

Are you ready for outcomes-based regulation?

Juanita Moolman, Head: Legal and Business Assurance in the Hollard HAD business unit.

It was refreshing for some, and possibly scary for others, to hear that, in future, an outcomes-based approach will be included in regulating the financial sector, instead of a purely rules-based approach.

In 2011 National Treasury published a document titled: "A Safer Financial Sector to Serve South Africa Better". This document proposes a comprehensive overhaul of financial sector regulation, which includes the twin peaks model of regulation. In February 2013, the Financial Regulatory Reform Steering Committee published a paper titled: "Implementing a Twin Peaks Model of Financial Regulation in South Africa". This document states that in future, the regulatory and supervisory frameworks will adopt a blend of outcomes- and rules-based regulation to achieve the desired regulatory outcomes.

Rules versus Outcomes

The current rules-based regulatory framework is well known and understood. The regulatory framework sets rules that must be adhered to by firms without much thought around the outcome that is being achieved. The rules in themselves aim to "force" a specific outcome. An example is the requirement in the Financial Advisory and Intermediary Services Act, 2002 ("FAIS") in terms whereof providers must include reference to the fact that a FAIS licence is held in all business documentation, advertisements and other promotional material. The reference to this licence is usually of little significance to customers and takes up space in marketing material or communication to customers that could be better used to provide more meaningful information. Non-compliance with these rules can result in harsh financial penalties and therefore compliance becomes a tick-box approach to avoid financial and reputational risk, often at the cost of meaningful interaction with customers.

Outcomes-based regulation represents a different approach. Outcomes-based regulation is a move away from reliance on detailed prescriptive rules, to high level, broadly stated outcomes that must be achieved. The Treating Customers Fairly approach followed by the Financial Services Board is an example of outcomes-based "regulation", where firms are required to demonstrate the delivery of those outcomes.

Benefits of Outcomes-based Regulation

It simplifies regulatory burdens and eliminates the one size fits all approach to regulation and therefore enables firms to operate under a tailored approach and to focus their compliance and other efforts on areas that hold more risk for customers.

It encourages innovation as firms develop their own solutions to achieve the outcomes in a way that adds value to the firm and its customers and avoids the unnecessary costs and effort of operating on the basis where rules, that are irrelevant in a given situation, must be complied with.

Where there are no irrelevant rules-based hurdles, it can potentially be a faster and simpler way to achieve the firm's outcomes or deliverables.

It results in increased flexibility for firms which enable these firms to be more flexible in the rapidly changing financial sector market. Firms have the flexibility to provide appropriate solutions to customers without absolute cut-offs in certain situations.

It avoids the situation where firms that are regulated attempt to avoid or get round the strict wording of a rule and instead, have to work to the general outcomes. It "levels the playing field" between firms with different risk appetites for rules based regulatory risks.

Outcomes are generally better understood and appreciated by customers than meaningless disclosures such as licence disclosures, and in turn will result in greater customer confidence.

Risks and Challenges of Outcomes-based Regulation

The main risk is that, for outcomes-based regulation to be effective, it must contain specific, clearly articulated outcomes. This will enable firms to demonstrably achieve these outcomes. One of the outcomes that firms must achieve in terms of the draft Policyholder Protection Rules ("PPR") that were published for comment in December 2016 is that "policyholders are confident that they are dealing with an insurer where the fair treatment of policyholders is central to the insurer's culture". It might be a challenge to prove that the outcome of policyholders being confident has been achieved. Another outcome that must be achieved under PPR is that "products are designed to meet the needs of identified customer groups and are targeted accordingly". With proper market analysis and record keeping firms will be able to demonstrate this outcome.

Rules bring certainty and some firms might be hesitant in the absence of rules they are accustomed to.

Looking forward

It is important for firms operating under outcomes-based regulation to develop and document comprehensive decision-making guidelines and guidelines around the internal processes that will be followed to achieve these outcomes, whilst keeping records to demonstrate the achievement of the outcomes. Firms will essentially write their own internal rules and become the regulators of these internal rules in an effort to be able to demonstrably achieve outcomes. This will be a more administratively burdensome process than simply ticking a list of requirements. Firms would need to establish parameters for assessing the achievement of outcomes and a monitoring network which demonstrates progress against those parameters.

Firms that do not know their clients and service providers well will struggle under an outcomes-based regime.

Accurate and reliable data will assist firms in defining the 'right' outcomes and to measure their performance against outcomes.

Once the initial challenges are overcome, outcomes-based regulation can result in fresh, creative and exciting offerings and interactions with customers that will really meet the needs of customers and firms.