‘Fit and proper’ due diligence

Integrity through fit and proper due diligence for shareholders and key personnel in financial institutions

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Why is 'fit and proper' due diligence important?

Besides being driven by a regulatory mandate in various countries across the world, financial institutions must ensure that key stakeholders adhere to specific ethical and professional standards. In ensuring that the stakeholders uphold trust and accountability within organisations, various regulators have provided guidelines on 'fit and proper' due diligence.

A glimpse into the 'global regulatory mandates'

Regulatory authorities across the globe emphasise the significance of 'fit and proper' due diligences to uphold the organisation's reliability in the industry

India

The Reserve Bank of India (RBI), in the exercise of its powers conferred **in Banking Regulations Act, 1949**, issued directions on the acquisition and holding of shares or voting rights in banking companies. The directions, **reference number RBI/DOR/2022-23/95 dated January 2023**, were issued with the intent of ensuring that the ultimate ownership and control of banking companies are well diversified, and the major shareholders of banking companies are 'fit and proper' on a continuing basis.[1]

Europe

The **Article 23(1)(b) of the Capital Requirements Directive (CRD), dated June 2013,** mandates that the European Central Bank to evaluate the reputation, knowledge, skills, and experience of anyone joining the management body of the target entity after an acquisition. This fit and proper assessment is part of the qualifying holding procedure, especially if new management members are to be appointed.[2]

1. The Reserve Bank of India – Master directions
2. EU banking supervision

Zambia

The Bank of Zambia undertakes fit and proper evaluations, as outlined in **the Banking and Financial Services Act of 2017 and the National Payments System Act of 2007**, for shareholders, directors, and senior management nominated to occupy key or significant positions within financial service providers and payment service providers, **notified under gazette notice number 1735 in December 2023.**[3]

Singapore

In Singapore, the fit and proper criteria that apply to all individuals and shareholders involved in banking activities are regulated by **the Monetary Authority of Singapore (MAS) as per the guideline number FSG-G01, last revised in July 2024**. MAS expects the individuals and shareholders to demonstrate competence, honesty, integrity, and sound financial standing.[4]

Ghana

The Bank of Ghana oversees the acquisition of financial institutions regulated under **the Banks & Specialized Deposit Taking Institutions Act, 2016** by third parties, resulting in the purchaser becoming a significant shareholder in the respective institution. The person or a group of persons, should meet the prescribed fit and proper directive to own and oversee a regulated financial institution, **as per the Merger and Acquisition Directives 2018.**[5]

Mauritius

In Mauritius, individuals acquiring shares, who may have the potential to exert considerable influence, over the financial institution must satisfy the criteria of being a fit and proper person before their shares can be recorded in the shareholders' register, in accordance with the **guideline number BOM/BSD 11, dated October 2003.**[6]

Jamaica

The Bank of Jamaica oversees and regulates Cambios and Remittance Companies under the Bank of **Jamaica Act, 1960**. Specifically, every director and significant shareholder (holding 10% or more of shares) must meet the "fit and proper" criteria, as **outlined in the 2017 notification.**[9]

Mayanmar

The Central Bank of Myanmar issued directives in March 2019 to clarify banking governance, building on the **Financial Institutions Law introduced in January 2016**. The "fit and proper" directive applies to all banks, covering major shareholders, significant interest acquisitions, directors, officers, and external auditors.[10]

South Africa

Prudential Authority (PA) and **the Financial Sector Conduct Authority (FSCA),** together known as the financial sector regulators, are required to establish fit and proper person criteria for significant owners of eligible financial institutions, mutual banks, managers of collective investment schemes, credit rating agencies, and controlling companies of banks and insurers, as **outlined in section 159(1) of the Financial Sector Regulation Act, 2017 (Act No. 9 of 2017).**[11]

Australia

In Australia, **the Financial Sector (Shareholdings) Act 1998 (FSSA)** regulates the ownership of locally incorporated banks, including subsidiaries of foreign banks. Significant shareholders must prove to the **Australian Prudential Regulation Authority (APRA)** that they are reputable and financially stable. For foreign banks, this applies to both the bank and its significant shareholders. Additionally, APRA requires substantial shareholders to show a long-term commitment to the bank and the ability to provide extra capital if needed.[12]

1. The Reserve Bank of India – Master directions
2. EU banking supervision
3. Government gazette – Zambia
4. Monetary Authority of Singapore
5. The Bank of Ghana – merger and acquisition directive
6. The Bank of Mauritius – guideline on fit and proper criteria
7. Prudential Authority – consultation paper, South African Government – Act No. 9 of 2017
8. Financial sector assessment program — Australia
9. The Bank of Jamaica - 'fit and proper' criteria for operators
10. Allen & Gledhill
11. Prudential Authority – consultation paper, South African Government – Act No. 9 of 2017
12. Financial sector assessment program — Australia

Applicability of 'fit and proper' due diligence

While the specific requirements vary by regulator and jurisdiction, overarching mandates for 'fit and proper' due diligence apply to:

Significant shareholders and ultimate beneficial owners (UBOs)

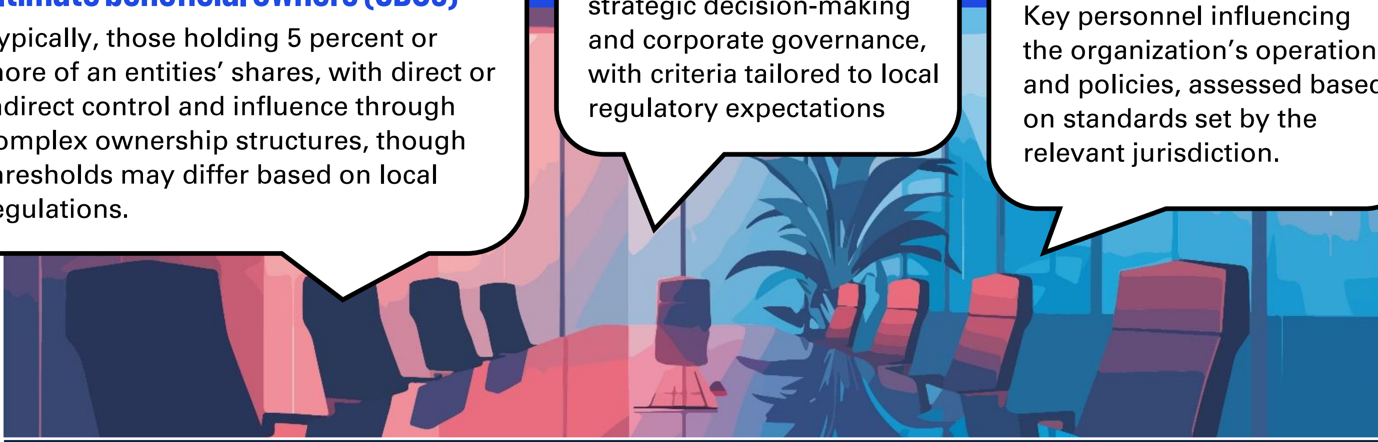
Typically, those holding 5 percent or more of an entities' shares, with direct or indirect control and influence through complex ownership structures, though thresholds may differ based on local regulations.

Board members

Individuals responsible for strategic decision-making and corporate governance, with criteria tailored to local regulatory expectations

Senior management

Key personnel influencing the organization's operations and policies, assessed based on standards set by the relevant jurisdiction.



Critical risks uncovered through 'fit and proper' due diligence

S.No	Broad risks	Impact	Example
1	**Financial mismanagement**	• Operational instability • Eroded stakeholder's trust • Regulatory and legal repercussions, • Financial losses and operational instability	In 2022, a prominent financial institution operating within Bahamas faced bankruptcy. This collapse occurred amidst serious accusations that the company's owners had engaged in embezzlement and the misappropriation of customer funds.
2	**Conflict of interest**	• Undermine decision-making processes • Bias and favoritism • Leads to choices that prioritize individual gains over the company's best interests.	In 2022, conflict of interest issues among some board members of a multinational automotive company were scrutinized for potentially influencing corporate decisions inappropriately.
3	**Legal and regulatory challenges**	• Loss of investor's trust • Financial penalties • Reputational damage • Operational disruptions • Regulatory scrutiny	In 2022, a government-backed company in Malaysia faced several regulatory issues due to the actions of a key shareholder who orchestrated a massive embezzlement scheme, leading to global security, substantial fines and legal actions against the company and associated entities.
4	**Ethical and reputational**	• Damage the company's public image • Supply chain disruptions • Stakeholder withdrawal • Employee disengagement • Increased regulatory scrutiny • Potential fines or legal costs.	In 2024, a prominent entrepreneur and his firm faced charges from U.S. regulatory authorities. They were accused of not disclosing substantial loans, which were secured using the company's assets as security.
5	**Operational disruption**	• Loss of market share • Brand reputation damage • Supply chain breakdown • Regulatory non-compliance • Increased costs	In 2022, an American social media company experienced significant operational disruptions due to management decisions during its acquisition by a businessman and investor, impacting service reliability and performance.

Approach to effective 'fit and proper' due diligence

Open-Source Intelligence

To compete in this increasingly complex market, effective Fit and Proper due diligence benefits from accessing information from leveraging registries, country-specific litigation websites, and directorship and shareholder information to uncover potential red flags, gather meaningful insights, assess risks, and devise appropriate risk mitigation actions.

Ask yourself:

- Who are the beneficial owners of the incoming investee companies? Do the shareholders, key personnel, or affiliated individuals have a track record of involvement in repeated legal disputes, political influence, criminal activities, or intellectual property infringement?

Discreet intelligence gathering

Robust fit and proper due diligence includes discreet intelligence on high-profile shareholders and key personnels, with potential political connections to understand issues of reputation, track record and integrity for enhanced decision making.

Ask yourself:

- What do trusted sources reveal about potential conflicts or undisclosed affiliations of shareholders and key personnel, and how consistent is this confidential information with other known data, requiring further review for any discrepancies?

Secure whistleblower systems

Establishing secure whistleblower systems is vital for identifying risks related to shareholders and key personnel. These systems enable employees to report concerns anonymously and safely, ensuring prompt addressing of fit and proper compliance issues.

Ask yourself:

- Are anonymous reporting channels available for mid and junior employees to report concerns about senior management, and how are these reports investigated while protecting whistleblowers from retaliation?

Ongoing risk monitoring

Regular risk monitoring helps identify and manage potential issues, ensuring compliance practices stay up-to-date with changing regulations worldwide.

Ask yourself:

- Are there any new regulatory changes or emerging threats that need to be incorporated into the framework? Are there any gaps or overlaps in risk ownership that need to be addressed?

Tailored risk-based approach

Adopt a tailored risk-based approach to categorize and prioritize potential risks according to severity. This ensures that high-risk areas, such as politically exposed persons or jurisdictions with high corruption levels, receive focused attention.

Ask yourself:

- What areas or profiles pose the highest risk, how are they identified, and what additional steps are taken for high-risk profiles beyond standard due diligence??

Social and Governance due diligence

In today's business landscape, social and governance factors are crucial to success. Any non-compliance can harm a company's reputation, financial stability, and regulatory standing.

Ask yourself:

- Are there any social or governance issues associated with the stakeholders or key personnels that could pose a risk to your business or investment?

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