THE FINANCIAL SERVICES TRIBUNAL

CASE NO: PA3/2024

In the matter of:

FINBOND MUTUAL BANK Applicant

and

THE PRUDENTIAL AUTHORITY Respondent

Tribunal Panel: Judge LTC Harms (Chairperson) with Judge DM Davis and Ms P Maseko (Members)

Date of hearing: 15 November 2024

Date of decision: 4 December 2024

Summary: Contravention of s 53 of the Mutual Banks Act 124 of 1993 – imposition of an administrative penalty ito s 167 of the Financial Sector Regulation Act 9 of 2017

DECISION

---

[1] The applicant seeks a reconsideration of a decision taken against the applicant by respondent to impose an administrative penalty of R 10 million of which R 5 million was suspended for a period of three years upon the applicant, following a finding that the applicant contravened s 53 of the Mutual Banks Act 124 of 1993 ('the Act'). The application turns on two questions, being whether there has been contravention of any financial sector law and, secondly, whether the administrative penalty which was imposed by respondent had been done as mandated in law and was appropriate in the circumstances.

[2] The statutory contravention of which the applicant had been charged is s 53 (3) (a) read with s 53 (3A) and s 92 (1) (c) of the Act. Applicant claims that s 53 is not a penal section and that s 92 (1) (c) of the Act is inapplicable.

<u>The factual matrix</u>

[3] In 2012 applicant advanced a loan to Finbond Group Limited ('FGL') to the value of R 155 852 593. The loan was reported in the applicant's audited financial statements for the financial years 2013-2019. It was reflected as an unsecured loan, bearing no interest and payable on demand.

[4] By 2018 the respondent was concerned about this loan as it had been advanced to Finbond Group Ltd, which company held 100% of the shares in the applicant. Respondent's concern was caused by the importance which it places on a bank's capital adequacy ratio which is regarded as a key indicator for the oversight authority to assess a bank's financial safety and soundness.

[5] In brief, the capital adequacy ratio is calculated by dividing the bank's net qualifying capital by risk – weighted assets. The higher the risk weighted assets, the lower the capital adequacy ratio. Where a bank has an exposure to a single counterparty which exceeds 25% of its net qualifying capital, respondent may require the bank to increase the risk weighting of its assets. It would appear that, where there is a large exposure that exceeds 25% of the net qualifying capital, respondent will require the bank to risk weight the portion of that exposure to 1250%.

[6] Respondent's concern caused it to engage KPMG, applicant's erstwhile auditors, to review the loan for the year ending 28 February 2018. By the time KPMG examined the loan as at 29 February 2018, it was in the amount of R 141.1 million.

[7] KPMG reported that 'FGL intends to repay the loan in full, from cash derived in the normal course of operations in the short to medium term and current performance of the business strongly supports such repayment will indeed take place within the expected timeframe. Being publicly traded in and a much sought – after equity share, FGL also has the ability to raise additional cash within a short space of time (approximately three months) by way of an issue of fresh shares to the public at any

time, should FGL deem an issue of shares for cash to represent a commercially desirable transaction for the Group. FGL is considering either the sale of its subsidiary Supreme Finance (Pty) Ltd (Supreme) to FMB after approval for the transaction is obtained or raising additional capital during the creation of a Bank Holding Entity which will materially reduce or eliminate the loan in its entirety.' KPMG also noted that there was no formal loan agreement in place between FGL and the applicant.

[8] Following this report, a meeting was held between applicant's board of directors and representatives of the respondent. During this meeting the respondent's representatives expressed concern regarding the large exposure caused by the loan. Confirming the KPMG report, respondent was informed by the applicant that it planned to reduce its exposure significantly by the end of 2018. The meeting also ended with a requirement from respondent that applicant provide respondent with a plan for the repayment of the loan.

[9] On 20 December 2018 respondent generated an email to the applicant in which it noted that the loan amounted to R 111 million, being approximately 30.2% of the net qualifying capital of the applicant. It again reiterated its concern regarding this loan, stating that it was required 'to be settled as a matter of urgency as communicated by the PA at its meeting with the Board of Directors of FMB.'

[10] According to a report provided to the respondent by Mazars[1] a meeting was then held between the applicant and respondent on 7 March 2019. The management of the applicant confirmed that it had complied with the recommendation for the sale of the debtors' book from Supreme to the applicant which 'resulted in the balance of the FGL being reduced to zero at the end of March 2019.' According to the Mazars report it reviewed the debtors' sale agreement and 'confirmed that it (the repayment of the loan) was not concluded post 7 March 2019 meeting'.

[11] On 20 March 2019, the respondent reiterated that the loan was to be settled as a matter of urgency and that the applicant was to provide its repayment plan for the loan. Pursuant thereto, on 4 April 2019 the applicant wrote to the Divisional Head: Banking Supervision at the South African Reserve Bank stating 'we wish to advise that

[1] Mazars provided this report to the respondent pursuant to a direction by the latter to the applicant to furnish the Registrar with a report in terms of s 5 (1) (b) of the Act

the loan between FMB and FGL has been settled in full as at the end of March 2019'. In response, an email of 5 April 2014 from Ms Eunice Geldenhuys of respondent was sent to Mr Hannes Cloete of applicant stating 'noted, thank you for the positive news. The matter is now closed.'

[12] To the extent that there was any doubt about the representation conveyed by applicant, in a letter of 12 July 2019 from the applicant to respondent the following appeared:

> 'The outstanding loan balance was extinguished at the end of March 2019 to a transfer of approximately R 87 million worth of loans from Supreme Finance (Pty) Ltd ... to FMB in terms of the Sale and Cession agreements between Supreme and FMB that has been in place since 2014 ... and by the transfer of the remainder in cash to FMB.'

[13] This letter was doubtless generated as a response to an earlier letter from the Chief Executive Officer of the respondent, Mr Kuben Naidoo, to Dr van Aardt, the Chief Executive Officer of the applicant, on 26 June 2019 in which, inter alia, he requested that 'Finbond is required to provide details regarding the settlement of the loan between Finbond and FGL as at the end of March 2019 particularly the value of the loan book acquired by the bank from Supreme Finance (Pty) Ltd and the portion settled in cash by FGL.'

[14] Dissatisfied with this explanation as provided by the applicant, respondent mandated that SNG – Grant Thornton, the erstwhile duty appointed auditors of the applicant, review the loan and the so-called settlement. It was as a result of this report that Mazars was then mandated to conduct its independent review in terms of s 5 of the Mutual Banks Act.

[15] Mazars summarised its review thus:

> 'Supreme did not transfer substantially all of the risk and rewards and had retained control of the debtors' book thereafter the derecognition criteria had not been met as required by IFRS 9. As a result, FMB should not have recognised Supreme's debtors as an asset. Consequently, this transfer should

not be used as a mechanism to settle the FGL loan. The fact that the correct accounting was not applied as further implications from the regulatory perspective.'

[16] As a result, Mazars concluded that the loan had not been settled as at 31 March 2019 as reported on by the applicant. Eventually a settlement of the loan by way of a cash transaction took place on or around 29 February 2020.

<u>The decision of the respondent</u>

[17] On 19 February 2024, after considering submissions made by the applicant, respondent imposed an administrative penalty on the applicant in the amount of R 10 million of which R 5 million was suspended for a period of three years, subject to the applicant not committing a similar contravention during this period.

[18] On 2 May 2024 respondent provided reasons for its decision, the key justification being that 'by reducing the intercompany loan account from Finbond to FGL, Finbond misrepresented its accounting records and consequently misrepresented the monthly DI returns submitted to the PA in 2014 to 2020 to achieve a favourable regulatory outcome.'

[19] In imposing the penalty, respondent stated that applicant had also contravened s 92 (1) of the Act by failing to comply with the provisions of s 53 of the Act.

<u>The applicant's case on reconsideration</u>

[20] Central to the submissions made by Mr Cook, who appeared together with Ms Hardy on behalf of the applicant, was that there had been no contravention of any financial sector law. In amplification, Mr Cook submitted that s 53 of the Act required a bank to submit returns to the respondent in a form as may be prescribed and in conformity with general accepted accounting practice. The only basis by which a contravention of s 53 could be classified as an offence was in terms of s 92 (1) (b) of the Act and not on the basis of s 53 itself which, in his view, does not create an offence of misrepresentation of accounting records and returns. In addition, Mr Cook submitted that a contravention of s 92 (1) (b) was entirely unrelated to a contravention

of s 92 (1)(c) as invoked by respondent. It was not possible to assert a contravention of s 92 (1) (c) in that s 92 (1) (b) was linked expressly to s 53. In short, an offence was created not by s 53 but by s 92 (1) (b), a section which had not been applied by respondent.

The relevant legislation

[21] In the light thereof, it is necessary to turn to these relevant sections. Section 53 (1) provides that a mutual bank shall, in order to enable the Registrar to determine –

(a) whether the mutual bank is complying with the provisions of sections 48 and 50 of this Act or of s 10 A of the South African Reserve Bank Act, 1989 (Act No. 90 of 1989) as applied by s 49 of this Act; or

(b) the nature and amounts of the mutual bank's assets and liabilities and contingent liabilities.

[22] Subsection (3) provides:

'A mutual bank shall, in addition to returns referred to in subsection (1) furnish the Registrar, subject to subsection (3 A), with the prescribed returns including returns relating to the extent and management of risk exposures and the conduct of its business.'

[23] Subsection (3 A) provides that:

'the returns referred to in subsections (1) and (3) shall be prepared in conformity with generally accepted accounting practice and shall be furnished to the Registrar in respect of such period at such times and in such form as may be prescribed.'

[24] To the extent relevant section 92 provides that:

(1) (b) provides that any person who contravenes or fails to comply with the provisions of sections 20 (7) and 31, 40 (2), 44 (8), 48 (2), 50 (1) or (3), 51, 53, 54 (2), 55 (1), 56 (1), 58 (1), 59(1) or (3) or 60; or (c) in any return statement, questionnaire or other document (other than a document in or in connection with the application referred to in s 18) under this Act furnishes information or

makes a statement that to the knowledge of such person is untrue or misleading in any material respect, shall be guilty of an offence.

[25] Mr Cook submitted that s 53 does not in and of itself provide for an offence. Compliance therewith means the obligation to provide the Registrar with returns relating to the extent and management of risk exposures in the conduct of its business. In essence, his argument was that the fact that the return may be inaccurate and thus fail to adequately reflect the management of risk exposures and the conduct of the business did not mean that a party, such as applicant in such circumstances, would fall foul of s 53, thereby triggering the commission of an offence.

[26] This is clearly an unsustainable argument. Asked as to whether this meant that a fraudulent return or one which grossly misrepresented the factual picture of applicant's financial position complied with s 53, Mr Cook was constrained to answer in the affirmative; a submission which only needs to be stated to justify the conclusion that it must be manifestly incorrect. To the extent that there is any need for textual support for the contrary conclusion, in terms of s 53 the return must comply with generally accepted accounting practices; that is it reflects an accurate financial position.

[27] On the basis of this conclusion, all that s 92 (1) (c) adds to a case against a bank that fails to provide returns in terms of s 53, is that the bank which breaches s 53 and provides information that is untrue, or misleading is guilty of an offence, as provided for in the section. But in its findings sent to applicant on 6 June 2022, s 92 (1)(c) was expressly cited as a legal basis for the imposition of administrative penalty.

[28] It follows that the only inquiry which is relevant to this reconsideration application is whether the returns that were provided under s 53 were untrue or misleading in the material respect.

[29] In short, the crisp question is whether, as the respondent found, the report that the loan from the applicant to FGL was settled by way of a journal entry relating to the sale of debtors from the Supreme Finance to the applicant, resulted in a misrepresentation of the accounting records of the applicant. Consequently, this would be a misrepresentation in its monthly DI returns submitted to the respondent in

order to achieve a favourable regulatory outcome by way of reducing the intercompany loan account.

[30] In particular, the question arose as to whether the representations made by the applicant on 4 April 2019 that the loan had been settled in full as at the end of March 2019 represented a materially misleading position. Returning to the Mazars report, it is significant that when it examined the transaction between Supreme and the applicant, it concluded that there was no exchange of funds emanating from the sale / cession agreement, creating a justifiable concern as to the true economic substance of the settlement of this related party loan. It noted that cashflow is a major indicator of economic substance which is lacking in this transaction. As a result, Mazars was able to conclude that the loan was not settled on 31 March 2019 as reported by the applicant and, as a result, this necessitated the later settlement of the loan in cash on or around 29 February 2020.

[31] The purported settlement of the loan which resulted in the correspondence of 4 April 2019 in which applicant stated that the loan had been settled in full was described by applicant in its representations to respondent as follows:

> 'As a practical and efficient methodology, obligations were offset, one against the other, as between Supreme Finance and FGL and between FGL and FMB. Journal entries were made in the books of each of the respective entities. These journal entries were used to capture all transactions in the books of the respective entities as sub-systems were not integrated into the general ledger system.
>
> FMB recorded the reversal of the prior month's journal entry on the first day of the month and the subsequent new month entry would be posted at the end of the month – at the end of the accounting period.
>
> There is nothing untoward in this accounting methodology. These reversals are to be seen in their proper context as a mechanism used by accountants to make accruals through adjusting and reversing entries.
>
> Adjusting entries consist of adjustments made to the accounting records in order to correctly reflect the position and performance of the reporting entity. The adjusting entries achieve this by including transactions that occurred during

the current accounting period, but which have not yet been recorded. They are thus a means correctly to reflect the amount of income/expense and asset/liability in the correct period. The accounting recognition of loans acquired during a month might require a months end adjusting journal entry to be passed.'

[32] But as the Mazars report notes:

'The manner in which the transaction was accounted for, via a journal which was processed on the last day of the month and reversed the very next day to reflect 'ownership' of debtors for just one day, again leads one to question the economic substance of these transactions. Based on the above assessment it appears to us the economic substance of the debtors sale agreement was to enable FGC to reduce the loan with FMB without incurring any cash flows.'

[33] The way in which applicant sought to ensure that the loans could be recorded as repaid justifies the application of the 'substance over form' doctrine as set out, inter alia, in *Erf 3183 / Ladysmith and another v CIR* 1996 (3) SA 942 (A) and *CSARS v NWK Ltd* 2011 (2) SA 67 (SCA).

[34] As Lewis JA said in *NWK* at para 55:

'In my view, the test to determine simulation cannot simply be whether there is an intention to give effect to a contract in accordance with its terms. Invariably where parties structure a transaction to achieve an objective other than the one ostensibly achieved they will intend to give effect to transaction of the terms agreed. The test should thus go further and require an examination of the commercial sense of the transaction: of its real substance and purpose.'

[35] From 2014, it appears that the accounting treatment of the loan from appellant to FGL involved the sale of the debtors' book from Supreme Finance to appellant in terms of which a journal entry was processed at the end of each month to recognise the debtors' book. On the very first day of the next month, this journal entry was reversed, thereby derecognising the debtors from the book of applicant. This had the result that the monthly DI returns submitted to respondent from 2014 were incorrect

and, according to respondent, were designed to achieve a favourable regulatory outcome.

[36] That background serves as a context to the essential case brought by the applicant for reconsideration, namely the accuracy of applicant's notification that the FGL loan had been settled as at 31 March 2019 which was then conveyed to the respondent. If journal entries were constructed to justify the returns to respondent and such returns did not reflect the economic substance of the loan relationship between applicant and FGL, that would be sufficient to bring the case within the framework of s 53 of the Act and thus be dispositive of this application.

[37] The evidence of the independent auditors, being Mazars, coupled to the reports of KPMG and SM Grant-Thornton which found that 'from the end of March 2019 until the repayment of the outstanding balance for the loan at the end of February 2020, the DI returns and the accounted record is not a true reflection of the affairs at the Bank in respect of the loan outstanding' points overwhelmingly to a simulated exercise. Through journal entries, the applicant sought to justify the veracity of its returns but, in substance, that these accounting entries did not reflect accurately on the state of the loan and hence the financial consequences for the applicant. To the contrary, in seeking to terminate the loan by way of journal entries, the applicant clearly sought to mislead the respondent. Indeed it did so in express terms, when on 4 April 2019 by way of a letter to respondent it stated; 'We wish to advise that the loan between FMB and FGL has been settled in full as at the end of March 2020.'

[38] Returning to s 92 (1) (c) of the Act, the words 'to the knowledge of such person is untrue or misleading in any material respect' does not require respondent to prove that applicant lied in its advice to respondent. However, as the evidence shows luminously, the representation of 4 April 2019 which was based on a journal entry was clearly misleading. The loan had not been settled.

Administrative penalty

[39] This finding leads to an assessment of the application for reconsideration of the administrative penalty which was imposed by respondent, that is of R 10 million of which R 5 million was suspended on conditions.

[40] The applicant lodged detailed written submissions with regard to the imposition of the penalty. Although there is a complaint from applicant that the respondent failed to engage with these comprehensive submissions, the fact is that consideration was given to the financial information concerning applicant including its profits, balance sheet and that it had suffered losses in the 2021 and 2022 financial years as a result of which the recommendation in respect of the administrative penalty was revised down from R 10 million of which R 5 million was suspended for three years. There is no merit in the argument that in the imposition of the final penalty, the respondent had failed to take account of applicant's submissions.

[41] The further question arises as to the requirement to have regard to the need to deter such conduct. Mr Cook sought to emphasise the extent of applicant's cooperation with respondent as provided for in s 167 (2) (a) (i) and (ii) of the Financial Sector Regulation Act 9 of 2017.

[42] He further submitted that the administrative penalty of R 10 million was penal in nature and was contrary to the intended role of deterrence as envisaged in the Act.

[43] As this Tribunal explained in *Moorcroft v Financial Service Sector Conduct Authority* [2022] ZAFST 133, deterrence is not a self-standing factor and has to be taken in conjunction with the degree to which a person has cooperated with the regulator regarding the contravention. The long period which the applicant relied on a simulated set of transactions to bolster its capital adequacy ratio is cause for concern in that this conduct represented a sustained attempt to misrepresent the substance of its financial position.

[44] Mr Cook submitted that the fine is so penal it would jeopardize the ongoing business operations of the applicant. In this case the applicant has been found to

have committed a serious offence which requires an adequate response from the Regulator in order to deter such activities by financial institutions.

[45] There was no basis put before this Tribunal to justify a conclusion that a fine of R 10 million of which R5 million was suspended was inappropriate within the context of this case or disproportionate to the conduct of the applicant. The suspension of 50% of the penalty shows that the respondent was cognisant of the financial burden of the penalty.

[46] In the result therefore the application for reconsideration is dismissed.

SIGNED on 4 December 2024

____

Judge DM Davis

obo the Tribunal Panel