. Consequently, they would be excluded from opening bank accounts. Most of these persons would be below the age of 18.<sup>70</sup> Increasingly, and as a result of the Aids pandemic, households are headed by persons who are underage. In 1996 (the most recent information we could obtain) 33 000 households in South Africa were already headed by minors between the ages of 10 and 14. Another 150 000 households were headed by minors between the ages of 15 and 19. The figures for the 2001 census are likely to be higher. These households are vulnerable and have a need for financial services, even if only to receive some form of social welfare benefit. (Under the

<sup>69</sup> According to the Department of Home Affairs 28 553 012 South African citizens were in possession of ID documents as of 24 June 2003. At the same time 596 751 Non-South African citizens were in possession of ID documents.

<sup>70</sup> Of the persons who do have ID documents, 496 005 are below the age of 18.

Banks Act<sup>71</sup> minors over the age of 16 may be a depositor with a bank and conclude transactions relating to such a deposit.)

*Difficulty to verify residential address:* Most poor South Africans, particularly those living in rural areas or informal urban or peri-urban settlements, are unable to present documents that will allow easy verification of their residential addresses. The current industry approach is to use utility bills as the most functional form of verification. Verifying the residential addresses of these customers would therefore be difficult if not impossible.

*A more mobile population requires more regular maintenance of records:* Regulation 19 under FICA requires an accountable institution, in respect of account holders, to maintain the correctness of particulars which are susceptible to change. These would primarily be residential address and contact details. The primary low income target market for the extension of financial services consists of very mobile persons. Maintaining up to date records for these clients would be significantly more onerous than for more settled and affluent clients.

*Incidence of fraudulent ID documents:* For obvious reasons no reliable statistics are available on the number of fraudulent ID documents that are in circulation in South Africa. What is known is that the number is substantial. Banks have confirmed that the presentation of fraudulent IDs poses a substantial problem for them. The presentation of such fraudulent IDs for CDD purposes introduces significant money laundering risk into the system and increases the compliance burden on banks. The high incidence of fraudulent ID documents is also the reason why banks refuse to accept the new format drivers licences as sufficient verification of identity. Since drivers licences are issued on the basis of ID documents, a valid licence may be issued on the basis of a fraudulent ID, causing a “washed identity”.

#### IMPACT ON PROVIDING ACCESS FOR LOW INCOME CUSTOMERS

The difficulties set out above affect the extension of banking services in the following ways.

*Excluding customers from opening accounts:* If low income clients are unable to produce the required identity documents or acceptable further documentation to

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<sup>71</sup> Section 87(1).

verify, for example, residential address, they would be prevented from opening an account or performing an occasional transaction. Whereas the impact of the inability to produce an ID document is easy to quantify (see above), it is more difficult to assess the impact of a client's inability to prove his or her residential address. In this regard much progress is being made with the development of the concept of reasonableness as contained in regulation 4.

*Limiting or excluding access to money remittance products that are cheap, safe and efficient:* A primary financial need for poor people is the ability to transfer money to remote beneficiaries safely and cost-effectively. Mostly, small amounts are involved. If the person who wishes to transfer the money does not hold an account with a financial institution, the transfer would qualify as an occasional transaction. Before undertaking such a transaction, the bank would be obliged to undertake the full CDD procedure set out above. This could exclude a significant number of persons from accessing the service and would also raise the cost of rendering the service. In particular, it will pose problems for the IBTG's proposed transfer of value product, as well as for the Post Office PIN product.

The difficulties for transfer of value products will be enhanced once FATF Special Recommendations VI and VII are implemented in our law. To the extent that agents are used as part of the distribution network, they will have to be registered and subject to all the FATF Recommendations that apply to banks. Moreover, all funds transfers will have to include accurate and meaningful originator information (name, address and account number) that must remain with the transfer through the payment chain.

*Increasing the cost of opening and servicing accounts:* Compliance with FICA's CDD procedures increases the cost of opening and servicing accounts. Due to the higher levels of mobility of low income clients, their lack of linkages to formal economy institutions, and the fact that it is relatively more costly and onerous for them to obtain official documents than it is for more affluent persons, it is generally more expensive for banks to open and service accounts and perform occasional transactions for clients in this market than for clients in more established and more affluent markets.

## 8.2. CDD FOR MEMBER-BASED FINANCIAL INSTITUTIONS

The importance of member-based financial institutions, especially stokvels and burial societies, for the provision of financial services to low income clients, was stressed in section 2.5 above. The difficulties posed by FICA for the rendering of formal financial services to these member-based institutions flow from the uncertainty about the legal personality of stokvels in particular.

Much of the legal uncertainty regarding the nature of the stokvel is caused by two sections of the Companies Act, 61 of 1973. Section 30(1) of the Act provides as follows:

“No company, association, syndicate or partnership consisting of more than twenty persons shall be permitted or formed in the Republic for the purpose of carrying on any business that has for its object the acquisition of gain by the company, association, syndicate or partnership, or by the individual members thereof, unless it is registered as a company under this Act or is formed in pursuance of some other law ....”

In terms of section 31 of the Companies Act an association of persons formed for the purpose of carrying on any business that has for its object the acquisition of gain by the association or by the individual members thereof, cannot be a body corporate unless it is registered as a company under the Companies Act or is formed in pursuance of some other law.

Read together the provisions in effect allow the formation of partnerships and profit-oriented associations with less than 20 members. However, these associations are not allowed to enjoy legal personality. They can only enjoy legal personality if they are incorporated under an Act such as the Companies Act.

An association will only be affected by these provisions if it has as its object “the acquisition of gain” whether by the association or by its individual members. In *Mitchell’s Plain Town Centre Merchants Association v McLeod* 1996 4 SA 159 (A) the Appellate Division interpreted “gain” as used in these two sections as follows:

“The key word is 'trading'. It is the clue to the meaning of 'gain'. 'Gain' in the context in which it appears in ss 30(1) and 31 means a commercial or material benefit or advantage, not necessarily a pecuniary profit, in contradistinction to the kind of benefit or result which a charitable, benevolent, humanitarian,

philanthropic, literary, scientific, political, cultural, religious, social, recreational or sporting organisation, for instance, seeks to achieve. The sections are concerned with commercial enterprises and 'gain' must be given a corresponding meaning (cf South African Flour Millers' Mutual Association v Rutowitz Flour Mills Ltd (supra at 202-3)). It is not a question of law; it is a matter of fact."<sup>72</sup>

Stokvels certainly do not have a charitable objective, but are concerned with gain for their members. It is therefore arguable that they are affected by these provisions of the Companies Act. In that case:

- the membership of the stokvel is limited to twenty members;
- the stokvel cannot enjoy legal personality; and
- if the membership exceeds twenty, the stokvel will be an illegal association with no existence in law.

The consequences for performing CDD for stokvels that wish to open a bank account are the following:

*CDD required for all stokvel members if less than 20:* For stokvels with 20 and fewer members, the CDD procedures that must be performed in respect of partnerships should probably be applied.<sup>73</sup> That entails the identification of every member of the stokvel and the verification of his or her details. For larger stokvels this is practically impossible. The current practice seems to be to identify stokvels in accordance with the requirements that apply to "other legal persons".<sup>74</sup> In essence this requires identification of the association and of every natural person who is authorised to enter into a transaction on behalf of the stokvel. Although much can be said for the practicality of this approach, it does seem to be based on dubious legal grounds.

*Stokvels with more than 20 members are unlawful and cannot open accounts:* The implications for stokvels with more than 20 members, is that they are illegal associations with no existence in law. Banks would therefore not be allowed to

<sup>72</sup> See also *Director: Mineral Development v Save The Vaal Environment* 1999 2 SA 709 (A).

<sup>73</sup> Regulations 13 and 14 under FICA. Some stokvels may be partnerships if they display the essential characteristics of a partnership and the members have the intention to be partners. Other stokvels in this position that do not display the characteristics or whose members lack the intention to be partners, will merely be contractual relationships. In this case the members jointly will be the customers of the bank and the bank will have to identify each of them in accordance with the Money Laundering Control Regulations.

<sup>74</sup> Regulations 11 and 12 under FICA.

open accounts on behalf of stokvels with more than 20 members. This is not adhered to in practice.

#### IMPACT ON PROVIDING ACCESS FOR LOW INCOME CUSTOMERS

If the legal interpretation as set out above is correct, and we submit that it is, the impact thereof is to effectively deny large numbers of low income South Africans access to formal banking services, even if this is only as the member of a stokvel which holds a formal bank account allowing it safe storage or investment of saved funds.

### 8.3. NEW REQUIREMENTS IN RESPECT OF MONEY TRANSFERS

FATF Special Recommendations VI and VII pose particular problems for the transfer of value product being proposed by the IBTG. The IBTG would like to maximise the reach of the potential distribution network for this product. They therefore propose that the service also be available at institutions that are currently not accountable institutions under FICA, such as Lotto outlets and municipal and government pay points.

Special Recommendation VI would require such agents or service providers, if they are to provide services for the transmission of money or value, to be licensed and registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. This would require such institutions to maintain the full compliance administration, an onerous duty indeed. In addition, they would also have to include the full information required by Special Recommendation VII in all money transfers.

It can be safely assumed that the cost and inconvenience imposed by these obligations would outweigh the benefit to the institutions concerned. In this way it would limit the potential distribution network of the product being proposed by the IBTG.

### 8.4. THE UTILISATION OF THIRD PARTY DISTRIBUTION CHANNELS TO MARKET BANKING PRODUCTS

The proposed narrow banks, as well as many of the new banks and proposed innovative banking models designed to serve the low income market, rely on third

party distribution channels to perform account opening procedures and source transactions. Unlike the situation where third parties perform the record-keeping functions on behalf of accountable institutions (section 24), neither FICA nor the regulations provide explicitly for CDD to be performed by third parties on behalf of an accountable institution. Currently this is dealt with in terms of the law of agency.

However, the provisions of the new FATF Recommendation 9 and its interpretative note need to be borne in mind. Recommendation 9 provides that countries may permit financial institutions to rely on intermediaries or other third parties to perform CDD procedures on their behalf, provided that (1) the financial institution should immediately obtain the necessary information of the CDD process, and (2) the financial institution should satisfy itself that the third party is regulated and supervised for, and has measures in place to comply with CDD requirements in line with the relevant FATF Recommendations. The interpretative note to this recommendation provides that “this recommendation does not apply to outsourcing or agency relationships”. On the face of it, it would seem to suggest that, where an agency relationship exists, the third party need not be regulated, but that the regulation of the primary accountable institution would suffice.

This legal uncertainty needs to be cleared up in our law. If the use of agents is limited or such agents or third parties required to be regulated under FICA itself, it will have two likely consequences:

- Firstly, it will make it more costly for the new banking models to be rolled out; and
- Secondly, it will inhibit the rural distribution of banking services, because it will limit the available distribution footprint, since it will impose more onerous compliance burdens on third parties.

#### 8.5. COMPLETING CDD BEFORE ANY TRANSACTIONS CAN BE PERFORMED

This problem arises in the context of the new banking models described in section 2.3 above. FICA requires full verification of the information required to identify the client before the client can transact against the account being opened. Exemption 2 relaxes this requirement by allowing the accountable institution to establish a business relationship (open the account), but not to conclude any transaction until the identity has been verified as prescribed. Should verification against more than

just an ID document be required, or should it be necessary for the verification to be done by the accountable institution itself, the consequent time lag, some role players indicated, could impact negatively on the attractiveness of the relevant business models.

#### 8.6. FATF RECOMMENDATION 8 – NEW TECHNOLOGIES

The Revised Recommendation 8 may add additional burdens to especially innovating new banks. It requires financial institutions to pay special attention to any money laundering threats that may arise from new or developing technologies that might favour anonymity, and take measures, if needed, to prevent their use in money laundering schemes.

## 9. FACILITATING MASS BANKING WITHIN THE FICA FRAMEWORK

Any option to facilitate access to financial services for low income clients must be assessed against the international money laundering control framework, especially the FATF Forty Recommendations. The revised FATF Recommendations do provide scope for the application of reduced CDD procedures where the risk is lower. FATF Recommendation 5 now provides that “financial institutions ... may determine the extent of such measures (CDD) on a risk sensitive basis depending on the type of customer, business relationship or transaction. ... Where there are low risks, countries may ... apply reduced or simplified procedures.”

Risk sensitive supervision and risk sensitive compliance in the money laundering control area have some way to go in South Africa. However, there is no doubt that this is the only feasible approach to successfully reconcile the twin goals of, on the one hand, securing and maintaining South Africa's FATF membership and compliance with international anti-money laundering standards and, on the other hand, extending access to financial services to the poor.

The following proposals seek to follow such a risk-sensitive approach, taking into account the risk guidelines contained in the FATF Recommendations. We understand the risk factors that FATF considers significant to include the following:

- The monetary value of a transaction;

- The use of legal persons as fronts;
- Cross-border wire transfers;
- The complexity and unusualness of transactions;
- Whether clients are politically exposed;
- Large cash transactions;
- Counterfeit documents;
- New and developing technologies that favour anonymity.

The extent to which these risk factors are present in products targeted at the low income market, would affect the extent to which “reduced or simplified procedures” can be followed.

The general risk of money laundering in South Africa and the sub-regions is considered substantial. The National Treasury estimates that up to US\$8 billion is dirty money is laundered through South Africa each year. Studies estimate that about US\$22 billion is laundered through the Southern African Development Community annually<sup>75</sup>.

## 9.1.

### AN APPROPRIATE MASS BANKING EXEMPTION

Exemption 17, the so-called mass market exemption, was intended to address the negative consequences of a stringent application of CDD procedures in the low income market. However, banks find the exemption unworkable in practice. The reasons cited include the following:

- Most new mass market products utilise internationally branded debit cards that provide cross-border funds transfer functionality. This is prohibited by the exemption.
- Low income clients, like any other clients, often require additional products over and above their transaction or savings account, for example investments. This negates the benefit of the exemption, since the bank has to complete the full CDD procedure for the client to access the new product, even though the monetary value involved falls entirely within the parameters anticipated by the exemption.
- The 180 day dormancy cut-off is unrealistic in a market where many clients are contract workers without regular income. The current dormancy cut-off period for most banks is 5 years.

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<sup>75</sup> “Bankers who launder dirty funds face jail”, Business Day, 1 November 2002.

Besides the difficulties with practical implementation, exemption 17 introduces substantial risk of money laundering into the system. If the transactions product anticipated by the exemption is used to its fullest extent, a client can deposit and withdraw up to R165 000 per month through the account<sup>76</sup>. This is well in excess of the US\$15 000 threshold for occasional transactions suggested by FATF.

Ideally a mass market exemption should be client-based, relieving banks from performing the full CDD in respect of clients falling below a defined income threshold. However, verifying that a client falls within that income category would potentially be more onerous than performing the full CDD. It is therefore suggested that the exemption focus primarily on the deposit flow through the account as the most reliable indication of the income of the client. We propose that consideration be given to applying reduced CDD procedures and record-keeping duties, i.e. clients are required to produce only an acceptable ID document, to bank accounts that:

- restrict the total monthly deposits which can be made into that account to a certain threshold value, for example R5000. (Currently 6.9 million existing bank accounts are credited with an amount of less than R4000 per month).<sup>77</sup>;
- are appropriately monitored by banks<sup>78</sup> on a real time basis;
- provide for specific procedures to be followed when the threshold is exceeded. If the increase in deposits into the account is permanent, the full CDD must be performed or the client must migrate to a different product. If the threshold is exceeded on more than one occasion without the necessary CDD procedures being performed, the account could be closed.

The exemption could also relieve banks from re-identifying existing clients whose transaction behaviour falls within the threshold set by the exemption.

A relaxation of the client identification and verification requirements under FICA will only be sensible if accompanied by a statutory relaxation of the common law duty that banks owe to owners of stolen cheques to correctly identify their customers. We suggest that an amendment to the Banks Act should be considered which

<sup>76</sup> The primary restriction is the amount that can be deposited in the account. The maximum is  $29 \times R5000 + R20000 = R165000$  per month.

<sup>77</sup> Information supplied by FinMark Trust.

<sup>78</sup> See, in this regard, FSA *Reducing money laundering risk: Know Your Customer and anti-money laundering monitoring* (August 2003).

would allow a limited exemption in respect of mass banking products. We believe that it will be vital to limit the monetary value of the cheques to which the exemption will apply in order to gain the necessary support for such an amendment. The risk that will be created will be balanced by the real time monitoring that will be performed.

## 9.2. AN APPROPRIATE THRESHOLD FOR OCCASIONAL TRANSACTIONS

To facilitate access for low income clients to appropriate transfer of value products in those instances where they do not hold formal bank accounts, as is the intention with the IBTG transfer of value product and the Post Office PIN product, an appropriate threshold for occasional transactions below which only reduced CDD procedures have to be followed, is recommended. This is recommended for transfers within the country, since the FATF requirements for cross-border transfers are more onerous. It is worth noting that the Post Office online PIN-based product accommodates transfers with a value of less than R2000. The principle is established by FATF Recommendation 5 that recommends that CDD only be performed for occasional transactions above a threshold of US\$15 000. The Recommendation by implication excludes the performance of any CDD below this threshold.

This exemption could be extended to include cross-border wire transfers, at least within the Common Monetary Area of a value of less than US\$ 3000, the threshold recommended by Special Recommendation VII.

If the IBTG transfer of value product is to utilise the full distribution network envisaged, it will be necessary to exempt the distribution agents who are not currently accountable institutions under FICA from compliance with the duties anticipated in at least Special Recommendation VI.

## 9.3. A PRAGMATIC AND RISK-SENSITIVE APPROACH TO THE VERIFICATION OF RESIDENTIAL ADDRESS

As indicated above, much progress has already been made with the phasing in of a risk sensitive approach when it comes to the verification of residential address. This approach is facilitated by the wording of Regulation 4 under FICA. It provides that the residential address must be verified by comparing it "with information which

can reasonably be expected to achieve such verification and is obtained by reasonably practical means, taking into account any guidance notes concerning the verification of identities". To date, no official Guidance Notes have been issued.

To facilitate serving the mass market in a cost effective manner, the Banking Council has issued a set of Practice Notes on 18 July 2003 designed to set the "industry minimum standard". The Practice Notes defines "mass market" as "an individual account holder with net income per month (i.e. income into the bank account) of less than R5000". It recommends that the identity of mass market account applicants be determined and verified as follows:

- Identity document;
- Request physical address details;
- Request details about the source of the income or funds being deposited.

It proceeds to state that "for customers in the so-called mass market banks should request proof of residential address. If the customer responds that he/she does not have any, and the bank is reasonably satisfied with that answer (i.e. the physical address details are consistent with such and answer) this answer should be noted and the account opened / transaction concluded."

According to the Practice Notes this simplified procedure should be ring-fenced to the following product groups only:

- Savings accounts;
- Transactions accounts; and
- Investments / deposits.

This approach will go far to address the practical difficulties of low income clients to provide proof of residential address. What remains is for it, or a similar flexible approach, to be captured in appropriate Guidance Notes.

#### 9.4.

#### AN APPROPRIATE CATEGORISATION OF STOKVELS

To cure the fundamental problem about the legal personality of stokvels will require an appropriate legislative enactment, probably an amendment to the Companies

Act. That is not the central thrust of this study and we do not explore this any further, save to say that it is undesirable that an entity that provides such an important building bloc for the rendering of financial services to the poor in this country should suffer from such legal uncertainty.

From a FICA point of view, an immediate option is to determine that stokvels and other member-based savings associations should be governed by the same identification and verification rules that currently apply to the “other legal persons” category, irrespective of the number of members that below to such institutions. This is the current industry practice, based on suspect legal grounds. Such a regulation will not cure the legal personality problem, but will provide concrete guidance to accountable institutions.

#### 9.5. FLEXIBILITY REGARDING THE USE OF THIRD PARTY DISTRIBUTION NETWORKS

The use of third party distribution networks holds great potential to reduce the costs of banking services for the poor. When complying with FATF Recommendation 9, the authorities should guard against regulating this to the extent that low income customers cease to be profitable. In principle, the law of agency should be allowed to govern the relationship between accountable institutions and third parties who source accounts and transactions for them.

#### 9.6. FLEXIBILITY TO ALLOW TRANSACTION IMMEDIACY

FICA and its regulations require that an accountable institution completes the full CDD process before a client can perform any transactions. This would hamstring certain types of newer banking models that rely on transaction immediacy for the success of their marketing efforts, for example cell phone based models.

In setting these standards, FICA applies a stricter standard than that required by the Revised FATF Recommendation 5. The latter provides that “countries may permit financial institutions to complete the verification as soon as reasonably practicable following the establishment of the relationship, where the money laundering risks are effectively managed and where this is essential not to interrupt the normal conduct of business.”

We recommend that FICA be brought in line with the revised FATF approach.

## PART 3 : THE FINANCIAL ADVISORS AND INTERMEDIARY SERVICES ACT

### 10. FAIS AND MASS BANKING

#### 10.1. INTRODUCTION

The Financial Advisors and Intermediary Services Act, Act 37 of 2002 (FAIS) seeks to ensure that clients who are being rendered financial services are able to make informed decisions about their use of those services and that their reasonable financial needs regarding financial products will be appropriately and suitably satisfied (section 16). Most of the provisions of FAIS came into operation on 15 November 2002<sup>79</sup>.

In terms of the scheme of the Act financial service providers, which are defined very widely, cannot operate as such unless a license is issued to them by the registrar of financial service providers. The executive officer of the Financial Services Board acts as the registrar of financial services providers. Financial services providers must comply with a code of conduct prepared by the registrar. Different codes of conduct may be drafted for different categories of financial services providers. The codes of conduct contain the specific provisions with which financial services providers must comply. The provisions deal with, inter alia, disclosure, record-keeping, avoidance of misleading advertising, safe-keeping of funds and documentation, and indemnity. Financial services providers must implement appropriate internal systems and appoint compliance officers to ensure compliance with the Act and the code of conduct.

Enforcement of FAIS, as far as the clients of financial services providers are concerned, is envisaged to be driven primarily by the Ombud for Financial Services Providers who have wide-reaching powers beyond those normally associated with a classic ombudsman. (The first Ombud is currently in the process of being appointed.) These include the power to make a monetary award as fair compensation for any financial prejudice or damage that a client may have

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<sup>79</sup> Sections 20-31 did not come into operation on that date, but have since come into operation. Sections 7 and 13(1) have not yet come into operation. These sections will come into operation when the Minister of Finance announces that full compliance with the Act is required.

suffered, including an award for interest, as well as the power to make “any other order which a Court may make” (section 28). The registrar may also declare a particular business practice to be undesirable for all or a category of financial services providers (section 34). Contraventions of the provisions of the Act can attract fines of up to R1 million or imprisonment for a period not exceeding 10 years.

## 10.2. CODE OF CONDUCT FOR SHORT-TERM DEPOSIT-TAKING BUSINESS

FAIS seeks to limit its application to short term bank deposits, i.e. deposits with a term not exceeding 12 months, to the extent that such deposits are regulated by the specific code of conduct for short term deposits that are provided for in section 15 of the Act. To date only a draft Code of Conduct for Authorised Financial Services Providers and Representatives conducting Short-term Deposit-taking Business (the Draft Code) has been published. The Draft Code is attached hereto as Appendix 1. The Draft Code provides that the entire Act, excluding –

- section 13(3), (4) and (5);
- section 14; and
- any other code of conduct contemplated by FAIS

is applicable to short term deposit-taking businesses, i.e. banks.

The Draft Code is similar to the Code of Banking Practice, a set of guidelines for banks developed by the Banking Council of South Africa. Most South African banks are members of the Banking Council and are thus committed to maintaining the standards of fairness set out in the Code of Banking Practice. They are therefore largely already compliant with FAIS and the Draft Code.

The Draft Code does impose several obligations on banks that are additional to those imposed by the Code of Banking Practice. The key additional requirements are the following:

- When advising a client, for example on opening a mass banking account, the bank or its representative must make reasonable enquiries to assess the client’s needs and objectives, having regard to the circumstances of the client

and the type of deposit on which advice is being given (clause 7(b) of the draft code);

- The bank must assist the client to choose a suitable account / deposit and to fully understand the financial implications of the product chosen by the client (clauses 6(d) and (e) of the draft code).

### 10.3.

#### REPRESENTATIVES OF AUTHORIZED FINANCIAL SERVICES PROVIDERS

The new generation mass banking models referred to in sections 2.3 above, rely on third party agents to perform their initial client liaison and account opening procedures. FAIS prohibits such agents from acting as representatives of authorized financial services providers (banks) unless they comply with the provisions of section 13. This section imposes certain control duties on the provider in respect of such representatives. Section 14 (which is excluded from applying to short-term deposit-taking business) requires providers to debar representatives who do not comply with the requirements in section 13 from rendering any further financial services on their behalf.

Section 13 requires a bank to enter into a service contract or other mandatory agreement with the representative. Failing which, the representative cannot act as such.

Section 13(1) and (2) requires the provider / bank to –

- accept responsibility for those activities of its representatives performed within the scope and course of implementing the service contract or mandatory agreement;
- at all times be satisfied that its representatives are competent to act, taking into account personal character qualities of honesty and integrity, as well as the competence and operational ability of the applicant to fulfill the responsibilities imposed by FAIS; and
- take reasonable steps to ensure that representatives comply with the applicable code of conduct as well as with other applicable laws on conduct of business.

These provisions are extensive and require financial services providers to secure and maintain extensive information about their agents. Moreover, they take full legal responsibility for all the actions of their agents. This will require maintaining a close relationship with agents. Failure to maintain a proper contractual relationship with such agents is an offence punishable with a fine of up to R1 million.

#### 10.4. OBSTACLES TO MASS BANKING PRESENTED BY FAIS

##### 10.4.1. INCREASING THE COST OF ACCOUNT OPENING

When considering the incremental impact of FAIS on the cost of account opening procedures, a clear distinction must be drawn between financial institutions who will be providing mass banking accounts or products off an existing internal account opening base, and financial institutions or service providers who intend providing such services from a newly developed base or via third party controlled or agent driven distribution channels.

Where existing systems are used, the basic architecture and staff skills are in place and they should be compliant with the Code of Banking Practice. Complying with the additional duties imposed by FAIS and the Code of Conduct would thus have a minimal impact. One of the banks that we consulted estimated that this would add about 5 minutes to the current account opening procedure of that bank. The costs would therefore not be significant. Other banks are of the view that the impact could be greater.

However, where a bank or service provider does not start from an existing account opening base, the costs of compliance with FAIS could be significant, particularly where the compliance has to be done by third parties unfamiliar with the banking environment.

##### 10.4.2. ENSURING THAT THIRD PARTY REPRESENTATIVES ARE FAIS COMPLIANT

The obligations on financial services providers in respect of third parties that provide financial services on their behalf, are set out in section 10.3 above. These duties are material. Moreover, the final incidence of the risk of FAIS compliance at all times remains with the bank or primary service provider. The sense that we gained from our interviews, is that this aspect has not yet received extensive

consideration from those parties developing new mass banking models that rely on third party controlled distribution models.

## 10.5.

### PROPOSALS TO FACILITATE MASS BANKING

FAIS provides three mechanisms whereby financial services providers or specific financial products can be exempted from the application of the Act.

- Section 1(2) of the Act empowers the registrar to exempt “any financial product ... taking into consideration the extent to which the rendering of financial services in respect of the product is regulated by any other law”.
- A more promising option lies in the provisions of section 1(4) read with the to be promulgated code of conduct for short term deposit-taking businesses. This section restricts the application of the entire Act to short term deposit-taking businesses to the extent that its application is regulated by the code of conduct for these businesses. In other words, the code of conduct can determine that certain financial products that qualify as short term deposits, for example mass banking products, would be exempted from the operation of the Act or that the Act would apply to such products only in a circumscribed manner.
- In terms of section 44 the registrar can, prior to the date determined by the Minister of Finance for financial institutions to comply fully with the Act, which determination has not yet taken place, exempt entire institutions from having to apply for a license under certain circumstances. This would not be an appropriate mechanism to use in the case of banks for whom mass banking products would only be a small part of their total offering of financial products or services.

Consideration could be given to an amendment to the Draft Code to exempt basic savings and transactions products targeted at the mass market from compliance with FAIS. This could be linked to an appropriate FICA mass market exemption (see section 9.1 above). Where financial institutions offer a menu of products with different characteristics and benefits, an exemption will not be appropriate.

## PART 4: OTHER LEGISLATIVE AND REGULATORY OBSTACLES TO MASS BANKING

### 11. POSITION OF MINORS

#### 11.1. INTRODUCTION

Industry players expressed concern about the contractual ability of minors to open bank accounts or indeed to perform banking transactions without the assistance of an adult parent or guardian. This is specifically relevant in our Aids prevalent society where increasingly households are being headed by minors. In 1996, as many as 33000 households<sup>80</sup> in South Africa were headed by minors between the ages of 10 and 14<sup>81</sup>. Another 150 000 households are headed by minors between the ages of 15 and 19<sup>82</sup>. The effects of AIDS are likely to significantly increase the number of households headed by minors. If they cannot open and transact against a bank account or perform other financial transactions, their ability to access, for example, government welfare payments, will be severely inhibited.

The Age of Majority Act, Act 57 of 1972 governs the age at which natural persons may enter into contractual relationships. The Act provides that majority is attained when a person turns 21. All persons under the age of 21 are minors. Minors need the assistance of their guardians to enter into valid contracts. A key question therefore is who has guardianship rights in respect of minors.

Section 1 of the Guardianship Act, 192 of 1993, provides that both parents shall be guardians if the child is legitimate. The mother shall be the guardian if the child is born out of wedlock. Section 3(1)(a) of the Children's Status Act 82 of 1987

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<sup>80</sup> Stats SA defines a household as follows: "A household is either:

(a) A one-person household, defined as an arrangement in which one person provides his or her own food or other essentials for living without combining with any other person to form part of a multi-person household, or  
(b) A multi-person household defined as a group of two or more persons living together who make common provision for food or other essentials for living.

The persons in a group may pool their incomes and have a common budget to a greater or lesser extent; -they may be related or unrelated persons or a combination of persons both related and unrelated."

<sup>81</sup> Census 1996, Statistics South Africa

<sup>82</sup> *Ibid.*

provides that the guardian of the minor shall be the mother's guardian if the mother is herself a minor.

If both parents are dead or incapable and a testamentary guardian was not appointed, a guardian must be appointed. Under the common law, the High Court is the upper guardian of minors and must therefore appoint a guardian. In most cases of orphans in South Africa, this would not have been done and they would therefore face the prospect of limited contractual capacity without the ready assistance of an adult that has the authority to assist them.

## 11.2.

### THE CONTRACTUAL CAPACITY OF MINORS

In terms of the common law, a natural person may not enter into a contractual relationship until he/she has reached the age of majority defined in the Age of Majority Act. Minors therefore have limited contractual capacity. They need the assistance of their guardians to enter into valid contracts. This also applies to financial transactions.

To this general rule, the Banks Act, 94 of 1990, has created an exception. Section 87(1) provides as follows<sup>83</sup> :

"Notwithstanding anything to the contrary contained in any law or the common law, and unless otherwise provided in the memorandum of association or articles of association of a bank, a minor over the age of 16 years or a married woman, whether or not under marital power, may be a depositor with a bank and may without the consent or assistance of his guardian or her husband, as the case may be, execute all necessary documents, give all necessary acquittances and cede, pledge, borrow against, and generally deal with, his or her deposit as he or she thinks fit, and shall enjoy all the privileges and be liable to all the obligations and conditions applicable to depositors.

This exemption applies only to deposit accounts, and does not apply to financial transactions that are not linked to deposit accounts. Minors therefore cannot make or receive money remittances.

A related problem arises from the regulations applicable to recipients of welfare grants. Child support grants must be paid to primary care givers and not to the

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<sup>83</sup> A similar provision is made in section 88 (1) of the Mutual Banks Act 124 of 1993.

children themselves. The Department of Welfare currently requires primary care givers to be over the age of 18. In the absence of either a guardian or a suitable primary care giver, these grants cannot reach the very people for whom they are intended. To deal with, inter alia, this problem, the Childrens Bill has been prepared.

### 11.3. THE CHILDREN'S BILL

The Children's Bill is currently being prepared by the Department of Social Development. In terms of the January 2003 version of this bill, provision is made for the lowering of the age of majority and for child-headed households.

Clause 29 of the Bill stipulates that a child, whether male or female, attains the age of majority and become a major upon reaching the age of 18 years.

Clause 234 of the bill addresses child-headed households. In terms of this clause a provincial head of social development may recognise a household as a child-headed household if –

- (a) the parent or primary care-giver of the household is terminally ill or has died because of AIDS or another cause;
- (b) no adult family member is available to provide care for the children in the household; and
- (c) a child has assumed the role of primary care-giver in respect of a child or children in the household.

A child-headed household must function under the general supervision of an adult designated by –

- (a) a child and family court; or
- (b) an organ of state or non-governmental organisation determined by the provincial head of social development.

That adult person –

- (a) may collect and administer for the child-headed household any social security grant or other grant or assistance to which the household is entitled; and
- (b) is accountable to the child and family court, or the provincial department of social development, or to another organ of state or a non-governmental organisation designated by the provincial head of social development, for the administration of any money received on behalf of the household.

Whereas the Children's Bill, if enacted, will make a major difference in terms of the contractual capacity of children between the ages of 18 and 21 since it will reduce the age of majority from 21 to 18, it is unclear what its impact will be for children below 18. The bill does not change the rules in respect of guardianship and children below the age of 18 who do not have legal guardians will still suffer from the same lack of contractual capacity.

Where the bill will bring some relief, is in respect of child-headed households. This is only in relation to the receipt and management of welfare grants on behalf of the minors involved. It does not extend to the contractual capacity of the minors to access financial services.

#### 11.4.

#### PROPOSALS TO FACILITATE MASS BANKING

Consideration must be given to access by minors (especially the heads of child-headed households) to financial services. However, welfare policy will have to crystallise in respect of issues such as the availability of such grants to heads of child-headed households irrespective of age, and whether grants are to be paid to minors or only to representative adults. Once the policy has been determined, the appropriate measures to ensure access to financial services can be determined. If the minor is to access the grant directly, those aged 16 years and older are currently assisted by the provisions of the Banks Act and the Mutual Banks Act that provide that minors that are 16 years and older can open and operate bank accounts. Should younger children require similar access the relevant sections will have to be amended to reduce the cut-off age. However, if the grants are to be accessed only through adults, that adult will have to assist the minor to open the account or will have to hold the account in his or her personal name. In the first

instance, the legislation should preferably empower the adult to assist the minor to open the account and in the second instance, it would be preferable if the law recognised the fiduciary nature of the duties of the adult in respect of the relevant funds.

## 12. STAMP DUTIES ACT

### 12.1. BACKGROUND

The Stamp Duties Act 77 of 1968 imposes duties on various legal instruments. For the purposes of the Act, an instrument includes a debit entry posted to a bank account.<sup>84</sup> Examples of debit entries are withdrawals, electronic transfers, third-party account payments, point-of-sale payments and debit orders. Tariff 6 of Schedule 1 to the Stamp Duties Act establishes the value of the duty, which is currently 20 cents. This duty is paid in addition to Value-added Tax (VAT) (currently set at 14%), which is paid on all bank charges. The South African Revenue Services (SARS) estimates that approximately R400 million is collected annually from stamp duties on debit transactions.

Stamp duties have a greater impact on new “innovative” banking products supplied by newer banking models than on products supplied by the large banks, due to the lower costs of the former. For instance, existing banks generally charge more than R2 for ATM withdrawals, while the “innovator” banks generally charge between R0 and R2. Research by the FinMark Trust shows that the total bank charges of dominant banks for the “typical” client are approximately R40 per month.<sup>85</sup> New “innovator” banks aim to charge clients significantly less than this amount.

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<sup>84</sup> The account is defined in the Act as an account at an institution which carries on “the business of a bank” as defined in section 1 of the Banks Act 94 of 1990 or the Postbank operated in terms of the provisions of Chapter VI of the Postal Services Act 124 of 1998 into which the depositor may deposit money and from which the institution or the Postbank where the account is held, may make a payment to any other person or electronically transfer an amount to any other account of such deposit held at any other institution contemplated in subparagraph (i) or to the account of any other person.

<sup>85</sup> This is based on a FinMark Trust Market Comparison that took place in 2002, which makes several assumptions about the number and value of transactions that a typical client is likely complete. The bank charges of the “typical client” are assumed to arise from: a monthly service fee, 2 debit orders, 2 ATM withdrawals--on us (w/d: R100 each), 1 ATM withdrawal--SASWITCH (w/d: R100 each), 2 Electronic payments (R100 each), 1 Statement requested – ATM, 1 Statement requested – Counter, 1 Deposit (R1,000). The FinMark Trust analysis compares 14 bank accounts at 6 existing South African banks.

## 12.2.

## CONSEQUENCES FOR LOW-INCOME BANKING

The Stamp Duties Act raises the costs of banking products in general and on products aimed at the mass-market in particular. It also raises the tax burden of low-income households. If we assume that the typical low-income client makes seven debit transactions per month, the Stamp Duty adds R1.40 per month to bank charges. To this must be added the VAT on bank charges. The following table illustrates the proportion of total costs and total taxes (not including corporate tax on banks and not including recovery of VAT) on ATM withdrawals attributable to stamp duties for 2 types of “big 4” products and three levels of “innovative” bank charges:

Product supplier	“Big 4” bank		“Innovative” bank		
Cost of ATM withdrawal	R6	R4	R2	R1	R0.50
Total tax	1.04	0.76	0.48	0.34	0.27
VAT	0.84	0.56	0.28	0.14	0.07
Stamp duty	0.20	0.20	0.20	0.20	0.20
Total cost to client (incl. VAT & stamp duty)	7.04	4.76	2.48	1.34	0.77
<i>Increase in cost to client due to taxes</i>	17%	19%	24%	34%	54%
<i>Increase in cost to client due to stamp duties</i>	3%	5%	10%	20%	40%

**Table 1: The impact of the Stamp Duties Act on total bank charges on products aimed at low-income markets<sup>86</sup>**

Source: Genesis Analytics

From the comparison it is clear that stamp duty comprises an increasing proportion of the costs of products aimed at the low income market as they become cheaper, as it is a fixed nominal amount rather than a proportional charge. It is worth bearing in mind that income tax on banks and the costs of administering the Stamp Duties Act and VAT are also significant. The cumulative effect of these taxes is to substantially raise the costs of providing access to financial services for the poor.

<sup>86</sup> The analysis of the “big 4” products is based on a market comparison of the cost of withdrawing R500 from an ATM at a bank at which the account is held, which range between approximately R4 and R6. New “innovative” products currently cost a fixed amount of approximately R2 per withdrawal, and at least one product supplier plans to charge between R0 and R2 per withdrawal.

### 12.3. IMPACT ON PROVIDING ACCESS FOR LOW INCOME CUSTOMERS

Given the cost-sensitivity of low-income clients, the stamp duty on debit entries presents an obstacle to the expansion of financial services to the poor. An analysis using the model developed by the FinMark Trust reveals that a R1.40 decrease in the cost of bank accounts could make access affordable for in excess of one hundred thousand additional households<sup>87</sup>. Relaxing the Stamp Duties Act for mass-market bank accounts could, therefore, have a substantial impact on the expansion of access to financial services to low-income households.

### 12.4. PROPOSALS TO FACILITATE MASS BANKING

The costs of the stamp duty in terms of lower access to financial services for the poor needs to be weighed against the revenue it generates. If all mass-banking accounts, of which there are currently approximately 6.9 million<sup>88</sup>, are exempted from paying the stamp duty, the state would forego approximately R116 million in annual revenue, assuming that the average client concludes 7 debit transactions per month. This constitutes approximately 28% of the total revenue generated from stamp duties on debit transactions, and 0.04% of the estimated total revenue to be collected in 2003/2004 in the National Revenue Fund. If an exemption were to be targeted at only the new “innovative” mass-banking products, foregone revenues are likely to be far lower than this, as it is unlikely that all 6.9 million low-income account holders will migrate to these products.

It should be borne in mind that stamp duties on fixed deposits and insurance policies were dropped in this financial year, “as a further step in tax simplification and to reduce costs of financial services this year”.<sup>89</sup> This proposal will come into effect from 1 April 2003 at an estimated cost of R200 million.

By reducing the tax, the state would gain additional revenues from taxes on income of banks that will have more clients to generate transaction revenue from as well as more assets (loaned off increased savings) to earn income from.

Exemption options include the following:

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<sup>87</sup> See footnote 7 above.

<sup>88</sup> Source: FinMark Trust. “Low-income” account is defined as a bank account credited with an amount of less than R4000 per month.

<sup>89</sup> Manuel *National Budget Speech* 2003, [www.treasury.gov.za](http://www.treasury.gov.za).

*Exempt transactions below a certain amount:* Debit transactions below a certain threshold amount could be exempted. What that threshold should be should be determined from a study of low income market behaviour.

*Link a stamp duty exemption to a cost-of-transaction ceiling:* Debit transactions that attract bank charges below a certain amount could be exempted. In addition to facilitating mass-banking, this may act as an incentive for banks to lower transaction costs. However, it may also induce a distortion in the pricing structure of banking products.

*Exempt products aimed at the mass-market:* Products specifically targeted at the low-income market could be exempted from the duty. This could be considered in tandem with the mass market exemption suggested for FICA.

*Levy stamp duty as a percentage of bank charges:* A final option to consider is to levy stamp duty as a percentage of the bank charge on the transaction involved, with an absolute cap. This would lower the burden on the low income client utilising cheaper products aimed at the low income market.

## 13. CASH RESERVE REQUIREMENT

It has been argued that the recent policy change by the South African Reserve Bank (SARB) to disallow up to 50% of cash in bank vaults and ATMs from being counted as part of the cash reserve requirement (CRR) imposed on banks, would have a significantly negative impact on the roll out of mass banking accounts, because servicing these accounts would be cash intensive due to the financial transaction needs of low income customers.

Cash reserve requirements are a standard component of bank regulations around the world and in South Africa. At 2.5% of liabilities (excluding capital and reserves), the South African requirements are not out of line with other countries<sup>90</sup>. Internationally the norm is that central banks do not pay interest on the cash reserve, although there are exceptions to this rule. The Governor of the SARB has the authority, conferred by the SARB Amendment Bill of 2000, to provide relief to

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<sup>90</sup> Nel "Minimum reserve requirements" SARB Quarterly Bulletin Dec 2000.

the banks by allowing vault cash to be counted in the calculation of the CRR. In South Africa banks have historically enjoyed 100% offset of vault cash against the CRR. This is gradually being phased out at a rate of 25% per year, so that by September 2003 the offset will be reduced to 50%.

Historically central banks manipulated the CRR as an instrument of monetary policy. This practice has gradually been abandoned and the CRR has become much more stable. Since 1998 the CRR for banks has been set at 2.5% of liabilities. No interest is paid on this. Applying this ratio to total banking sector liabilities, excluding capital and reserves (R 872 billion<sup>91</sup>) would indicate a CRR for the sector of approximately R21 billion. If we assume no offset and that these funds were invested at current rates of around 10%, compliance with the CRR implies a revenue loss to the commercial banks of around R2 billion per annum (against total interest income of R116 billion). In reality the rate would be lower in that those Central Banks that do pay interest on cash reserves do so at rates that do not compete with the commercial banks – say 5% or a cost of R1 billion.

The Reserve Bank has indicated that they are keen to eliminate the offset provisions for the following reasons :

- The CRR is an accepted part of the prudential framework of bank regulation. Thus, those banks with large distribution networks, even though they must hold proportionally larger amounts of cash, should still have reserves at the central bank for the normal prudential reasons.
- The CRR plays an important role in the monetary system by ensuring that the banks are short on a daily basis and therefore need to participate in the Reserve Bank's accommodation facility, which is the key mechanism for the implementation of interest rate policy.
- Compliance cannot be guaranteed if the cash is in the commercial bank's vaults. In fact, some banks with excess vault cash have been providing facilities to shortage banks, distorting the overall position.

The cost of the CRR for banks has declined for a number of reasons. Firstly, the SARB has reduced the burden on the banks with respect to the distribution of notes and coins as it has become directly involved in distribution and has established additional regional cash depots. Secondly, technology has increased the banks' ability to optimize their cash holdings. For example, cash distribution is

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<sup>91</sup> 2002.

now handled by specialist outsource companies that can optimize distribution over several institutions. Thirdly, the relative burden of cash holdings in branches has declined as more and more transactions occur electronically.

On the face of it, the removal of the offset concession does impose costs on the banks. However, it may be that such costs are within the normal and accepted regulatory costs that banks face internationally. Certainly when considered in conjunction with other developments that should promote the use of non-cash payment solutions, this change will add to the pressure forcing banks to promote non-cash solutions for the mass market. However, it is not clear to what extent banks will be able to further cut costs or promote the usage of electronic channels to minimize the use of cash in the network, without a decline in overall demand for banking services. It seems that electronic products are already more widely used by individuals with low incomes in South Africa than in many other countries.

From the data assembled by Nel<sup>92</sup>, it would seem that South Africa's stance on the CRR is more restrictive than the OECD countries with which our financial system is most often compared. Compare the CRR in the UK (0.15%), Australia (0%), Canada (0%). A good measure of this would be the extent to which cash as a liquid asset, is relevant to the management of liquidity in markets with deep and liquid capital markets and where depositors are likely to effect withdrawals electronically.

Should the banks be able to convincingly demonstrate that there are no further substantial cost efficiencies that can be achieved from other sources, the SARB may consider a further reduction in the level of cash reserves or a relaxation of level of vault cash that is excluded from being counted as part of the CRR, to provide some income relief to the banks. A reduction in the CRR to 2% or 1.5% would not be out of line with OECD norms and would offset a large portion of the loss of income faced by the banks, which have until now been in a position to offset vault cash against the CRR.

It is very difficult to calculate the incremental cost that the CRR would impose on a mass banking rollout. It would depend on a number of factors, including the number of Points of Representation (PORs), daily cash flow for each POR, daily processing capacity (staff and machines), vault limits, distance (and time taken) to the central bank depot, and whether the collection can be handled as part of a shared run in the bullion van by the cash handling company, or whether it is

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<sup>92</sup> Ibid.

provided only for the bank concerned. The cost of the cash handling will also include a not inconsiderable cash insurance charge relative to the area in which the cash run takes place. It is also highly unlikely that the micro-saving product will be handled on a stand alone basis. On the assumption that clients will make their deposits soon after the end of the month, when the bank is making net out payments to salaried individuals, the cash holdings at a POR may actually decline.

It is therefore very difficult to quantify the impact of this obstacle or indeed to determine whether it is an obstacle at all. No recommendations are therefore made in this regard.

## 14. BASEL II CAPITAL ACCORD

### 14.1. BACKGROUND

The Basel I Capital Accord was drawn up in 1988 and sets the definitive international standards for the measurement, reporting and regulation of risk in the banking (and increasingly also the insurance) sectors. Although South Africa is not part of the Basel Committee and is, therefore, under no obligation to comply with the accord, the SARB has adopted the standards set by the accord in our domestic regulatory regime. Even in the absence of an official commitment by South Africa to follow the methodology proposed by the accord, it is quite clear that compliance to these standards is a requirement set by the international market as a prerequisite for attracting any foreign capital or business. Over the last 10 years the banking sector has outgrown the original Basel I Accord and this led to the formulation of the new Basel II Accord.

The Basel II Accord is primarily aimed at 'internationally active banks' and is designed to utilise the advanced risk measurement systems of these banks to measure risk more accurately. The application of the Accord will, however, extend beyond these banks to smaller or niche banks as well. To accommodate the smaller banks, provision is made for a simpler and more prescriptive risk measurement approach that is similar to Basel I, but with some key improvements. It is expected that this approach will be more conservative and will lead to higher capital charges than under the more advanced approaches. The new Accord has gone through three rounds of consultations and comments, which included South African banks, and is currently in the process of being finalised with official implementation intended to commence at the end of 2006. In many cases,

however, banks and regulators have already started implementing aspects of the Accord.

The Basel II Accord allows substantial regulatory discretion in the implementation of the suggested rules and methods and essentially represents a set of bank risk management best practices. As a non-member of the Basel committee, South Africa has even more freedom in the application of the Accord. This could include keeping certain bank categories under the original Accord or adjusting overly punitive components of the Accord to suite the South African environment. As the new Accord was designed around internationally active banks, concerns have been raised around its suitability and cost to smaller banks and particularly those operating in an emerging market context. The most important changes between Basel I and Basel II are set out in Appendix A hereto. This section seeks to anticipate the expected impact of these changes on the South African mass banking market.

#### 14.2. CONSEQUENCES FOR LOW INCOME BANKING

The changes implemented by Basel II could affect banks at two levels.

##### 14.2.1. AS REGULATED ENTITIES PROVIDING LOANS TO CLIENTS IN VARIOUS RISK CATEGORIES

International literature suggests that the issues of concern to smaller banks are the cost of technology required to comply with regulation (i.e. to be able to use the advanced Internal Ratings Based (IRB) approach in order to reduce capital requirements) and the labour intensity of maintaining the necessary databases and systems (for the same reason). The result of both of these items is that smaller banks will, in many cases, have to apply the standardised approach, which is more conservative than the IRB approaches and, therefore, will result in a higher capital charge.

It does not seem to be a major concern in South Africa as the small banks serving the mass market are already required to maintain much higher capital ratios than required under regulation (e.g. African Bank:35%, Capitec >50%) in order to attract investment (due to the perceived risk in the mass market). The capital market has, therefore, already priced in the underlying risk of the client market in which these banks operate. This suggests that the mass market banks will not benefit in terms

of capital requirement from using the advanced IRB approach. Despite this, several of these banks have indicated their intent to follow the IRB approach as it provides them with better risk management tools for managing their risks and is in line with practices that have been adopted even before these were captured in the Basel II Accord.

Where components of the new Accord are found to be overly punitive, forcing banks to allocate more capital than required to particular categories of business, the SARB has indicated that it will utilise the room for discretion (as allowed under the Accord) when enforcing specific aspects of the Accord.

#### 14.2.2.

#### AS CLIENTS OF LARGER BANKS RECEIVING FUNDING FOR ONLENDING

The impact of Basel II on capital requirements is still uncertain and, therefore, the appetite for and cost of large institutions lending to financial institutions serving the mass market, also remain uncertain. The fear that larger institutions may be less willing to provide wholesale finance, is due to the perception that the increased risk sensitivity will lead to a general increase in capital requirements. Although this is not the intention of Basel II (on average it is intended to keep capital requirements at the current levels), it may be true for specific product areas and, therefore, for specialised institutions focusing on these product areas.

Basel II aims at being more sensitive to the true credit risks and attempts to measure these risks more accurately. There are two possible scenarios:

- The new capital rules may, through more accurate and sensitive measurement, find that more capital should be allocated to certain categories of loans. If the measurement of risk is more accurate than before, the higher risk charges are relevant and should be applied. Due to the pivotal and sensitive role of the banking sector in the economy, any arguments for accepting more risk for “development purposes” (i.e. that, as a developing country, our markets are inherently more risky and should not be penalised for this as this may stunt development), should be treated with caution.
- If, however, the new Accord systematically overestimates the underlying risk, this is a problem that can and should be addressed. In such cases, the SARB has already indicated that it will apply regulatory discretion in the application of the Accord. The extent of this problem, however, can only be determined by applying the new rules to existing banks and seeing how it affects the capital

requirements. This is a complicated and costly exercise, but anything short of this is really anecdotal.

At the moment, there is no conclusive evidence that the new accord will systematically increase the capital required. In fact, in some retail product areas like mortgage lending, it will reduce the capital required. The SARB has indicated that they will complete a more detailed quantitative impact study towards the beginning of next year in order to test the detailed application of the Accord to the South African environment.

#### 14.3. IMPACT ON PROVIDING ACCESS FOR LOW INCOME CUSTOMERS

Although the above raises valid concerns that should be addressed, it is not clear that this will negatively impact on the South African market. As mentioned in the previous section, the SARB focuses on appropriate measurement of underlying risks and not blind compliance to a set of rules. If the rules are found to be inappropriate they have indicated that they will exercise their discretion (as allowed for in the Accord) in the implementation and adjustment of these rules. With regards to the expected increase in cost of funding to mass market banks, it has been shown in the previous section that the market has already priced in risk beyond the extent of the Accord. The result is that the mass market institutions have been allocating (and possibly over allocating) capital based on perceived underlying risk. Better identification of these risks should not lead to dramatic changes in capital required and may even reduce it.

#### 14.4. PROPOSALS TO FACILITATE MASS BANKING

The above discussion should make it clear that there are some issues of concern in the proposed new Accord. In the comment on the latest Basel consultative paper prepared by the SARB and including the comments of several banks many of these concerns have been brought to the attention of the Basel committee. Furthermore, the SARB has made it clear that it will not mechanically apply the new Accord without properly assessing the implications for the market. Where the Accord is found to be inappropriate or overly punitive, the regulator has also indicated that it will exercise the discretion allowed for under the Accord to prevent unnecessary cost to the market. In order to quantify and address the remaining

uncertainties the SARB is planning a thorough local quantitative impact study along the lines of the BIS Quantitative Impact Study. This study will focus on the particular issues of concern to the local market.

In addition to the above, it was shown that the South African risk management regime has already made significant advances in the measuring and monitoring of risk over the last few years, which have extended beyond the Accord. This ensured that risk management and, particularly, the allocation of capital was done on best measurement of underlying risk and not simply following rules set out in the Accord. Mass market institutions have accordingly been allocating capital in excess of that required under the Basel Accord and it is expected that banks lending to micro finance institutions were doing the same. The implication is that, firstly, even if the new accord increases the capital required under the Accord it is not expected to exceed the allocation of capital as dictated by the market. Secondly, the high levels of capital held by the mass market institutions would offset increased perceptions of risk under the new Accord. The implication for the mass market banks is that there is no clear evidence to suggest that there should be any significant changes in the lines of funding received from larger banking institutions. This seems to be confirmed by the fact that the latter issue was not reflected in comments the South African banking sector put forward in its formal response on the third Basel consultative paper.

## 15. CONCLUSION

On the product development side, efforts to extend access to financial services fall into two categories. On the one hand, the big banks have formed an Inter-Bank Task Group to develop proposals for products that would enable them to extend their services to the currently unbanked. The currently proposals of the IBTG are for a basic savings account and a transfer of value product. These would primarily be delivered via the existing branch networks of the big banks, although they also envisage utilising accredited agents.

On the other hand, a number of smaller banks and potential market entrants are developing products that aim to utilise modern technologies such as GSM networks and POS devices and third party distribution networks to deliver financial services to low income clients at dramatically reduced fees. These include savings accounts and transactions accounts.

The ability to roll out these accounts in a mass banking roll out will indeed be materially affected by a number of legislative and regulatory frameworks. We considered the impact of the following:

- The Financial Intelligence Centre Act and regulations, seen within the context of applicable international standards on money laundering control;
- The Financial Advisory and Intermediary Services Act;
- The contractual capacity of minors;
- The Stamp Duties Act;
- The Cash Reserve Requirement;
- The Basel II Capital Accord.

We deal with each in turn.

*Money laundering controls:* Through the enactment of FICA and its accompanying regulations, the government sought to implement the FATF Forty Recommendations. Since the promulgation of FICA, FATF has issued a set of Revised Forty Recommendations as well as a set of Special Recommendations on Terrorist Financing. As a FATF member we are bound to amend our domestic law

to accommodate these changed international standards. The combined effect of FICA and the new international standards on a mass banking roll out, is material. We identified the following current and potential obstacles:

- The single biggest obstacle is the duty on banks to verify the **residential address** of clients who either want to open an account or perform a once-off transaction. Most poor people do not have the documentary proof to submit for verification.
- The requirement to produce an **ID document** is impossible for the approximately 1,5 million people who do not have ID documents.
- There is uncertainty about how the South African authorities will seek to implement the new FATF Recommendation 9 which deals with the **ability of third parties to perform CDD** on behalf of accountable institutions. If the authorities choose to deal with this on a purely agency basis, the problem would be limited. If, however, they require such third parties to be fully regulated under FICA, it could undermine the attractiveness of a number of the new proposed banking models.
- Similarly, the new Special Recommendation VI, by requiring all persons offering **money transmission services to be registered** and compliant with FATF Recommendations, will probably limit the distribution network that can be utilised as part of the proposed IBTG transfer of value product.
- The requirement to perform the full CDD procedure for **money remittance transactions** where clients do not hold accounts with the financial institutions concerned will make low value transactions far less attractive.
- Due to the legal nature of **stokvels**, banks must perform full CDD procedures for all stokvel members, if the stokvel has less than 20 members, before it can open an account for that stokvel. Banks cannot legally open accounts for stokvels with more than 20 members unless they are registered as companies.
- As FICA is currently worded, a bank cannot conduct any transactions with a client until it has completed the verification of the client's details. That will inhibit new banking models that require **transaction immediacy** for marketing success. The new FATF Recommendation 5 is more flexible in this regard.
- The new FATF Recommendation 8 that require financial institutions to pay special attention to any money laundering threats that may arise from **new or developing technologies**, may impact the newer banking models utilising technologies that favour anonymity.
- The combined impact of compliance with the money laundering control framework on the **cost** of banks will be material.

We make the following recommendations to facilitate mass banking:

- The further development of risk-sensitive supervision and risk-sensitive compliance in the money laundering control area. The new FATF Recommendations facilitate such an approach. A risk-based orientation is already evident in the approach being followed by banks to the verification of residential address. This approach should be captured in appropriate formal Guidance Notes issued by the FIC.
- An appropriate mass banking exemption should replace the current unworkable exemption 17. Such an exemption should focus on the total monthly deposits into an account and limit these to below a threshold value.
- There should be a threshold value for occasional transactions below which only reduced CDD procedures need to be performed.
- For the purposes of the performance of CDD, stokvels should be treated as “other legal persons”. The gap in our law regarding the legal personality of stokvels should be cleared.
- For the purposes of performing CDD procedures, third parties should be treated as agents rather than being required to be subject to the full FATF standards.
- FICA and its regulations need to be aligned to the FATF Recommendation to allow financial institutions to perform certain transactions in the normal course of business before verification procedures have been completed.

*The Financial Advisory and Intermediary Services Act:* The impact of FAIS and the draft Code of Conduct for Short-Term Deposit-Taking Business on extension of banking services to the poor will depend on the financial institutions concerned. For established banks, the impact is likely to be limited, especially since they already comply with the Banking Council's Code of Banking Practice. For banks who intend to utilise non-financial third parties to distribute their products, the impact will be material, since they will have to ensure compliance by these institutions with FAIS. We propose that the Draft Code provide for specific basic (with the emphasis on basic) products aimed at the low end of the market to be exempted from complying with FAIS.

*Contractual capacity of minors:* Under the common law, minors (persons under the age of 21) have limited contractual capacity. That includes the ability to access financial services. This is problematic in a society where parents die from Aids and leave children for whom no formal guardians have been appointed. From a financial services point of view, child-headed households face a dual problem. Firstly, can they access welfare grants intended for them and, secondly, can they place those grants in a bank account and deal with them?

The Banks Act (section 87) allows persons above the age of 16 to be depositors and to deal with their deposits. They would still not be able to access credit, make or receive money transfers, or access any financial services other than savings and transactions accounts.

The Children's Bill seeks to decrease the age of majority to 18 years and to create procedures for the designation of adults to collect and administer welfare grants on behalf of child-headed households. This may effectively curtail the ability of minors to access financial services and leave them open to abuse. No recommendations can be made until welfare policy has crystallised.

*Stamp Duties Act:* The Stamp Duties Act imposes a duty of 20 cents on every debit entry posted to a bank account. The impact of this duty increases proportionally as the actual fee charged by the bank for the performance of the transaction decreases. At low fee levels, such as some of the levels proposed by the new banking models, the stamp duty does become a material obstacle to the extension of access. We propose a number of exemption options, including levying stamp duty as a percentage of the bank charge, with an absolute cap.

*Cash Reserve Requirement:* It has been argued that the recent policy change by the SARB to disallow up to 50% of cash in bank vaults and ATMs from being counted as part of the cash reserve requirement imposed on banks, would have a significantly negative impact on the roll out of mass banking accounts, because servicing these accounts would be cash intensive due to the financial transaction needs of low income customers. We found that generally the cost of the CRR for banks has declined and that such costs are within the normal and accepted regulatory costs that banks face internationally. There is also no direct proof that a mass banking roll out will indeed increase the cash holding requirement for banks. We therefore do not find this a material obstacle.

*Basel II Capital Accord:* The Basel II Capital Accord is designed to utilise the advanced risk measurement systems of “internationally active banks” to measure risk more accurately. South Africa is under no obligation to comply with the Accord, and thus have more freedom in its application. The Accord could affect banks involved with a mass banking roll out in two ways:

- As regulated entities providing loans to clients in high risk categories; and
- As clients of larger banks receiving funding for onlending.

Indications are that the market has already forced institutions active in the mass market to maintain much higher capital ratios than that required by the regulator. Even if the Accord increases capital required, it is not expected to exceed the allocation of capital dictated by the market. Moreover, due to their higher capital holdings there is no clear evidence that there should be any significant changes in the lines of funding received by mass market banks from larger banking institutions. We therefore do not find that this is a material obstacle.

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## GLOSSARY

<b>ATM</b>	Automated Teller Machine
<b>APR</b>	Annual Percentage Rate
<b>BEE</b>	Black Economic Empowerment
<b>BIS</b>	Bank for International Settlements
<b>CAA</b>	Credit Agreements Act
<b>CDD</b>	Customer Due Diligence
<b>CRR</b>	Cash Reserve Requirement
<b>ECI</b>	Ebony Consulting International
<b>EU</b>	European Union
<b>FAIS</b>	Financial Advisory and Intermediary Services Act
<b>FATF</b>	Financial Action Task Force
<b>FIC</b>	Financial Intelligence Centre
<b>FICA</b>	Financial Intelligence Centre Act
<b>IBTG</b>	Inter-Bank Task Group
<b>IRB</b>	Internal Ratings Based
<b>MFRC</b>	Micro Finance Regulatory Council
<b>NGO</b>	Non-Governmental Organisation
<b>NLR</b>	National Loans Register
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>POR</b>	Point of Representation
<b>ROSCA</b>	Rotating Savings and Credit Associations
<b>SARB</b>	South African Reserve Bank
<b>SARS</b>	South African Revenue Services
<b>SACCO</b>	Savings and Credit Co-operative
<b>SMME</b>	Small, Medium and Micro Enterprises
<b>VAT</b>	Value-added Tax

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# APPENDIX 1: FAIS SPECIFIC CODE OF CONDUCT FOR SHORT-TERM DEPOSIT TAKING BUSINESS

**BOARD NOTICE ..... OF 2002**

**FINANCIAL SERVICES BOARD**

**FINANCIAL ADVISORY AND INTERMEDIARY SERVICES ACT, 2002**

**(ACT NO. .... OF 2002)**

## **SPECIFIC CODE OF CONDUCT FOR AUTHORISED FINANCIAL SERVICES PROVIDERS AND REPRESENTATIVES CONDUCTING SHORT-TERM DEPOSIT-TAKING BUSINESS**

I, ....., Registrar of Financial Services Providers, hereby under section 15 of the Financial Advisory and Intermediary Services Act, 2002 (Act No ..... of 2002), publish a specific code of conduct for authorised financial services providers, and their representatives, involved in short-term deposit-taking business, as contained in the Schedule hereto, which I have drafted after consultation with the Advisory Committee on Financial Services Providers, the Banking Council of South Africa, other representative bodies of the financial services industry and client and consumer bodies determined by that Committee, and the Registrar of Banks.

**J. VAN ROOYEN,**

Registrar of Financial Services Providers

## SCHEDULE

### CODE OF CONDUCT FOR AUTHORISED FINANCIAL SERVICES PROVIDERS AND THEIR REPRESENTATIVES CONDUCTING SHORT-TERM DEPOSIT- TAKING BUSINESS, 2002

#### ARRANGEMENT OF PARTS

Part	Heading	Sections
I	Introductory provisions	1-4
II	General duties of providers	5-8
III	Confidentiality and privacy	9
IV	Advertising	10
V	Complaint Resolution	11 – 14
VI	Miscellaneous	15 – 16

## PART I

### INTRODUCTORY PROVISIONS

#### Definitions

1. In this Code “the Act” means the Financial Advisory and Intermediary Services Act, 2002 (Act No. .... of 2002), a word or expression to which a meaning has been assigned in the Act shall have that meaning, and, unless the context indicates otherwise –

“advertisement”, in relation to a provider, means any written, printed, electronic or oral communication (including a communication by means of a public radio service) which is directed to the general public, or any section thereof, or to any client on request, by a provider, which is intended merely to call attention to the marketing or promotion of short-term deposit-taking business offered by the provider, and which does not purport to provide detailed information regarding any such business; and “advertising” or “advertises” has a corresponding meaning;

“client” means a client in respect of short-term deposit-taking business;

“deposit” means a financial product referred to in the definition of “short-term deposit-taking business”;

“provider” means an authorised financial services provider which is a bank as defined in the Banks Act, 1990 (Act No. 94 of 1990), or a mutual bank as defined in the Mutual Banks Act, 1993 (Act No. 124 of 1993), conducting short-term deposit-taking business and includes, where appropriate, any representative of the provider;

“short-term deposit-taking business”, in respect of a provider, means the rendering of a financial service in respect of a deposit referred to in paragraph (f) of the definition of “financial product” in section 1(1) of the Act, with a term not exceeding 12 months;

“transaction requirement” means any application, proposal, order, instruction or other contractual information required to be completed for, or submitted to, a provider by or on behalf of a client, relating to the investment in any deposit, including any amendment or variation thereof;

“writing” includes communication by telefax or any appropriate electronic medium which is accurately and readily reducible to written or printed form; and “written” has a corresponding meaning.

### **Application of Act**

- 2.** The Act, including any measure or decision referred to in the definition of “this Act” in section 1(1) of the Act, but excluding
- (a) section 13(3), (4) and (5);
  - (b) section 14(1),(2) and (3) and
  - (c) any other code of conduct contemplated in section 1(1) of the Act, than this Code;
- , shall apply in respect of any provider, deposit, short-term deposit-taking business and client.

**Construction**

3. This Code must, subject to section 2, be construed-
- (a) in a manner conducive to the promotion and achievement of the objectives of codes of conduct as stated in section 16 of the Act; and
  - (b) as being in addition to any other law not inconsistent with its provisions and not as replacing any such law.

**Application of Code**

4. The provisions of this Code apply to any provider when conducting short-term deposit-taking business in relation to clients including, where appropriate in terms of any such provision, at any time prior to dealing with a client, during negotiations or after conclusion of the transaction.

## **PART II**

### **GENERAL DUTIES OF PROVIDERS**

#### **Unsolicited contacting of client**

- 5.** A provider must, in the event of unsolicited contacting of a client—
- (a) in making the contact arrangements, and in all communications and dealings with the client thereafter, act honourably, professionally and abiding the convenience of the client; and
  - (b) at the commencement of any such contact, visit or call initiated by the provider, explain the purpose thereof.

#### **General duties of provider**

- 6.** A provider must, subject to the provisions of this Code—
- (a) act fairly and reasonably, and with uncompromising integrity in order to promote trust and confidence;
  - (b) ensure compliance with this Code in any contract concluded with a client, and with any other applicable law, and make copies of this Code available to clients;
  - (c) make relevant information available in plain language in English and where appropriate in the other official languages;
  - (d) assist a client to choose a deposit fitting the client's needs;
  - (e) assist a client to fully understand the financial implications of the product chosen by the client;
  - (f) not request a client to sign any written or printed form or document or any transaction requirement unless all details required to be inserted thereon by the client or on behalf of the client have been completed;

- (g) take care to ensure that the relevant services relating to deposits are safe and secure;
- (h) ensure that its relevant staff members comply with this Code and that the procedures followed by them reflect the commitments set out in this Code;
- (i) inform clients if deposit-related products or services are being offered in different ways (for example electronic services) and inform clients how to get more information in this regard; and
- (j) maintain adequate internal complaints procedures.

#### **Other information and explanations**

##### **7. A provider must-**

- (a) ensure that contractual terms and conditions are fair in substance, and clearly distinguishable from marketing or promotional material, and set out the applicable rights and responsibilities of the client clearly with avoidance of unclear technical or legal language and, where the latter must necessarily be used, with proper explanations thereof;
- (b) when furnishing advice to a client, make reasonable enquiries to assess the client's needs and objectives, having regard to the circumstances of the client and the type of deposit on which advice is being given;
- (c) make available where appropriate beforehand or at the required time (for instance, when a contract is concluded), or at any reasonable time at the request of a client, in writing or, where appropriate or urgent, orally-
  - (i) clear information on the key features of the deposit in which the client is interested in order to assist the client to make an informed choice, including any applicable cooling-off periods;

- (ii) information on how a relevant account with the provider will operate, including information on withdrawal of funds, earning and payment of interest, differences between debit and stop orders where appropriate and any applicable special procedures and safeguards to ensure safe business;
- (iii) full details of applicable fees and charges, including whether they will be negotiable or not, and of any applicable additional charges or interest in case of early withdrawals or cancellation;
- (iv) information on applicable interest rates, including deduction or payment of interest, methods of calculation thereof and possible changes to be effected thereto;
- (v) information on possible later changes to terms and conditions of a relevant contract, and circumstances under which later changes may occur which might affect the deposit adversely;
- (vi) information on manner in which funds may be dealt with at maturity;
- (vii) information on a client's rights to access personal information held by the provider on the client;
- (viii) information regarding required client identification when opening an account, and availability of unique identification methods with the use of PINS and passwords during the relationship with the client;
- (ix) information on when account details may be passed to, or required checks must be made with, credit reference agencies, fraud prevention agencies and other legally relevant entities;
- (x) information on closing of branches, outlets or ATMs of the provider;
- (xi) advertising and promotional material complying particularly with this Code;

- (xii) information within a reasonable period of time on any set-off that may be effected by the provider between the credit balance of any deposit and any other business debt with the provider in its capacity as a bank or mutual bank; and
- (xiii) information on closing of deposit accounts of clients, which must only be effected after reasonable prior written notice at the last address of the client furnished to the provider and without prejudice to any legal rights of a client in respect thereof: Provided that it will be permissible to effect closing of accounts without prior notice to the client, if and when so required by law.

#### **Account operations**

##### **8. A provider must-**

- (a) provide account statements to a client, as indicated by the client to the provider, whether then to be so provided orally or in writing, or through telephonic banking, or as otherwise agreed with the client;
- (b) provide a client information on-
  - (i) charges to be levied on furnishing of account statements (if any);
  - (ii) procedures to be followed by a client in case of statement errors;
  - (iii) procedures to be followed by a client prior to automatic roll-overs of deposits being effected where the client does not wish this to happen;
  - (iv) procedures to be followed by a client whenever changes in personal identification or addresses occur; and
  - (v) safeguards and essential precautions to be implemented, followed and taken in connection with telephonic and electronic banking procedures in respect of deposit accounts.

**PART III****CONFIDENTIALITY AND PRIVACY**

- 9.** A provider-
- (a) may not disclose private information on a client to any other person, except-
    - (i) under compulsion of law;
    - (ii) where it would be in the public interest;
    - (iii) where the interests of the provider require disclosure; or
    - (iv) where disclosure is made at the client's request or with the client's written consent;
  - (b) must ensure that where details of other deposit-taking services of the provider are brought to the attention of a client, this will only occur with the client's consent and without any direct or indirect presurising of the client to require provision of such other services; and
  - (c) must inform a client of recording of telephonic conversations with the client (if any), and of the reasons therefore.

**PART IV****ADVERTISING**

10. (1) An advertisement by any provider regarding a deposit must-
- (a) not contain any statement, promise or forecast which is fraudulent, untrue or misleading;
  - (b) if it contains-
    - (i) performance data (including awards and rankings), include references to their source and date;
    - (ii) illustrations, forecasts or hypothetical data-
      - (aa) contain support in the form of clearly stated basic assumptions (including but not limited to any relevant assumptions in respect of performance, returns, costs and charges) with a reasonable prospect of being met under current circumstances;
      - (bb) make it clear that they are not guaranteed and are provided for illustrative purposes only; and
      - (cc) also contain, where returns or benefits are dependent on the performance of underlying assets or other variable market factors, clear indications of such dependence;

- (iii) a warning statement about risks involved in buying or investing in a deposit, prominently display such statement; and
  - (iv) information about past performances, also contain a warning that past performances are not necessarily indicative of future performances; and
- (c) if the investment value of a deposit mentioned in the advertisement is not guaranteed, contain a warning that no guarantees are provided.
- (2) Where a provider advertises a deposit by telephone-
  - (a) an electronic, voicellogged record of all communications must be kept until such time as it becomes clear that no rendering of a financial service to a particular person so addressed by telephone will follow;
  - (b) a copy of all such records must be provided on request by the client or the registrar within seven days of the request;
  - (c) the client must be provided with basic details (such as business name and telephone number or address) of the provider, and of its relevant compliance department.
- (3) Where a provider advertises a financial service or product by means of a public radio service, the provisions of subsection (2)(c) apply with the necessary changes.

## PART V

### COMPLAINT RESOLUTION

#### General

**11. (1)** In this Part-

“complaint” means a complaint as defined in section 1(1) of the Act (excluding the reference to section 26(1)(a)(iii) thereof), submitted by a client to a provider for purposes of resolution by the provider;

“internal complaint resolution system and procedures”, in relation to a provider and a client, means the system and procedures established and maintained by the provider in accordance with this Code for the resolution of complaints by clients;

“Ombud” means the Ombud for Financial Services Providers referred to in section 20(2) of the Act;

“resolution”, or “internal resolution”, in relation to a complaint and a provider, means the process of the resolving of a complaint through and in accordance with the internal complaint resolution system and procedures of the provider;

“Rules” means the Rules on Proceedings of the Office of the Ombud for Financial Services Providers, 2002, published by Board Notice .... of 2002 in Gazette No. ... of .....

**(2)** A provider must-

- (a) request that any client who has a complaint against the provider must lodge such complaint in writing;
- (b) maintain a record of such complaints for a period of five years;
- (c) handle complaints from clients in a timely and fair manner;

- (d) take steps to investigate and respond promptly to such complaints; and
- (e) where such a complaint is not resolved to the client's satisfaction, advise the client in terms of the Act or any other law.

### **Basic principles of systems and procedures**

- 12.** A provider must maintain an internal complaint resolution system and procedures based on the following:
- (a) Maintenance of a comprehensive complaints policy outlining the provider's commitment to, and system and procedures for, internal resolution of complaints;
  - (b) transparency and visibility: ensuring that clients have full knowledge of the procedures for resolution of their complaints;
  - (c) accessibility of facilities: ensuring the existence of easy access to such procedures at any office or branch of the provider open to clients, or through ancillary postal, fax, telephonic or electronic helpdesk support; and
  - (d) fairness: ensuring that a resolution of a complaint can during and by means of the resolution process be effected which is fair to both clients and the provider and its staff.

### **Resolution of complaints**

- 13.** The internal complaint resolution system and procedures of the provider must be designed to ensure the existence and maintenance of at least the following for purposes of effective and fair resolution of complaints:
- (a) availability of adequate manpower and other resources;
  - (b) adequate training of all relevant staff, including imparting and ensuring full knowledge of the provisions of the Act, the Rules and this Code with regard to resolution of complaints;

- (c) ensure that responsibilities and mandates are delegated to facilitate complaints resolution of a routine nature;
- (d) ensure that there is provision for the escalation of non-routine serious complaints and the handling thereof by staff with adequate expertise;
- (e) internal follow-up procedures to ensure avoidance of occurrences giving rise to complaints, or to improve services and complaint systems and procedures where necessary; and
- (f) no levying of any fee or charge on any client for the utilisation by the client of the internal complaint resolution system and procedures of the provider, nor for any efforts of the provider to facilitate and resolve any complaint.

#### **Specific obligations**

**14. (1)** Subject to the other provisions of this Part, the internal complaint resolution system and procedures of a provider must contain arrangements which-

- (a) must-
  - (i) reduce the details of the internal complaint resolution system and procedures of the provider, including all subsequent updating or upgrading thereof, to writing;
  - (ii) provide that access to the procedures is at all times available to clients at any relevant office or branch of the provider, or by electronic medium, and that such availability is appropriately made known by public press or electronic announcements or separate business communications to existing clients;
  - (iii) include in the details envisaged in subparagraph (i), a reference to the duties of the provider and the rights of a client set out in Rule 6(a) and (b) of the Rules;
  - (iv) include in such details a clear summary of the provisions of the Act, which will apply whenever the client, after

dismissal of a complaint by the provider, wishes to pursue further proceedings before the Ombud; and

- (v) include in such details the name, address and other contact particulars of the Ombud;
- (b) must stipulate that complaints must, if possible, be submitted in writing and must contain all relevant information, and that copies of all relevant documentation must be attached thereto;
- (c) must provide that the receipt of complaints are promptly acknowledged in writing to the client, with communication particulars of contact staff to be involved in the resolution of the complaint, and are properly internally recorded by the relevant staff for purposes of compliance with section 18(b) and (d) of the Act;
- (d) must make provision that after the receipt and recording of a particular complaint, the complaint will as soon as practically possible be forwarded to the relevant staff appointed to consider its resolution, and that-
  - (i) the complaint receives proper consideration;
  - (ii) appropriate management controls are available to exercise effective control and supervision of the consideration process;
  - (iii) the client is informed of the results of the consideration within the time referred to in Rule 6(b) of the Rules: Provided that if the outcome is not favourable to the client, full written reasons must be furnished to the client within the time referred to in Rule 6(b) of the Rules, and the client must be advised that the complaint may within six months be pursued with the Ombud whose name, address and other contact particulars must simultaneously be provided to the client.

- (2) In any case where a complaint is resolved in favour of a client, the provider must ensure that a full and appropriate level of redress is offered to the client without any delay

## **PART VI**

### **MISCELLANEOUS**

#### **Waiver of rights**

15. No provider may request or induce in any manner a client to waive any right or benefit conferred on the client by or in terms of any provision of this Code, or recognise, accept or act on any such waiver by the client, and any such waiver is null and void.

#### **Short title and commencement**

16. This Code is called the Specific Code of Conduct for Authorised Financial Services Providers and Representatives conducting Short-term Deposit-taking Business, 2002, and comes into operation on the date determined by the Minister under section 7(1) of the Act.

## APPENDIX 2: BASEL II CHANGES

This section highlights some of the main differences between Basel I and Basel II that are relevant to the low income banking market:

- Basel II provide for three different methods for calculating risk to replace the single Basel I approach:
  - *The standardised approach:* This approach is the simplest of the three and resembles the approach under the Basel I accord, but requires much more detail. Assets are classified into standardised risk buckets that are allocated specific predefined risk weightings. These weights are set by the Accord, but there is some room for regulatory discretion. In comparison to Basel I there are more risk buckets (e.g. a 150% bucket has been added). This approach applies conservative risk weights and will result in a risk charge that is similar to Basel I, but higher than the capital required under the two more advanced approaches.
  - *The fundamental internal ratings based (IRB) approach:* This approach allows for the use of a bank's internal risk measurement systems in the classification of assets, but also sets out standard risk weightings in some areas. Using this approach should result in a lower risk charge than under Basel I and the Basel II standardised approach, but higher than the advanced IRB approach.
  - *The advanced IRB approach:* This approach relies completely on the use of internal risk measurement systems for the classification of assets and the calculation of the capital required. Banks need to have advanced internal systems and sufficient historical data in order to qualify for using this approach. Both the fundamental and advanced IRB approaches are expected to result in a lower capital charge for the banks that qualify to apply them.
- Lower risk weighting for some retail product categories (e.g. SME lending, residential mortgages, overdue loans that have significant levels of provision) than in Basel I.

- Application of the IRB approaches will generally increase capital requirements for lower rated borrowers and decrease requirements for higher rated borrowers.
- *Increased importance of external credit ratings.* External credit ratings are used in the allocation of loans to risk categories. Good external ratings will lower the capital required and, therefore, may force smaller institutions to obtain costly ratings, which they otherwise would not have required. For example, a lower risk weighting is allocated under the standardised approach in the new accord for banks with good external credit ratings. Previously weightings were simply based on membership of OECD. The newer ratings will penalise lower rated member countries of the OECD.
- In addition to credit risk, the new accord also explicitly requires the calculation of *operational risk*. The quantitative impact surveys undertaken by the BIS indicates that this is expected to make up more than 90% of the increased capital requirements for the 'other countries' group which includes South Africa. In South Africa, this is one of the main elements of concern as it leads to large increases in capital that is not offset by reductions in capital allocated to credit risk.
- The new Accord accounts for more extensive risk mitigation through, for example, the use of derivatives. This is one of the areas in which significant development has taken place over the last decade.