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BANK FAILURES – LESSONS FOR SOUTH AFRICA

by

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CHAPTER 1 INTRODUCTION

1 The Global Financial Crisis

In 2008 the global financial system came very close to collapsing entirely.\(^1\) In the eternal words of the then USA president, George W Bush: “This sucker might go down”.\(^2\)

A wide range of factors contributed to what has since become known as the Global Financial Crisis or GFC. Those factors included outright greed, questionable (if not criminal) lending practices, an over reliance on the supposed infallibility of mathematical financial models, unregulated over-the-counter trading of extremely complex financial instruments and a “light touch” approach to the regulation of financial institutions.

Globally financial institutions’ regulatory landscapes have changed dramatically as a result of the lessons learnt from the GFC.

2 South Africa’s New Regulatory Framework For Financial Institutions

South Africa’s own financial institution regulatory framework has recently been almost completely overhauled when the Financial Sector Regulation Act\(^3\) (FSRA) came into force. The South African Reserve Bank (SARB), as South Africa’s central bank, is no longer just charged with protecting the value of South Africa’s currency. The maintenance of financial stability in South Africa now stands shoulder-to-shoulder with currency value protection as the SARB’s two main mandates.\(^4\)

The SARB is supported in its new financial stability maintenance mandate by two newly created regulators. The first is the Prudential Authority, which supervises compliance with prudential requirements across the entire South African financial

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1 Tooze *Crashed How a Decade of Financial Crises Changed the World* (2019) 164-165.
3 9 of 2017.
4 s 11(1) of the FSRA and s 3 of the South African Reserve Bank Act 90 of 1989.
system. The Financial Sector Conduct Authority is the second new regulator. Its main function is to supervise market conduct across the entire South African financial system.

Much has already been written about South Africa’s new financial institution regulatory system. That new system’s main purpose is to equip the SARB with the necessary statutory powers to deal with any significant threat to South Africa’s financial stability. In other words, its main purpose is to enable the SARB to deal with South Africa’s version of a “systemic event”, such as the GFC.

3 Research Question And Methodology

This contribution will not focus on the SARB’s new financial disaster “fire fighting” mandate and powers. Rather, this dissertation identifies the causes of certain banks’ failures during the GFC. Those causes were, in part, the very causes of the GFC itself. Those causes are potentially just as relevant in South Africa today as they were in the USA in 2007 and 2008. This dissertation then analyses the extent to which South Africa’s law currently has the ability to prevent those identified causes from coming about in South Africa. For if those causes do come about in South Africa, they are likely to threaten South Africa’s financial stability.

The GFC originated in the USA. Many of the USA’s technical banking terms that are necessary for an understanding of how the GFC came about are foreign to the South African legal scholar. Consequently, most of those terms and their meanings are included, for easy reference, in the glossary that is at the end of this dissertation.

4 The GFC And Its Causes

There was no one single cause of the GFC. Rather, it was a case of “collective causes by building blocks”, with one cause stacked on top of another preceding

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5 s 34(1)(a) of FSRA.
6 s 58(1)(a) of FSRA.
cause, until the collective weight of the causes made the whole financial system groan, wobble and very nearly collapse. To understand the causes of the GFC, it is necessary to understand what the GFC actually was.

In simple terms, this is how the GFC came about:

4.1 Banks are businesses and have a profit motive. Legally, economically and morally there is nothing wrong with that reality. Rather, it is the way in which that motive was pursued in the lead up to the GFC that cannot be justified.

4.2 Traditionally banks make profit by receiving deposits from customers, paying relatively low interest to those customers on those deposits and then lending some of those deposits to other customers at higher interest rates.\(^8\)

4.3 By the mid-2000s that traditional banking model no longer generated significant profits for a lot of the US banks that applied it. Howard Greenspan, the then chairman of the USA Federal Reserve Board, had cut interest rates in the USA extremely low in the aftermath of the 9/11 attacks and other economic considerations.\(^9\) With interest rates in the USA being very low, US banks could not lend money to customers at much higher interest rates. As a result, many US banks found their profit margins under severe pressure.

4.4 The Clinton administration had vigorously advanced the extension of home ownership to previously “underserved” US communities (mainly Blacks and Hispanics).\(^10\)

4.5 US mortgage brokers and banks were quick to enter the market of providing home acquisition finance to members of those underserved communities.\(^11\) Mortgage brokers were third party contractors who were the intermediaries between members of those communities and the participating banks.

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\(^8\) Lanchester (n 2) 15-16 and 59.
\(^9\) Lanchester (n 2) 90.
\(^10\) Lanchester (n 2) 83-84
US mortgage brokers were, for all intents and purposes, unregulated and not subject to regulatory supervision.\textsuperscript{12} Many mortgage brokers behaved not only unethically, but actually criminally, in their property finance transactions with members of the underserved communities (let us call those members "sub-prime applicants" for the sake of brevity).\textsuperscript{13}

4.6 There was little, if any, need or incentive for US mortgage brokers or the participating banks to properly assess the sub-prime applicants' credit worthiness. That was so for at least two reasons:

4.6.1 Firstly, there was no statutory or regulatory duty on the mortgage brokers or the participating banks to conduct any creditworthiness or affordability assessments on the sub-prime applicants.

4.6.2 Secondly, the typical US mortgagor-mortgagee relationship was no longer one that would exist over the life of the mortgage. The mortgagees' (i.e. the banks') rights under the mortgages that they concluded with the sub-prime applicants (called "sub-prime" mortgages) were grouped together and on-sold in parcels.\textsuperscript{14} The initial mortgage broker and the initial mortgagee (the bank) had no risk that the sub-prime applicant (now a sub-prime mortgagor) would default under the sub-prime mortgage, because the entire mortgage transaction had been moved off the bank's books of account.\textsuperscript{15} The initial mortgagee (the bank) was no longer the creditor under the sub-prime mortgage and the sub-prime mortgagor was no longer that bank's debtor.

4.7 This resulted in sub-prime mortgages being granted to persons who, with the best will in the world, would never have been able to meet their payment obligations under the sub-prime mortgages.\textsuperscript{16} Many of the sub-prime

\textsuperscript{12} Lanchester (n 2) 106.
\textsuperscript{13} Lanchester (n 2) 103, 111.
\textsuperscript{14} Tooze (n 1) 50-51 and Brummer (n 11) 23.
\textsuperscript{15} Lanchester (n 2) 98-99.
\textsuperscript{16} Tooze (n 1) 64 and Brummer (n 11) 21.
mortgages were called “ninja mortgages”, “ninja” being an acronym for “no income, no job or assets”17.

Based on the (now astounding) financial modelling assumption that nationwide US property prices would always continue to rise, the granting of sub-prime mortgages somehow made sense at the time. For as long as US property prices continued to increase, most sub-prime mortgagors’ properties’ values would also increase. Their property could always be sold (voluntarily under a refinancing arrangement or compulsory under a foreclosure) at a sufficient profit with which to settle the outstanding amounts under the sub-prime mortgages.18

The US financial institutions’ financial models never factored in the possibility that nationwide US property prices could stop rising and could actually go into decline. That is exactly the possibility that eventually realised.

4.8 Sub-prime mortgagors presented a higher credit default risk than normal (or then “prime”) mortgagors. To compensate for that higher risk, the sub-prime mortgages bore interest at much higher rates than “prime” mortgages did. At a time when interest rates in the USA were generally very low, securitised instruments and derivatives related to the high interest bearing sub-prime mortgages became attractive to investors.19

4.9 The initial sub-prime mortgagees transferred their rights to payment of the capital, interest and other fees under the sub-prime mortgages to separate juristic persons (called “structured investment vehicles” (SIVs)20 or “special purpose vehicles” (SPVs)21).22 These transfers were particularly relevant where the mortgagee transferees were banks.

17 Lanchester (n 2) 106.
18 Brummer (n 11) 27.
19 Brummer (n 11) 38, 42.
20 Lanchester (n 2) 101 and Morris The Trillion Dollar Meltdown Easy Money, High Rollers, And The Great Credit Crash (2008) 82.
21 Lanchester (n 2) 55.
22 Brummer (n 11) 38-39.
Those transferee banks’ exposure to the risk of default under sub-prime mortgages was transferred to SIVs or SPVs. The sub-prime mortgages no longer showed on those banks’ financial statements or books of account. This meant that those banks could ignore the sub-prime mortgage default risk in measuring whether or not they were complying with their regulatory obligations, such as maintaining the prescribed minimum capital reserves.23

4.10 The SIVs and SPVs, in turn, issued securities (called “mortgage backed securities” (MBS)) to third party investors. Those securities entitled the investors to receive distributions from the SIVs or SPVs based on the underlying mortgages’ revenue streams.24

More sophisticated structures followed. Under those structures a SIV or SPV issued securities (called “collateralised mortgage obligations” (CMOs) or “collateralised loan obligations” (CLOs)) to investors. Those securities entitled the investor to participate in the revenue streams of particular categories of mortgages in the SIV or SPV.25 The distributions varied according to the category of the underlying mortgages to which the particular security was linked (a process that was called “tranching”).26

Prime mortgages had a relatively low default risk. As a result, CMOs or CLOs that were linked to prime mortgage revenue streams bore relatively low returns.

Sub-prime mortgages obviously had a much higher default risk. CMOs or CLOs that were linked to sub-prime mortgage revenue streams accordingly yielded higher returns.27

4.11 It will be recalled that at the time interest rates in the USA were very low. Since conventional debentures normally yielded a market related interest rate

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23 Tooze (n 1) 48-49 and Brummer (n 11) 39.
24 Tooze (n 1) 49.
25 Tooze (n 1) 49.
26 Lanchester (n 2) 55.
27 Morris (n 20) 107.
return, conventional debentures had become unattractive as an investment choice to institutional investors.

Shares had also become unattractive to institutional investors. After the Enron Arthur Andersen debacle, institutional investors had become distrusting of stock exchange listed shares.28

In that context, the high returns flowing from sub-prime mortgage linked “securitised” CMOs / CLOs29 became attractive to investors with a high risk appetite. As did “collateralised debt obligations” (CDOs).

The terminology for the various sub-prime mortgage related financial instruments overlaps somewhat. For purposes of this dissertation CDOs were not actually securities issued by the SIVs or SPVs (unlike CMOs and CLOs). Rather, CDOs were “synthetic” CMO’s or CLO’s in that they were derivatives that were notionally issued in respect of certain categories of the mortgages in the SIVs or SPVs.30

Perhaps the investors in those securities (CMOs and CLOs) and derivatives (CDOs) can be excused for investing in those instruments. After all, most of the CMOs, CLOs and CDOs were given AAA credit ratings by the world’s leading rating agencies.31 Which meant that, according to those ratings anyway, those investments were as safe as investing in USA Treasury bills.

4.12 The risk that the underlying sub-prime mortgages would go into default was supposedly further mitigated by the SIVs or SPVs taking out insurance against the realisation of that risk. That insurance was called a “cross-default swap” (CDS).32

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28 Lanchester (n 2) 89.
29 Tooze (n 1) 49.
30 Tooze (n 1) 56 and Morris (n 20) 107.
31 Tooze (n 1) 49; 56, Lanchester (n 2) 182 and Brummer (n 11) 38, 50.
32 Tooze (n 1) 52 and Morris (n 20) 108-109.
Under a CDS Party A guaranteed, for a fee, to Party B that Party B would not suffer any losses on a particular group of securities or instruments held by Party B. If those losses actually realised, then Party A obviously had to make good on its guarantee and compensate Party B for the losses that it had suffered. A crucial contributing cause of the GFC was that under a CDS the indemnified party could call on the indemnifying party to provide security (called “post collateral”) for its contingent obligations under the CDS.

American International Group (AIG) issued the majority of CDSs in respect of MBS, CMOs, CLOs and CDOs. During the GFC the US government had to bail out AIG in order to prevent its collapse. Interestingly, AIG did not fail because it could not pay the indemnities under the CDSs that it had issued. It never came to that. The mere anticipation that those indemnity claims would be made against AIG in the future triggered its failure. (To reduce the number of acronyms used in this dissertation as much as possible, from here onwards MBS, CMOs, CLOs, CDOs and CDSs will be referred to together as “SRIs” (sub-prime related instruments)).

Indemnified parties under AIG issued CDSs called on AIG to provide security for AIG’s contingent payment obligations under those CDSs. The wholesale lending market had also lost confidence in AIG, and AIG suddenly found itself excluded from its normal short-term loan sources. AIG could not raise the necessary funding with which to provide the security. AIG had failed and only a massive US governmental bailout kept it afloat.

AIG’s failure and resulting bailout demonstrate two themes that feature throughout the GFC. The first is that some financial institutions were simple “Too Big To Fail”. More correctly put, some financial institutions were “Too big for government to allow it to fail because it would drag the entire financial system down with it”. AIG was clearly Too Big To Fail. The second theme is the extent to which financial institutions were interconnected. Failure of one financial institution could drag down several other financial institutions.

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33 Morris (n 20) 75.
because they were so heavily interconnected. One must bear in mind that AIG was an insurer, not a bank or a SIV or SPV. AIG’s bailout also provides some idea of the broader scale of the GFC: The US government bailed out AIG at a price of US$85 billion.\(^{34}\) That is not a small figure. Yet it was but one of many USA governmental bailouts, recapitalisations and stimulus packages that the US government undertook to counter the GFC.

4.13 Following the 1929 great crash and the resulting 1930s great depression, the USA had introduced federal legislation known as the Glass-Steagall Act\(^ {35}\) that prohibited retail banks from also being investment banks, and *vice versa*. That prohibition was withdrawn in 1999.\(^ {36}\) Eager not to miss out on the profits that were being made from the trade in SRIs, some retail banks in the USA, the UK and the Eurozone started trading significantly in SRIs.\(^ {37}\) Some of those banks were not only trading on behalf of their clients, they were also trading with their “own” money. Retail banks\(^ {38}\) take deposits from their customers, and have been likened to “piggy banks”.\(^ {39}\) Investment banks have been likened to “casinos”, given the higher risk nature of the instruments that they trade in.\(^ {40}\) Retail banks that were trading in SRIs can therefore be likened to “casinos gambling with the piggy bank”, since they were speculating with their customers’ deposits.

4.14 Banks, both in the USA and elsewhere, are dependent on short term inter-bank loans. That was also the case in 2007 and 2008. If banks are no longer prepared to lend to one another, then the entire financial system freezes up. In 2007 and 2008 investment banks in the USA were very dependent on the availability of short-term inter-bank loans. When that market froze up and the banks stopped lending to one another, the Wall Street investment banks were facing unprecedented liquidity problems.

\(^ {34}\) Lanchester (n 2) 61.
\(^ {35}\) formally the Banking Act of 1933.
\(^ {36}\) by the Financial Services Modernization Act of 1999.
\(^ {37}\) Tooze (n 1) 54.
\(^ {39}\) Lanchester (n 2) 50-51.
\(^ {40}\) Lanchester (n 2) 50-51.
USA investment bank Bear Stearns had become so illiquid that it was commercially insolvent. US retail bank J P Morgan Chase acquired the illiquid, commercially insolvent Bear Stearns at a massive discount, and with very generous US governmental support. US investment bank Merrill Lynch suffered the same fate as Bear Stearns. Merrill Lynch was reluctantly acquired by Bank of America (following the application of governmental pressure on Bank of America). Merrill Lynch had the added complication that it held significant volumes of SRI's on its balance sheet.

Lehman Brothers was another US investment bank that was very reliant on the availability of short term loans.\(^{41}\) When the availability of those loans froze up, Lehman Brothers frantically looked for someone to acquire it, hoping to avoid its failure in the same way that Bear Stearns and Merrill Lynch had escaped final financial failure by being acquired. Acquisition negotiations between Lehman Brothers and Barclays Bank had advanced quite far but then suddenly and unexpectedly screeched to a complete stop. The reason? The UK authorities would not give the regulatory approval that was necessary for Barclays to acquire Lehman Brothers. Messrs Brown and Darling were not prepared to risk further US sub-prime contamination of the UK financial system. Lehman Brothers was placed in “chapter 11 bankruptcy protection”, the USA equivalent of South Africa’s business rescue regime.\(^{42}\) The US government’s decision not to bail out Lehman Brothers but to allow it to fail surprised and shocked the already jittery financial markets.\(^{43}\) The US government’s decision not to bail out Lehman Brother caused such turmoil in the financial markets that the US government would not allow another significant US financial institution to fail during the GFC. The cost of bailing them out was very high, but the price of not bailing them out was even higher.

4.15 Let us take stock quickly of where the world found itself at that time.

Three of the five main US investment banks (Bear Stearns, Merrill Lynch and Lehman Brothers) had failed.

\(^{41}\) Tooze (n 1) 60.

\(^{42}\) Lanchester (n 2) 29.

\(^{43}\) Tooze (n 1) 9 and Lanchester (n 2) 63.
The two remaining main US investment banks (Morgan Stanley and Goldman Sachs) were under severe liquidity pressure. So much so that Goldman Sachs eventually persuaded Warren Buffet to inject significant funds into Goldman Sachs in a public relations attempt to restore investor confidence in Goldman Sachs.

Morgan Stanley would by all indications have failed if it was not for a massive US governmental recapitalisation of that investment bank.

Massive US retail bank Citigroup was fighting for its financial life. The SRIs that it had traded in had become its near fatal disease.

In the UK retail bank Northern Rock had failed.

UK retail bank Royal Bank of Scotland was so deep under water that it would have failed, but for it being recapitalised by the UK government.

The German Bundesbank had to bail out three German banks in order to save them from collapse. Just like the Royal Bank of Scotland the three German banks concerned had traded heavily in SRIs.

Switzerland’s Union Bank of Switzerland (UBS) was also fighting for its financial life. It was another victim of having traded heavily in SRIs.

How did the international financial system get to that point?

4.15.1 French bank BNP Paribus (another SRI trade victim) sounded the GFC’s starter’s gun when it announced that it was freezing three of its US SRI linked funds. BNP froze those funds because liquidity in the relevant SRI markets had completely evaporated – there was no demand any more for those SRIs. That, in turn, made valuing the assets in those funds impossible “regardless of their quality or rating”.

That was the tipping point into the GFC. If assets (SRIs) could not be valued then they could not be used by the owner of the assets as “collateral” (security). If that owner could not post any collateral (provide any security), then that owner became unable to borrow short term in the inter-bank or

44 Brummer (n 11) 57-60.
45 Brummer (n11) 57, 205.
46 Brummer (n 11) 60-61
47 Tooze (n 1) 144.
wholesale markets. “And if there was no [inter-bank or wholesale] funding all
the banks were in trouble, no matter how large their exposure to real estate.
In a general liquidity freeze … no bank was safe”.48

4.15.2 The failure of UK retail bank Northern Rock illustrates well how US sub-prime
mortgages were a *sine qua non* for the GFC, but that they were not its actual
proximate cause. The freezing up of the inter-bank and wholesale lending
market was the proximate cause of the GFC.

Northern Rock was an extremely aggressive lender in the UK’s mortgage
market. So aggressive was its business model that it funded only 20% to 25%
of the mortgage loans that it advanced to customers from its customers’
deposits. The remaining 75% to 80% of its mortgage loans were financed
from short term borrowings made by it on the inter-bank and wholesale short
term loan market.49

Northern Rock actually had very little SRI exposure. However, it sourced its
funding from markets in which some of the participants had significant SRI
exposure. That SRI exposure caused lending on those markets to stop. When
lending on those markets seized up, so did Northern Rock.50

4.15.3 The proverbial music had stopped playing. It was time to determine who
owned valueless SRI assets and who owed SRI obligations, particularly under
the lethal CDSs. The problem was that nobody actually knew. The trade in
SRIs had been so big, and SRIs were such complex documents, that few of
the major financial institutions actually knew what their own resulting asset
and exposure positions were.

4.15.4 Since the financial institutions did not know what their peers’ exposure to SRIs
was, they would no longer lend to their peers.51 Inter-bank loans stopped.
Banks that were dependent on inter-bank financing (such as Lehman Brothers

48 Tooze (n 1) 144.
49 Tooze (n 1) 145 and Brummer (n 11) 13.
50 Tooze (n 1) 46.
51 Brummer (n 11) 13.
in the USA and Northern Rock in the UK) ran into commercially insolvency. Both failed as a result.

4.15.5 To compound matters, the housing bubbles in the USA and the UK had burst. Many mortgages were foreclosed with resulting sales in execution. Those homeowner mortgagors who could still afford to continue to service their mortgages often found themselves in “negative equity” - the amounts that they owed under their mortgages were higher than the market values of their homes.

4.15.6 Credit is the life blood of most economies. Since lending had stopped, so had the granting of credit. The affected countries’ economies contracted accordingly. (In the USA the period following the GFC is actually known as the “Great Recession”.)

4.15.7 Understandably consumer spending decreased significantly. As a result, suppliers found less or no demand for their products. For example, the unthinkable happened in the USA when iconic vehicle manufacturer General Motors became insolvent due to a massive fall in the demand for its vehicles. General Motors, like most of the affected Wall Street banks, would eventually be bailed out by the US government with taxpayers’ money.

An international financial calamity had occurred that nearly destroyed the international financial system. All of which had started with the reckless, if not criminal, granting of credit to home buyers in the USA without adequate affordability assessments being conducted and with highly irregular business practices being followed.

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52 Tooze (n 1) 156.
53 Some 9.3 million US families lost their homes – Tooze (n 1) 281.
54 Tooze (n 1) 156.
55 Lanchester (n 2) 16.
56 Brummer (n 11) 35.
The remainder of this dissertation will analyse South African law’s state of preparedness to prevent some of these causes of the GFC from raising their ugly heads in South Africa.
CHAPTER 2 THE UNREGULATED AND UNSCRUPULOUS EXTENSION OF CREDIT UNDER SUB-PRIME MORTGAGES

1. The Unregulated And Unscrupulous USA Sub-prime Mortgage Broker Industry

Institutionally, US banks drove the demand for the granting of ever increasing numbers of sub-prime mortgages.\(^{57}\) The people who actually interacted face-to-face with the sub-prime borrowers, and induced them to apply for sub-prime financing, were the mortgage brokers. Mortgage brokers were mostly not employed by the USA banks. Rather, they acted as third party contractors of the banks. Two aspects of the mortgage brokers' conduct in respect of sub-prime mortgages stand out.

Firstly, they operated in an essentially unregulated and unsupervised industry.\(^{58}\) In some USA states the companies that the mortgage brokers worked for had to be licensed, but the actual individual brokers did not undergo any scrutiny nor were they under any regulatory supervision.\(^{59}\) The USA's financial regulators were not that interested in the mortgage brokers' conduct either. For example, the Federal Reserve Board chairman in the lead up to the GFC, Howard Greenspan, apparently decided not to investigate growing indications that predatory conduct was taking place in the sub-prime mortgage market.\(^{60}\)

Secondly, and without painting all mortgage brokers with the same brush, many mortgage brokers acted, at best unethically, more probably criminally.\(^{61}\) At the lower end of the unacceptable practices scale were “stated income loans”, also known as “liar loans”.\(^{62}\) The mortgage broker would simply take the sub-prime mortgage applicant at his word about his actual earnings, thus inviting an

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\(^{57}\) Brummer (n 11) 21.
\(^{58}\) Brummer (n 11) 23-24.
\(^{59}\) Lanchester (n 2) 106.
\(^{60}\) Morris (n 20) 69.
\(^{61}\) Lanchester (n 2) 106.
\(^{62}\) Brummer (n 11) 22.
overstated answer. Hot on the heels of liar loans followed “ninja loans” – mortgages granted to applicants with “no income, no job or assets”.

Some banks and mortgage brokers made applicants apply for (higher interest bearing) sub-prime mortgages, even though the applicants qualified for less expensive prime mortgages. Another common scam was to print a high interest rate in the sub-prime mortgage agreement but to assure the applicant that that was just an error and a lesser rate will apply. Of course it never did. The commission of fraud was a common occurrence in the US sub-prime mortgage broker industry.

Other typical examples of predatory conduct in the US sub-prime mortgage industry included:

- the mortgagee initially agreed to a very low interest rate under the mortgage, but did not point out to the mortgagor that under the mortgage agreement that interest rate would automatically reset very soon to double, or even triple, the initial rate;

- the total monthly payments that the sub-prime mortgagors had to make under the sub-prime mortgages often amounted to more than the mortgagors' total monthly income;

- excessive fees were hidden in the stated capital or principal amount;

- mortgagees paid mortgage brokers “yield spread premiums”. These were simply bonuses paid by banks to mortgage brokers because the brokers procured that applicants for mortgages applied for types of mortgages that

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63 Lanchester (n 2) 106.
64 Lanchester (n 2) 106.
65 Lanchester (n 2) 108.
66 Lanchester (n 2) 108
67 Lanchester (n 2) 111.
68 Morris (n 20) 69.
69 Morris 69 (n 20) and Brummer (n 11) 21.
70 Morris (n 20) 70.
71 Morris (n 20) 70.
bore higher interest rates than the rates under the categories of mortgages for which the applicants actually qualified;\textsuperscript{72} and

- the content and consequences of the loan and mortgage agreements were not explained to the sub-prime applicants at all.\textsuperscript{73}


The short answer is no. For at least two reasons (and ignoring the obvious fact that the mortgage brokers would have subject to regulation and supervision by the Financial Sector Conduct Authority).

Firstly, if the sub-prime mortgage transactions took place in South Africa, most of them would have been subject to the National Credit Act (NCA).\textsuperscript{74} A mortgage agreement is a “credit agreement” under the NCA.\textsuperscript{75} Before entering into such a credit agreement the potential mortgagee must first assess the applicant’s existing financial means, prospects and obligations.\textsuperscript{76} If the potential mortgagee (a) does not conduct such an assessment or (b) enters into the mortgage agreement even though the preponderance of information available to it indicated that the applicant would become “over-indebted” if he or she concludes the mortgage agreement, that credit agreement is “reckless”.\textsuperscript{77}

The mortgage applicant will be over-indebted if the preponderance of available information indicates that he or she will be unable to timely discharge his or her obligations under his or her credit agreements, which obviously includes that particular mortgage agreement itself.\textsuperscript{78} The conclusion of most sub-prime mortgages will result in the mortgagee becoming over-indebted. The consequences of a credit agreement being reckless are severe: A court can set

\textsuperscript{72} Morris (n 20) 70.
\textsuperscript{73} Brummer (n 11) 30-31.
\textsuperscript{74} 34 of 2005.
\textsuperscript{75} s 8(1)(b) and 8(4)(d).
\textsuperscript{76} s 81(2)(a)(iii).
\textsuperscript{77} s 80(1).
\textsuperscript{78} s 79(1).
aside all of the borrower’s rights and obligations under the agreement\(^{79}\) or suspend the force and effect of the agreement.\(^{80}\) Given these severe consequences, it is unlikely that any significant South African institutional lender will knowingly enter into a sub-prime mortgage.

Secondly, to the extent that the lender does not reasonably ensure that the applicant generally understands and appreciates the risks and costs of the credit which she is to receive under the mortgage agreement, and her rights and obligations under the mortgage agreement, the mortgage agreement is reckless.\(^{81}\) The same deterrent factor applies as under the first reason.

\(^{79}\) s 83(2)(a).
\(^{80}\) s 83(2)(b).
\(^{81}\) s 81(2)(a)(i).
CHAPTER 3 POOR REGULATION OF FINANCIAL INSTITUTIONS

1  Minimalist And Sloppy Regulation Of Financial Institutions Before The GFC

In the decades leading up to the GFC the scope of the USA’s and the UK’s regulation of financial institutions had been decreased dramatically. For example, by 2006 only 25% of all lending transactions in the USA took place in sectors that were actually regulated.\(^{82}\) Which means that 75% of all USA lending transactions at the time were not regulated at all.

There were at least two reasons for that “light touch” approach to the regulation of financial institutions. Firstly, there was international competition between the main financial centres for investors. London was competing directly with Wall Street for the US dollar banking business of non-US participants.\(^{83}\) To enhance London’s competitiveness as a financial centre, Gordon Brown mandated the UK’s main financial regulator (the Financial Services Authority (FSA)) to offer “not only light but limited regulation”.\(^{84}\) And light touch regulation is exactly what the FSA applied.\(^{85}\) That, in turn, placed the USA under pressure to similarly deregularise its financial institutions so that New York would not be overtaken by the city of London as the financial capital of the world.\(^{86}\)

Secondly, since the 1980s the prevailing economic policies in the USA, the UK and various other free market countries included the “liberalisation” of the financial markets and the deregularisation of the financial system.\(^{87}\) A laissez-fair\(^{88}\) and “light touch” approach to the regulation and supervision of financial institutions was considered the best approach.\(^{89}\) Howard Greenspan, the highly regarded chairman of the USA’s Federal Reserve Board in the years leading up to the GFC, believed that “markets could be entirely trusted to regulate themselves”.\(^{90}\) For the chairman of

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\(^{82}\) Morris (n 20) 54.
\(^{83}\) Tooze (n 1) 80.
\(^{84}\) Tooze (n 1) 81.
\(^{85}\) Brummer (n 11) 99.
\(^{86}\) Tooze (n 1) 88.
\(^{87}\) Lanchester (n 2) 8.
\(^{88}\) Tooze (n 1) 166.
\(^{89}\) Lanchester (n 2) 156 and further.
\(^{90}\) Lanchester (n 2) 121.
the custodian of the USA’s financial system to hold such a belief was frankly incredibly, given that the great crash of 1929 had conclusively proven some 79 years before that that belief was totally wrong.91

The level of regulation of US financial institutions was further reduced as a result of ignorance and lobbying respectively. USA legislators did not understand what derivatives (such as CDO) were or how they worked.92 One cannot regulate what one does not understand. The powerful USA banking lobby group also played its part – it actually managed to have federal legislation passed whereby CDSs were expressly not subject to any regulation.93

Even where regulation of financial institutions was in place, it was sometimes administered very sloppily indeed.94 It is an astonishing fact that from April 2004 to February 2007 the FSA’s personnel who supervised Northern Rock were insurance regulators, not bank supervisors.95

Another regulatory failure that contributed to the GFC was a lack of co-operation between the various financial regulators. For example, the FBI had been raising sub-prime fraud as a “significant and growing” crime since 2004.96 Apparently none of the USA’s financial regulators took any notice.

2 Does Minimalist And Sloppy Regulation Of South Africa’s Financial Institutions Pose A Systemic Risk To South Africa’s Financial Stability?

Lanchester97 correctly points out that there are two aspects to financial regulation: the regulatory framework itself (which he calls the “framework”) and the way in which that framework is applied (which he calls the “regime”).

92 Lanchester (n 2) 157.
93 Lanchester (n 2) 158.
94 Brummer (n 11) 215-216.
95 Brummer (n 11) 107.
96 Brummer (n 11) 111.
97 Lanchester (n 2) 162.
Since 1994 the scope and level of the regulation of South Africa’s financial institutions have steadily expanded and improved. Legislation such as the Financial Advisory and Intermediary Services Act (“FAISA”),98 the Financial Intelligence Centre Act,99 the NCA and the FSRA has certainly strengthened and improved the framework for regulating South Africa’s financial institutions.

The real question is whether South Africa’s financial regulators have sufficiently skilled and competent employees and adequate resources with which to discharge their mandates proactively, as opposed to reactively. Preventing a systemic event from occurring is obviously preferable to managing one that has occurred.

In this context South Africa’s financial regulators face two significant challenges. Firstly, the very financial institutions that the regulators must supervise attract the brightest and best human capital.100 It is just about impossible to see how the regulators can compete with the financial institutions in attracting those top drawer employees, given the financial institutions’ very rewarding remuneration packages. If the supervisor does not actually understand the intricacies of the superviseds’ businesses, regulators’ ability to proactively prevent possible causes of systemic events from coming about is obviously reduced.

Secondly, it will take a very well informed and intelligent person or team to identify in advance a number of seemingly unrelated circumstances that actually inter-connect so closely that together they constitute a systemic risk. For example, in all of the material that I read on the GFC I have not found any evidence that anyone had actually foreseen that the granting of sub-prime mortgages would eventually cause the complete drying up of inter-bank lending. I can only assume that the reason for that is that no-one actually foresaw that outcome.

Then again, the GFC was caused, in part, by a “light touch” approach to the regulation of financial institutions and a lack of inter-agency co-operation. South

98 37 of 2002
100 Based on my personal experience. Many of the intellectually gifted people that I was at school with, at university with or had worked with in law firms now hold senior positions at South African banks.
Africa’s financial sector regulatory framework is definitely not designed to facilitate a light touch approach to the regulation of financial institutions. Nor has such a “light touch” approach traditionally been the mind-set of the SARB, including the mind-set of its former Banks Supervision Department which is now the PA. The FSCA has, from the time of its conversion from the Financial Services Board, certainly not adopted a light touch approach to the regulation of financial institutions’ market conduct. Quite the opposite. The indications are that none of the regulators under South Africa’s Twin Peak model is likely to consistently regulate financial institutions minimalistically and sloppily.

The FSRA also contains numerous mandatory requirements regarding inter-regulator interactions and exchange of information. These mandatory requirements increase the likelihood that the risk of a looming systemic event will be identified timeously. These mandatory requirements and related aspect include:

- The establishment of the Financial Stability Oversight Committee with its express financial stability support and co-operation objectives.
- The establishment of the Financial Sector Contingency Forum with its express financial stability support and co-operation objectives.
- The PA’s and FSCA’s express duties to assist, and provide information to, the SARB to maintain, protect and enhance financial stability.
- The statutory duty of all other organs of state (in addition to the PA and the FSCA) to provide to the SARB such information as is required to maintain and restore financial stability.
- The establishment of the Financial System Council of Regulations.
- The establishment of the Financial Sector Inter-Ministerial Council.

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101 s 20(1).
102 s 20(2).
103 s 25(1).
104 s 25(2).
105 s 26(1).
106 s 28(a).
107 s 79(1).
108 s 83(1).
The statutory framework for appropriate inter-regulatory co-operation and flow of information is certainly in place. The question whether the regulators and other participants will use this framework optimally is a practical one, rather than a strictly legal one.
CHAPTER 4 FINANCIAL INSTITUTIONS’ BOARDS’ INABILITY TO FULLY UNDERSTAND AND MANAGE THE INSTITUTIONS’ AFFAIRS

1. The Dilemma

Companies’ boards of directors are generally responsible for the management of the companies. Boards do not manage their companies’ day-to-day affairs. Rather, they are the fiduciaries of their companies’ affairs and the ultimate corporate governance safeguard.

Generally directors, as members of the board, must apply reasonable skill, care and diligence in their management and supervision of their companies’ affairs. It is impossible for directors to act with reasonable skill, care and diligence if they do not understand the intricacies of the company’s affairs.

Many of the mathematicians who were employed by the US banks that traded in SRIs themselves did not fully understand the (incorrect) mathematical models that they were using to try to manage risk under sub-prime mortgages and SRIs. How then could a director (particularly a non-executive director) of a participating financial institution possibly be expected to consider whether the SRI risks that the institution was taking were acceptable?

There were two extremes to this dilemma. At the one end of the spectrum SRIs and many financial institutions’ attempts to mathematically manage the resulting risk had become so complex that many of those institutions’ directors did not understand their institutions’ true state of affairs.

For example, in November 2008 Citigroup announced that it had suffered losses of US$11 billion as a result of its trade in SRIs. Citigroup’s then CFO could not confirm that Citigroup had written off all of its now valueless SRIs and that the total loss figure would not increase further. If the CFO of a massive US retail-cum-investment bank such as Citigroup was unable to determine whether all of its

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109 Lanchester (n 2) 142.
110 Morris (n 20) xi.
valueless SRIs had been identified and written off, how can a non-executive director of a financial institution possibly be expected to understand that institution’s true state of affairs?

At the other end of the spectrum some US financial institutions deliberately chose not to trade in SRIs, despite the very high profits that that trade generated. For example, US retail bank J P Morgan Chase actually designed CDOs and CDSs but never traded in them insofar as they were applied to sub-prime mortgages. J P Morgan’s relevant executives simply could not understand how the sub-prime risk was being managed to an acceptable level by the SRI participants. (The answer is, of course, that it was not.) J P Morgan’s internal risk control and commercial common sense prevented it from trading in any SRIs.\textsuperscript{111}

One definite red flag to investors, customers and regulators of financial institutions should be an all-powerful CEO whose “word is law”. If the CEO, not the board, is the final decision maker in respect of the institution’s affairs, alarm bells should start ringing very loudly indeed.

Northern Rock, at the urging of its CEO, Adam Applegarth, had adopted a risky business model whereby it financed almost 80\% of its long term mortgage products with short term inter-bank loans.\textsuperscript{112} When inter-bank loans dried up Northern Rock was doomed.

Some of Northern Rock’s directors had cautioned against that business model.\textsuperscript{113} But as Lanchester explains:

“Applegarth had become so used to giving the orders and leading the way that he found it all but impossible to heed warning voices ... He was powerful enough to ride roughshod over the bank’s board of directors, which lacked the confidence or ability to call a halt to the imprudent expansion.”\textsuperscript{114}

\textsuperscript{111} Lanchester (n 2) 102.
\textsuperscript{112} (n 49).
\textsuperscript{113} Brummer (n 11) 74.
\textsuperscript{114} Lanchester (n 2) 16.
Markus Jooste, the former all powerful CEO of Steinhoff, is another textbook example of massive risk accumulating in a group of companies because the CEO had a dominating personality and thus had the final say in any important matters.  

2. *Does The Dilemma Pose A Potential Systemic Risk To South Africa’s Financial Stability?*

Unfortunately the answer can only be yes.

Under the Companies Act the “business and affairs of a company must be managed by or under the direction of its board …”. It is clearly impossible for a board of a bank to manage, or even to supervise the management of, the business and affairs of that bank if the directors do not understand the intricacies of that bank’s business and affairs.

At first glance the Companies Act is not of much assistance insofar as the mandatory mitigation of that risk is concerned (admittedly because it was not drafted with the mitigation of that risk in mind). The lower threshold of the statutory degree of skill, care and diligence with which a director (thus including the directors of a bank) must act is the degree of skill, care and diligence that can reasonably be expected of a person carrying on the same functions in relation to that company as are being carried on by that particular director. That imposes on each director an objectively measurable duty to act with the necessary skill, care and diligence as a director of the bank. If a person is a non-executive director of a bank, the test will be what degree of skill, care and diligence can reasonably be expected of a non-executive director of a bank? If a director is an executive director of a bank, the test will be what degree of skill, care and diligence can reasonably be expected of that particular type of executive director of a bank?

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116 71 of 2008.
117 s 66(1).
118 s 76(3)(c).
The shortcoming, insofar as mitigating the risk identified earlier is concerned, is that a breach of that degree of skill, care and diligence potentially renders the director concerned personally liable.\textsuperscript{119} However, the Companies Act does not make it compulsory to appoint only persons who will be able to meet at least that minimum threshold as directors of a company. The Companies Act provides for potential personal liability of uninformed or incompetent directors but does not provide any quality assurance that only informed and competent persons will be appointed as directors of companies (and thus of banks).

How much can a bank’s director rely on the bank’s employees to provide the board with all relevant information, so that the board is able to make well informed decisions? There are two sides to this coin.

On the one side a director is potentially personally liable if he or she “knew” certain states of affairs of the bank but nevertheless acquiesced therein.\textsuperscript{120} “Know” means more than just actual knowledge. A director is regarded to know something if he or she should reasonably have investigated a particular matter or taken other measures, in each case that would have provided him or her with actual knowledge.\textsuperscript{121} Clearly a director cannot just say “I did not know and saw no reason why the matter should not be investigated deeper”.

On the other side, and slightly conversely, a director is entitled to rely on employees of the company (bank) whom the director reasonably believes to be reliable and competent in respect of the matters of the bank that have been delegated to them.

Neither side of that coin really assists in mitigating the identified risk. They either simply add towards rendering the director potentially personally liable or towards mitigating that potential personal liability.

Just before we put the Companies Act back on the shelf in despair, we turn to part B of Chapter 3 of that act. There we find a partial solution for the dilemma in the

\textsuperscript{119} s 77(2)(b) and 218(2).
\textsuperscript{120} s 77(3)(b)-(e).
\textsuperscript{121} definition of “knows” in s 1.
statutorily regulated position of companies’ company secretaries. A South African bank must be a public company, and thus must have a company secretary. A company secretary’s statutory duties include that he or she must provide the directors collectively and individually with guidance on their duties and responsibilities and make them aware of any law relevant to or affecting the company (in this case, the bank).

That being the case, the company secretary is best placed to advise the board on what upward reporting should be made to the board. The guidance that a bank’s company secretary must give to the bank’s directors on their duties must include guidance on how they should discharge their duties of skill, care and diligence. That duty is never exercised in a vacuum – it always applies in particular context. The company secretary is ideally placed to ensure that as part of that guidance, he or she ensures that the bank’s board is provided with such information as will enable each of the bank’s directors, whatever his or her experience base, with enough information to properly consider, and actually understand, the company’s affairs. In short, it is a bank’s company secretary’s statutory duty to ensure that each of the bank’s directors has sufficient information available to him or her to ensure that he or she actually understands the bank’s business and can make well informed decisions in respect thereof.

122 s 86(1).
123 s 88(2)(a)-(b).
CHAPTER 5 BANKERS’ BONUS CULTURE

1  Bankers’ Bonus Culture

Bonuses form a significant part of most investment bankers’ remuneration packages. As at 2010, bonuses formed 60% of the average investment banker’s remuneration.124 On the supposed premise that risk and reward go hand in hand, massive bonuses are said to be bankers’ reward for taking profitable and successful risks. Apparently there is no other side to that bonus coin though – if a banker takes a risk and that risk does not translate into a profit, there are no repercussions for that banker.125 In over simplified terms, bankers’ bonus culture is said to encourage bankers to take risks with other people’s money.

Banking has been described not just as involving the management of risk, but rather as being the management of risk.126 The challenge therefore is how to reward bankers for successfully managing inevitable risk but to also appropriately sanction them if they take unnecessary or reckless risks.

What is clear though is that bankers’ bonus culture is firmly entrenched. In 2008 the UK government had to bail out the Royal Bank of Scotland, which had significant sub-prime exposure. Some £15 billion of British taxpayers’ money was injected into RBS to keep it afloat.127 Somehow, despite that bailout, RBS saw nothing untoward in announcing in February 2009 that it would pay some £1 billion in bonuses.128

The bonus culture is not restricted to banks. Some other corporates apply it too. For example, during September 2008 the New York Federal Reserve had to bail out insurance giant AIG, the major issuer of CDSs.129 AIG had posted a loss of US$61.7 billion for the fourth quarter of 2008, the largest in the USA’s corporate history.130

124 Lanchester (n 2) 12.
125 Brummer (n 11) 224-225.
126 Lanchester (n 2) 24.
127 Tooze (n 1) 191.
128 Tooze (n 1) 292.
129 Tooze (n 1) 178.
130 Tooze (n 1) 292.
And yet, in March 2009, AIG announced that its division that had caused a major part of that loss would receive US$165 million in bonuses.\textsuperscript{131}

The US public and the Obama administration had had enough. The US president summoned the CEOs of the 13 biggest US banks to the White House on 27 March 2009.\textsuperscript{132} President Obama requested those CEOs to show restraint in the payment of bonuses.\textsuperscript{133} Incredibly, despite the bail outs, the public outcry and the president’s appeal, some of the CEOs still tried to justify senior bankers’ incredibly high remuneration to president Obama.\textsuperscript{134}

Lanchester\textsuperscript{135} summarises the problem well:

\begin{quote}
“The problem ... [is] ... that [bankers’] pay emphasized and encouraged the benefits of taking risks, while removing the consequences when things went wrong. ... [B]ankers’ pay structures rewarded them when things went up, but did not punish them when things went down. That, added to the fact that so much [of bankers’] pay came in the form of bonuses, encouraged a culture of gambling on big returns ....”
\end{quote}

Brummer is even franker: “Greed had triumphed over the traditional banking virtue of prudence”.\textsuperscript{136}

Cohan laments the intrusive and restrictive regulatory framework that has been imposed on US banks with the passing of the Dodd-Frank Act,\textsuperscript{137} an act that he describes as running into some 2,300 pages and with some 22,000 pages of accompanying regulations.\textsuperscript{138} He regards the new regulatory framework as counter-productive and as addressing the wrong issues.\textsuperscript{139} According to Cohan extensive regulation of US banks is not the answer\textsuperscript{140} because it does not address the root of the problem. He describes the root of the problem as follows: “[it is] one of improper

\textsuperscript{131} Tooze (n 1) 292-293.
\textsuperscript{132} Cohan (n 38) 101.
\textsuperscript{133} Tooze (n 1) 296.
\textsuperscript{134} Tooze (n 1) 296 and Cohan (n 38) 100.
\textsuperscript{135} Lanchester (n 2) 178.
\textsuperscript{136} Brummer (n 11) 53.
\textsuperscript{137} Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
\textsuperscript{138} Cohan (n 38) 103-110.
\textsuperscript{139} Cohan (n 38) 108-128.
\textsuperscript{140} Cohan (n 38) 132.
incentives. When people are rewarded to take risks with other people’s money, that’s exactly what they will do.”

Cohan also argues that a compliance based regulatory framework is “incredibly dumb regulation”. He believes that there should be “smart regulation” of US banks and that the way to bring about that smart regulation is to make bankers personally liable if they lose other people’s money.

2 Does Bankers’ Bonus Culture Pose A Systemic Risk To South Africa’s Financial Stability?

Some of the US banks that were represented at the 2008 meeting with president Obama nowadays have corporate presences and banking operations in South Africa.

Corporate culture grows from the top. To the extent that those US banks’ head offices in the USA still practice bonus cultures, there is no reason to think that their South African outposts do not do so either. In which case there is no reason to think that their competitor South African banks do not do so either.

The question is whether a bonus culture of instant (or at least short term) gratification and reward without long term accountability poses a systemic risk to South Africa’s financial stability?

At face value, it does. If one is rewarded (and rewarded handsomely at that) for an immediate outcome but one is not also measured on the longer term consequences of that outcome, it certainly creates a risk. That risk is that the objective downside to the longer term outcomes will far outweigh the subjective upside to the instant gratification and reward.

141 Cohan (n 38) 114.
142 Cohan (n 38) 142.
143 Cohan (n 38) 142.
144 Cohan (n 38) 142.
At least two factors come into play here. Firstly, the high amounts of bankers’ bonuses in themselves do not create such a risk. But if those amounts are so high that if, for example, three years’ of bonuses are enough to set one up for life, then obviously it encourages conduct that is focused on short term gain rather than long term consequences.

Secondly (and this is not limited to banks, it applies to various multinational groups of companies), today’s financial sector employees are talented, skilled and highly mobile. Most of them do not stay in the same position for years on end. Instead, they tend to move upwards (either within the bank or group or externally in another group) every four years or so. This creates a very real risk under the bonus culture. By the time that the risk that was created under the bonus driven actions comes to realise and the full extent of the long term damage becomes clear, the persons who were responsible for creating the risk are often no longer employed in that business unit, company or group. The damage that they have caused becomes someone else’s problem.

One cannot answer the question whether South Africa’s banks’ bonus culture poses a systemic risk to our financial stability in the abstract. One would have to gauge exactly how each South African bank applies that culture and determine whether it factors long term consequences into its application of the culture. It certainly is a matter that deserves close scrutiny and consideration by South Africa’s financial regulators.
CHAPTER 6 THE COMBINED RETAIL AND INVESTMENT BANK

1. Retail Banks And Investment Banks

Traditionally retail banks receive deposits from their customers and then lend out parts of those deposits to certain of its customers. Investment banks are normally not deposit taking institutions. Rather, they fund their activities with money borrowed from other banks or institutional lenders, from public offerings of their securities and from the fees that they generate. They represent clients in issuing and trading financial instruments. Investment banks also advise, and often finance or underwrite, clients on merger and acquisition transactions, initial public offerings, rights issues and similar transactions. The critical point is that investment banks do not only trade on behalf of their clients (ie as their clients’ agents) but often trade for their own account (ie as principals).

Following the great crash of 1929 and the resulting Great Depression, a USA federal law known as the Glass-Steagall Act was enacted whereby investment banks were not allowed to be retail banks too, and vice versa. J P Morgan Bank was, for example, split up in 1935 into retail bank J P Morgan Chase and investment bank Morgan Stanley. That US prohibition was removed in 1999, following intense lobbying by the banking interest group.

US investment banks Lehman Brothers and Merrill Lynch were significant players in SRIs. Lehman ultimately failed because:

- it held too many SRIs;
- those SRIs became valueless and as a result Lehman could no longer borrow in the short-term inter-bank market; and
- Lehman became commercially insolvent. Its cash flow had seized up.

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145 Cohan (n 38) 28-36.
146 The Banking Act of 1933 (also known as the Glass-Steagall Act) (USA federal legislation).
147 Lanchester (n 2) 50.
148 Cohan (n 38) xii.
149 Lanchester (n 2) 161.
150 Tooze (n 1) 149.
151 Tooze (n 1) 149.
152 Tooze (n 1) 144.
Lehman’s failure illustrates the dangers of banks trading in securities and other financial instruments for their own account. More concerning though, is what happened to some of the US retail banks.

Once the Glass-Steagall prohibition was lifted, US retail bank giant Citigroup started trading, for its own account, in huge volumes of SRIs.\textsuperscript{153} Although Citigroup did not fail during the GFC, that was only because of massive, repetitive recapitalisations of Citigroup by the US authorities. But for those interventions, there is no doubt that Citigroup’s investment bank activities would have resulted in its failure.\textsuperscript{154}

US investment bank Merrill Lynch also traded heavily, for its own account, in SRIs.\textsuperscript{155} There is little doubt that, given its exposure to sub-prime related assets, Merrill Lynch would also have failed during the GFC but for its US government supported acquisition by retail bank Bank of America. That acquisition caused Bank of America significant problems though – on its consolidated financial statements the state of Merrill Lynch’s SRI ravaged balance sheet put the solvency of holding company, and retail bank, Bank of Africa itself at risk.\textsuperscript{156}

Citigroup’s woes under the GFC is a clear warning of the potential dangers of having a combined retail-and-investment bank in one legal person. By November 2008 Citigroup had announced losses running into more than US$10 billion, caused mostly by its trading in SRIs. Those losses potentially put the safety of its retail customers’ deposits at risk.

Following the GFC there have been calls both in the UK\textsuperscript{157} and the USA\textsuperscript{158} for the compulsory separation of retail banking and investment banking units into separate legal entities. The rationale for the proposed separation is that retail banks’ customers’ deposits should not be used for, not be placed at risk by, their bank’s investment banking operations.

\textsuperscript{153} Lanchester (n 2) 101.
\textsuperscript{154} Tooze 197, 295, 306.
\textsuperscript{155} Lanchester (n 2) 101 and Tooze (n 1) 149-150, 175.
\textsuperscript{156} Tooze (n 1) 299.
\textsuperscript{157} Lanchester (n 2) 193-195 and Cohan (n 38) 66-70.
\textsuperscript{158} See eg Morris (n 20) 163.
The Dodd-Frank Act did not reinstate the Glass-Steagall prohibition. The Dodd-Frank Act\textsuperscript{159} does contain some limitations on USA banks though, in that it prohibits US banks from:

- “engaging in proprietary trading”.\textsuperscript{160} (Proprietary trading occurs if a bank buys or sells any securities or derivatives as a principal and thus for its own account.);\textsuperscript{161} or

- having an ownership interest in a hedge fund or in a private equity fund.\textsuperscript{162}

2. Does The Conducting Of Retail And Investment Banking Operations In One And The Same South African Bank Pose A Systemic Risk To South Africa’s Financial Stability?

The Banks Act\textsuperscript{163} does not prohibit South African retail banks from also conducting investment banking activities. As a result, most of South Africa’s big commercial banks conduct their retail and investment banking activities in one and the same legal entity. Which means, of course, that the safety of the banks’ retail customers’ deposits is potentially exposed to the results of the bank’s investment banking activities.

There are at least two reasons why the proposed splitting out of retail and investment banking units is not without merit. Firstly, standalone investment banks do not take deposits. Instead, they borrow the required funds from institutional investors. Which means that before an institutional investor lends funds to an investment bank, the institutional investor will (hopefully) conduct a proper due diligence, both on the investment bank itself and on the particular transaction (or category of transactions) for which the borrowed funds are to be used. This means

\textsuperscript{159} s 619.
\textsuperscript{160} s 619(a)(1)(A).
\textsuperscript{161} s 619(h)(4).
\textsuperscript{162} s 619(a)(1)(B).
\textsuperscript{163} 94 of 1990.
that there is an extra set of check and balances in the process, on top of the benefit that customers’ deposits are not potentially being placed at risk.

Secondly, banks have a profit motive. In some cases, some banks seem to have a profit maximisation motive. Banks’ returns on lending out customers’ deposits to natural person customers are subject to the limitations imposed by the NCA. With returns on credit granted by banks being limited under the NCA, it is only human to admit that it must be tempting for any retail-cum-investment bank to use at least part of its stockpile of customer deposits for investment banking purposes. The likely returns on investment banking transactions are typically higher than the likely returns on retail banking loans.

Even if, or when, South Africa gets its own bank deposit repayment guarantee scheme, it does not follow that the compulsory splitting up of banks’ retail and investment banking units does not still warrant attention. If a retail bank’s investment banking operations cause that bank to fail completely, then the bank will not be able to honour its deposit repayment obligations. South Africa does not have endless supplies of taxpayer’s money. In fact, quite the opposite. To the extent that South Africa’s eventual deposit guarantee scheme is to be funded with taxpayers’ money, that money is much better spent on economic stimulus packages and job creation than on paying to retail bank customers what their own bank should have been able to pay to them in the first place.

It is going to be interesting to see whether, and if so, the SARB, the Prudential Authority or the FSCA considers the mandatory separation of South African banks’ retail and investment banking operations further.
CHAPTER 7 GREED AND OUTRIGHT CRIMINAL CONDUCT

1. Criminal Conduct In The Financial Sector

Risky, even reckless, bankers’ bonus driven conduct is one thing. Bankers’ conduct that falls within the common law or statutory definition of a criminal offence is, of course, another matter. It is criminal conduct and theoretically, at least, exposes the perpetrating banker to criminal prosecution. To take a GFC example: If an investment bank had knowingly dressed unsafe sub-prime mortgages up as AAA credit rated CDOs and stated that all of the underlying mortgages were prime, that obviously amounted to the commission of fraud.164

In fact, in 2010 the US Securities Exchange Commission (SEC) announced that it was bringing charges against Goldman Sachs “for misleading the investors to whom it had sold inferior quality mortgage-backed securities”.165 The matter was settled out of court in that Goldman Sachs, without admitting or denying any wrongdoing, paid some US$ 550 million to the SEC and investors.166

Cohan argues that what is needed is the vigorous criminal prosecution of Wall Street bankers who commit criminal offences, not more cumbersome and stifling regulation of Wall Street’s financial institutions.167

2. Does Criminal Conduct In South Africa’s Financial Sector Pose A Potential Systemic Risk To South Africa’s Financial Stability?

Sadly the answer can only be yes. The fact that a culture of bribery, corruption, greed and self-enrichment has become the norm in large parts of South Africa’s population is so well known that a court can probably take judicial notice of that fact.

164 Tooze (n 1) 59.
165 Tooze (n 1) 307.
167 Cohan (n 38) xxvii.
The criminal way in which the affairs of VBS Mutual Bank (VBS) was conducted speaks for itself. A report that was commissioned by the Prudential Authority\(^\text{168}\) into VBS’ affairs shows that:

- Some R2 billion was illegally looted from VBS;\(^\text{169}\)
- VBS’ methodology was to bribe officials at municipalities and other public entities to illegally “invest” their entities’ surplus funds with VBS.\(^\text{170}\) Those “investments” were illegally made since the applicable regulations precluded municipalities and other public entities from investing with a mutual bank such as VBS;\(^\text{171}\) and
- “[VBS was] corrupt and rotten to the core. Indeed, there is hardly a person in its employ in any position of authority who [was] not, in some way, complicit.”\(^\text{172}\)

VBS was an extreme case, in that its entire management team participated in its criminal activities. But the demise of Barings Bank as a result of the actions of Nick Leeson, its Singaporean trading team head, shows clearly that a small number of bank employees who hold strategic positions can create systemic risk. That is so particularly if they act unlawfully and illegally. The fact that a bank’s entire board and most of its senior managers are neither participating in nor aware of large scale illegal acts being committed in the bank does not decrease the risk.

South Africa is particularly vulnerable to corrupt and other criminal activities in financial institutions causing systemic risk. There are a number of reasons for this. Firstly, a culture of corruption, self-help and criminality has set in in large parts of South Africa’s population. Secondly, the National Prosecuting Authority’s effectiveness has been undermined by political and external interference.\(^\text{173}\) Thirdly, as a deterrent factor, South Africa’s criminal justice system is failing. Given that justice must not only be done but must also be seen to be done, the perception unfortunately is that more often than not white collar criminals “get away with it”. Almost a year and a half after VBS imploded, no criminal prosecutions of the main

\(^{168}\) Advocate Terry Motau SC “VBS mutual bank The Great Bank Heist Investigator’s Report to the Prudential Authority” (31 September 2018) (“Motau Report”).

\(^{169}\) Foreword to the Motau Report.

\(^{170}\) Motau Report 37-56.

\(^{171}\) Motau Report 40-41.

\(^{172}\) Motau Report 138.

\(^{173}\) Mailovich “Political interference undermined NPA, Mxolisi Nxasana told state capture enquiry” 02-09-2019 (www.businesslive.co.za/bd/national/2019-09-02-political (07-10-2019)).
criminal protagonists have been announced, let alone instituted, conducted or finalised.

The conclusion that South Africa’s corrupt and criminal sub-culture and ineffective criminal justice system pose potential systemic risks to its financial stability is unavoidable.
CHAPTER 8 CONCLUSION

In this contribution the causes of the failures of some banks during the GFC were identified. Those were:

- The unregulated and unscrupulous extension of credit in the USA under sub-prime mortgages.
- The poor regulation of financial institutions.
- The inability of boards of directors of financial institutions to fully understand and manage the institutions’ affairs (“Board Supervision”).
- Bankers’ bonus culture.
- Retail banking and investment banking units being housed in one and the same legal entity.
- Greed and outright criminal conduct.

The extent to which South African law currently has the ability to prevent those causes from coming about in South Africa was then analysed. The analysis showed that, on the whole, South African law is well placed to prevent those causes from coming about in South Africa.

The FSRA and FAISA regulatory frameworks make it very unlikely indeed that a significant unregulated and unscrupulous sub-prime mortgage industry would ever come about in South Africa. Equally, the regulation of South Africa’s financial institutions is now on a firm footing under the FSRA (apart from the fact that South Africa’s financial system safety net still does not contain a deposit insurance scheme). The quality of that regulation and the accompanying supervision is likely to improve further. Insofar as South African law’s regulation of Board Supervision is concerned, the danger posed by the Board Supervision dilemma is a practical one, rather than a legal one.

South African law does not expressly address the risk posed by bankers’ bonus culture. If needs be though, the Minister of Finance, the Governor of the SARB and the SARB itself may use their respective powers under the FSRA to (a) designate
banks whose bonus cultures potentially pose the risk of a systemic event as “systemically important financial institutions”\textsuperscript{174} and (b) have appropriate bonus culture risk mitigating requirements imposed on those financial institutions.\textsuperscript{175} Albeit that the Conduct of Financial Institutions Bill is not law yet, if the current version of that bill\textsuperscript{176} is enacted then the resulting act will deal more expressly with the FSCA’s ability to deal with financial institution’s remuneration structures,\textsuperscript{177} which would obviously include banker’s bonus culture.

South African law does not expressly grant anyone the power to force a bank to split out its retail banking and investment banking units into separate legal entities. However, it can be argued strongly that the Governor of the SARB and SARB, acting collectively, have the power to do so under the FSRA\textsuperscript{178} if such a measure is needed to mitigate the risk of a systemic event occurring.

South Africa’s law is well placed to successfully prosecute the perpetrators of outright financial crime. The risk to South Africa’s financial stability in this regard is not a legal one. Rather, it is one of a lack of political to so prosecute, inadequate resources to so prosecute and ultimately “justice simply not being seen to be done”. As a result, there is not a strong legal deterrent to the commission of sophisticated financial crime in South Africa.

\textsuperscript{174} s 29(1)(a).
\textsuperscript{175} s 30(1)(i).
\textsuperscript{176} [B-2018].
\textsuperscript{177} s 44 & 45.
\textsuperscript{178} s 29(1) & 30(1)(d).
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**Glossary Of Some Relevant US Banking Terms**

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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<tbody>
<tr>
<td>AIG</td>
<td>American International Group, a US insurance company that provided most of the CDSs in respect of SRIs.</td>
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<tr>
<td>CDOs</td>
<td>Collateralised debt obligations, being “synthetic” CMOs or CLOs in that they were derivatives that were issued in respect of certain categories of the mortgages in a SIV or a SPV but had no direct link to those mortgages. Rather, CDS synthetically tracked the value of those mortgages as if the CDOs had been issued by the SIV or SPV (whereas, in most cases, the CDOs were issued by a third party).</td>
</tr>
<tr>
<td>CDS</td>
<td>A credit default swap, being an agreement whereby a party undertook to make good to another party any losses on a particular group of securities or instruments held by that second party.</td>
</tr>
<tr>
<td>CLOs</td>
<td>Collateralised loan obligations, being securities issued by a SIV or SPV that entitled the holder thereof to participate in the revenue streams of only certain specified categories of mortgages held by the SIV or SPV.</td>
</tr>
<tr>
<td>CMOs</td>
<td>Collateralised mortgage obligations, being securities issued by a SIV or SPV that entitled the holder thereof to participate in the revenue streams of only certain specified categories of mortgages held by the SIV or SPV.</td>
</tr>
<tr>
<td>GFC</td>
<td>The Global Financial Crisis.</td>
</tr>
<tr>
<td>MBS</td>
<td>Mortgage backed securities, being securities issued by a SIV or SPV that entitled the holder of the securities investors to receive distributions based on all (not just some) of the SIV’s or SPV’s underlying mortgages’ revenue streams.</td>
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</tbody>
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Negative equity When a mortgagor owes more under his or her mortgage than the market value of the mortgaged property.

SIV A structured investment vehicle, being a juristic person that held rights under sub-prime mortgages and/or issued SRIs.

SPV A special purpose vehicle, being a juristic person that held rights under sub-prime mortgages and/or issued SRIs.

SRIs Sub-prime mortgage related instruments, including MBS, CMOs, CLOs, CDOs and CDSs.

Sub-prime mortgage A loan made on the security of a mortgage to a borrower who would not have qualified for that loan under normal credit worthiness and affordability criteria. (The term is not a reference to the prime interest rate. The term means “less than good”, “prime” being a reference to “prime” meat, i.e. first grade meat.)

Too Big To Fail A financial institution that is so big that a national the government cannot allow it to fail because if it fails it will drag the entire financial system down with it.