**Suggested Answers Nov 2012**

**QUESTION 1**

1. **Systemic risk** while there is a concern to protect depositors against loss through default by individual institutions, public policy is also concerned with confidence in the system as a whole. Part of the conventional wisdom in banking is that default by one institution can spread to undermine other institutions.

Systemic risk derives in part from interbank linkages. If banks have large interbank deposits with a failed bank, for example, they may in turn suffer illiquidity or in extreme cases insolvency.

Systemic risk derives also from linkages between banks through the payment system. With net settlement systems, banks send innumerable payment instructions to other banks during the course of the day. At the end of the day, the instructions are netted and settled. If a bank fails and is unable to settle the payment obligations it has accumulated to other banks during the day, those other banks are in jeopardy of defaulting on the payment obligations they have in turn contracted.

Then there is systemic risk because of the public perception that other banks are in the same position as the suspect or failed bank. There is a run on these other banks as the public moves to bank perceived to be the very strongest, or there is a flight to cash. These banks may be perfectly healthy, but will face liquidity crisis if there is a rush to withdraw deposits.

1. **Prevention of fraud**:- even the most ardent free marketer accepts the need for controls to minimize fraud. Markets cannot work smoothly unless persons can deal with each other in the knowledge that fraud is an exceptional rather than a regular feature if the environment. As well as this more theoretical justification, there are the enormous costs of banking fraud. Bank failures through fraud are a direct economic cost. There are also social costs such as those caused by the criminals who could not operate at least on the same scale without being able to launder and transfer their ill-gotten gains through the banking system. It is difficult to escape the conclusion that fraud prevention is as important as prudential supervision.

Bank fraud may involve either insiders or outsiders to a bank. The collapse of the international bank; the Bank of Credit and Commerce International (BCCI) highlighted the problem of insider fraud. This was not a unique example as insider fraud has featured in the collapse of banking institutions around the world.

Fraud by outsiders may be at the expense of the bank or may involve fraudsters using banks and the banking system to facilitate their schemes or to secrete their gains. Examples include: cheque fraud, credit card fraud and mortgage fraud

1. **Avoidance of money laundering:-** Fraud and other crimes by outsiders can involve the use of the banking system to facilitate criminal purposes. No bank need suffer direct loss. Money laundering is the best example. In broad terms it is the dishonest concealment of the true source of moneys, although these may later reappear in legitimate investments, as phoney loan repayments and so on.

Money laundering is increasingly seen to be within the sphere of responsibility of central banks and bank regulatory authorities. This is because it adversely affects public confidence in and the stability of the banking system. In broad terms, money laundering legislation encourages banks to put in place effective procedures to ensure that all persons conducting business with them are properly identified and the transactions which do not appear legitimate are reported see The Money Laundering and Proceeds of Serious Crime and Terrorist Financing Act 2006.

**(Total 15 marks)**

**QUESTION 2**

The Act of Parliament that establishes the **Financial Intelligence Unit** is the **Money Laundering and Proceeds of Serious Crime and Terrorist Financing Act 2006.**

The **Financial Intelligence Unit** is established under section 11 of the Act. Among many of its functions, the Unit has the following functions:-

1. receive, analyze and assess report of suspicious transactions issued by financial institutions under the Act;
2. send any report referred to in paragraph (a) to the appropriate law enforcement authorities and, the supervisory authorities if, on the basis of its analysis and assessment, the Financial Intelligence Unit has determined that there is an element of money laundering or financing of terrorism;
3. enter the premises of any financial institution during ordinary business hours to inspect any record kept pursuant to the Act, and ask any question relating to such record, make notes and take copies of whole or any part of the record;
4. send to the appropriate law enforcement authorities, any information derived from an inspection carried out pursuant to paragraph (c), if it gives the Unit reasonable grounds to suspect that a transaction involves proceeds of crime or terrorist financing;
5. instruct any financial institution to take such steps as may be appropriate to facilitate any investigation anticipation by the Unit;
6. compile statistics and records, disseminate information within Malawi or elsewhere, make recommendations arising out of any information received, issue guidelines to financial institutions and advise the Minister accordingly
7. create training requirements and provide such training for any financial institution in respect of transaction record–keeping and reporting obligations under the Act;
8. consult with any relevant person, institution or organization for the purposes of exercising its powers or duties;
9. extend assistance to foreign jurisdictions with respect to property tracking, monitoring and confiscation orders;
10. educate the public and create awareness on matters relating to money laundering or terrorist financing. *(5 marks)*

**(Total 15 marks)**

**QUESTION 3**

The Basel Committee was established in 1974 as a Committee on Banking Regulations and Supervisory Practices in the aftermath of serious disturbances in international currency and banking markets. The Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision in the expectation that the member authorities and other nations’ authorities will take steps to implement them through their own national systems, whether in statutory or otherwise.

The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters. Its objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. It seeks to do so by exchanging information on national supervisory issues, approaches and techniques, with a view to promoting common understanding. At times, the Committee uses this common understanding to develop guidelines and supervisory standards in areas where they are considered desirable. In this regard, the Committee is best known for its international standards on: capital adequacy; the Core Principles for Effective Banking Supervision; and the Concordat on cross-border banking supervision.

Given the global market within which Malawi’s banks operate, the Basel Committee offers undoubted guidance on the international best practices to be embraced by the local banks.

**(Total 15 marks)**

**QUESTION 4**

In relation to prudential bank regulation:-

1. The objectives of the Reserve Bank in supervising banks include the following:-

* ensuring the safety and soundness of the financial system
* Avoiding systemic risk. The risk that failure of one market participant may have a knock-on-effect on other market participants through inter-bank linkages and bank runs.
* Avoiding moral hazard associated with Lender of last resort.
* Maintaining confidence in banks due to banks’ pivotal position in the financial system. Banks are key participants in payment, clearing and settlement systems.
* Providing assurance of a smooth-functioning payment system. Payment systems revolve around banks, a well functioning payments system is essential to the working of a modern economy and any serious disruptions to it may adversely affect economic activity.
* Protecting depositors’ funds. A disturbance in the financial security of many individuals can spill over and severely disrupt economic activity.
* Preventing fraud, money laundering and terrorist financing.

1. Legislative technique

Legislative technique involves the use of legislation to achieve prudential bank regulation. In that regard, the Banking Act 1989, section 3 prohibits a person from transacting banking business in Malaŵi without a valid license, and generally permits only companies to be licensed. This means that no person can apply for a banking license without initially satisfying the Registrar of Companies requirements for the registration of a limited company under the Companies Act, 1984. The Companies Act, 1984 requires the following for any consortium of two or more persons to be registered as a company (streamlined as fitting to qualify for application for a banking license): there should be at least two or more persons acting in consent; the company should be limited by shares. While companies can be limited by shares, guarantee or unlimited, no company can be approved a banking license unless if it limited by shares. A qualifying limited company can be either private or public. The company should register with the Registrar of Companies its Memorandum and Articles of Association. The Memorandum of Association should be signed by each shareholder including the number of shares held by each. The Memorandum of Association should outline the objectives of the company

1. Capital Adequacy Illustrative of the standards imposed on banks which want to be authorized are those concerning capital adequacy and large exposures. Capital adequacy rules are perhaps the outstanding example of convergence at the international level in the bank regulation. The international standards on capital adequacy grew out of the work of the Basle Committee on Banking Supervision. They were prompted by concern over the deteriorating capital levels of international banks from the early 1980s as a result of increased competition and the debt crisis in developing countries.

Capital adequacy standards are to provide a cushion of capital which may protect depositor’s funds in the event of a bank incurring significant loss. Apart from legislation, the Reserve Bank issues Directives covering specific issues on prudential regulation. A directive in point is the Directive on Minimum Capital Ratios for Bank which provides that: "Capital adequacy" means the maintaining of sufficient capital as called for in Section 15 of the Banking Act of 1989 and is specified in the requirements of this directive; and "Capital deficiency" is defined as a failure to meet all the capital requirements of this directive by a bank.

**(Total 15 marks)**

**QUESTION 5**

1. **In-house payment:-** this occurs when both payor and payee have accounts at the same bank. The payor’s account is debited and the payee’s credited. No other bank is involved. Typically the payment either creates or increases a debt owed by the payor to the bank or discharges or reduces an existing debt the bank owes to the payor. At the same time payment discharges the payor’s obligation to the payee. The bank is now obliged to the payee or the payee’s debt to the bank is reduced. Additional parties do not affect this basic method of how payment is effected.

Where payor and payee have accounts at different branches of the same bank, an internal clearing office may be used. This is typically the case where cheques have been used. Note that payment need not be in-house, even if payor and payee have accounts at the same bank. Thus where the different branches are in different jurisdictions and payment is in the currency if a third country, payment may involve the bank’s correspondent in the control of currency.

1. **Domestic Payment**:- this is where payment is in the local currency between banks in the same country. In this case settlement can be across the books of that country’s central bank. With a credit transfer, the payor instructs its bank, which sends a payment message to the payee’s bank. With a debit transfer the payor has authorized its bank to pay when the payee presents a debit instrument or otherwise sends a debit instruction. In both cases the payor’s bank debits its customer’s account. Conversely, the payee’s bank credits its customer’s account.

The banks themselves settle by making payment across the books of the central bank either immediately in the case of real-time gross settlement or periodically in the case of net settlement. Where a bank does not have an account with the central bank it must settle through a bank which does.

1. **Completion of payment involving an interbank transfer between a bank and its correspondent:-** with an interbank transfer between a bank and its correspondent, there is authority that payment is complete when the payee bank id notified that funds are made available for the credit of the customer’s account. Consequently, the payor has no claim against its bank for not effecting the transfer if the payee bank ceases trading after such notification, since the transfer is complete at that point.

**(Total 15 marks)**

**QUESTION 6**

The Registrar will be advised that international banks are subject to local as well as special regulatory regimes. At national level, bank regulators have grappled with the problems of prudential regulation of international banks for a considerable time. In some jurisdictions bank regulators have requires that a foreign bank establishing a subsidiary there should stand by it for example by means of a comfort letter. This has the obvious advantage that the whole of the capital of the international banking group will be available if the subsidiary runs into difficulty.

With a branch, it will be the home country of the bank which will be exercising primary control over its soundness. The host country to the branch will have little influence for example over its capital adequacy. Consequently, some host jurisdictions have enhanced regulation of the branches of foreign banks established there. One approach is to require the foreign bank to establish a subsidiary or a joint venture with a local bank which can then be regulated in the same way as local banks.

# At an international level the Basel Committee on Banking Supervision has been addressing the prudential concerns about international banking for the last quarter century. In 1975 it drew up a set of principles, the 1973 Concordat to guide the division of responsibilities in regulating international banks. In brief these were that the supervision of foreign banking establishments should be the joint responsibility of host and country regulators. No foreign banking establishment should escape regulation, each country ensuring that it is supervised and each judging that regulation by both it and the other is regular and adequate.

# The 1975 Concordat was replaced by the 1983 Concordat which reformulated and supplemented the earlier principles, in particular to take into account of the subsequent acceptance of the principle that the soundness if an international bank cannot be fully evaluated unless regulators can examine the totality of its business worldwide, through the technique of consolidation.

# The principle of consolidated supervision as the Concordat explained, is that parent banks and parent supervisory authorities monitor the risk exposure of the banks or banking groups for which they are responsible as well as the adequacy of their capital on the basis of the totality of their business wherever conducted.

# This principle does not imply any lessening of host authority’s responsibilities for supervising foreign bank establishments which operate there. The 1983 Concordat noted that adequate supervision of a bank’s foreign establishment calls not only for the appropriate allocation of responsibilities between home and host regulators but also for contact and cooperation between them.

**(Total 20 marks)**

**QUESTION 7**

A ‘governing law and jurisdiction’ clause relates to two distinct questions. First, it deals with the question of which law is to constitute the proper or governing law of the agreement. Secondly, it deals with the separate issue of which courts are to have jurisdiction to hear a dispute concerning the agreement. The clause presupposes that the bank will wish the agreement to be governed by Malawian law and will wish to be certain that it may proceed against its customer in the Malawian courts, although at the same time seeking to reserve to the bank the ability to proceed in the courts of other countries if it should appear advantageous to do so.

Governing law in default of choice

In the absence of an express choice of governing law in an agreement, established rules apply for the purpose of determining the law which governs the contract. It is generally accepted that, in the absence of agreement to the contrary, a contract between a bank and its customer is governed by the law of the place where the account is kept: see ***Libyan Arab Foreign Bank v Bankers Trust Co*** [1989] QB 728, [1989] 3 All ER 252.

Where both parties are Malawian and the contract is to be performed in Malawi, the application of these rules will generally result in the agreement being governed by Malawian law. Equally, in such a situation, the Malawian courts will assume jurisdiction over a dispute arising out of such an agreement in accordance with jurisdictional rules applied by the Malawian courts. Accordingly, in the case of a purely domestic transaction, there is generally no need for a governing law and jurisdiction clause although, as is mentioned below, this conclusion will not always follow.

Foreign customers

Where, on the other hand, the bank is contracting with a foreign customer, it may be that the bank will wish to take proceedings against the customer in the customer’s own jurisdiction where the greater part of the customer’s assets is likely to be located.

In such a situation, it would clearly be preferable if Malawian law were to be applied by the courts of the customer’s jurisdiction for the purpose of such proceedings, and while the question of whether to recognise a choice of Malawian law would be determined according to the law of the relevant jurisdiction, and therefore there would be no guarantee that the choice of Malawian law provision would be recognised by the foreign court, the absence of any choice of law provision would generally increase the likelihood of the foreign court deciding to apply the laws of its own jurisdiction in determining the dispute.

Alternatively, the bank may wish to proceed against the customer in the Malawian courts, with a view to enforcing any judgment obtained either in Malawi or, if the customer has assets in another jurisdiction, through the courts of the other jurisdiction in accordance with such procedures as may be available.

The object of the jurisdiction clause in this context is to minimise the risk of the Malawian courts, or the courts of whatever jurisdiction is chosen, declining to exercise jurisdiction over the dispute. The express submission by a foreign customer to the jurisdiction of the courts of a particular jurisdiction would make it difficult for that customer to argue that those courts are not the appropriate forum for the trial of disputes arising out of the agreement. A further advantage of an express submission by the customer to the courts of a particular jurisdiction is that a judgment

Unusual circumstances

Even where the parties to an agreement are both Malawian, consideration should always be given as to whether there are, in the particular circumstances, grounds for the inclusion of a governing law and jurisdiction clause. For example, the Malawian customer may have assets in another jurisdiction, in which case an express submission by the customer to the jurisdiction of the courts of the country in which such assets are located, as well as to the Malawian courts, together with a choice of Malawian law as the governing law of the contract, will clearly be of value to the bank in any subsequent proceedings

**(Total 20 marks)**

**QUESTION 8**

Analytically, without relating the discussion to the practices of any particular market, a bank’s involvement with an issue of securities can involve, in broad terms, a hierarchy of four types of agreement with an issuer:

1. **Brokerage agreement:** Under it, there is no commitments on the bank’s part but it will agree to provide services such as disseminating the prospectus or offering circular, handling applications for securities and may be liaising with a stock exchange of the securities are to be listed. The bank will not be under a contractual obligation to solicit subscriptions.
2. **Placement agreement:** There will be no obligation on the bank to take any securities but it will be obliged to secure subscriptions for the securities. This could be with professional investors or the public generally. One legal issue is the standard to be expected of the ban in executing its task of placing the securities. In the absence of an express provision, it will need to exercise reasonable care and skill.
3. **Underwriting and issue of securities:** The bank commits itself to take them up in the event that the issue is undersubscribed. It is clearly distinguished from a brokerage agreement and a placement agreement. The advantage of underwriting to the issuer is obvious; it knows that it will be paid for the securities. Underwriting by the bank may even enhance the marketability of the securities. Where more than one bank is acting as underwriter, there needs to be an agreement on whether their liability is several, or joint and several.

An underwriting bank can enter sub-underwriting agreements with others, under which the latter agree to underwrite a certain amount of the securities. Other than by contract, an underwriting bank has no duty to the issuer in sub-underwriting its commitment.

1. **Purchase Agreement:** The bank agrees to purchase the whole of the securities and then sell them to investors. If it does so there is a clear risk in relation to its capital. Moreover, various consequences flow because in this situation it is acting as principal, rather than as agent of the issuer. If it is in direct contractual relations with those to whom it on-sells, investors can thus make contractual claims directly against it. A bank may become responsible for any faults in the prospectus offering circular, or the like published by the issuer.

How a bank becomes contractually involved in a distribution of an issuer’s securities clearly depends on the circumstances. The issuer may have been a long-established customer of the bank, or have used it for a previous issue. At the underwriting or purchase end of the spectrum the issuer may conduct an auction, or call for tenders by those wishing to be involved in a distribution. There may be a number of banks involved which are organized as a syndicate.

With short-term debt securities, which are to be regularly issued, the issuer even establish a tender panel for those it is prepared to have tender purchase and distribute any particular issue. The agreement establishing a tender panel may commit the issuer on how securities will be allocated depending on the level of bids.

In whatever way tendering is used in the distribution of securities, its legal character must be taken into account. In Malawian law a tender is an offer. Since a bank tendering is making an offer, it can withdraw it before acceptance if it decides it has pitched its bidding incorrectly or if the market changes. Conversely, the issuer is not obliged to accept the best bid in terms of price. Both rules are , of course, subject to contract. A bank could make an irrevocable tender: an issuer could commit itself to accepting bids from the lowest upwards. Depending on the market, it may be that the practice is to deal with tenders in a certain way. If the practice meets the standards for a trade usage the parties would be bound by the implied term.

**(Total 20 marks)**

**QUESTION 9**

The **Money Laundering and Proceeds of Serious Crime and Terrorist Financing Act 2006** provides, in section 24, that every financial institution before entering into a business relationship with a customer must:

1. ascertain the identity of the customer or beneficial owner on the basis of an official or other identifying document;
2. verify the identity of the customer on the basis of reliable and independent source of documents, data, information or other evidence as is reasonably capable of verifying the identity of the customer in the following circumstances:

* When a financial institution enters into a continuing business relationship, or in the absence of a business relationship, conducts any transaction;
* When carrying out an electronic funds transfer;
* When there is a suspicion of money laundering offence or the financing of terrorism; or
* when the financial institution has doubts about the veracity or adequacy of the customer identification and verification documentation or information it had previously obtained.

1. Every financial institution when establishing a business relationship, must obtain information on the purpose and nature of the business relationship;
2. If a transaction is conducted by a natural person the financial institution must adequately identify and verify the identity of the person including information relating to the name, address and occupation of the person, the national identity card or passport or the applicable official identifying document of the person, take reasonable measures to establish the source of wealth and source of property of the person;
3. If the transaction is conducted by a legal entity the financial institution must adequately identify and verify its legal existence and structure, including information relating to:

* the name, legal form, address and directors of the entity,
* the principal owners and beneficiaries and control structure of the entity,
* provision regulating the power to bind the entity, and verify that any person purporting to act on behalf of the customer is so authorized, and identify those persons,

1. If the customer is a public official, in addition to the requirements in above, every financial institution must:

* have appropriate risk management system to determine whether the customer is a public official;
* obtain the approval of senior management before establishing a business relationship with the customer, and
* conduct regular enhanced monitoring of the business relationship.

A person who contravenes this section commits a criminal offence and is liable, in the case of a natural person, to imprisonment for two years and to a fine of K100,000, or in the case of a corporation, to a fine of K500,000 and loss of business authority.

**(Total 20 marks)**

**QUESTION 10**

According to Lord Goff in ***Attorney General v Guardian Newspapers Ltd***  [1990] the duty of confidentiality relaxed as follows:-

1. *Where disclosure is under the compulsion of law:-* disclosure orders against banks are usually made in two circumstances. First is where a party commences a tracing action and applies to court for an order compelling a bank to disclose certain information about its customer. Secondly where a specific statutory provision compels the bank to disclose certain information about its customer. Examples of such statutes continue to increase. Some of them are the **Money Laundering, Proceeds of Serious Crime and Terrorist Financing Act** **2006**- section 28 compels a financial institution to submit a report to the Financial Intelligence Unit on suspicious transactions; **Banker’s Books Evidence Act 1967** - section 9 permits a court to warrant disclosure of customer’s information on suspicion of an offence; **Taxation Act 2008**- section 83 requires any person (which includes a legal entity/ financial institution) to give certain information on taxation matters to the Commissioner. The provisions of the **Financial Services Act 2010** and the **Banking Act 2009** may also constitute a qualification to the banker’s duty of confidentiality.

*(5 marks)*

*Where there is a duty to the public to disclose:-* the law knows that danger to the state or public duty may supersede the duty of the agent to the principal. It is however difficult to divide the line between a state or public duty and a private duty. An example of a situation where a bank may be compelled to disclose its customer’s information is where the customer is trading with an enemy in time of war. *(5 marks)*

*Where the interests of the bank require disclosure:-* the law also allows a bank to disclose a customer’s information for the sake of its own genuine interests. Typical examples here are where a banker is making demand upon a guarantor, he must, of necessity, disclose the balance of the principal debtor’s account. Another example is where a writ is being issued against a customer, a banker will have to provide details of the customer’s account history and balance to the lawyer preparing the writ. *(5 marks)*

*Where the disclosure is made by the express or implied consent of the customer:-* this may be with the express approval of the customer. For example, when he gives the bank permission to disclose information about the operation of his account to a potential guarantor or an auditor for the purposes of preparing the customer’s own accounts. Implied authority may arise when a reply is made to a status enquiry originating from another bank. *(5 marks)*

**(Total 20 marks)**