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A bank's right to terminate its relationship with its customers in light of reputational risk

by

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Summary

This dissertation examines a bank's right to unilaterally terminate its contractual relationship with a customer on the basis of reputational risk. The law of contract allows a bank to terminate the bank-customer agreement when the customer is in serious breach of the contract. Over the years, however, a pattern has started to develop by which a bank can unilaterally terminate the bank-customer relationship of high-risk customers based on reputational risk. Banks are reluctant to facilitate the transactions of individuals surrounded by negative publicity, due to fears of how the bank's investors, customers or counterparts might perceive the bank.

Compliance with anti-money laundering (AML) and counter financing of terrorism (CFT) requirements, as set out by both domestic and foreign legislation, results in higher costs for the bank. As such, the profitability of a particular bank-customer relationship may ultimately decline to such an extent that the bank rather decides to make an appropriate business decision by terminating the relationship.

Correspondent banking relationships are agreements in terms of which one bank will provide services for another in jurisdictions where the first bank lacks a physical presence. As such, whenever there is a perception that a local bank does not comply with the relevant AML/CFT laws as set out by its domestic legislation, the correspondent bank might decide to terminate its relationship with the local bank, leaving the latter financially excluded from the correspondent banking market. Such a situation would hinder the growth of the South African economy and may also cause a systemic event in the financial industry.

Adequate customer due diligence (CDD) measures assist a bank in formulating a clear understanding of the business of its customers. The information obtained through CDD may also assist the bank in determining the reputation of a particular customer. This information can also assist law enforcement in combatting financial crimes. In this regard, it is recommended that a bank should be able to trace the information that was shared with Financial Intelligence Units (FIUs) and law enforcement agencies, so that the bank may reasonably determine the level of reputational risk involved in the relationship.

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Chapter 1:
Introduction

1.1 Introduction

Banks deciding to terminate the bank-customer relationship of high-risk customers is not a new phenomenon in South African law. Adverse publicity, whether or not accurate, resulting from illicit business activities by prominent customers may cause damage to the bank's own reputation and could undermine public confidence in global financial standards.[1] Banks tend to mitigate reputational risk by terminating the bank-customer relationship in order to prevent it from being perceived by other market participants as an institution that is likely to facilitate unlawful activities.[2] Indeed, reputational risk, if not adequately managed or mitigated, may cause widespread contagion in broader financial markets.[3] South African banks borrow foreign currencies from other international banks as a normal course of its business.[4] As such, the relevant banks are likely to include a covenant in the loan agreement which stipulates that both the correspondent and respondent bank shall comply with the necessary anti-money laundering (AML) and counter financing of terrorism (CFT) laws

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[1] The court *in Annex Distribution v Bank of Baroda* 2018 (1) SA 562 (GP), with reference to the decision in *Bredenkamp v Standard Bank* 2010 (4) SA 468 (SCA) para 63, held that "[i]rrespective of whether negative publicity about the client is true, a bank is fully entitled to terminate the relationship with a client that has a bad reputation". In *Minister of Finance v Oakbay Investments (Pty) Ltd and Others* 2018 (3) SA 515 (GP) the bank identified certain elements which played a vital role in the bank's decision to terminate the bank-customer relationship unilaterally in light of the reputational risk involved:

> "they did so in compliance with their obligations in terms of the FIC Act. They explained the prejudice they would suffer if they failed to adhere to international best practice and standards and if they did not protect their reputation. They also asserted their right to choose the clients with whom to have a relationship. They were prudent to disassociate from any conduct that would disturb the financial stability of the country. Their conduct ought to boost rather than harm confidence in the South African banking system."

[2] In *Breedenkamp and Others v Standard Bank of South Africa Ltd and Another* 2009 (5) SA 304 (GSJ) para 31 the bank, in support of its decision to terminate the account of a high-risk individual, argued that a continuation of the bank-customer relationship with Mr Bredenkamp would have resulted in serious implications for the bank, its customers and its investors, due to the perception that it would create in the eyes of "domestic and foreign onlookers". The bank was concerned that an association with a conductor and/or financier of improper and unlawful transactions would pose a threat to its reputation and as such decided to terminate the bank-customer relationship unilaterally.

[3] S Lumpkin "Risks in Financial Group Structures" OECD Journal: Financial Market Trends 2010 (2) 4 available at https://www.oecd.org/daf/fin/financial-markets/47070880.pdf (accessed on 2 February 2020).

[4] Financial Stability Board (FSB) "Enhancing cross-border payments – Stage 1 report to the G20: Technical background report" (2020) 7 available at https://www.fsb.org/wp-content/uploads/P090420-2.pdf (accessed on 2 February 2020).

as enacted both in its domestic legislation and in the legislation of the jurisdictions within which it operates.[5] A failure by either party to comply with the relevant laws will cause a breach in the underlying correspondent banking agreement, rendering the loans due and payable with immediate effect.[6] This may cause severe strain on the bank's liquidity position, which might lead to a need for implicit support.[7] Hence, it is necessary to have adequate and appropriate structures in place that can effectively address reputational risk from both a prudential and an AML/CFT supervisory perspective.

The termination of correspondent banking relationships based on perceived and speculative risk of non-compliance with AML/CFT laws may cause local banks to have limited access to foreign markets, or alternatively result in them being financially excluded from international markets.[8] This would hamper economic growth in South Africa, making it more difficult for banks to operate in competitive markets.

Considering the above, the purpose of this dissertation is to analyse the right of a bank to unilaterally terminate its relationship with its customer based on reputational risk. When information is made public through the judiciary process, a bank may observe a sudden shock in its reputation and share value due to the reaction of investors and customers. In this regard, a multi-agency approach to sharing of information may potentially assist a bank in determining the appropriate level of reputational risk concerned with high risk customers.

1.2 Outline

In Chapter 2, I will set out the principles governing the bank-customer relationship and the termination thereof. The termination of a credit facility will be discussed followed by a brief discussion of the new Conduct Standard for Banks as set out by the Financial Sector Conduct Authority (FSCA). Lastly, the relevant provisions dealing with account closures as contained in the Code of Banking Practice will be set out.

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[5] IMF Staff Discussion Note "The withdrawal of correspondent banking relationships: A case for policy action" (2016) 22 available at https://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf (accessed on 5 February 2020).

[6] Minister of Finance v Oakbay Investments Case no 80978/2016 "The explanatory supporting affidavit of Standard Bank" (2016) para 70.

[7] BCBS "Enhancements to the Basel II framework" (2009) para 48 available at https://www.bis.org/publ/bcbs157.pdf (accessed on 5 February 2020).

[8] IMF Staff Discussion Note "The withdrawal of correspondent banking relationships: A case for policy action" (2016) 6.

In Chapter 3, reputational risk will be discussed. I will specifically explain where customer due diligence fits into reputational risk. This chapter will set out the relevant customer due diligence (CDD) standard that was developed by the Financial Action Task Force (FATF). It will further discuss the provisions of CDD as incorporated in the Financial Intelligence Centre Act 38 of 2001 (FIC Act), since it affords the bank a statutory right to exit the bank-customer relationship. Non-compliance with these measures can result in serious prudential consequences and may cause a spill-over effect in correspondent banking markets. Additionally, a bank may potentially have more exposure to reputational risk when dealing with politically exposed persons (PEPs). This chapter will therefore discuss the reputational risk present in dealing with politically exposed persons (PEPs) and will discuss the CDD measures as set out in the FIC Act.

In Chapter 4, the concept of de-risking will be discussed. Particular attention will be given to the views of the United Kingdom's Financial Conduct Authority (UKFCA), FATF, ESAAMLG, FIC, FSB and BCBS. This chapter will conclude with recommendations regarding this issue.

In Chapter 5, I will provide an analysis of case law focusing on the unilateral termination of the bank-customer relationship. Chapter 6 will conclude the dissertation by recommending a "Fusion Centre" model to fast-track information that may potentially be shared with a bank so that the bank can proactively prepare for any exposure to reputational risk resulting from information that is made publicly available through the judiciary process or other media statements.

Chapter 2:
The bank-customer relationship

2.1 Overview

The contract underlying the bank-customer relationship is often described as "multi-faceted" due to the different types of contracts involved, such as a loan for use, *depositum*, mandate and deposit-taking.[1] Due to the multi-faceted nature of the underlying contract, it is often referred to as a "contract *sui generis*".[2] The relationship between a bank and its customer in respect of a current account is one of debtor and creditor.[3] If the customer deposits money into his account and the balance reflects a credit amount, it will be regarded as a loan given by the customer to his bank. Hence, the bank will be the debtor whereas the customer will be the creditor.[4] In terms of an account that is overdrawn, the roles of the parties will be reversed and the customer becomes the debtor and the bank the creditor.[5] Furthermore, the bank-customer relationship universally incorporates a mandate.[6] In terms of the contract of mandate, the bank undertakes to carry out one or more banking services for the customer.[7] The duties of a party to the contract of mandate include the duty not to cause damage to the other party.[8]

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[1] Sharrock R (ed), Hugo C, Lawack V, Ramdhin A, Roestoff M, Schulze WG & Van Heerden C *The law of banking and payment in South Africa* (2016) 115. See also Schulze WG "The sources of South African banking law - A twenty-first-century perspective (Part I")" (2002) 14 *SA Merc LJ* 438 440.

[2] *GS George Consultants and Investments (Pty) Ltd v Datasys (Pty) Ltd* 1988 (3) SA 726 (W) 736. In *Standard Bank of South Africa Ltd v ABSA Bank Ltd* 1995 (2) SA 740 (T) 747, Moseneke J had an alternative view by stating that "the proper course to take is not to apply a rigid and pre-existing characterisation of the customer-banker legal relationship, but to examine the specific legal *nexus* which exists between a particular banker and its customer". See also *Di Giulio v First National Bank of South Africa Ltd* 2002 (6) SA 281 (C) para 20.

[3] *Standard Bank of South Africa Ltd v Oneanate Investments (Pty) Ltd* 1995 (4) SA 510 (C) 530*; Kearney NO v Standard Bank of South Africa Ltd* 1961 (2) SA 647 (T) 650; *Muller NO and Another v Community Medical Aid Scheme* 2012 (2) SA 286 (SCA) para 13; *Di Giulio v First National Bank of South Africa Ltd* 2002 (6) SA 281 (C) para 19*; Absa Bank Ltd v Lombard Insurance Co Ltd* 2012 (6) SA 569 (SCA) para 19.

[4] *Standard Bank of South Africa Ltd V Oneanate Investments (Pty) Ltd* 1995 (4) SA 510 (C) 531-532.

[5] *Kearney NO v Standard Bank of South Africa Ltd* 1961 (2) SA 647 (T) 650.

[6] *Di Giulio v First National Bank of South Africa Ltd* 2002 (6) SA 281 (C) paras 17-20.

[7] *Di Giulio v First National Bank of South Africa Ltd* 2002 (6) SA 281 (C) paras 17-20.

[8] Schulze WG "The bank's right to cancel the contract between it and its customer unilaterally" (2011) 32 *Obiter* 211-223 220.

2.2 Terminating the bank-customer agreement

The bank-customer relationship may be terminated by mutual agreement or unilaterally by either the bank or its customer.[9] The customer is entitled to summarily terminate the contract with his bank by informing it of his retracting intention.[10] The holder of a deposit account should, however, allow his bank an agreed period of notice before terminating the contract.[11] The underlying contract generally includes a *lex commissorium*, which entitles the bank to terminate the contract unilaterally.[12] When a party to the contract conducts his business activities in a manner that is likely to cause harm to the other party, that party will be in breach of his duty and the latter may be entitled to cancel the agreement even in the absence of a cancellation clause.[13] However, the breach must be serious enough to warrant cancellation.[14] The test for seriousness is said to be an objective one that necessitates a value judgment by the courts, balancing the opposing interests of the parties in a fair and reasonable manner, bearing in mind that rescission is an extraordinary remedy.[15] Relevant factors in this regard may include whether or not the breach goes to the root of the contract in its totality and whether the debtor failed to perform a vital part of his obligations.[16]

The bank is obligated to give its customer a reasonable period of notice before terminating the relationship.[17] It is also accepted that "reasonable notice" depends on the type of account and the special facts or circumstances of each case.[18] Relevant

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[9] Malan FR, Pretorius JT & Du Toit SF *Malan on bills of exchange, cheques and promissory notes in South African law* (5 ed 2009) 326.
[10] *Bredenkamp v Standard Bank of South Africa* 2009 (6) SA 277 (GSJ) para 29.
[11] Sharrock R *The law of banking and payment in South Africa* (2016) 162 fn 327.
[12] Sharrock R *The law of banking and payment in South Africa* (2016) 162 fn 327.
[13] Sharrock R *The law of banking and payment in South Africa* (2016) 220. See also Du Toit SF "Closing bank accounts: recent developments" (2017) *ABLU* 32. See Schulze WG "The bank's right to cancel the contract between it and its customer unilaterally" (2011) 32 *Obiter* 211-223 220.
[14] *Prosperity Ltd v Lloyds Bank Ltd* (1923) 39 TLR 372. In this case, a month's notice was considered insufficient.
[15] *Singh v McCarthy Retail Ltd t/a McIntosh Motors* 2000 (4) SA 795 (SCA) paras 12 and 15.
[16] Hutchison D & Pretorius C *The law of contract in South Africa* (3 ed 2017) 308.
[17] *Joachimson v Swiss Bank Corporation* (1921) 3 KB 110 (CA) 127. In *Bredenkamp v Standard Bank* 2009 (6) SA 277 (GSJ) para 29, Lamont J confirmed this position by stating that "..the term within the contract allows the bank at will, subject only to give reasonable notice, to terminate the contract". In *Swart v Vosloo* 1965 (1) SA 100 (A) 115, Wessels JA confirmed that the cancellation of any contract has consequences upon the reciprocal rights and duties of the parties thereto and thus serves as a further justification for holding that if a party exercises his contractual right of cancellation, he should communicate such decision to the other party *effectively* in order to terminate the contract. The court in *Annex Distribution (Pty) Ltd and Others v Bank of Baroda* 2018 (1) SA 562 (GP) para 24 held that a period of three months' notice was sufficient.
[18] Hapgood M *Paget's Law of banking* (13 ed 2007) 153. See also *Prosperity Ltd v Lloyds Bank Ltd* (1923) 39 TLR 372.

factors may include the nature of the account as well as the time required by the customer to make alternative arrangements.[19] While a bank is indeed entitled to demand repayment of an overdraft forthwith, this action is different from closing the account.[20] Banks are required to advise their customers that a facility is to be withdrawn to prevent prejudice to their good name and business reputation if further cheques are issued after the facility has been withdrawn.[21]

The bank-customer relationship further terminates upon the death of a natural person customer.[22] When the customer is a juristic person, the contract will terminate upon dissolution of the entity.[23] In instances where a customer is sequestrated or placed under liquidation, the contractual relationship will not automatically terminate.[24] In this regard, if the trustee of the insolvent estate elects to keep the insolvent's bank account open, the contract will not automatically be terminated by insolvency but may restrict the bank's ability to perform its mandate towards such customer.[25] Whatever the reason for terminating the bank-customer agreement might be, banks are required to apply its corporate mind to the matter by considering and assessing the reasons for such decision.[26]

2.3 Terminating a credit facility

The termination of a credit facility is different from the termination of a current account. A customer that requires a credit card from his bank will enter into a credit agreement. The credit facility will potentially be subject to the provisions of the National Credit Act 34 of 2005 (NCA). The NCA provides that the credit provider in respect of a credit facility may suspend that facility at any time if the consumer is in default under the agreement.[27] The credit provider may terminate that credit facility by giving prior written notice of at least ten business days before terminating the facility.[28] This type

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[19] Sharrock R *The law of banking and payment in South Africa* (2016) 163.
[20] Ombudsman for Banking "Bulletin no 3" (15 August 2012) para 2 available at https://www.obssa.co.za/wp-content/uploads/2018/02/Bulletin-3-Closure-of-bank-accounts-Final-30.01.2018.pdf (accessed on 13 February 2020).
[21] Ombudsman for Banking "Bulletin no.3" (15 August 2012) para 2.
[22] Sharrock R *The law of banking and payment in South Africa* (2016) 163.
[23] Sharrock R *The law of banking and payment in South Africa* (2016) 164.
[24] Sharrock R *The law of banking and payment in South Africa* (2016) 164.
[25] Sharrock R *The law of banking and payment in South Africa* (2016) 164.
[26] Schulze WG "The bank's right to cancel the contract between it and its customer unilaterally" (2011) 32 *Obiter* 211-223 221.
[27] Section 123(3)(a) of the National Credit Act 34 of 2005.
[28] Section 123(3)(b) of the National Credit Act 34 of 2005.

of credit agreement will, however, remain in effect to the extent necessary until the customer has paid all amounts legally charged to that account.[29]

The NCA does not require reasons to be given for terminating the credit facility and some authors suggest that credit providers may cancel the credit facility without having any reason for doing so.[30] Whenever the NCA is not applicable and no cancellation clause is present, the bank may terminate the overdraft agreement if the customer is in breach of that agreement, provided that the breach is serious enough to warrant cancellation.[31] In this regard, when a bank discovers that its customer is engaging in unlawful activities, it will be entitled to terminate the relationship.[32] However, if the bank unjustifiably terminates the overdraft facility and continues to dishonour the customer's payment instructions, it will amount to a breach of contract on the banks' part and thus the bank will be liable for damages.[33]

2.4 Conduct Standard for Banks

Until recently, banks have been able to terminate the bank-customer relationship on reasonable notice and without having to provide the customer with reasons for such decision.[34] However, the Conduct Standard for Banks, which have been implemented by the Financial Sector Conduct Authority (FSCA), has created a shift in paradigm, since a more stringent procedure is now required before banks can effectively terminate the bank-customer relationship.[35] According to the FSCA's Conduct Standard for Banks, banks are required to:

> "document, adopt and implement processes and procedures relating to the-
> (a) refusal to provide a financial product or financial service to one or more financial customers;

[29] Section 123(4) of the National Credit Act 34 of 2005.
[30] Otto JM & Otto R-L *The National Credit Act explained* (4 ed 2016) para 33.2.
[31] Sharrock R *The law of banking and payment in South Africa* (2016) 164.
[32] Malan FR, Pretorius JT & Du Toit SF *Malan on bills of exchange, cheques and promissory notes in South African law* (2009) 318.
[33] Sharrock R *The law of banking and payment in South Africa* (2016) 150.
[34] *Annex Distribution (Pty) Ltd and Others v Bank of Baroda* 2018 (1) SA 562 (GP). See also *Bredenkamp and Others v Standard Bank of South Africa* 2010 (4) SA 468 SCA.
[35] FSCA "Conduct Standard 3 of 2020", available at https://www.fsca.co.za/Regulatory%20Frameworks/Pages/Standards.aspx (accessed on 14 September 2020).

(b) withdrawal, termination or closure of a financial product or withdrawal or termination of a financial service in respect of one or more financial customers".[36]

Whenever a bank decides to terminate the bank-customer relationship, it is required to provide the customer with reasonable notice of termination and must also provide the customer with reasons for the termination.[37] The exception to this rule is that banks do not have to provide reasonable prior notice or reasons for terminating the bank-customer relationship if:

- the bank is compelled to do so by law; or
- the bank has a reasonable suspicion that the financial product or financial service is being used for any illegal purpose; and
- the bank has made the required reports to the appropriate authority.[38]

The underlying bank-customer contract is also required to make clear provision for the types of circumstances in which the contract may be terminated by the bank.[39]

2.5 The Code of Banking Practice

The Code of Banking Practice 2012 (the Code) is a voluntary code that sets out the minimum standards for service and conduct that customers can expect from their banks. In terms of the Code, a bank will assist its customer to terminate the contract if he no longer requires use of the account.[40] It also stipulates that the bank will not terminate the account without first providing its customer with reasonable prior notice.[41] According to the banking Ombudsman, one to two months for individual accounts and two to three months for business accounts would be considered reasonable, depending on the nature of the accounts and the number and nature of transactions on the account.[42] In terms of the Code, a bank reserves the right to protect

[36] Provision 9(1) of FSCA Conduct Standard 3 of 2020.
[37] Provision 9(2) and 9(3) of FSCA Conduct Standard 3 of 2020.
[38] Provision 9(4) of FSCA Conduct Standard 3 of 2020.
[39] Provision 9(5) of FSCA Conduct Standard 3 of 2020.
[40] The Code of Banking Practice (2012) para 7.3.1.
[41] The Code of Banking Practice (2012) para 7.3.2. Ombudsman for Banking "Bulletin no.3" (15 August 2012) para 2.
[42] Ombudsman for Banking "Bulletin no.3" (15 August 2012) para 4.

its interests in its sole discretion, which might include terminating the account without providing prior notice in the following circumstances:

- if it is compelled to do so by law or international best practice;
- if the account has not been used for a significant period; or
- if a bank has reason to believe that the account holder is using the account for any illicit purposes.[43]

Although the Code is described as the minimum set of standards that customers may expect from their bank's facilities, it is only binding on personal and small business customers.[44]

2.6 Concluding remark

As mentioned above, the duties of a party to the contract of mandate include the duty not to cause damage to the other party. When a party to the contract conducts his business activities in a manner that is likely to cause harm to the other party, that party will be in breach of his duty and the latter may be entitled to cancel the agreement even in the absence of a cancellation clause. The new Conduct Standard for Banks is aimed at protecting financial customers against abuse of power in this regard, as it affords consumers with the right to know the reasons for the bank's decision in terminating the bank-customer relationship. A balanced approach is applied because it also protects the interests of banks by entitling them to terminate relationships without providing reasons under certain instances.

If a customer uses his account for unlawful purposes, that customer will potentially cause damage to the bank's reputation, especially if it attracts negative publicity.[45] In this regard, the bank will be able to protect its interests by terminating the relationship without providing reasons. Case law also confirms that banks are entitled to terminate the bank-customer relationship based on reputational risk, irrespective of whether the negative publicity about a customer is true.[46]

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[43] The Code of Banking Practice (2012) para 7.3.3.
[44] The Code of Banking Practice (2012) para 1.
[45] See *Minister of Finance v Oakbay Investments* 2018 (3) SA 515 (GP).
[46] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639 para 22.

Adequate CDD measures allow a bank to gather quality information on its customer so that the bank can understand who it is doing business with. When a bank knows its customer, it can establish the role of that customer in society. This allows the bank to determine the reputation of the customer involved, to assess if there is any exposure to reputational risk from an AML/CFT point of view. This is of particular importance when dealing with politically exposed persons (PEPs). These persons are normally in a position of power due to their prominent public function and may therefore potentially abuse the powers that are conferred upon them for their own illicit enrichment. Due to the positions that they hold, banks face significant reputational risk when dealing with such customers. The link between reputational risk and CDD is explored in the next chapter in more detail.

Chapter 3:
Reputational risk

3.1 What is reputational risk?

The Basel Committee on Banking Supervision (BCBS) defines reputational risk as:

> "[t]he risk arising from negative perception on the part of customers, counterparties, shareholders, investors, debt-holders, market analysts, other relevant parties or regulators that can adversely affect a bank's ability to maintain existing, or establish new, business relationships and continued access to sources of funding (eg through the interbank or securitisation markets)".[1]

Reputational risk is related mostly to cases of money laundering or insider trading and may also be present for the current and prospective impact on revenue and capital arising from negative public opinion.[2] Adverse publicity involving a bank's business practices and associations, whether or not accurate, may cause a loss of public confidence in the integrity of the bank.[3] The reputational risk for the bank in such an instance represents the potential that borrowers, depositors and investors might stop doing business with the bank due to the bank's association in a money laundering scandal.[4] Reputational risk is therefore described as a "multidimensional" form of risk and ultimately reflects the perception of other market participants.[5] In instances where a bank's customer is publicised in the media for alleged association with unlawful

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[1] BCBS "The Basel framework" (2020) 1073 available at https://www.bis.org/basel_framework/ (accessed on 1 September 2020).

[2] Romero AG "Integrity and good governance - reputation risk in the public sector and financial institutions" 23 *BIS Review* (2003) 5 available at https://www.bis.org/review/r030522e.pdf (accessed on 1 August 2020).

[3] Association of Certified Anti-Money Laundering Specialists (ACAMS) "Study guide CAMS certification exam" 6th ed (2012-2016) 7. See also http://files.acams.org/pdfs/docs/ACAMS_Flasahcards_Printable_Version.pdf 2 (accessed on 1 August 2020).

[4] In *Bredenkamp and Others v Standard bank of SA Ltd* 2010 (4) SA 468 (SCA) para 17 the bank, in support of its decision to terminate the customer's account, argued that if it maintains the relationship with the customer then other market participants might reasonably believe or suspect that accounts held at the bank may be used for unlawful purposes. Such a perception will destruct the bank's reputation in the eyes of regulators and investors.

[5] BCBS "SRP30 Risk management" (2019) para 30.29 available at https://www.bis.org/basel_framework/chapter/SRP/30.htm (accessed on 1 January 2020).

activities, the bank is required to conduct reactive reporting.[6] After such a report has been filed, the Financial Intelligence Centre (FIC) may request information obtained by banks as part of its customer due diligence (CDD).[7] This results in costly information requests and ongoing CDD, which may affect the profitability of the business relationship concerned.[8] Non-compliance with such reporting will, however, result in regulatory sanctions being imposed on the non-compliant bank, which could affect the reputation of the bank involved.[9] Banks often "de-risk" the account of a negatively publicised customer regardless of whether or not the allegations in the media are correct.[10] Accordingly, "[a] party has always had the right to justify a cancellation with objective facts unbeknown to that party at the time when the cancellation took place".[11] The concept of de-risking is discussed in more detail in Chapter 4 below.

The ability of a bank to fund its business and market confidence is intertwined with the reputation of a bank. Therefore, reputational risk may also affect the bank's liabilities.[12] According to the BCBS, reputational risk can result in the provision of implicit support, which may also bring forth other risks, such as credit, liquidity, market and legal risks.[13] All of these risks can negatively impact the bank's revenue, liquidity and capital position.[14] With regard to the prudential risk that may arise from

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[6] Section 29 of the FIC Act. See also FIC "Guidance Note 4B" (2019) para 63 available at https://www.fic.gov.za/Documents/190326_FIC%20Guidance%20Note%2004B.pdf (accessed on 3 March 2020).

[7] Section 32 of the FIC Act.

[8] In *Hlongwane and Others v Absa Bank Limited and Another* (75782/13) [2016] ZAGPPHC 938 (10 November 2016) para 30, the court considered the ongoing compliance costs associated with the relationship of a politically exposed person (PEP). The court held in this regard that the bank had no obligation to maintain a relationship with a customer whose monitoring in terms of money laundering measures put in place would be more onerous when compared with the benefit, in terms of fees, that it would receive from the customer.

[9] Section 45C(2) of the FIC Act. See also Recommendation 13 of the FATF "International standards on combating money laundering and the financing of terrorism & proliferation" (The FATF Recommendations) (2012). In additional to the normal CDD measures in relation to cross-border correspondent banking relationships, the FATF standard requires correspondent banks to gather sufficient information about a respondent bank to understand fully the nature of the respondent's business. It further provides that the correspondent bank should "determine from publicly available information the reputation of the institution and the quality of supervision, including whether it has been subject to a money laundering or terrorist financing investigation or regulatory action". See also https://www.businesslive.co.za/bd/national/2020-09-08-banks-fork-out-r277m-in-fines-for-non-compliance-with-fica-tito-mboweni-says/ (accessed on 24 September 2020).

[10] See *Bredenkamp v Standard Bank* 2010 (4) SA 468 (SCA) para 19.

[11] *Bredenkamp v Standard Bank* 2010 (4) SA 468 (SCA) para 63.

[12] BCBS "SRP30 Risk management" (2019) para 30.30.

[13] BCBS "SRP30 Risk management" (2019) para 30.30. See BCBS "Identification and management of step-in risk" Consultative document (2017) para 1.2.3 available at https://www.bis.org/bcbs/publ/d398.pdf (accessed on 1 May 2020).

[14] BCBS "Enhancements to the Basel II framework" (2009) 19.

reputational risk, the BCBS requires banks to identify potential sources of reputational risk exposure, including the bank's liabilities, off-balance sheet vehicles, business lines, affiliated operations and relevant markets in which it operates.[15] The risks that arise should ultimately be incorporated into the bank's risk management processes and appropriately addressed in both its internal capital adequacy assessment process (ICAAP) and liquidity contingency plans.[16]

Reputational risk furthermore exists throughout the existence of a bank, and exposure to such risk is an essential function of adequate internal risk management processes, including management's reaction to external influences on bank-related transactions.[17]

3.2 Where does customer due diligence fit into reputational risk?

The importance of effective know-your-customer (KYC) controls and procedures within banks have been highlighted since 2001 by the BCBS.[18] According to the BCBS, CDD on both new and existing customers is a vital component of such controls and the inadequacy or absence thereof may cause banks to become subject to reputational, operational, legal and concentration risks.[19] Deficiencies in a bank's anti-money laundering (AML) or counter financing of terrorism (CFT) processes may cause significant prudential consequences.[20] Accordingly, banks are required to have adequate policies and processes in place, including strict CDD rules to promote high

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[15] BCBS "SRP30 Risk management" (2019) para 30.30. See also Regulation 39(3) of the Regulations relating to banks (*GG no. 35950*) 2012 882 available at http://www.treasury.gov.za/legislation/35950_12-12_ReserveBankCV01.pdf (accessed on 4 May 2020).

[16] BCBS "SRP30 Risk management" (2019) para 30.30. See also South African Reserve Bank (SARB) Guidance note 4 of 2015 (G4/2015) para 3.8.2 available at https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/6837/G4%20of%202015.pdf (accessed on 4 May 2020).

[17] BCBS "SRP30 Risk management" (2019) para 30.29.

[18] BCBS "Customer due diligence for banks" (2001) para 1 available at https://www.bis.org/publ/bcbs85.pdf.

[19] BCBS "Customer due diligence for banks" (2001) para 10 available at https://www.bis.org/publ/bcbs85.pdf (accessed on 6 May 2020). See also BCBS "Guidelines for sound management of risks related to money laundering and financing of terrorism" (2014 revised 2020) 2 available at https://www.bis.org/bcbs/publ/d505.pdf (accessed on 6 May 2020).

[20] BCBS "Guidelines for sound management of risks related to money laundering and financing of terrorism" (2014) 46, the BCBS indicates that AML/CFT deficiencies could potentially result in significant regulatory actions and criminal sanctions that may lead to reputational damage affecting the bank's depositor outflows, loss of counterparties or loss of market access, including loss of correspondent banking relationships. Furthermore, failures in AML/CFT may also lead to the revocation of a banking licence or termination of deposit insurance in some countries.

ethical and professional standards in the banking sector to prevent it from being used for illicit purposes.[21] In this regard, the BCBS notes that "[t]his requirement is to be seen as a specific part of banks' general obligation to have sound risk management programmes in place to address *all kinds of risks*, including ML and FT risks".[22]

The banks in South Africa are required to use their CDD processes as one of their measures to mitigate ML/TF risks that are associated with a proposed business relationship or single transaction.[23] The CDD process provides a bank with the information required to satisfactorily know who it is doing business with, to know who benefits from the business it does with its customers, to understand the nature of the business it does with its customers and to determine when the business with customers should be considered unusual or suspicious.[24]

3.3 The FATF Standard

The CDD standard as set out in the FIC Act was adopted from the standard developed by the Financial Action Task Force (FATF), which is an "independent inter-governmental body that develops and promotes policies to protect the global financial system against money laundering, terrorist financing and the financing of proliferation of weapons of mass destruction".[25] The recommendations made by the FATF is recognised as the global AML/CFT standard.[26] South Africa is the only African member of the FATF.[27]

The risk-based approach (RBA) is essential to the effective implementation of the FATF framework, since it encourages member countries to adopt a more flexible set of CDD measures, thereby effectively moving away from the "rules-based"

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[21] BCBS "Core principles for effective banking supervision" (2012) principle 29 13 available at https://www.bis.org/publ/bcbs230.pdf (accessed on 8 May 2020).
[22] BCBS "Guidelines for sound management of risks related to money laundering and financing of terrorism" (2014) 4 (emphasis added).
[23] FIC "Guidance note 7" (2017) 26 available at https://www.fic.gov.za/Documents/171002_FIC%20Guidance%20Note%2007.pdf (accessed on 9 May 2020).
[24] FIC "Guidance note 7" (2017) 26.
[25] FATF "The FATF recommendations" (2012) 6.
[26] FATF "The FATF recommendations" (2012) 1.
[27] See https://www.fic.gov.za/International/FATF/Pages/FATF.aspx#:~:text=Style%20Regional%20Bodies-,FATF,is%20the%20only%20African%20member.&text=South%20Africa%2C%20together%20with%20the,of%20the%20FATF%20since%202003 (accessed on 1 June 2020).

approach.[28] Through the utilisation of a RBA, banks are able to target their resources in accordance with the relevant degree of risk associated with a particular customer's business relationship. In this regard, where a country identifies higher risks, it should ensure that its AML/CFT regime addresses these risks effectively and proportionately.[29] Where countries identify lower risks, they may decide to implement simplified measures.[30]

Banks in countries that fall within the FATF framework are prohibited from keeping anonymous accounts or accounts in fictitious names.[31] Banks in member countries are therefore required to implement CDD through law or other enforceable means.[32] CDD measures should be undertaken when banks establish business relations or perform transactions above the applicable designated threshold.[33] Furthermore, banks should be required to undertake CDD when there is a suspicion of ML/TF.[34] Lastly, banks should undertake CDD when they have doubts about the veracity or adequacy of previously obtained customer identification data.[35]

This FATF standard places a duty on member countries in terms of which the banks in such countries are required to comply with the following:

First, banks should have a system in place that can effectively identify their customers and verify customer details by using independent source documents, data or information.[36] Second, banks should be able to identify the beneficial owner and take reasonable measures to verify the identity of the beneficial owner so that the bank knows who it is doing business with.[37] For legal entities and similar arrangements, banks are also required to understand the ownership and control structure of such customers.[38]

Third, banks are required to obtain information describing the purpose and intended nature of the business relationship concerned, to formulate a clear

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[28] FATF "Guidance for a risk-based approach – The banking sector" (2014) 3 available at https://www.fatf-gafi.org/documents/riskbasedapproach/documents/risk-based-approach-banking-sector.html?hf=10&b=0&s=desc(fatf_releasedate) (accessed on 4 June 2020).
[29] FATF "The FATF recommendations" (2012) 9.
[30] FATF "The FATF recommendations" (2012) 9.
[31] FATF "The FATF recommendations" (2012) 12.
[32] FATF "The FATF recommendations" (2012) 12.
[33] FATF "The FATF recommendations" (2012) 12.
[34] FATF "The FATF recommendations" (2012) 12.
[35] FATF "The FATF recommendations" 2012 12.
[36] FATF "The FATF recommendations" 2012 12.
[37] FATF "The FATF recommendations" 2012 12.
[38] FATF "The FATF recommendations" 2012 12.

understanding of the underlying relationship.[39] Fourth, banks should conduct ongoing due diligence on the business relationship and should further scrutinise transactions that are undertaken throughout the course of the bank-customer relationship to ensure that transactions are conducted consistent with the bank's knowledge of the customer, their business and risk profile, and the source of funds used during the relationship.[40]

Banks need to apply each of these measures using the risk-based approach.[41] Whenever a bank is unable to comply with these four requirements, it should terminate the relationship with the customer and may not open an account for the customer.[42]

3.4 Financial Intelligence Centre Act – Customer due diligence

Under the domestic laws of South Africa, the CDD standard as set out above has been entrenched in the FIC Act. The FIC Act was enacted to assist in the:

- identification of the proceeds of illegal activities;
- combating of money laundering activities and the financing of terrorist and related activities; and
- implementation of financial sanctions pursuant to resolutions adopted by the Security Council of the United Nations.[43]

The FIC Act imposes compulsory obligations on banks as accountable institutions, due to the fact that banks may potentially be abused for money-laundering or terrorism financing purposes.[44] Accordingly, banks need to comprehend their exposure to ML/TF risks. By understanding and managing these risks, banks not only protect and maintain the integrity of their businesses but also promote the integrity of the South African financial system as a whole.[45] To address these risks, banks are required *inter alia* to apply a RBA when carrying out CDD as set out below.[46]

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[39] FATF "The FATF recommendations" (2012) 12.
[40] FATF "The FATF recommendations" (2012) 12.
[41] FATF "The FATF recommendations" (2012) 13.
[42] FATF "The FATF recommendations" (2012) 13.
[43] Preamble to the FIC Act.
[44] See sections 20A, 21, 21A-H, 22, 22A, 23, 27, 28, 28A, 29, 30, 31 and 32 of the FIC Act for a list of regulatory requirements to which banks need to adhere.
[45] Financial Intelligence Centre "Guidance note 7" (2017) 6.
[46] Financial Intelligence Centre "Guidance note 7" (2017) 9.

3.4.1 Anonymous customers

Banks may not establish business relationships or conclude a single transaction with anonymous customers or customers with false or fictitious names.[47] Instead, banks need to obtain specified information from the customer, such as the customer's name, identification number and contact details, during its customer onboarding process.[48] The manner in which banks comply with this provision must be recorded in their risk management and compliance programme (RMCP).[49]

3.4.2 Establishment and verification of identities

Banks are required to both establish and verify the identity of a customer who wants to enter into a business relationship or conclude a single transaction with it.[50] When a customer is acting on behalf of another person, the bank is required to establish and verify the identity of that other person and the customer's authority to act on behalf of that other person.[51] If a bank finds itself in a position whereby another person is acting on behalf of one of the bank's customers, the bank must establish and verify both the identity of that other person and that other person's authority to act on behalf of the bank's customer.[52] A natural person's identity can be determined by requesting the person's full names, date of birth and unique identification number issued by the government.[53] Verification methods should be conducted by using original source data that can be obtained from a reliable and independent third-party source.[54] After applying this process, banks should have an adequate level of confidence in that it knows who the customer is in accordance with the bank's risk assessment pertaining to that customer engagement.[55]

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[47] Section 20A of the FIC Act. See also recommendation 13 of FATF "The FATF recommendations" (2012).
[48] Financial Intelligence Centre "Guidance note 7" (2017) 30.
[49] Section 42(2)(c) of the FIC Act.
[50] Section 21(1)(a) of the FIC Act. See also recommendation 10 of FATF "The FATF recommendations" (2012).
[51] Section 21(1)(b) of the FIC Act.
[52] Section 21(1)(c) of the FIC Act.
[53] Financial Intelligence Centre "Guidance note 7" (2017) paras 85 and 86.
[54] Financial Intelligence Centre "Guidance note 7" (2017) para 87.
[55] Financial Intelligence Centre "Guidance note 7" (2017) para 82.

3.4.3 Obtaining information

Banks are required to collect information from a prospective customer who wants to establish a business relationship so that the bank can determine whether future transactions that will be performed in the course of that business relationship correspond with its knowledge of the customer's business affairs.[56] The information that should be collected in this regard include information that can adequately describe:

- the nature of the business relationship concerned;[57]
- the intended purpose of the business relationship concerned;[58] and
- the source of the funds that the prospective customer expects to use in performing transactions during the bank-customer relationship.[59]

Compliance with this provision should result in banks being able to view the frequency and the nature of transactions that could be expected to be performed during the normal course of the customer's business.[60] The manner in which the banks comply with this provision must also be recorded in their RMCP.[61] A failure on the part of a bank to comply with the abovementioned due diligence requirements will affect its status as non-compliant and could result in an administrative sanction against the bank.[62]

3.4.4 Corporate vehicles

When the customer is a corporate vehicle, additional due diligence is required for purposes of establishing and verifying the identities of such customers. In this regard, banks need to establish the nature of the customer's business and the ownership and control structure of the customer.[63] The bank is also required to establish the identity of the beneficial owner of the corporate vehicle by determining the identity of each

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[56] Section 21A of the FIC Act.
[57] According to FIC "Guidance note 7" (2017) para 124: "the purpose and intended nature of the business relationship will be self-evident given the nature of the product or service that the client is requesting". See also section 21A(a) of the FIC Act.
[58] Section 21A(b) of the FIC Act.
[59] Section 21A(c) of the FIC Act.
[60] FIC "Guidance note 7" (2017) para 123.
[61] Section 42(2)(e) of the FIC Act.
[62] Section 46A of the FIC Act.
[63] Section 21B(1) of the FIC Act.

natural person who, independently or together with another person, has a controlling ownership interest in that corporate vehicle.[64] When banks are unable to establish the identity of the beneficial owner of the legal person or if there is no natural person with a controlling ownership interest, the bank must determine the identity of every single natural person who exercises control over the legal person through other means.[65] If a bank is unable to determine this, it should establish the identity of the beneficial owner by determining the identity of each natural person who exercises control over the management of the legal person.[66] This is also described as a process of "elimination" that banks must follow to determine the beneficial owner of a particular legal person.[67] Attributes that can adequately describe a juristic person's identity include:

- the name under which the juristic person has been incorporated and its registration number;
- the trading name of the entity if it is different from the name under which it has been incorporated;
- the type of legal entity, for instance a company or close corporation;
- the address of its registered office;
- income tax and value added tax numbers, et cetera.[68]

The verification of a legal person's identity should be completed by using information that are controlled or created by public sector institutions, such as the Companies and Intellectual Property Commission (CIPC).[69] The process used by a bank to conduct such CDD must also be described in its RMCP.[70]

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[64] Section 21B(2)(i) of the FIC Act. According to FIC "Guidance note 7" (2017) glossary, a "controlling ownership interest" is described as the ability by virtue of voting rights attached to share holdings to take relevant decisions within the entity and impose those resolutions.
[65] Section 21B(2)(ii) of the FIC Act. FIC "Guidance note 7" (2017) para 103 provides an example of exercising control through "other means", which includes, persons exercising control through voting rights attaching to different classes of shares or through shareholders agreements.
[66] Section 21B(2)(iii) of the FIC Act.
[67] FIC "Guidance note 7" (2017) para 103.
[68] FIC "Guidance note 7" (2017) paras 98 and 99.
[69] Section 21B(2)(b) of the FIC Act. See FIC "Guidance note 7" (2017) para 100.
[70] Section 42(2)(f) of the FIC Act.

When the customer is a partnership, the starting point for banks is to establish whether the partnership is identified by a unique name or description.[71] Once this information has been established, banks should take reasonable steps to verify it.[72] The partnership agreement, which establishes the partnership and governs its functioning and membership, can be used to fulfil this purpose.[73] The measures that banks use to verify the identities of partnerships must be described in their RMCP.[74]

When the customer is an *inter vivos* trust (a trust created during the lifetime of a person), banks are required to establish the unique reference number identifying the trust in the Master's Office and the address of the Master of the High Court where the trust is registered, as part of the due diligence requirements describing the identity of the trust.[75] Once established, the bank should verify such information.[76] The primary source of confirmation for this information is the trust deed and the information controlled by the relevant offices of the Master of the High Court.[77] The provision of the FIC Act relating to trusts further require banks to establish:[78]

- the identity of each trustee;
- the identity of each person who purports to be authorised to act on behalf of the trust when entering into a business relationship or concluding a single transaction with the bank;
- the identity of the founder; and
- the identity of each beneficiary mentioned in the trust deed or founding instrument in terms of which the trust is created.

After establishing all relevant identities as mentioned above, the bank must also embark on a verification process.[79] The different measures that a bank uses to verify the identities of trusts must be described in its RMCP.[80]

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[71] Section 21B(3) of the FIC Act. See FIC "Guidance note 7" (2017) para 106.
[72] Section 21B(3)(e) of the FIC Act.
[73] FIC "Guidance note 7" (2017) para 106.
[74] Section 42(2)(f) of the FIC Act.
[75] Section 21B(4) of the FIC Act. See also FIC "Guidance note 7" (2017) paras 111-114.
[76] Section 21B(4) of the FIC Act.
[77] FIC "Guidance note 7" (2017) para 116.
[78] Section 21B(4) of the FIC Act. See FIC "Guidance note 7" (2017) para 117.
[79] Section 21B(4) of the FIC Act.
[80] Section 42(2)(f) and (j) of the FIC Act.

3.4.5 Ongoing due diligence

Throughout the course of the bank-customer relationship, banks need to identify the activities performed by their customers that are likely to involve the exploitation of the facilities for illicit purposes.[81] As such, banks need to embark on a process known as "ongoing due diligence". Accordingly, banks need to monitor the source of funds of their customers to determine whether the transactional activities correspond with the bank's knowledge of the business and risk profile of the customer involved.[82] Banks need to unveil the background of all unusually large transactions, including complex transactions that have unusual patterns with no apparent commercial or lawful purpose.[83] The degree of ML/TF risk associated with the customer's relationship with the bank will ultimately dictate the intensity and frequency of the required ongoing CDD in accordance with the RBA.[84] In this regard, the bank must include in its RMCP the manner in which it will examine the transactional activity as stipulated above, and how it will keep the written findings thereof.[85]

3.4.6 Doubts about the veracity of previously obtained information

If a bank discovers any inadequacies in terms of previously obtained information, the bank must repeat the steps laid out above,[86] and the steps taken need to be in accordance with the bank's RMCP to the extent that it is necessary to confirm the information in question.[87] The manner in and process by which the bank conducts subsequent information requests and checks should also be documented in its RMCP.[88]

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[81] FIC "Draft guidance on the implementation of new measures to be introduced by the Financial Intelligence Centre Amendment Act" (2017) 68 available at https://www.fic.gov.za/Documents/DRAFT%20GUIDANCE%20ON%20THE%20IMPLEMENTATION%20OF%20THE%20AMENDMENT%20ACT%20as%20of%2014%20June%202017.pdf (assessed on 1 May 2019).
[82] Section 21C(a)(i) of the FIC Act.
[83] Section 21C(a)(ii) of the FIC Act. See also sections 21, 21A and 21B of the FIC Act.
[84] FIC "Guidance Note 7" (2017) para 129.
[85] Sections 42(2)(g) and (h) of the FIC Act. See FIC "Guidance Note 7" (2017) para 129.
[86] Sections 21 and 21B of the FIC Act.
[87] Section 21D of the FIC Act.
[88] Section 42(2)(i) of the FIC Act.

3.4.7 Terminating accounts based on the inability to apply customer due diligence measures as set out above

Banks are prohibited from entering into or maintaining business relationships or concluding single transactions if they are unable to perform the required CDD as set out above,[89] and should consider making a suspicious transaction report (STR) or suspicious activity report (SAR) to the FIC.[90] This provision ultimately allows banks to mitigate the risks involved in the bank-customer relationship. This process should, however, only be used as a measure of las resort where a bank has reached a conclusion that ML/TD risks cannot be mitigated adequately or effectively.[91] This aspect will be expanded upon in Chapter 4 below.

3.4.8 Reputational risk of politically exposed persons and customer due diligence

The FIC Act provides detailed provisions on the due diligence required when banks deal with foreign prominent public officials (FPPO) or domestic prominent influential persons (DPIP), including such persons' family members and known close associates.[92] When dealing with these persons, banks may be subject to significant reputational and legal risks.[93] Internationally, these individuals are categorised as politically exposed persons (PEPs) and are defined as persons who are or have been entrusted with prominent public functions, including heads of state or of government, senior politicians, senior government, judicial or military officials, senior executives of publicly owned corporations and important political party officials.[94] In countries such as South Africa, where corruption is widespread, there is a high risk that PEPs might abuse their public powers for their own illicit enrichment through the receipt of bribes, embezzlement and other means.[95] These individuals may also use their families or close associates to conceal funds or assets that have been misappropriated as a result of the abuse of their official position or otherwise resulting from bribery and

[89] Sections 21, 21A, 21B or 21C of the FIC Act.
[90] Sections 21E and 29 of the FIC Act. See FIC "Guidance Note 7" (2017) para 134.
[91] FIC "Guidance Note 7" (2017) para 70.
[92] Sections 21F 21G and 21H of the FIC Act.
[93] BCBS "Customer Due Diligence for Banks" (2001) para 41.
[94] BCBS "Customer Due Diligence for Banks" (2001) para 41. See Schedule 3A and 3B of the FIC Act for a list of domestic prominent influential persons and foreign prominent public officials.
[95] BCBS "Customer Due Diligence for Banks" (2001) para 41.

corruption.[96] In addition, they may also abuse their power and influence to gain representation and access to, or control of, legal entities for similar arrangements.[97]

Accepting and managing funds from corrupt PEPs could tarnish a bank's own reputation and could undermine public confidence in the global standards.[98] Banks may be subject to costly information requests and seizure orders from various law enforcement or judicial authorities and could also be liable to actions for damages by the state concerned or the victims of a regime.[99]

In this regard, the FATF has developed an international standard with particular attention to PEPs, which have also been incorporated in the FIC Act.[100] Accordingly, a distinction is made between foreign prominent public officials and domestic prominent influential persons. When dealing with these persons, banks must obtain senior management approval for establishing the business relationship.[101] Banks must also take "reasonable measures" to establish the source of funds and source of wealth of such customers.[102] Establishing the source of wealth requires an examination of the activities that generated the total net worth of such a customer.[103] When a bank however determines the source of funds, it should assess the origin and the means of transfer for funds involved in a transaction.[104]

Banks are also required to conduct enhanced ongoing monitoring of the business relationship concerned.[105] Important to note is that a domestic prominent influential person is not automatically regarded as a high risk customer, whereas a relationship with a foreign prominent public official is automatically regarded as high risk.[106] When dealing with DPIPs, banks must first consider each relationship on its own merits in order to determine whether there is any reason to conclude that the relationship bears

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[96] See sections 21F, 21G and 21H of the FIC Act. The term "families" includes close family members such as spouses, children, parents and siblings and may also include other blood relatives and relatives by marriage according to the FIC's website https://www.fic.gov.za/Pages/FAQ.aspx?p=3.
[97] The Wolfsberg Group "Wolfsberg Guidance on Politically Exposed Persons (PEPs)" (2017) 2 available at https://www.wolfsberg-principles.com/sites/default/files/wb/pdfs/wolfsberg-standards/4.%20Wolfsberg-Guidance-on-PEPs-May-2017.pdf.
[98] BCBS "Customer Due Diligence for Banks" (2001) para 42.
[99] BCBS "Customer Due Diligence for Banks" (2001) para 42.
[100] FATF "The FATF Recommendations" (2012) 14.
[101] Sections 21F(a) and 21G(a) of the FIC Act.
[102] Sections 21F(b) and 21G(b) of the FIC Act.
[103] FIC "Guidance Note 7" (2017) para 145.
[104] FIC "Guidance Note 7" (2017) para 145.
[105] Sections 21F(b) and 21G(b) of the FIC Act.
[106] See the insertion of "and that…the prospective business relationship entails higher risk" in section 21G of the FIC Act. See FATF Recommendation 12 "FATF Recommendations" (2012) 14.

a higher risk of abuse for money laundering and terrorist financing purposes.[107] If the bank has determined that the relationship with the DPIP is high risk, the bank should then apply the enhanced due diligence measures as required.[108]

In practice, banks are likely to apply enhanced due diligence on DPIPs regardless of the particular customer's ML/TF risk rating.[109] In practice, banks might also fail to establish that a prospective customer is a DPIP or a family member or known associate of such DPIP due to limited or outdated information in the public domain.[110] However, reputational risk may be addressed proactively if banks are aware of each and every account that is held by a DPIP or FPPO at its institution.

The current approach in South Africa is that banks are required to consult commercially available sources of information to determine whether a particular person occupies a public function.[111] This exercise, however, will not provide the bank with automatic indemnity from regulatory action regarding compliance with these requirements.[112] A bank could also, as part of its customer-onboarding process, incorporate a clause in the bank-customer agreement that requires DPIPs or FPIPs to disclose the fact that they are or have recently become a DPIP or FPIP, or a family member or close associate of such a person. According to the FIC and the Wolfsberg Group, the question whether a customer or beneficial owner involved in the business relationship performs a political function should form part of the standardised account opening process, especially in cases of customers from corruption prone countries.[113]

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[107] FIC "Guidance note 7" (2017) para 139.
[108] FIC "Guidance note 7" (2017) para 139.
[109] Greenberg S and Gray L "Politically Exposed Persons: A policy paper on strengthening preventative measures" (2009) 15 available at https://www.un.org/ruleoflaw/files/Politically%20Exposed%20Persons%20A%20Policy%20Paper%20on%20Strengthening%20Preventive%20Measures.pdf (accessed on 5 August 2020).
[110] FATF "Guidance on Politically Exposed Persons (PEPs)" (2013) para 60 available at https://www.fatf-gafi.org/media/fatf/documents/recommendations/Guidance-PEP-Rec12-22.pdf (accessed on 16 August 2020). See also BCBS "Customer due diligence for banks" (2001) 13 fn 16, which states in this regard that:

> "PEPs (or rather their family members and friends) would not necessarily present themselves in that capacity, but rather as ordinary (albeit wealthy) business people, *masking the fact they owe their high position in a legitimate business corporation only to their privileged relation with the holder of the public office*" (emphasis added).

[111] FIC "Draft guidance on the implementation of new measures to be introduced by the Financial Intelligence Centre Amendment Act" (2017) para 35.
[112] FIC "Guidance note 7" (2017) para 151.
[113] The Wolfsberg Group "Wolfsberg guidance on politically exposed persons (PEPs)" (2017) 5. See also FIC "Frequently asked questions" Q26 available at https://www.fic.gov.za/Pages/FAQ.aspx?p=3 (accessed on 17 August 2020).

In this regard, if a bank were to incorporate a clause in its bank-customer agreement as part of its customer onboarding process, any failure on the part of the customer to disclose such information will result in a breach of contract. This will entitle the bank to both cancel the agreement and institute the *actio legis Aquiliae*, provided that the bank's reputation was harmed due to the customer's non-disclosure.[114]

In line with the RBA, banks are required to allocate more resources when dealing with PEPs due to the higher degree of risk present in such a relationship.[115] The allocation of additional resources and ongoing due diligence could reduce the profitability of the business relationship concerned. If banks, however, reach a particular stage in the business relationship where the ongoing compliance costs of a customer outweigh the benefit that the bank receives from the customer, the bank is entitled to make an appropriate business decision by terminating the relationship.[116] The courts in South Africa recognise that banks operate in highly regulated markets, both domestically and internationally. Hence, the courts are reluctant to second-guess a bank's decision to exit the relationship with a particular customer due to the reputational risk concerned.[117]

3.5 Concluding remark

Adequate CDD processes allow a bank to formulate a clear understanding of the underlying business relationship. The information that a bank obtains as part of its CDD process may be used to establish the reputation of a customer. Once a customer's reputation is established, the bank can adequately determine whether there is a likelihood of exposure to reputational risk in the bank-customer relationship. Ongoing CDD and information requests by law enforcement results in higher compliance costs that may affect the profitability of the business relationship

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[114] See *Media 24 Ltd v SA Taxi Securitisation (Pty) Ltd* 2011 5 SA 329 (SCA).
[115] See in general FATF "Guidance for a risk-based approach: The banking sector" (2014) available at http://www.fatf-gafi.org/media/fatf/documents/reports/Risk-Based-Approach-Banking-Sector.pdf (accessed on 18 August 2020).
[116] *Hlongwane and Others v Absa Bank Limited and Another* (75782/13) [2016] ZAGPPHC 938 (10 November 2016).
[117] *Annex Distribution (Pty) Ltd and Others v Bank of Baroda* 2018 (1) SA 562 (GP) para 22. See *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 65. See also De Koker L, Singh S and Capal J "Closure of bank accounts of remittance service providers: global challenges and community perspectives in Australia" *University of Queensland Law Journal* (2017) 36(1) 119-154 137 available at http://www.austlii.edu.au/au/journals/UQLawJl/2017/6.pdf (accessed on 18 August 2020).

concerned. In this regard, a bank usually terminates the bank-customer relationship as it is the most appropriate business decision available.[118]

Information obtained by a bank as part of its CDD process, may be shared with a financial intelligence unit (FIU), provided that the bank reported suspicious or unusual transactions, or cash deposits or withdrawals above the designated threshold.[119] The FIU may then make that information available to law enforcement agencies upon request.[120] Of particular concern, however, is that there is no process currently in place that can trace the information that was shared to review how many of the matters ultimately reach the courts and results in successful prosecutions, preservation orders and recoveries.[121] Such a mechanism may potentially assist a bank to make rational and timeous de-risking business decisions and will promote transparency in the South African financial system.

[118] See *Hlongwane and Others v Absa Bank Limited and Another* (75782/13) [2016] ZAGPPHC 938 (10 November 2016).
[119] Section 32 of the FIC Act.
[120] Section 40 of the FIC Act.
[121] See Budhram T "Intelligence-led policing: A proactive approach to combating corruption" (2015) *SA Crime Quarterly* 52 53.

Chapter 4:
"De-risking"

4.1 Introduction

The FATF describes "de-risking" as a phenomenon whereby financial institutions terminate business relationships with customers or categories of customers to evade, rather than manage, risks in line with the RBA.[1] De-risking may cover a set of actions on the part of banks to effectively avert the business and reputational risks altogether.[2] De-risking can ultimately be the result of various drivers, such as a bank's concern about its profitability, prudential requirements, anxiety after the global financial crisis and/or reputational risk.[3]

4.2 Regulatory action as a source of reputational risk and driver of de-risking

Regulatory actions against a bank and its reputation play a vital role in correspondent banking relationships.[4] The Bank for International Settlements (BIS) notes that correspondent banking is a vital component of the global financial system, especially for cross border transactions.[5] Correspondent banking relationships allow a bank to access financial products and services in different jurisdictions.[6] This relationship provides cross-border payment services to the customers of a bank, thereby supporting financial inclusion and international trade.[7]

Certain banks in South Africa operate globally and require correspondent banking relationships to provide cross-border payment services.[8] These banks need

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[1] FATF "Clarifies risk-based approach case-by-case, not wholesale de-risking" (2014), available at http://www.fatf-gafi.org/documents/news/rbaand-de-risking.html (accessed on 18 August 2020).
[2] IMF Staff discussion note" The withdrawal of Correspondent Banking Relationships: A case for policy action" (2016) 7.
[3] FATF "Clarifies risk-based approach case-by-case, not wholesale de-risking" (2014).
[4] Recommendation 13 of the "FATF Recommendations" (2012) 14.
[5] BIS Committee on Payments and Market Infrastructures "Correspondent banking" (2016) para 1 available at https://www.bis.org/cpmi/publ/d147.pdf (accessed on 1 September 2020).
[6] BIS Committee on Payments and Market Infrastructures "Correspondent banking" (2016) para 1 available at https://www.bis.org/cpmi/publ/d147.pdf (accessed on 1 September 2020).
[7] BIS Committee on Payments and Market Infrastructures "Correspondent banking" (2016) para 1 available at https://www.bis.org/cpmi/publ/d147.pdf (accessed on 1 September 2020).
[8] BIS "The payment system in South Africa" para 4.2 available at https://www.bis.org/cpmi/paysys/southafrica.pdf (accessed on 1 September 2020).

to comply with AML/CFT requirements, anti-bribery and tax evasion laws, both applicable in the jurisdictions in which they operate and those in their home jurisdictions.[9] These banks fund their business activities by borrowing money, especially foreign currencies, from other international banks.[10] Due to the global reach of international standards, such as those of the FATF and BCBS, international lenders are likely to include a covenant in their loan agreements requiring both parties to comply with all applicable AML and anti-corruption laws.[11] Any failure to comply with the relevant laws would not only render all loans immediately due and payable, but will also entitle the prejudiced party to terminate the correspondent bank-customer relationship due to the materiality of such breach.[12] To mitigate potential regulatory actions and reputational damage, correspondent banks have recently been cutting back services for respondent banks that offer products or services or have customers that pose a higher risk for AML/CFT, as these relationships are often more difficult to manage.[13] The IMF notes that one of the main drivers for termination of correspondent banking relationships in the United States (US) was due to a conflict of regulations arising from data privacy constrains on cross border information sharing.[14] This ultimately prevented banks in the US from undertaking the needed due diligence with their foreign bank customers.[15]

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[9] Annex distribution v Bank of Baroda 2018 (1) SA 562 (GP) para 38, the bank confirmed this position by stating that:

> "the bank operates in more than 25 countries. Accordingly, any transaction conducted by any branch of the bank in any jurisdiction internationally, is a transaction conducted by the bank and attributable to it in every jurisdiction".

See IMF Staff discussion note The withdrawal of Correspondent Banking Relationships: A case for policy action" (2016) 7.

[10] Financial Stability Board (FSB) "Enhancing cross-border payments: Stage 1 report to the G20: Technical background report" (2020) 7.

[11] *Minister of Finance v Oakbay Investments* case no 80978/2016 "The explanatory supporting affidavit of Standard Bank (2016) para 70. See FATF "Guidance on correspondent banking services" (2016) 4 available at http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-Correspondent-Banking-Services.pdf (accessed on 2 September 2020).

[12] *Minister of Finance v Oakbay Investments* case no 80978/2016 "The explanatory supporting affidavit of Standard Bank (2016) para 70. See FATF "Guidance on correspondent banking services" (2016) 4.

[13] BIS Committee on Payment and market infrastructures "Correspondent banking" (2016) 1. See Financial Stability Board (FSB) "FSB action plan to assess and address the decline in correspondent banking – Progress report" (2019) 15 available at https://www.fsb.org/wp-content/uploads/P290519-1.pdf (accessed on 2 September 2020).

[14] IMF "Recent trends in correspondent banking relationships – further considerations" (2017) para 25 available at https://www.imf.org/en/Publications/Policy-Papers/Issues/2017/04/21/recent-trends-in-correspondent-banking-relationships-further-considerations (accessed on 3 September 2020).

[15] IMF "Recent trends in correspondent banking relationships – further considerations" (2017) para 25 available at https://www.imf.org/en/Publications/Policy-Papers/Issues/2017/04/21/recent-trends-in-correspondent-banking-relationships-further-considerations (accessed on 3 September 2020).

The United Kingdom's Financial Conduct Authority (UKFCA) notes that international banks have removed bank accounts or services from customers that pose higher money laundering risks.[16] The UKFCA shows that the termination of correspondent banking relationships is largely attributable to the increasing overall cost of regulatory compliance.[17] According to the IMF Staff Note, the effective implementation of customer due diligence procedures may also be leading banks to terminate correspondent banking relationships in order to comply with targeted financial sanctions.[18]

The Eastern and Southern Africa Anti-money Laundering Group (ESAAMLG) conducted a survey whereby the group have identified certain key factors that ultimately led to the termination of bank-customer relationships in the ESAAMLG region.[19] These factors include incomplete customer due diligence (CDD) and customer concerns, including the inability to identify the beneficial owner or interested party, payment transparency and source of funds/wealth.[20] Also, the main reason driving terminations by the banking sector was found to be the need to conform to regulatory obligations so as to avoid sanctions and reputational damage.[21]

The Financial Intelligence Centre in South Africa notes that de-risking poses a threat to financial integrity and may give rise to financial exclusion risk and reputational risk.[22] Also, the FATF submits that de-risking may introduce risk and opacity in the global financial system, as the termination of accounts may potentially force customers into less regulated or unregulated spheres.[23]

The ongoing decline in correspondent banking relationships may have serious prudential consequences for a bank if it is unable to access foreign markets due to the

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[16] Artingstall D, Dove N and Levi M "Drivers and impacts of de-risking - A study of representative views and data in the UK, by John Howell & Co. Ltd. for the Financial Conduct Authority" (2016) 5 available at https://www.fca.org.uk/publication/research/drivers-impacts-of-derisking.pdf (accessed on 3 September 2020).
[17] Artingstall D, Dove N and Levi M "Drivers and impacts of de-risking - A study of representative views and data in the UK, by John Howell & Co. Ltd. for the Financial Conduct Authority" (2016) 8.
[18] IMF Staff discussion note" The withdrawal of Correspondent Banking Relationships: A case for policy action" (2016) 22.
[19] ESAAMLG "Report of the survey to assess the existence, causes and impact of de-risking within the Eastern and Southern Africa anti-money laundering group (ESAAMLG) region" (2017) available at https://esaamlg.org/reports/ESAAMLG_survey_reports_on_de%20_risking.pdf.
[20] ESAAMLG "Report of the survey to assess the existence, causes and impact of de-risking within the Eastern and Southern Africa anti-money laundering group (ESAAMLG) region" (2017) 32.
[21] ESAAMLG "Report of the survey to assess the existence, causes and impact of de-risking within the Eastern and Southern Africa anti-money laundering group (ESAAMLG) region" (2017) 10.
[22] FIC "Guidance note 7" (2017) paras 65-70.
[23] FATF "Clarifies risk-based approach case-by-case, not wholesale de-risking" (2014).

closure of the local bank's account. When a local bank forms part of a large financial conglomerate, or is highly interconnected, and relies on foreign markets as part of its usual business activities, the closure of the local bank's account may potentially result in systemic risk for South Africa

4.3 De-risking as a potential source for systemic risk

The termination of correspondent banking relationships based on perceived non-compliance with relevant AML/CFT laws, may have a material effect on financial stability in South Africa. Both the IMF and FSB note that the effect of the withdrawal of correspondent banking relationships may become systemic in nature if left unaddressed.[24] Systemic risk is described as the impairment of the overall functioning of the financial system which is triggered by the failure or malfunction of one or more key market components.[25] A more detailed and comprehensive definition of systemic risk was given by the G10 in 2001, which defined it as:

> "the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy." [26]

The withdrawal of correspondent banking relationships causes a decline in the business accounts that are held at international financial institutions, leading to concentration in cross-border payment markets.[27] Banks are dependent on cross-border payment and clearing providers, and a high degree of interdependency in any market creates the potential for systemic risk.[28] Any failure or malfunction in a systemic important entity can cause widespread distress, which could trigger broader contagion

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[24] IMF Staff discussion note" The withdrawal of Correspondent Banking Relationships: A case for policy action" (2016) 6. See FSB "Report to the G20 on actions taken to assess and address the decline in correspondent banking" (2015) 1 available at https://www.fsb.org/wp-content/uploads/Correspondent-banking-report-to-G20-Summit.pdf (accessed on 8 September 2020).

[25]IMF Staff discussion note" The withdrawal of Correspondent Banking Relationships: A case for policy action" (2016) 6. See FSB "Report to the G20 on actions taken to assess and address the decline in correspondent banking" (2015) 1.

[26] Group of 10 "Report on consolidation in the financial sector" (2001) 126 available at https://www.imf.org/external/np/g10/2001/01/Eng/pdf/file1.pdf (accessed on 1 May 2019).

[27] World Bank Group "The Decline in Access to Correspondent Banking Services in Emerging Markets: Trends, Impacts, and Solutions" (2018) para 3.5 available at http://pubdocs.worldbank.org/en/786671524166274491/TheDeclineReportlow.pdf (accessed on 5 May 2019).

[28] Group of Ten "Report on consolidation in the financial sector" (2001) 4.

in international financial markets.[29] This could, in turn, cause a "domino effect" of failures in the current financial system.[30] The absence or inadequacy of regulations pertaining to the withdrawal of correspondent banking relationships may also potentially create moral hazard in powerful economies.

4.4 Moral hazard

Moral hazard arises when parties have incentives to accept excessive risks because the costs that arise from taking on such risks are borne by others.[31] In the absence of market discipline, large financial institutions will usually accept higher risks due to government bailouts.[32] In this regard, macro-prudential supervision of systemically important entities promotes early intervention as a measure to reduce the impact of potential stress on financial institutions.[33] Robust prudential regulation, supervision and resolution therefore promote good corporate governance and sound risk management at financial institutions.[34] It also ensures that a financial institution's weaknesses are promptly identified and corrected.[35] An absence of strong regulation and supervision dictates the inability to understand the risks that are taken by financial institutions, which could give rise to late intervention and an increase in resolution costs.[36] Financial supervision is therefore necessary to balance several factors, such as addressing the risks to confidence in the financial system; contagion to otherwise

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[29] IMF BIS & FSB "Guidance to assess the systemic importance of financial Institutions, markets and instruments: initial considerations" (2009) 5 available at https://www.imf.org/external/np/g20/pdf/100109.pdf (accessed on 3 May 2019). See National Treasury, SARB and FSB policy document "Strengthening South Africa's resolution framework for financial institutions" (2015) 3 available at http://www.treasury.gov.za/twinpeaks/Strengthening%20South%20Africa%E2%80%99s%20Resolution%20Framework%20for%20Financial%20Institutions.pdf (accessed on 10 September 2020).

[30] National Treasury, SARB and FSB policy document "Strengthening South Africa's resolution framework for financial institutions" (2015) 3.

[31] International Association of Deposit Insurers (IADI) "IADI core principles for effective deposit insurance systems" (2014) 10 available at https://www.iadi.org/en/assets/File/Core%20Principles/cprevised2014nov.pdf (accessed on 4 May 2019).

[32] National Treasury Policy Document "A safer financial sector to serve South Africa better" (2011) 20. See Van Heerden & Van Niekerk "The financial stability mandate of the South African Central Bank in the post-crisis landscape (2018) 33 *J.I.B.L.R.* 114. See also Llewellyn "Institutional structure of financial regulation and supervision: the basic issues" (2006) Paper presented at a World Bank seminar Aligning Supervisory Structures with Country Needs**.**

[33] Financial Stability Board (FSB) "Reducing the moral hazard posed by systemically important financial institutions: FSB recommendations and timelines" (2010) 7 available at: http://www.fsb.org/wp-content/uploads/r_101111a.pdf?page_moved=1 (accessed 6 May 2019).

[34] IADI Core Principles for Effective Deposit Insurance Systems (2014) 11.

[35] IADI Core Principles for Effective Deposit Insurance Systems (2014) 13.

[36] IADI Core Principles for Effective Deposit Insurance Systems (2014) 13.

sound institutions; and minimising the distortion to market signals and discipline.[37] As such, the collaboration and co-operation between AML/CFT supervisors and prudential regulators may potentially be useful to determine the extent of reputational risk involved within a particular financial institution. This may assist in proactively preventing contagion to sound financial institutions.

4.5 Remarks

From the above analysis one can reasonably conclude that reputational risk needs to be addressed through the collaboration of and co-operation between AML/CFT supervisors and prudential authorities. The reason for this is because most terminations concerning reputational risk stem from regulatory actions, financial sanctions, compliance/non-compliance with local and international AML/CFT laws or standards, ongoing compliance costs, et cetera. If a bank retains a customer that causes ongoing adverse publicity resulting from suspected illegal activities and such information reaches foreign investors, the latter may decide to withdraw from the business relationship with the local bank regardless of whether or not the bank complied with the relevant reporting requirements. As mentioned above, reputational risk may also lead to the provision of implicit support affecting the bank's liquidity position. With regard to the prudential consequences due to deficiencies in banks' AML/CFT systems, the BCBS notes that such deficiencies may result in regulatory actions or criminal sanctions that lead to reputational damage affecting both the bank's depositor outflows and access to other markets.[38]

It is the objective of the Prudential Authority (PA) in South Africa to promote and enhance the safety and soundness of market infrastructures, and it bears the functions of supporting financial inclusion and sustainable competition in the provision of financial products and financial services.[39] The PA can consult with the FIC to obtain additional information as part of its on-site examination powers to ensure that the bank is not controlled or owned by persons with links to significant ML/TF risks.[40] The

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[37] BCBS "Core Principles for Effective Banking Supervision" (2012) 16.
[38] BCBS "Introduction of guidelines on interaction and cooperation between prudential and AML/CFT supervision" consultative document (2019) para 16 available at https://www.bis.org/bcbs/publ/d483.pdf (accessed on 13 September 2020).
[39] Section 34 of the Financial Sector Regulation Act 9 of 2017 ("FSRA").
[40] Sections 34(1)(b), 34(3)(a), 76 and 132 of the FSRA. See BCBS "Introduction of guidelines and cooperation between prudential and AML/CFT supervision" Consultative Document (2019) para 15.

information can also be used to ensure that persons who may exert power or influence over the bank have a record of integrity and good repute.[41]

As indicated, reputational risk is based on perception and not on facts. Correspondent banking CDD requires an assessment of reputation and regulatory action to establish the relevant degree of risk associated with that relationship. In this regard, imposing risk-sensitive regulatory requirements on the decision to maintain customers may be used to address the increase in de-risking. In France, for example, recent regulation specifies that correspondent banks should also consider corrective actions taken by respondent banks in response to regulatory actions when assessing the reputation of such a bank.[42]

[41] BCBS "Introduction of guidelines and cooperation between prudential and AML/CFT supervision" Consultative Document (2019) para 15.
[42] BIS "Closing the loop: AML/CFT supervision of correspondent banking" *FSI Insights on policy implementation no 28* (2020) para 14 available at https://service.betterregulation.com/sites/default/files/insights28.pdf (accessed on 20 September 2020).

Chapter 5:
Case law analysis

5.1 Introduction

The closure of bank accounts due to reputational risk is a complex issue taking place in two different markets. The upstream market is the market for correspondent banking services, whereas the downstream market is the market for domestic day-to-day transactional activities. The absence or ignorance of account closures in the downstream market may cause account closures in the upstream market. This means that reputational risk, if not mitigated in the down-stream market, may cause a spill-over effect in the upstream market. Vice versa, the termination of accounts in the upstream market due to reputational risk may have serious prudential consequences for the lower stream markets. In this regard, it is necessary to reflect on the principles that were laid out by South African courts.

5.2 *Bredenkamp v Standard Bank of South Africa*

This case was heard long before the FIC Act was amended in 2017. However, courts still refer to this case when deciding on matters that deal with the unilateral termination of bank accounts due to the importance of the Supreme Court of Appeal's decision.

In the *Bredenkamp* case,[1] the appellants, John Bredenkamp and two companies under his control, held a number of current accounts with Standard Bank of SA Ltd, as well as a MasterCard credit card and two foreign currency accounts.[2] Mr Bredenkamp allegedly was involved in various business activities, including tobacco trading, grey-market arms trading and trafficking, equity investments, oil distribution and diamond extraction.[3] He was also listed as a "Specially Designated National" (SDN) by the US Department of Treasury's Office of Foreign Assets Control.[4] SDNs consist of individuals and entities who are owned or controlled by "targeted countries" and includes individuals and entities such as terrorists and narcotics traffickers

[1] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA).
[2] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 3.
[3] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 15.
[4] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 12.

designated under programs that are not country-specific.[5] In this regard, the bank was concerned that foreign onlookers were going to perceive Standard Bank as an entity that can be used to facilitate money laundering and this created reputational risk for it.[6] The bank further contended that the ongoing relationship would create certain business risks for Standard Bank.[7] Based on the above factors, Standard Bank decided to terminate its relationship with the appellants. Standard Bank notified the appellants that their credit card facilities were suspended and that it intended to withdraw them after twenty-nine days.[8]

The bank relied on two grounds to justify its decision to close the accounts of Mr Bredenkamp and his associated entities. First, the bank relied on an express term in its contract, which entitled it to close the account by providing reasonable prior notice.[9] Second, the bank relied on an implied term that had the same effect, namely than an indefinite contractual relationship may be terminated provided that reasonable notice is provided.[10] In this regard, Mr Bredenkamp argued that the term operated in an unbalanced way and was therefore unconstitutional.[11] Mr Bredenkamp sought an order prohibiting Standard Bank from closing his accounts in the absence of good cause.[12]

With reference to the facts of the case as set out above, the court reached the following conclusion: The bank was entitled to terminate the bank-customer relationship in accordance with the bank-customer agreement.[13] The bank perceived that the SDN listing created both reputational and business risks.[14] These risks were assessed at a level of seniority and a conclusion was reached to terminate the relationship as such in a *bona fide* manner.[15]

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[5] See "Specially Designated Nationals And Blocked Persons List (SDN) Human Readable Lists'' available at https://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx (accessed on 1 May 2019).
[6] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 17.
[7] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 17.
[8] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 4.
[9] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 6.
[10] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 6.
[11] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 22.
[12] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 25.
[13] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 64.
[14] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 64.
[15] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 64.

The bank moreover provided its customers with reasonable notice to take their business elsewhere.[16] The court also held that the termination was not contrary to public policy and did not offend any identifiable constitutional value.[17]

5.3 *Annex Distribution v Bank of Baroda*

In *Annex Distribution v Bank of Baroda*,[18] the bank notified the applicants, who were all under the power and control of the Gupta family, that it intended to sever ties with them and to close their accounts.[19] The applicants sought a court order interdicting and restraining the bank from de-activating and closing their accounts, terminating their relationship and requested a determination regarding the reasonable notice period.[20] The court held that a notice period of three months was more than reasonable to allow the applicants ample opportunity to move their business elsewhere.[21] The applicants further contended that they were not listed on any sanction list as was present in *Bredenkamp*. The court, however, held that the absence of a listing is only one factor to take into consideration when making a decision.[22] In this regard, the court stated that there are many other factors relating to the bank's obligations in terms of the regulatory framework that also needed to be taken into consideration.[23] These obligations would therefore override the absence of a listing. Fabricius J then came to the crux of the case and stated that:[24]

> "[g]iven these stiff penalties for failure to comply with FICA, even inadvertently, or due to lack of resources, the logical means to avoid these risks is to terminate the banking relationship with clients that are deemed to be of unusually high risk. I agree with this contention. It is sound and it is based on the regulatory provisions that I have referred to. Such decision by a bank would also enhance the integrity of the financial system, support openness rather than subversion and enhance the rule of law rather than undermine it".

[16] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 64.
[17] *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 64.
[18] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639.
[19] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639 para 1.
[20] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639 paras 2 and 10.
[21] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639 para 24.
[22] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639 para 40.
[23] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639 para 41.
[24] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639 para 37.

Fabricius J supported the bank's decision to terminate the customer's relationship and based his findings on the following principles that were laid down in the *Bredenkamp* case:[25]

- A bank is entitled to terminate a contract with its customer on the notice periods specified in the bank-customer agreement. In the absence of an express termination clause, a bank has the right to terminate on reasonable notice;
- A bank has no obligation to provide motives for terminating its relationship. The reasons for terminating the relationship are generally irrelevant unless there is an abuse of rights;
- There are no self-standing rights to reasonableness, fairness or goodwill in the law of contract. Even if there were, however, it would be fair for a bank to exercise its contractual right to terminate the bank-customer agreement on proper notice;
- A bank is further entitled to terminate the relationship with a customer on the bases of reputational and business risks, and courts should be reluctant to second-guess that decision;
- Regardless of whether negative publicity about the customer is true, a bank is fully entitled to terminate the bank-customer relationship if the customer has a bad reputation; and
- The fact that a customer may have difficulty finding another bank does not impose any obligation on the bank to retain the customer.

With reference to the above findings, a court will most likely reach a different conclusion today due to the adoption of the Conduct Standard for Banks. It is however clear that a bank is fully entitled to terminate the relationship of its customer based on reputational risk.

[25] *Annex Distribution v Bank of Baroda* (52590/2017) [2017] ZAGPPHC 639 para 22.

Chapter 6:
Conclusion

The law of contract makes it clear that a bank is entitled to unilaterally terminate the relationship with its customer, provided that the bank gives its customer reasonable notice to take its business elsewhere.[1] It is also clear that a bank may withdraw from the relationship when there is ongoing adverse media associated with one of its customers due to the reputational risk involved.[2] A bank is not required to establish the truth of such allegations and may terminate the relationship of the customer to protect its reputation from being damaged.[3] If a local bank maintains an association with a customer that is surrounded by negative publicity, the bank might find itself in a position where its correspondent banking facilities are terminated due to the perception that the local bank is not complying with the FIC Act. This may result in the local bank, together with its customers, being financially excluded from the correspondent banking market.

As indicated, when a local bank enters into a loan agreement with an international bank, the loan-agreement typically includes a clause that requires the banks to comply with AML/CFT legislation as enacted in both its home jurisdictions and the jurisdictions in which it operates.[4] Any perceived non-compliance with AML/CFT laws may cause the local bank to be in breach of the loan agreement, which then renders the loans under that agreement due and payable with immediate effect. This may further affect the local bank's liquidity position. De-risking in correspondent

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[1] *Joachimson v Swiss Bank Corporation* (1921) 3 KB 110 (CA) 127. See *Bredenkamp v Standard Bank* 2009 (6) SA 277 (GSJ) para 29.
[2] *Annex distribution v Bank of Baroda* 2018 (1) SA 562 (GP); *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA); *Minister of Finance v Oakbay Investments (Pty) Ltd and Others* 2018 (3) SA 515 (GP); *Hlongwane and Others v Absa Bank Limited and Another* (75782/13) [2016] ZAGPPHC 938 (10 November 2016).
[3] *Annex distribution v Bank of Baroda* 2018 (1) SA 562 (GP) para 40.
[4] *Annex distribution v Bank of Baroda* 2018 (1) SA 562 (GP) para 38 the bank confirmed this position by stating that:

> "the bank operates in more than 25 countries. Accordingly, any transaction conducted by any branch of the bank in any jurisdiction internationally, is a transaction conducted by the bank and attributable to it in every jurisdiction".

banking markets may potentially cause a systemic event in South Africa due to the concentrated banking sector.[5]

Reputational risk may ultimately be described as a two-edged sword. It relates to both the conduct of a bank on the one side, and the prudential consequences that might follow on the other side. To address this type of risk in a proportionate manner, it requires the attention of the FIC, the FSCA, and the Prudential Authority. Any weaknesses or breaches in a bank's compliance with AML/CFT requirements could result in regulatory action and reputational risk.[6] The BCBS states in this regard that "ML/FT risks may affect the prudential analysis in the different components of its assessment of the bank's soundness".[7] In line with the approach of the BCBS, the Prudential Authority should be required to take into consideration the impact of ML/FT risks by collecting and considering all relevant information identified by the FIC.[8]

With regard to the CDD measures in correspondent banking relationships, the FATF requires the correspondent bank to determine, from publicly available information, the reputation of the local bank.[9] The bank needs to take into account any regulatory actions against the bank and whether the bank is subject to a ML/TF investigation.[10] International banks should follow the approach of France, where recent regulation specifies that correspondent banks should also consider corrective actions taken by respondent banks in response to regulatory actions when assessing the reputation of such a bank.[11]

A bank will usually experience high levels of reputational risk exposure when, for example, the bank's association with a prominent customer who is also subject to a ML/TF investigation is revealed to the public. Case law in South Africa that deals with a bank's right to unilaterally terminate accounts contains a singular element, namely

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[5] SARB "Financial Stability Review" (2018) 1 available at https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8904/Second%20edition%202018%20FSR.pdf (accessed on 20 August 2020).

[6] BCBS "Introduction of guidelines on interaction and cooperation between prudential and AML/CFT supervision" (2019) 7.

[7] BCBS "Introduction of guidelines on interaction and cooperation between prudential and AML/CFT supervision" (2019) 7.

[8] BCBS "Introduction of guidelines on interaction and cooperation between prudential and AML/CFT supervision" (2019) 7.

[9] FATF "The FATF recommendations" (2012) 16.

[10] FATF "The FATF recommendations" (2012) 16.

[11] BIS "Closing the loop: AML/CFT supervision of correspondent banking" *FSI Insights on policy implementation no 28* (2020) para 14 available at https://service.betterregulation.com/sites/default/files/insights28.pdf (accessed on 20 September 2020).

customers that are categorised as high risk due to alleged involvement in corruption or other unlawful activities.[12]

In this regard, a multi-agency model may potentially assist a bank in making timeous de-risking decisions. South Africa recently introduced a "Fusion Centre" to combat Covid-19 related offences. It pulls together the FIC, the independent Police Investigative Directorate, the National Prosecuting Authority, the Directorate for Priority Crime Investigation, the State Security Agency, the South African Revenue Service as well as the Special Investigative Unit.[13] Fusion Centres generally perform intelligence analysis of information on corruption.[14] Indeed, Fusion Centres are designed to fast-track information from a variety of sources.[15] It is therefore recommended that a Fusion Centre should be developed in South Africa to cover ML/TF matters in general.

As such, all the relevant bodies in a Fusion Centre may potentially have in-depth knowledge regarding the status of a particular matter. Co-ordinated efforts between the various role-players may therefore assist a bank in its decision to de-risk a customer. In this regard, if a bank knows when a customer of the bank that is subject to a ML/TF investigation will appear in court, the bank can proactively prepare for any reputational risk that might follow due to its association with the customer being revealed to the public through the judiciary process or any related public statements.[16] The tracing of intelligence to get feedback on the particular stage of a case is still a

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[12] In *Bredenkamp and Others v Standard Bank of SA Ltd* 2010 (4) SA 468 (SCA) para 14, the bank's customer was listed by OFAC as a SDN because he was said to be:

> "a 'crony' of President Mugabe of Zimbabwe and that he had provided financial and logistical support to the 'regime' that has enabled Mugabe 'to pursue policies that seriously undermine democratic processes and institutions in Zimbabwe".

The allegations in *Annex Distribution (Pty) Ltd and Others v Bank of Baroda* 2018 (1) SA 562 (GP) included allegations of corruption, money-laundering and unlawful conduct that had been carried out by the Gupta family and the Oakbay Group which allegations then also found its way in the media and other public fora. In *Hlongwane and Others v Absa Bank Limited and Another* (75782/13) [2016] ZAGPPHC 938 (10 November 2016), the bank terminated the account of a politically exposed person due to the perceived high risk of money laundering that was associated with the relationship.

[13] Parliamentary Monitoring Group "SIU on terms of reference for COVID-19 PPE procurement" (2020) available at https://pmg.org.za/committee-meeting/30873/ (accessed on 1 October 2020).

[14] Budhram T "Intelligence-led policing: A proactive approach to combating corruption" *SA Crime Quarterly* 52 (2015) available at http://www.scielo.org.za/scielo.php?script=sci_arttext&pid=S1991-38772015000200006#back26 (accessed on 1 October 2020).

[15] US Department of Justice "Intelligence-Led Policing: The New Intelligence Architecture" (2005) available at https://www.ncjrs.gov/pdffiles1/bja/210681.pdf (accessed on 1 October 2020).

[16] See in general Budhram T "Intelligence-led policing: A proactive approach to combating corruption" *SA Crime Quarterly* 52 (2015).

prevalent issue in South Africa.[17] A Fusion Centre can therefore assist to trace the status of a particular ML/FT case, which in turn, may potentially be shared with the South African Anti-Money Laundering Integrated Task Force (SAMLIT), if appropriate information sharing mechanisms are put in place.[18] This will ultimately allow a bank to determine when a matter that involves its customer will be heard by a court. In this regard the bank can then proactively de-risk the customer to mitigate any reputational risk that might follow due to such information being made available to the public through the judiciary process.

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[17] Budhram T "Intelligence-led policing: A proactive approach to combating corruption" *SA Crime Quarterly* 52 (2015) 53, explains this position quite well by stating that:

> "In the FIC, the type of intelligence generated determines the nodal point to which information is disseminated. The reports may be forwarded to either the National Intelligence Co-coordinating Committee or the Justice, Crime Prevention and Security Cluster, which is made up of the SAPS, the Asset Forfeiture Unit, the Anti-Corruption Task Team and the South African Revenue Service. *But the decision on whether to act on the intelligence and to furnish feedback to the FIC is at the discretion of the respective bodies*". - (emphasis added).

[18] FIC "Public private sector partnership to assist in combating financial crime**"** media release (2019) available at https://www.fic.gov.za/Documents/Media%20Release%20-%20SAMLIT.pdf (accessed on 3 October 2020).

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