
Implementing a twin peaks model of financial regulation in South Africa

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Foreword

As outlined in the original policy document, *A safer financial sector to serve South Africa better*, published in February 2011, South Africa is committed to the highest standards for regulating the financial sector. This is because the financial sector affects all – people and companies - who transact through the financial system, including those who do so from outside South Africa's borders. It affects pensioners, workers, depositors, employers, businesses – as all receive, invest, or send money via a financial institution.

The 2008 global financial crisis has demonstrated the weaknesses of a light-touch financial regulatory system. Even though our financial system weathered the storm, South Africa lost nearly a million jobs as a result of the global contagion that originated from the crisis in the banking and financial systems of the developed world. Had South Africa experienced a financial crisis, many more jobs would have been lost.

The dilemma that faces most countries is that the financial sector is globally integrated, but regulated nationally. For this reason, there needs to be minimum international standards and greater co-ordination among different national regulators. Through our participation in multilateral institutions and forums such as the IMF, the G20, the Financial Stability Board, the Basel Committee on Bank Supervision, the International Organisation of Securities Commissions and the International Association of Insurance Supervisors, South Africa has committed itself to implement higher global financial standards to make the financial sector safer and better.

It is against this background that we have committed ourselves to a wide-ranging set of reforms. One of the most important strands of this work has been the effort to improve the institutional structures to support financial regulation. These reforms were announced in the original 2011 policy document. The document proposed a shift to a “twin peaks” system of financial sector regulation, a proposal which was adopted by Cabinet in July 2011.

The main objective of the policy is the development of institutions to deal with system-wide macro-prudential risks. This will be achieved by separating the oversight of *market conduct regulation* (regulating how firms conduct their business, design and price their products, and treat their customers) from *prudential regulation* (regulating financial institutions' solvency and liquidity).

This document provides more detailed proposals on implementing the decisions arising from the original 2011 policy document. It outlines the most important building blocks of the new system, presents the governance and accountability framework, and sets out the approach to prudential and market conduct regulation. It was prepared by the Financial Regulatory Reform Steering Committee (FRRSC)¹, which comprises of senior officials from the three key financial regulatory institutions (South African Reserve Bank, Financial Services Board and National Treasury).

The report, together with the original 2011 policy document, *A safer financial sector to serve South Africa better*, is the basis for consultation with the public and key stakeholders, after which this document will be revised and presented to the Governor of the South African Reserve Bank and myself for further consideration. Thereafter I will prepare and table the legislation necessary for the implementation of the twin peaks model of regulation.

An effective regulatory framework requires strong coordination by regulators. This document is a testament to the strong partnership between the National Treasury, the South African Reserve Bank, and the Financial Services Board, which together with the National Credit Regulator, are working together to bring about a better, safer and more inclusive financial sector to serve all South Africans.

A handwritten signature in black ink that reads "Pravin Gordhan". The signature is written in a cursive style and is underlined with a single horizontal line.

Pravin Gordhan

Minister of Finance

¹ The task team, known as the Financial Regulatory Reform Steering Committee (FRRSC), is co-chaired by Lesetja Kganyago, Deputy Governor of the South African Reserve Bank; Ismail Momoniat, Deputy Director-General: Tax and Financial Sector Policy of the National Treasury; and Dube Tshidi, Chief Executive Officer of the FSB

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Overview

In 2007, Government launched a formal review of South Africa's financial regulatory system. This review was expanded in 2009 to take into account the lessons learnt from the global financial crisis that began in 2008. This work culminated in the Minister of Finance publishing a policy document, *A Safer Financial Sector to Serve South Africa Better*, in 2011.

The policy document noted that the domestic financial sector had weathered the global financial crisis relatively well due to the country's sound macroeconomic fundamentals and a robust financial regulatory framework. However, it cautioned against becoming complacent and proposed to move towards a "twin peaks" model of financial regulation. Speaking about the proposed change during his 2012 Budget Speech, the Minister of Finance said:

As announced last year, we intend to shift towards a twin peaks system for financial regulation, where we separate prudential from market conduct supervision of the financial sector. Consultations will continue this year, with a view to tabling legislation in early 2013.²

The **prudential regulator's** objective will be to maintain and enhance the safety and soundness of regulated financial institutions. Prudential safety and soundness imply the continued financial health of regulated institutions. The prudential regulator, which will form part of the South African Reserve Bank ("the Bank"), will be responsible for the prudential regulation and supervision of banks and insurers. In this context, prudential regulation includes both micro and macroprudential aspects (see box below).

The **market conduct regulator's** objective will be to protect consumers of financial services and promote confidence in the South African financial system. This responsibility will be carried out by the Financial Services Board, which will be transformed in order to meet its revised mandate with regards to market conduct regulation.

² National Treasury (2012) "2012 Budget Speech" (Pretoria: National Treasury, 22 February 2012), page 28.

Macroprudential and microprudential

The term “macroprudential” regulation or supervision refers to the analysis of strengths and vulnerabilities of financial systems as a whole (systemic risk). Macroprudential assessments cover a wide range of economic and financial circumstances and information, such as gross domestic product growth and inflation, the structure of a financial system, and qualitative information on the institutional and regulatory framework. The term “microprudential” refers to the safety and soundness of individual financial institutions.

Government, through the Minister of Finance, is responsible for the policy framework for the regulation of the financial system. In terms of this framework, the Bank will take a leading role in promoting financial system stability by becoming the **systemic regulator** for the South African financial system, and supervising and monitoring the financial system to give effect to the financial stability objective.

This document goes into greater detail on the proposed twin peaks reforms and how they will be implemented. A summary of the chapters follows.

Chapter 1 – Setting the scene

Under the twin peaks model, the financial services industry and related structures will have two regulators: a prudential regulator, which will operate within the Bank, and a new market conduct regulator, which will be established from a restructured Financial Services Board (FSB).

The proposed reforms aim to maintain and enhance the following policy objectives:

- Financial stability
- Consumer protection and market conduct
- Expanding access through financial inclusion
- Combating financial crime.

The regulatory and supervisory framework will aim to be:

- Transparent
- Comprehensive and consistent
- Appropriate, intensive and intrusive
- Outcomes-based
- Risk-based and proportional
- Pre-emptive and proactive

- A credible deterrent to non-compliance with prescribed standards
- Aligned with applicable international standards.

These overarching principles – as well as the economic arguments in favour of moving towards a twin peaks model, and a discussion of the global context in which such reforms are taking place – are discussed in greater detail in Chapter 1. To realise the above principles, which are outlined in the original 2011 document *A safer financial sector to serve South Africa better*, entry to the financial sector must be subject to an appropriate licensing or registration process. Such a process will include a high standard for the determination of fitness and propriety (“fit and proper” test) for all participants in the sector.

Chapter 2 – Governance and accountability framework

The governance framework will provide clarity on the policy objectives of Government and ensure that regulators have the necessary operational independence, allowing them to perform their duties impartially. The accountability of regulators will be achieved by:

- Consulting appropriately with stakeholders
- Tabling strategic plans, budgets (where relevant) and an annual report in Parliament, and answering any questions that may arise
- Audits where required by the Public Finance Management Act (1999) (PFMA)
- Providing for a regular flow of information to the National Treasury and the Minister of Finance.

The prudential regulator will be accountable to the South African Reserve Bank. It will provide information and interact regularly with the Minister of Finance on regulatory and supervisory matters, and table a report in Parliament annually. The prudential regulator will be funded in line with international best practice, and consideration is being given to various models, including a formula-based levy on regulated financial institutions.

The market conduct regulator will be governed by an executive management team appointed by the Minister of Finance. It will provide information and interact regularly with the Minister of Finance on regulatory and supervisory matters and table a report in Parliament annually. The market conduct regulator will be funded by industry levies.

Both funding models will be aligned with international best practice to ensure transparency and independence from political interference and perceived “regulatory capture” by industry.

Chapter 3 – Strengthening financial stability oversight

The implementation of the twin peaks model will result in existing regulatory entities and structures being rearranged. The Financial Stability Oversight Committee (FSOC) will be given legislative backing and it will coordinate efforts to maintain financial stability and limit systemic risk, including:

- Overseeing financial stability, including identifying risks and responding appropriately
- Playing an advisory role in crisis management and resolution, while considering the specific roles of the Minister of Finance, the Governor of the South African Reserve Bank and the Bank as the resolution authority.

FSOC members will include representatives from both the prudential and market conduct regulators, with observers from the National Treasury. It will be chaired by the Governor of the Reserve Bank.

The Bank, as systemic regulator, will have a mandate that extends to overseeing systemic risks that may arise from key financial markets infrastructure. The Bank is legally responsible for regulating and supervising payment, clearing and settlement systems, including the licensing of the South African Multiple Option Settlement (SAMOS) system and Bankserv. The National Payment System Act (1998) will be amended to provide for mandatory consultation with the market conduct regulator on relevant matters, although ultimate responsibility for licensing and supervision will reside with the Bank.

The regulators will be jointly responsible for the licensing of securities exchanges, with the market conduct regulator as lead regulator. The market conduct regulator will be legally required to consult with the South African Reserve Bank on relevant matters. The Bank, in its role as systemic regulator, will also be entitled to access information from the relevant exchange. The prudential rules applicable to members of the exchange will also be subject to approval by the Bank. In addition, clearing house licenses and rules will, where practical, be a joint responsibility.

The Financial Markets Bill (2012) creates a licensing regime for a central clearing counterparty and a trade repository to better monitor and mitigate the risks posed by over-the-counter derivative instruments. As the systemic regulator, the Bank will also oversee the financial stability risks emanating from this infrastructure.

Coordinated conglomerate supervision is pivotal to a twin peaks regulatory framework, especially where a financial group includes both banking and insurance businesses. Such supervision will be developed as a financial stability function of the Bank, and coordinated with the market conduct regulator to address market conduct risks in conglomerates.

Chapter 4 – Prudential regulation and supervision

In addition to the overarching principles outlined in Chapter 1, the prudential regulator's envisaged regulatory and supervisory approach will be based on 10 guidelines:

- Regulations will be designed to proactively identify and address possible market imperfections.
- Regulations will mostly be principle-based.
- Regulations will be aligned with international best practice.
- Regulations will generally apply to financial institutions and their activities.
- All activities or financial products that are consistent with the prescribed principles should be regarded as permissible unless the regulator specifies otherwise.
- Registration, approval or licensing will be required before a person or institution can carry out specified regulated activities.
- The prudential regulator will have the authority to set licensing, registration and approval criteria and reject applications that do not meet these requirements.
- The criteria for licensing, registration or granting approval will be consistent with those applied in prevailing legislation and supervisory practice.
- At the minimum, the registration, licensing or approval process will consist of an assessment of the ownership structure and governance of an institution and its wider group.
- The prudential regulator will have the authority to implement timely corrective actions for regulation transgressions.

Chapter 5 – Market conduct regulation and supervision

The market conduct regulator will be guided by the eight overarching principles listed earlier. It will employ a range of supervisory tools. Traditional tools will include both scheduled and ad hoc on-site visits, reviewing compliance and other reports, issuing ad hoc information requests, and reviewing and analysing reports and other information obtained offsite. New supervisory tools will include “mystery shopper” techniques (where anonymous, independent observers posing as customers or potential customers test the quality of institutions’ interactions with customers), sourcing information from third parties (such as intermediaries, suppliers, the media, ombud schemes and consumer bodies), new or existing consumer and industry surveys, and revised and enhanced reporting requirements from regulated institutions.

Reporting requirements will need to be comprehensive and rigorous to allow the market conduct regulator to identify conduct risks and unfair customer treatment. These reporting mechanisms will include both non-public components (to be incorporated as deemed appropriate into existing regulatory returns and compliance reports) and the public disclosure of identified measures.

The market conduct regulator will be empowered to intervene to mitigate emerging conduct risks both at an industry and institution level.

Chapter 6 – Crisis management and resolution

The global financial crisis illustrated the importance of having mechanisms in place to deal with disruptions that threaten financial stability. The South African Reserve Bank has been identified as the resolution authority in South Africa due to its financial stability mandate, its responsibility for both micro- and macroprudential supervision, and its role in managing money-market liquidity. However, if taxpayers’ money is at risk, decisions to use fiscal resources will be taken by the Minister of Finance, who operates within the appropriate legislative framework (e.g. the Public Finance Management Act and appropriation laws).

The resolution framework will ensure financial stability rather than institutional soundness. It will not be limited to specific types of institutions, but will be applied to all elements of the financial system that are systemically significant. Such elements could include banks, non-bank financial institutions, major participants or exposures in financial markets – including market infrastructure organisations and markets themselves.

The criteria to determine whether an institution, organisation or market falls within the framework will be based on that institution's contribution to systemic risk, or its systemic significance, at a given point in time.

Chapter 7 – Enforcement

Enforcing the twin peaks model will require various approaches. Enforcement options will include summary administrative penalties, referrals to an administrative enforcement forum and criminal prosecution. Supervisory actions will include suspending or withdrawing licences and approvals, issuing orders to take or cease particular actions and debarments. The enforcement regime will build on the successes of, and lessons learnt from, the FSB Enforcement Committee. Consideration will be given to decriminalising certain contraventions, instituting a voluntary disclosure programme and rationalising judicial and administrative review. A key goal of enforcement is deterrence.

Although the shift towards a twin peaks model will not require any material change to the mandate or positioning of the Financial Intelligence Centre (FIC), the demarcation of responsibilities between the market conduct and the prudential regulator will result in practical changes to supervising compliance with the FIC Act (2001). In particular, the obligations imposed on supervisory bodies in terms of the act will need to be appropriately allocated to the market conduct and prudential regulators.

Compliance with anti-money laundering (AML) and the combating of the financing of terrorism (CFT) regulations will be supervised as part of regulated institutions' enterprise-wide risk-management process. Significant reputational risks may arise for the institution, the regulators and the financial system as a whole if compliance is not effectively monitored. The prudential regulator will supervise AML and CFT compliance in institutions that fall under its authority, while the market conduct regulator will carry out AML and CFT supervision for those that do not fall under the prudential regulator.

Chapter 8 – Implementation and next steps

The twin peaks model will be implemented in two phases. During the first phase, which will run during 2013/14, supporting legislation will be developed and tabled in Parliament to enable both the South African Reserve Bank and the FSB to assume their additional responsibilities. Implementing the twin peaks model will also require the transfer of resources and staff that are currently responsible for prudential regulation in the FSB to the Bank.

The second phase will be implemented over the next several years and will consist of the broader harmonisation process of specific financial-sector regulatory and supervisory systems and frameworks. Public consultation processes will be followed for both the development of legislation and the coordination of specific financial-sector regulatory frameworks.

Comments should be sent to the Head of the FRRSC Secretariat, Mr Unathi Kamlana, via fax to 012 313 4974 or by email to twinpeaks@resbank.co.za. The closing date for comments is 8 March 2013.

1. Setting the scene

1.1 Moving towards a twin peaks model

In February 2011, the Minister of Finance published *A Safer Financial Sector to Serve South Africa Better* – a policy document that announced that South Africa would move towards a twin peaks model of financial regulation. The proposed twin peaks model, approved by Cabinet when it adopted the *A Safer Financial Sector to Serve South Africa Better* policy document, is one where prudential and market conduct regulation is undertaken by dedicated and separate regulators. The prudential regulator, located within the South African Reserve Bank, will assume responsibility for prudential regulation and supervision of regulated financial institutions, while the FSB will be transformed into a focused market conduct regulator responsible for protecting consumers of financial services and promoting confidence in the South African financial system. The Minister and the Governor of the South African Reserve Bank established a joint task team³ that included representatives from the National Treasury, the South African Reserve Bank and the FSB to:

- Coordinate and drive initiatives for implementing a twin peaks regulatory framework.
- Formulate and implement an explicit financial stability mandate within an appropriate macroprudential framework in the South African Reserve Bank.
- Contribute to formulating macroprudential policies to limit the cost of system-wide distress in the financial system.

The South African Reserve Bank will also be responsible for:

- Maintaining overall financial stability with the assistance of the market conduct regulator.
- Overseeing systemic risks that may arise from key financial markets infrastructure – the Bank is well placed to perform this role due to its ability to assess the safety and soundness of key role players in the payments system. It is also able to provide emergency liquidity and respond to relevant macroeconomic developments.

³ The task team, known as the Financial Regulatory Reform Steering Committee (FRRSC), is co-chaired by Lesetja Kganyago, Deputy Governor of the South African Reserve Bank; Ismail Momoniat, Deputy Director-General: Tax and Financial Sector Policy of the National Treasury; and Dube Tshidi, Executive Officer of the FSB.

The FSB will be transformed to create the new market conduct regulator, which will be responsible for regulating and supervising the financial services sector's market conduct, including banks, insurers, financial advisers, financial intermediaries, investment institutions and the broader financial markets.

The underlying key motivations for the twin peaks reforms are outlined below:

- a) There is a need to develop rigorous market conduct regulation for the financial sector in order to deal with possible market abuses and ensure adequate investor / consumer protection;
- b) Specific legislation requiring tougher and different mechanisms may be necessary for the financial sector, including adherence to higher standards of disclosure, strengthening the powers of financial regulators and emergency provisions as they apply when a financial institution experiences capital, liquidity or insolvency pressures;
- c) Due to the nature of risks inherent in the financial sector, which may be systemic, regulators should be empowered to act swiftly, without fear, favour or any interference.
- d) The regulatory framework for the financial sector should ensure that all financial institutions are subjected to the same regulatory standards, regardless of ownership (public or private), in order to reduce regulatory arbitrage;
- e) Coordination between regulators is a key pillar of successful regulation. Regulators should therefore be obliged to consult other regulators when their actions impact on other areas of regulation; and
- f) The principle in (e) above should also apply within government where regulatory agencies resort under various departments. Such co-ordination should also be extended to apply between relevant departments and the legislation they are responsible for.

Overarching regulatory and supervisory principles

The regulatory and supervisory frameworks will aim to be:

- **Transparent** – Appropriate information regarding the regulators’ decisions, actions and approaches will be made available to its governance structures, regulated entities and the public in general, through consultation or other means, within the bounds of necessary confidentiality safeguards.
- **Comprehensive and consistent** – Regulatory and supervisory frameworks will identify and address inappropriate risks and gaps in the regulatory coverage of financial services activities. These frameworks will limit opportunity for regulatory arbitrage between comparable financial services by ensuring consistent principles and rules for comparable activities. The supervisory frameworks will also ensure comprehensive coverage and consistent supervisory intensity based on identified risks.
- **Appropriate, intensive and intrusive** – Supervisory frameworks will empower the regulators to gain meaningful, timely insight into the risks arising from supervised entities’ activities.
- **Outcomes-based** – The regulatory and supervisory frameworks will adopt a blend of principles- and rules-based regulation to achieve the desired regulatory outcomes. Where principles-based regulation is used, the framework will ensure the principles are legally binding and enforceable.
- **Risk-based and proportional** – The regulatory and supervisory frameworks will enable the regulators to assess the risks associated with different regulated activities, systems, entities or groups of entities. The frameworks will be sufficiently flexible to ensure that regulatory, supervisory and enforcement approaches are proportionate to the risks.
- **Pre-emptive and proactive** – The frameworks will enable the regulators to identify emerging risks to financial stability and consumers as early as possible and grant them the authority to intervene to reduce the likelihood of these risks materialising.
- **Credible deterrence** – To achieve the desired outcomes, regulated entities must know that the regulators have the authority to enforce adherence to prescribed principles and rules, and will not hesitate to do so.

- **Aligned with applicable international standards** – The frameworks must adhere to applicable standards set by relevant international standard-setting bodies. South Africa will continue to play an active role in shaping such international standards.

To realise these principles, entry to the financial sector must be subject to an appropriate licensing or registration process. Such a process will include a high standard for the determination of fitness and propriety of all players in the financial sector.

The regulators will be cognisant of the trade-offs inherent in applying the above principles, and will seek the optimum balance in enforcing the regulatory frameworks. For example, the principle of comprehensive and consistent regulation and supervision needs to be balanced against the need to adopt a risk-based and proportional approach. Minimising the scope for regulatory arbitrage should not result in an inflexible “one-size-fits-all” framework.

The prudential and market conduct regulators may emphasise some of these principles more than others in the way they pursue their respective mandates and objectives. This is discussed in greater detail in Chapters 4 and 5.

Scope of responsibility

The FRRSC’s analysis of the risks associated with regulated financial services, classes of institutions, infrastructure and markets in South Africa indicated that the market conduct regulator should be responsible for regulating and supervising the market conduct of all regulated financial markets, institutions and activities, while the prudential regulator should be responsible for the prudential regulation and supervision of banks, long-term and short-term insurers. As systemic regulator, the South African Reserve Bank will also oversee key financial markets infrastructure (see Section 3.2). In certain cases, particularly where market conduct-related risks substantially outweigh prudential or financial stability risks, the market conduct regulator will be responsible for both prudential (if any) and market conduct regulation (see Table 1.1).

The legislative framework will facilitate coordination and allocation of supervisory responsibilities relating to new and emerging areas of financial services activity between the prudential and market conduct regulators, in consultation with the National Treasury and with due consideration of their respective mandates.

Table 1.1: Division of responsibility between prudential and market conduct regulators

Regulated financial sector/activity	Systemic regulator	Prudential regulator	Market conduct regulator	All supervision by market conduct regulator ⁴
Long-term insurance	✓	✓	✓	
Short-term insurance	✓	✓	✓	
Micro-insurance	✓		✓	✓
Banking	✓	✓	✓	
Credit provision conduct of business	✓			✓
Collective investment schemes and management companies	✓			✓
Financial advisory and intermediary services	✓			✓
Exchanges	✓	✓	✓	
National payment system	✓		✓	
Other financial markets infrastructure ⁵	✓		✓	
Credit ratings agencies	✓			✓
Pension Funds	✓			✓

For pension funds, prudential regulation and supervision will be carried out by a ring-fenced unit within the market conduct regulator. The authorities will closely monitor this arrangement and, on the basis of this assessment, decide whether to move the prudential regulation of pension funds fully into the prudential regulator.

The National Credit Regulator (NCR) plays an important role in the market conduct regulation of credit extension, for both banks and non-bank financial institutions. It needs to be noted that the six major retail banks account for almost 90 per cent of all credit extension. Whilst the 2011 policy document noted that market conduct standards must be strengthened in the retail banking sector, such powers need to include the regulation of banking products and charges, as well as bank lending practices. However, one of the key lessons from the financial crisis is the risk of regulatory arbitrage that arises when more than one regulator operates over prudential or market conduct objectives. The National Treasury will engage the Department of Trade and Industry to assess the current arrangements, including the impact of having two separate regulators covering different aspects of market conduct in the retail banking sector. Steps will be taken to ensure coherence in the regulation of market conduct.

⁴ The market conduct regulator's mandate includes supporting financial stability. In cases where the prudential regulator does not fulfil a microprudential function in relation to a particular entity or activity, the market conduct regulator will engage the prudential regulator and the FSOC regarding relevant systemic issues, particularly when the entity or activity concerned forms part of a larger group or conglomerate. In addition, in entities where financial soundness requirements are limited to ensuring that there are sufficient liquid assets for operational purposes, there is no "promise" to customers that needs to be protected through prudential regulation, so the market conduct regulator may monitor compliance with liquid asset requirements. Examples of such entities would be collective investment scheme management companies and financial services providers licensed under the Financial Advisory and Intermediary Services Act.

⁵ These include central counterparties, clearing houses, central securities depository and trade repositories.

Cooperation and coordination

Table 1.1 shows that the regulators will jointly supervise a number of financial sectors. A key strength of the twin peaks model is that it allows each regulator to focus on its core mandate – financial soundness and stability in the case of the prudential regulator, and market conduct in the case of the market conduct regulator – but for the model to work there needs to be cooperation between the regulators to form a consolidated view of risks in a particular sector and implement coordinated actions.

The regulators will therefore ensure that robust mechanisms are put in place to ensure effective synchronisation between themselves, and between them and other relevant domestic or international regulatory agencies. These mechanisms will seek to minimise the risks of duplication, inconsistencies and gaps in regulation and supervision and will, at minimum:

- Contain a general requirement to share and protect the confidentiality of information.
- Specify how to handle conglomerates or groups where each regulator is responsible for different elements within a group or both regulators are responsible for certain elements within a group.
- Specify processes for authorising, licensing or approving entities or individuals under dual regulation.
- Establish inter-regulatory or other multi-stakeholder committees, working groups and similar structures.
- Specify processes to deal with potential conflicting policy objectives.
- Set predefined roles for each regulator during a crisis.

These formal mechanisms will be strengthened through non-legislated coordination mechanisms such as memoranda of understanding, and by including inter-regulatory cooperation in each regulator's senior-management key performance indicators. Provided they are consistently and constructively applied, such non-legislated channels may be more effective in ensuring prompt and targeted engagement between regulators (and between regulators and their international counterparts) than more formal, rigid structures.

Where an institution is regulated by both regulators, a “two-key approach” to licensing/registration will be adopted. Although this may result in a single licence or registration, approval from both regulators will be required. The consultation process to manage such approvals will need to be specified.

It should be noted that there are also a number of other financial and non-financial regulators, often reporting to different Ministers. Hence Cabinet approved the principle of coordination between regulators as a key pillar of successful regulation. Cabinet also approved the principle that regulators should therefore be obliged to consult other regulators when their actions impact on other areas of regulation.

1.2 The global context for regulatory reform

In the wake of the global financial crisis, policy makers around the world have focused on fixing the weaknesses revealed in their financial regulatory frameworks. Many regulatory authorities have launched substantial systemic reforms. There has also been a coordinated global effort to improve the way that risk in the financial sector (particularly systemic risk) is managed at national and international level.

International coordination

As the global crisis took hold in mid-2008, it soon became clear that coordinated action would be needed, not only to prevent a collapse of the world financial system, but also to oversee the building of a stronger, more effective global framework for financial sector regulation and supervision. This effort has proceeded on several levels – including at the political/economic level between governments, and at the regulatory/technical level involving regulatory agencies and central banks. Finance ministers have been centrally involved in these processes, working to set out the direction for a new global financial system. For example:

- At the October 2008 G7 Summit in Washington, and the follow-up G20 Summit in November, it was agreed that the global response to the financial and economic crisis should be coordinated by the G20. This was a particularly significant step in that it recognised the importance for global financial stability of the leading emerging economies such as Brazil, China and South Africa.
- At the London G20 Summit of April 2009, the new Financial Stability Board was created, and a commitment to much stronger regulation, particularly of systemically important financial institutions, such as hedge funds and credit rating agencies, was established.
- Subsequent G20 summits at Pittsburgh, Toronto, Seoul, Cannes and Los Cabos have seen practical measures agreed to in the areas of bank capital, over-the-counter derivatives, credit ratings agencies and other regulatory gaps identified.

- The summits have attempted to forge a clear political commitment to a common economic strategy for dealing with the downturn that has followed the crisis. Reform of the International Monetary Fund to provide it with greater capacity to deal with economic turbulence, and an updated governance structure reflecting the growing importance of the leading emerging economies, has been a key outcome of this process.

At the regulatory level, central bank governors and banking, insurance, pensions and investment institution supervisors have continued to coordinate action through a range of forums outlined below.

International standard-setting bodies

South Africa is affiliated to the following bodies and subscribes to their principles and standards:

Basel Committee on Banking Supervision: Established by the G10 central banks in 1974, this committee provides a forum for regular cooperation among member countries on banking supervisory matters. Its objective is to improve the quality of banking supervision worldwide.

Committee on the Global Financial System: Consisting of major advanced and emerging economy central banks, this committee monitors global financial system conditions and analyses financial market functioning to improve market functioning and promote financial stability.

Committee on Payment and Settlement Systems: Provides a forum for cooperation among member central banks on issues related to payment, clearing and settlement systems. It monitors and analyses developments in such systems and formulates broad oversight standards in these areas.

Financial Action Task Force: This 36-member intergovernmental body, established by the Group of Seven, aims to develop and promote national and international policies to combat money laundering and terrorist financing.

International Association of Deposit Insurers: The association represents over 70 jurisdictions and provides a forum for deposit insurers, central banks and international organisations to discuss issues related to financial stability, deposit insurance and resolution activities.

International Association of Insurance Supervisors: Represents insurance regulators and supervisors from nearly 140 countries. It aims to promote effective and globally consistent regulation and supervision of the insurance industry.

International Accounting Standards Board: A privately funded board with members from nine countries that aims to develop, in the public interest, a set of high-quality, understandable and enforceable global accounting standards.

International Auditing and Assurance Standards Board: Develops auditing and assurance standards and guidance for all professional accountants.

International Financial Consumer Protection Network: Recently recognised by the Group of 20 (G20) and Financial Stability Board as the body to take the lead on global financial consumer protection, as the sole international organisation of consumer protection regulators.

International Monetary Fund: The fund analyses its members' macroeconomic and financial policies, as well the international monetary system in general, to develop and monitor global monetary standards and codes.

International Organisation of Pension Supervisors: An international body that sets standards on pension supervision and regulation, taking into account the variety of private pension systems.

International Organisation of Securities Commissions: The international policy forum for national regulators of securities and futures markets. It develops standards of securities regulation to maintain

efficient and sound markets.

Joint Forum: Established in 1996 under the aegis of the Basel Committee on Banking Supervision, the International Organisation of Securities Commissions and IAIS to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.

Organisation for Economic Cooperation and Development: Aims to promote policies designed to achieve sustained economic growth and employment in its member countries. Encourages the convergence of relevant policies, laws and regulations to promote efficiency in financial markets and enterprises.

World Bank: Develops international standards to promote financial-sector development. Together with other standards-setting bodies, it has developed international standards for insolvency and creditors' rights, financial infrastructure and public debt management. In cooperation with the International Monetary Fund, the World Bank assesses compliance with the core international financial-sector standards and the issuance of reports on the observance of standards and codes.

In April 2009 the Financial Stability Board was established. This body, the successor of the Financial Stability Forum, coordinates the work of national financial authorities and international standard-setting bodies, and develops and promotes effective regulatory, supervisory and other policies. The Board has taken forward initiatives in a number of areas that presented clear systemic risks. These include the establishment of specific regulatory regimes to deal with global systemically important financial institutions, regulation of so-called shadow banking, compensation practices in banking, over-the-counter derivatives trading, and the introduction of a common framework for crisis management and resolution of financial institutions.

Country case studies relevant to South Africa

Global reforms have been complemented by a range of domestic reforms. In many cases, these have focused on changing the content of regulation. Each G20 country, for example, is carrying out its own work to implement strengthened global standards.⁶ Some jurisdictions have also worked to reform institutional arrangements.

Since 2008, a number of influential think tanks, practitioners, and academics have argued for the wider adoption of the twin peaks model.⁷ The Netherlands and Australia both have successful twin peaks systems in place, while the United Kingdom is moving in that direction. Other jurisdictions have adopted features of this model in their regulatory frameworks.

⁶ Detailed reports on the progress of all G20 jurisdictions (including South Africa) are available at http://www.financialstabilityboard.org/publications/r_120619nr.htm

⁷ eg G30 Report on the Structure of Supervision (2009) available at http://www.group30.org/rpt_06.shtml, S. Fischer (2009), Kremer and Schoenmaker (2010)

The French government, for example, has merged banking and insurance supervision into a single body – the *Autorité de Contrôle Prudentiel*, closely linked to the central bank, with a separate securities markets and conduct regulator. Canada has an integrated regulator but retains strong twin peaks components. Many features of the original Dodd-Frank reforms for the US regulatory architecture were based on twin peaks modelling.⁸

One reason for the popularity of the twin peaks model is that both of the countries that had this system in place (Australia and the Netherlands) are generally held to have had a “good crisis”.⁹

The Dutch government implemented twin peaks regulation in 2002, based on a rationale that the effectiveness of regulation would be enhanced by moving to clear responsibilities and accountabilities based on distinct authorities with objectives for prudential and conduct of business regulation.

The UK is similar to South Africa in that it has also committed to moving to a variant of the twin peaks model, with a reform programme expected to be implemented in the first half of this year. The UK is also leading the way in introducing macroprudential regulation, with the establishment last year of a Financial Policy Committee, an advisory committee that will take on formal macroprudential powers. The UK reforms are similar to those proposed by South Africa, particularly in respect of a clear and distinct role for the central bank, a specialist prudential regulatory function within the central bank, and a separate market conduct regulator. Both models place significant weight on the operational independence of these regulatory bodies.

Common threads across these jurisdictions are a significant role for the central bank in systemic and prudential regulation; and a strong, integrated market conduct regulator with oversight of all aspects of financial sector market conduct, including banking and credit extension.

The shared experience of South Africa, Australia, the Netherlands, Canada, the UK and the US shows that it is possible for different jurisdictions to ask different questions, but nevertheless arrive at very similar answers. As an active participant in international reform programmes,

⁸ Not all of the measures originally contemplated have been implemented due to changes as a result of Congressional compromise and negotiation in passing the Dodd-Frank Act).

⁹ Despite its early adoption of the twin peaks model, the Netherlands was not wholly immune to the financial crisis. DSB Bank, a systemically significant institution, failed in 2009; Fortis, a Dutch-Belgian bancassurance firm, collapsed following its participation in the takeover of ABN Amro.

South Africa remains at the forefront in implementing global best practice in financial sector regulation. Our overall reform programme, including twin peaks, is grounded in this principle.

1.3 Assessment of costs and benefits

This section discusses the costs and benefits of implementing a twin peaks model.

A case for regulation¹⁰

A key lesson of the global crisis is that inappropriate and/or insufficient financial regulation can impose enormous costs. Yet inept regulation can also result in costs. A good regulatory system needs to balance the costs of compliance with the need to ensure compliance.

The economic case for regulation relies on four types of market failure:

- **Externalities** arise when economic agents are neither charged nor compensated for the economic impact of their choices on others. In the financial sector, the externalities associated with an institution's failure may be substantial. For example, a pension fund or bank's failure will result in losses for pensioners and bank depositors. In addition, systemic externalities could arise, where the failure of one institution causes the failure of other institutions, and potentially the entire financial system.
- **Public goods** do not lend themselves to market allocation because it is difficult to exclude individuals from enjoying the goods or services once they are produced, and because it costs little for an additional individual to use them. Many elements of financial market infrastructure are public goods. For example, although the national payment system has been an expensive and complex system to set up and maintain, the cost of an additional transaction is very low. To avoid abuse, the national payment system is owned by all users of the system and needs careful regulation.

¹⁰ The words regulation and supervision are often raised interchangeably in the policy document. Supervision has to do with monitoring and enforcement, and regulation with rule-making. Regulation are therefore a policy framework where the "actual hard rules that are written down" and supervision the "application of those rules to a particular firm or group of firms and going in there and making sure that they are complying with those rules". As such the pursuit of financial stability is the common goal of both regulation and supervision. (Quote attributed to Clive Maxwell, Director for Financial Stability at HM Treasury, as reported in "The Future of EU financial regulation and supervision (European Union Committee- Fourteenth Report as reported in the UK House of Lords in its 2008-09 session)).

- **Insufficient information and information asymmetries** about the characteristics of a good or service may prevent markets from forming. Customers may be at a disadvantage due to information asymmetry because they might purchase a financial service that they think does one thing but actually does another. Disclosure rules, interventions aimed at ensuring product suitability and other consumer protection and redress mechanisms help protect customers against the risk of inappropriate decisions.
- **Market power**, where a few buyers or sellers are able to exert significant authority over prices, can dampen expansion and exclude some otherwise willing market participants.

The key objective of regulation is to improve the functioning of the financial system and, in doing so, support consumer confidence and economic growth. In designing South Africa’s twin peaks model, it is important to balance the costs of regulation with its benefits. The benefits to society include putting in place appropriate measures to limit the occurrence of market failures. Table 1.2 sets out how the National Treasury policy document aims to mitigate the types of market failure mentioned above.

Table 1.2: Proposals to mitigate market failures

Market failure	Regulatory response
Externalities	Prudential oversight concerns itself with institutions’ safety and soundness – in other words, ensuring that they remain solvent and liquid. The twin peaks model will enhance prudential oversight to ensure both better micro- and macroprudential oversight.
Public goods	Improved macroprudential oversight will include better oversight over key public goods such as financial markets infrastructure.
Information asymmetries	Information asymmetries expose consumers to the risk of making inappropriate financial decisions, which can be exacerbated when institutions exploit these asymmetries. Consolidating the market conduct regulator’s role will strengthen business regulation in the areas of disclosure, product suitability and other consumer protection measures.
Market power	Large, consolidated financial institutions may abuse their market power. This falls under the legislative jurisdiction of the Competition Commission of South Africa.

Economic theory is not the only justification for regulation. There are political reasons too. David Llewellyn notes that “although there are costs involved, the consumer may demand regulation, supervision and various forms of compensation mechanisms. There is an evident consumer demand for regulation and hence, irrespective of theoretical reasoning, there is a welfare gain to be secured if, within reason, this demand is satisfied”.¹¹

¹¹ Llewellyn, D (1999) “The Economic Rationale for Financial Regulation”. (London: Financial Services Authority).

Llewellyn sets out a number of reasons for this, including potential cost savings for consumers (as they can rely on a regulator to investigate the financial position of institutions) and the ability to seek redress for losses.

Appropriate prudential regulation will reduce the likelihood of an institution's failure and the need to bail it out using taxpayer money, while appropriate market conduct regulation will reduce the likelihood of consumer losses and bolster consumer confidence. It is difficult to quantify these economic benefits, but it is clear that appropriate regulation reduces risk and so provides substantial macroeconomic benefits.¹²

Impact assessment

Economic

An economic impact assessment is a tool for evaluating the effect of a policy on the economy, often in terms of changes in economic growth, employment and income. Such an assessment can also involve micro-analyses of policy effects on households and institutions, measured by changes in consumer spending power, industry structure, and institutions' costs and decision-making on investment, location and so on.

Economic impacts are measured by calculating the difference between economic activity occurring with and without the policy change (that is, changes to the status quo). Impacts may be direct or indirect, temporary or permanent, immediate or lagged. The status quo is typically analysed in a background assessment.

Economic impact assessments may take place before approval of an intervention to identify its effect during and after implementation to enable corrective action or inform future programmes.

Costs of regulation to the regulators

As part of the evaluation of the impact of a twin peaks model, it is important to identify the costs of regulation to the regulators. This is because the regulators will invariably pass on these costs to the regulated industry. The regulators' costs could be passed on in three ways:

- Through direct levies, fees and charges (this is how the FSB is currently funded)
- Through a fiscal transfer

¹² See, for example, Ingves (2011) www.bis.org/speeches/sp120120.htm or Barrell (2009) www.fsa.gov.uk/pubs/occpapers/op38.pdf.

- By other means. The Banking Supervision department, for example, is indirectly financed through the South African Reserve Bank's income. The majority of this income is from seigniorage¹³ and from the interest on banks' cash reserves.

There will be development and implementation costs arising from transforming the existing regulatory authorities into the two new regulators, as well as ongoing operational costs. In preliminary estimates, the overall cost implications were projected to be relatively modest because they essentially involve a shift of resources from one institution to another.

Costs of regulation to the regulated

Regulation creates direct and indirect costs to regulated entities. For example, the requirement for banks to hold capital and cash reserves presents an opportunity cost for banks. This is part of the regulatory design, as banks are required to hold a portion of their capital in highly liquid assets to help protect against insolvency.

Shifting towards a twin peaks model has two components:

- A change in the institutional structure of regulation (the policy questions here are, "Who are the regulators and what do they regulate?").
- A change in the type of regulation (the question here is, "What tools are used by the regulators to regulate?").

Ongoing monitoring of the costs and benefits of individual regulatory measures on institutions is necessary to ensure appropriate regulation.

Arguments in favour of the twin peaks model

The need for government intervention

A financial crisis can impose considerable economic costs in lost output and through a substantial deterioration in public finances. In such cases, the government may need to intervene. In addition, as highlighted in the National Treasury policy document, stability is not the only policy objective of the financial sector, which also needs to be more transparent, competitive and cost-effective.

¹³ Seigniorage revenue is the difference between interest earned on securities acquired in exchange for bank notes, and the costs of producing and distributing those notes.

Objectives of the twin peaks model

The twin peaks model has two broad objectives: to strengthen South Africa's approach to market conduct regulation and to create a more resilient, stable financial system. Better market conduct will result in improved consumer confidence in financial services and, ultimately, enhanced financial sector sustainability and greater economic growth, development and employment. A strengthened regulatory focus on financial stability will help prevent crises from developing and more easily resolve those that do occur, at a lower cost to consumers and the taxpayer.

Alternative policy options considered

Before the National Treasury published the policy document, three options were considered:

- Do nothing (retain the status quo)
- Move towards a single regulator responsible for financial regulation
- Move towards a twin peaks model.

Given the fragmented nature of the South African financial system, doing nothing was not an option. As the policy document discusses, there were a variety of other options, each with costs and benefits. A twin peaks model was seen to be the least disruptive option that would offer the most benefits as it would be able to leverage off existing strengths in both the South African Reserve Bank and the FSB.

Addressing industry concerns

The FRRSC reviewed the financial industry's contributions on the current costs of regulation and came to the conclusion that, if implemented properly, the twin peaks model can address many of the following concerns and issues:

- Regulation needs to be appropriately targeted to achieve its objectives.
- There is a need for regulatory certainty.
- Regulation needs to balance the sometimes conflicting goals of financial stability, consumer protection, competitiveness and affordability, integrity and financial inclusion.
- Reporting requirements need to be streamlined.
- The volume and frequency of regulatory changes affect institutions' operational risk and cost structures.

- Implementation time frames need to be practical, as unrealistic deadlines influence risk and costs.

Further consultation with industry is envisaged.

1.4 Conclusion

Under the twin peaks model, the prudential regulator will assume responsibility for prudential regulation and supervision of regulated financial institutions, while the FSB will be transformed into a focused market conduct regulator. Both regulators will base their regulatory framework on eight shared overarching principles, although the significance each of these regulators will place on certain principles will differ. Coordination, cooperation and information-sharing between these regulators will be crucial for the success of the model.

The economic cost of implementing a twin peaks model will be relatively minimal. Indeed, the overall economic impact of moving in this direction is expected to be positive in that the safety and soundness of the domestic financial system will be enhanced, particularly with regard to the risks posed by conglomerates.

2. Governance and accountability framework

2.1 Introduction

Governance refers to the processes and decisions used to direct an organisation, specify its authority and hold it accountable for its actions. Good governance provides the foundation for strong performance and builds community confidence in a public entity.

The twin peaks model depends on appropriate and effective governance structures that clearly set out the function, mandate, powers and accountability of each regulator. An appropriate governance framework will:

- Establish statutory structures and institutional frameworks
- Address organisational effectiveness and adaptability
- Institute governance mechanisms to ensure operational independence and independent oversight
- Institute accountability mechanisms to enhance transparency and fairness
- Institute a standardised system for appointing, remunerating or removing senior staff and oversight committees
- Provide clarity regarding the roles of various stakeholders such as the Minister of Finance, the Governor of the South African Reserve Bank, the National Treasury and each regulator's governance and executive management structures
- Specify funding mechanisms
- Facilitate coordination and information-sharing within and between the regulators
- Entrench a culture of regularly reviewing performance and conducting benchmarking studies against other countries to align domestic regulation with global best practice.

2.2 Governance pillars

A good governance framework for financial-sector regulation is based on clear policy setting and operational roles, including issues of accountability, responsibility and independence.

Policy setting

The mandate of financial-sector regulators and supervisors is derived from the policy and legislative framework proposed by Government, within specific legislation enacted by Parliament. At the pinnacle of this framework sits the public policy objectives which the authorities are responsible for advancing through the exercise of their functions. Examples of policy objectives, in no particular order, include financial system soundness and stability, fair and equitable treatment of customers, access to financial services. Government has an important role to play in balancing these narrow policy objectives with other, broader objectives, e.g. economic growth.

For reasons of accountability, it is important that, while regulators and supervisors play a key role in formulating policy, the setting of policy is the responsibility of Government. Moreover, in an increasingly dynamic globalised market, policy must be able to continually evolve – for example, the global financial crisis has led to governments around the world widening the scope of activities that regulators need to oversee. It is appropriate that more far-reaching actions are debated by Parliament to ensure appropriate accountability.

Operational independence

Financial-sector regulators must have the authority to work independently within an approved legislative and policy framework. They should have the autonomy to set appropriate rules and regulations for sectors under their supervision and the authority to enforce these rules by, for instance, revoking licences or monitoring an organisation's activities, provided this is done within their mandates and the legal protection afforded to them.

The two dimensions of operational independence – independence from political interference and freedom from regulatory capture – are equally important and call for a balanced approach to regulation that will not promote one at the expense of the other.

Accountability and integrity

Regulators carry out their functions in the interests of the public. For a regulator's decision to win public and industry support, the decision-making process must entail:

- Effective stakeholder consultation
- Legislation that entrenches the option to appeal or review any decision or rule made.

In general, the regulators' transparency and accountability will also be enhanced by:

- Establishing a stringent code of conduct
- Ensuring a regular flow of information to the National Treasury, including on actual performance against stated objectives
- Undergoing required audits
- Tabling strategic plans, budgets (where applicable) and an annual report in Parliament through the Minister of Finance, and by the Minister responding to questions in Parliament
- The Minister of Finance being in a position to order an independent inquiry into any regulatory failure/s.

To enhance accountability without compromising operational independence, the roles and responsibilities of the Minister of Finance, the National Treasury (as the line department) and both the prudential and market conduct regulators need to be clearly defined. The Minister of Finance, who is accountable to Parliament, is ultimately responsible for overseeing the financial sector.

2.3 The prudential regulator's governance framework

Governance and accountability

The prudential regulator's internal governance model will be based on the South African Reserve Bank's current governance system – its board, which includes independent, non-executive external members, will have administrative oversight over matters such as budgets, remuneration, risk management, audit and performance management.

The prudential regulator will operate within the control of the Bank, comprising departments that will report to a deputy governor. These departments will obtain their authority from, and be accountable in terms of legislation. The various heads of prudential supervision will also be appointed in terms of this legislation. Locating the prudential regulator function within the Bank will support the efficient, effective and continual information-sharing that is key to the financial stability mandate. It will also facilitate coordination with other relevant authorities in the event of a crisis.

The prudential regulator will be accountable to the South African Reserve Bank. It will provide information to and interact regularly with the Minister of Finance on regulatory and supervisory matters, and table a report in Parliament annually.

Funding model

The prudential regulator will be funded in line with international best practice to ensure transparency regarding the cost of supervision and the protection of the independence of the regulator. A variety of options are being considered, including a formula-based levy on regulated financial institutions. Details will be communicated in due course.

2.4 The market conduct regulator's governance framework

Governance and accountability

A full-time commissioner and executive management team appointed by the Minister of Finance will govern the market conduct regulator. The executive group will be responsible for determining the regulator's goals, priorities and strategies, within the bounds of policy priorities set by the Minister of Finance. For PFMA purposes, the executive team will be the market conduct regulator's accounting authority, responsible for fiduciary, compliance, audit, risk management and related reporting.

Various independent governance committees – including an audit committee, a remuneration committee and a risk committee – will administratively oversee the executive group. These committees will mostly consist of qualified, independent, non-executive external members appointed by the Minister of Finance. The Minister will appoint an independent chairperson to each committee and will set their remuneration. Each governance committee will have publicly disclosed terms of reference, which will be approved by the Minister of Finance and monitored by the National Treasury. The market conduct regulator will also provide information to and interact regularly with the Minister of Finance on regulatory and supervisory matters.

Funding

The market conduct regulator will be funded by industry levies to eliminate the risk of potential political interference that could arise from being funded mainly through the fiscus.

This funding model has been successfully followed by a number of international regulatory and supervisory bodies, and has been the funding mechanism for the FSB since its inception in 1991. However, it is possible that the levy formulae applied to particular types of entities and regulated activities may need to be adjusted to take into account the market conduct regulator's mandate in a twin peaks model of financial regulation.

2.5 Summary

- The prudential regulator's internal governance arrangements will be based on the current South African Reserve Bank's governance model, and will operate within the Bank, reporting to a Deputy Governor.
- The market conduct regulator will be governed by a full-time Commissioner and executive management team appointed by the Minister of Finance. Various independent governance committees – including an audit committee, a remuneration committee and a risk committee – will exercise administrative oversight over the executive team.
- The two regulators will be funded according to international best practice, including retaining the current levy-based system of funding for the market conduct regulator and considering options, including a formula-based levy model, for the prudential regulator.

3. Strengthening financial stability oversight

3.1 Introduction

An open letter sent by the Minister of Finance to the Governor of the South African Reserve Bank in February 2010¹⁴ articulated the need to comprehensively understand financial stability and focus on macro- and microprudential analysis, regulation and supervision. As a result, the South African Reserve Bank is now explicitly mandated to oversee and maintain the South African financial system's stability.

As a member of the G20 and the Financial Stability Board, South Africa is committed to promoting financial stability and strengthening the resilience of the global financial system. The South African Reserve Bank, as the prudential regulator's future base, and the FSB, as the basis of the new market conduct regulator, are implementing the core elements of a new global financial regulatory framework that will make the domestic financial system more resilient and stable.

The Bank will expand its oversight of the systemic macroprudential aspects of the domestic financial system, and formalise structures and resources devoted to this task. This involves establishing a framework for macroprudential surveillance and formulating a financial stability policy. The framework includes the responsibility for identifying systemic risk in the financial system, monitoring and analysing market and other financial and economic factors that may lead to accumulation of systemic risks, formulating and implementing appropriate policies, and assessing how such policies may affect the financial system.

3.2 Financial stability oversight

South Africa's move towards a twin peaks model of financial regulation, with an increased focus on financial stability, will require careful consideration of the interaction between monetary policy and the financial stability objective.

¹⁴ The letter is available at www.treasury.gov.za/comm_media/press/2010/2010021701.pdf

The model will result in a number of changes to the institutional framework for financial regulation, including:

- Formalising the FSOC within the South African Reserve Bank through legislative backing, and to include the market conduct regulator as a member and the National Treasury (as observer).
- Expanding the South African Reserve Bank's financial stability mandate to include responsibility for overseeing systemic risks that may arise from key financial markets infrastructure.
- Further developing conglomerate supervision as a financial stability function within the South African Reserve Bank.

Interaction between monetary policy and the financial stability objective

Monetary policy and financial stability are generally complementary objectives.¹⁵ However, the two objectives also have the potential to be in conflict. For example, a narrow focus on short-term price stability could succeed in reducing inflation,¹⁶ but low interest rates may lead to undue optimism and risk-taking, fuelling a financial-sector boom marked by asset price bubbles, mispricing of risk, and financial imbalances without an increase in conventionally measured inflation.¹⁷ For this reason, the monetary policy and financial stability authorities need to put in place mechanisms to manage both overlaps and potential conflict between the monetary policy and the financial stability objective.

The South African Reserve Bank has two separate policy-making committees: a Monetary Policy Committee and a Financial Stability Committee. Both these committees are chaired by the Governor of the South African Reserve Bank and, although they enjoy equal status, they have different objectives and responsibilities. While there is overlapping membership, there are also members that serve on one committee but not on the other. As the work of the two committees evolves, care must be taken to manage any potential conflict.

¹⁵ Goodhart (2010) highlights that central banks have always had a financial stability mandate, even if this was often implicit. Over time the importance of this mandate has varied.

¹⁶ See Aglietta (2004:18).

¹⁷ See Taylor (2009) for an analysis of how a long period of low interest rates in the United States contributed to the global financial crisis.

The role of the Financial Stability Oversight Committee

The FSOC will be responsible for the oversight of financial stability within the twin peaks model. It will be chaired by the Governor of the South African Reserve Bank and its membership will include the prudential regulator, other relevant officials from the Bank and market conduct regulator representatives, with the National Treasury participating as an observer. It will have discretion on the role and participation of other stakeholders whose actions are relevant for financial stability.

The primary benefit of such a coordinating structure is that it recognises that each member has a perspective on – and expertise with respect to – financial-system issues, and that combining this knowledge should significantly reduce the risks threatening financial stability and increase the effectiveness of any action taken. While the mandate of financial stability lies with the Bank, it is imperative that regulators consider financial stability in their activities. The South African Reserve Bank is not, and cannot be, the sole custodian of financial stability. Rather, it plays an important part in a system that includes the government, other regulators and self-regulatory agencies. The FSOC provides a platform from which to coordinate this collective effort.

The FSOC's mandate will include:

- Facilitating information-sharing and the collective oversight of financial stability from a systemic perspective.
- Identifying financial stability risks and responding appropriately. The FSOC will have the authority to make recommendations regarding financial stability to relevant financial authorities on a “comply-or-explain” basis.
- Enhancing effective cooperation and coordination in times of crisis by harnessing the collective and individual powers of its members to address systemic problems.

The FSOC will play a central advisory role in crisis management and resolution.

Oversight of the national payment system and financial markets infrastructure

The national payment system

The South African Reserve Bank's financial stability responsibility includes overseeing the national payment system – a key component of South Africa's monetary and financial system, as almost all economic transactions involve some form of payment.

The South African Reserve Bank Act (1989) empowers the Bank to “perform such functions, implement such rules and procedures and, in general take such steps as may be necessary to establish, conduct, monitor, regulate and supervise the payment, clearing and/or settlement systems”. In terms of this mandate, the South African Reserve Bank performs two main functions, namely operating an interbank settlement system and regulating the national payment system.

The National Payment System Act provides for a payment system management body to be created and outlines the framework under which it is to operate, its membership and its responsibilities. In terms of the National Payment System Act, the South African Reserve Bank has the right to recognise or derecognise such a body should it fail to perform its duties.

South Africa’s payment system management body, the Payment Association of South Africa (PASA), was established as an umbrella body to represent and manage the conduct of its members in the payment system. PASA aims to assist the South African Reserve Bank in ensuring a safe and efficient payment system, particularly relating to payment clearing. PASA, with the Bank’s support, manages the rules of engagement in the different payment streams and ensures that all legal and contractual requirements are adhered to. It also assists the Bank regarding matters within the payment clearing domain affecting its members, for example, the licensing of the payment clearing house system operators.¹⁸

The rules and behaviour of participants in the payment clearing environment are key to a safe and efficient payment system. Although the National Payment System Act allows for a payment system management body to assist the South African Reserve Bank in this regard, the ultimate responsibility remains with the Bank.

Given that the conduct of participants in the payment and clearing systems could have significant consequences for end customers, PASA, the Bank and the market conduct regulator will have to work together closely to identify and mitigate any market conduct risks.

Financial markets infrastructure

Markets play a central role in the financial system and have the potential to generate or transmit risks. Close supervision by both regulators will therefore be required.

¹⁸ A payment clearing house system operator is a legal person that clears payments on behalf of two or more settlement system participants (banks) and/or designated clearing participants.

The South African Reserve Bank, as systemic regulator, and the market conduct regulator will jointly be responsible for:

- **Licensing financial markets infrastructure.** Based on Committee on Payment and Settlement Systems principles,¹⁹ financial markets infrastructure licence conditions should require reporting on systemic, prudential and market conduct issues to both regulators. However, given the systemic nature of SAMOS and Bankserv, a dual licence approach for payment system infrastructure may also create risks. It is therefore proposed that the National Payment System Act (1998) be amended to provide for mandatory consultation with the market conduct regulator on relevant matters, although ultimate responsibility for licensing and supervision will reside with the Bank.
- **Licensing and supervising exchanges.** This will be done under the leadership of the market conduct regulator, which will be legally required to consult with the Bank and obtain its approval on prudential rules relating to exchanges.
- **Establishing rules and awarding licences for clearing houses,** as far as this is possible to do jointly.
- **Overseeing the relationship between the payments system operator and the central clearing counterparty, and their respective members.** This will be under the leadership of the prudential regulator.

As systemic regulator, the South African Reserve Bank will be responsible for:

- **Overseeing systemic risks posed by key financial markets infrastructure.**
- **Overseeing the regulation of the central clearing counterparty and trade repository.** The Financial Markets Bill (2012) creates a licencing regime for a central clearing counterparty and a trade repository to monitor and mitigate the risk posed by over-the-counter derivative instruments. The Bank will oversee the systemic risks posed by these infrastructures.
- **Ensuring that exchanges and central counterparties adhere to specific regulatory requirements linked to emergency liquidity facilities.** An exchange or central counterparty that is provided with a liquidity facility will be required to meet specific regulatory and reporting requirements to ensure that it manages its liquidity situation

¹⁹ Committee on Payment and Settlement Systems & the International Organisation of Securities Commissions (2012) "Principles for Financial Market Infrastructures". Available at: <http://www.bis.org/publ/cpss101.htm>. Bank for International Settlements and International Organisation of Securities Commissions.

well. The South African Reserve Bank will be legally empowered to access information from the exchange in this regard.

- **Approving rules for systemically important clearing and settlement members** and ensuring that these rules align with the South African Reserve Bank's requirements for other activities (for instance, requirements to ensure that risk monitoring for clearing members with a banking licence is conducted appropriately).

The market conduct regulator will be responsible for:

- **Overseeing the relationship between the exchanges, the central securities depository, the trade repository and their members.** There is a requirement for regulatory approval of "additional business". If this additional business brings prudential or systemic risk, the market conduct regulator must consult the Bank.

Conglomerate supervision as a financial stability function

Financial regulators are currently responsible for microprudential supervision of solo entities and macroprudential supervision of banking or insurance groups on a consolidated basis (consolidated supervision). However, there may be entities within these groups whose core business does not relate to either banking or insurance. These entities may therefore not be adequately supervised.

In July 2012, the Joint Forum²⁰ issued the revised Joint Forum Principles²¹ for the supervision of financial conglomerates, in particular those that conduct business across borders. The revised principles emphasise essential elements of conglomerate supervision, namely:

- Detecting and correcting multiple use of capital (that is, double counting or multiple gearing of capital).
- Assessing group risks (for example, contagion, concentration, management complexity and conflicts of interest).
- Minimising regulatory arbitrage.

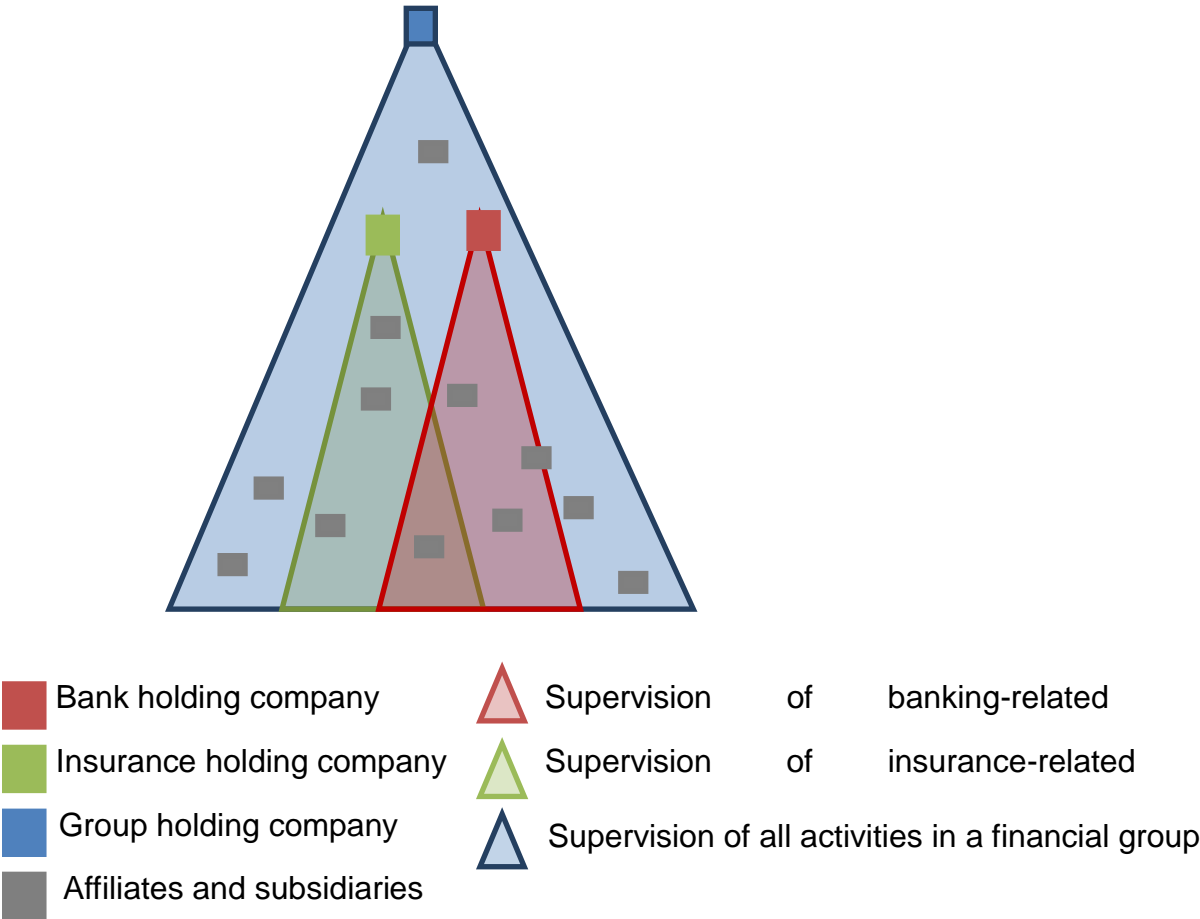
²⁰ The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. The Joint Forum is comprised of an equal number of senior bank, insurance and securities supervisors representing each supervisory constituency.

²¹ Joint Forum (2012) "Revised Joint Forum Principles". Available at: <http://www.bis.org/publ/joint29.htm> (accessed on 9 October 2012).

The revised principles highlight the need to appoint a conglomerate supervisor responsible for group-level supervision of all entities in a financial group, regardless of their primary functions, and facilitating coordination, cooperation and information-sharing between relevant supervisors. Such supervision should also oversee securities-related and other financial or outsourced activities that may, when aggregated, affect the group’s risk profile and systemic significance.

Figure 3.1 depicts the interaction between microprudential supervision of solo entities and macroprudential supervision of relevant banking or insurance groups (which includes consolidated and conglomerate supervision).

Figure 3.1: Interaction between microprudential, consolidated and conglomerate supervision



Conglomerate supervision is pivotal for resolution planning, in particular where systemically significant institutions form part of a financial group that includes both banking and insurance business. For South Africa to comply with the revised Joint Forum Principles, the area of conglomerate supervision will be developed as a financial stability function of the South African Reserve Bank.

3.3 Summary

- The South African Reserve Bank has been explicitly mandated to oversee and maintain financial stability, working closely with the market conduct regulator.
- The mandate will be carried out by expanding the Bank's functions to include macroprudential supervision of financial institutions, systemic supervision and oversight of conglomerate institutions and key financial markets infrastructure, and establishing the Bank as the resolution authority.
- The Financial Stability Oversight Committee will be formalised and given legislative backing.

4. Prudential regulation and supervision

4.1 Introduction

The financial sector needs to be regulated to correct shortcomings of the market system with minimal disruption. In the context of prudential regulation, market imperfections include a lack of incentives for market participants to be concerned about the health of the system itself, and financial consumers' and investors' inability to assess the soundness of financial service providers due to information asymmetry. A sound, well-regulated financial system is essential for financial stability and to support economic growth and development, and to create jobs.

The recent global financial crisis highlighted the complementary relationship between the macroprudential and microprudential elements of effective supervision. Supervisors need to assess risk in a broader context than the balance sheet of individual regulated financial institutions or groups.

4.2 Objective and mandate

The prudential regulator's strategic objective will be to maintain and enhance the safety and soundness of regulated financial institutions, for the protection of consumers of financial services. Prudential safety and soundness imply the ongoing financial health of individually regulated institutions, which supports confidence in the financial sector. The prudential regulator, which will fall under the authority of the South African Reserve Bank, will be responsible for the prudential regulation and supervision of banks, insurers and other financial-sector institutions.

To deliver on its strategic objective, the prudential regulator will be mandated to:

- **Create and maintain an effective legal and regulatory environment** (prudential regulation), within which defined financial institutions, activities or markets must:
 - Be registered or approved
 - Comply with all legal requirements
 - Adhere to good risk-management standards for prudential operation.
- **Supervise registered or approved institutions** by monitoring and enforcing compliance with legal requirements and prescribed good-practice standards, taking into account the level of risk they undertake (prudential supervision).

- **Proactively identify and mitigate specific or systemic problems** that may threaten public confidence in the financial system. This includes deregistering high-risk entities to minimise losses.
- **Contribute to the financial policy objectives** of financial stability, financial inclusion and combating financial crime.

4.3 Regulatory and supervisory principles

To implement the twin peaks model's overarching regulatory and supervisory principles (discussed in Chapter 1), the following principles will apply to the prudential regulator:

- Regulations will be designed to proactively identify possible market imperfections and address them at minimal cost and with minimal disruption to financial institutions.
- Regulations will be largely based on principles, rather than rules,²² with the rationale for prudential regulation being fully transparent.
- Regulations will be aligned with international best practice and standards, as appropriate for South Africa.
- Regulations will generally apply to financial institutions and their activities to impose sanctions, mitigate risk or resolve institutions in distress.
- Regulations will not list all types of permissible activities. Any activities or financial products that are consistent with the prescribed principles can be assumed permissible until the regulator specifies otherwise.
- Registration, approval or licensing will be required before any person or institution may carry out regulated activities. Effective action against unregistered entities known to be conducting such business is an essential part of regulation.
- The prudential regulator will have the authority to institute timely corrective actions, including deregistering an institution or withdrawing its licence, to force it to cease activities. These actions will be subject to the necessary consultations.
- The prudential regulator will have the authority and independence to set criteria for approval, registration or licensing, and to reject applications that do not meet these standards or other legislative requirements.
- These criteria must be consistent with prevailing legislation and supervisory practice.

²² There are some exceptions where rules will be necessary, such as the internationally agreed rules regarding early intervention and prompt corrective actions for banks in distress, where it is important to limit supervisory forbearance in the interest of the financial system.

- At the minimum, registration or approval will require assessment of an institution or group's ownership and governance. This includes assessing the fitness and propriety of board members and senior management, the institution's strategic and operational plan, its internal controls and risk management, and its projected financial condition (including its capital base).

Registration or approval will not be transferable from one financial institution to another. All institutions wishing to be active in defined areas will have to apply. This application will be considered in the public interest and against relevant prescribed criteria.

4.4 Regulatory and supervisory approach

The prudential regulator's supervisory approach will be risk-based. This means the supervisory intensity for a given registered institution will reflect the level of risk that it faces and, to a certain extent, the level of risk it poses to the consumer, other institutions and the financial system as a whole.

The key function of risk-based supervision is to assess institutional performance, based on qualitative and quantitative research into the following elements:

- The risk inherent in each supervised institution, based on factors such as size, clients and counterparties, activities, products, markets, interconnectedness and so on.
- The robustness of a regulated institution's corporate governance, risk-management and control policies, systems, processes and procedures, including the extent and quality of board and senior-management oversight.
- How identified risks relate to the institution's capital and reserve funds or other prudential measures.

The prudential regulator's risk-based approach requires its supervisors to:

- Determine how well supervised institutions identify, evaluate, monitor and control or mitigate material risks.
- Review the policies, systems and procedures supervised institutions use to manage these risks.
- Assess how well supervised institutions manage material risks relating to capital and reserve funds or other prudential measures.

- Consider material risks that are external to individually supervised institutions.
- Establish and maintain an early-warning system to identify increased risk on an institutional, sectoral, regional, national or international level in a timely manner.
- Employ a forward-looking, rather than a reactive, approach to supervision.
- Respond appropriately to the outcome of the qualitative and quantitative assessments outlined above.
- Ensure that they have and retain adequate resources.

The prudential regulator will also consult with and transparently inform all relevant parties about impending legislative and regulatory changes and their potential impact.

Harmonising prudential supervisory objectives, principles and methods across the various types of regulated financial institutions and markets will be a key focus area.

4.5 Summary

- The prudential regulator's strategic objective will be to maintain and enhance the safety and soundness of regulated financial institutions.
- The prudential regulator will be responsible for the prudential regulation and supervision of banks, cooperative banks and insurers.
- The prudential regulator will adopt a risk-based approach to supervision.
- The supervisory objectives, principles and methods will be harmonised across the various types of regulated financial institutions.

5. Market conduct regulation and supervision

5.1 Introduction

Asymmetry of information between financial services consumers and financial institutions makes consumers vulnerable to exploitation. The nature of financial products and services is such that the consequences of unfair treatment or poor decisions are often only felt many years after transacting, potentially resulting in significant hardship. In South Africa, these challenges are exacerbated by low levels of financial literacy.

Financial transactions are often premised on a promise to deliver funds at a later date. It is important that customers have confidence in such promises. Market conduct regulation and supervision mitigate the risk of vulnerable consumers being exploited and complement prudential objectives to enhance confidence in the financial system.

Government's policy document states that "market conduct oversight must be sufficiently strong to complement prudential regulation, particularly in the banking sector". The document also highlights the need to design legislation for the financial services sector to protect consumers from risks inherent in financial products and services, and to set standards of conduct that are more stringent than those generally applied to non-financial services.

In light of these imperatives, the FSB will be transformed into a dedicated financial market conduct regulator with a new mandate, objectives, and regulatory and supervisory frameworks. The new entity will be responsible for regulating and supervising the market conduct of banks, insurers, financial intermediaries, retirement funds and administrators, investment institutions and financial markets.

5.2 Objective and mandate

The market conduct regulator's objective will be to protect consumers of financial services and promote confidence in the South African financial system.

The market conduct regulator will be mandated to:

- Promote the fair treatment of financial services customers
- Promote financial awareness and financial literacy amongst South Africans
- Protect and enhance the efficiency and integrity of South Africa's financial markets

- Contribute to the financial sector's policy objectives of financial stability, financial inclusion and combating financial crime.

These actions are related and cannot be delivered in isolation. Indeed, one of the key reasons to protect and enhance the efficiency and integrity of South Africa's financial markets is to ensure that customers are treated fairly. Customers confident of fair treatment will more willingly participate in the financial system, so enhancing its effectiveness. The most appropriate way to ensure that customers are treated fairly is to promote financial literacy so that they are aware of their rights and responsibilities.

The market conduct regulator's role with respect to financial stability is discussed in Chapter 3, while its role in combating financial crime is outlined in Chapter 7. This chapter discusses its role in supporting financial inclusion.

5.3 Regulatory and supervisory principles

The market conduct regulator will adhere to the eight overarching regulatory and supervisory principles set out in Chapter 1. In terms of these principles, the market conduct regulator's regulatory and supervisory frameworks will aim to be:

- **Transparent:** Transparency will be achieved through the oversight, reporting, governance and stakeholder structures discussed in Chapter 2.
- **Comprehensive and consistent:** The market conduct regulator's regulatory and supervisory framework will seek to balance principles- and rules-based components. Principles-based components – such as the obligation to deliver “treating customers fairly” (TCF) outcomes – will apply universally to the conduct of all regulated financial institutions. Rules will be implemented as needed, and consistently between comparable activities.
- **Appropriate, intensive and intrusive:** The regulator will proactively identify areas of concern and act to prevent negative consumer outcomes, rather than reacting to complaints or existing prejudice. This approach will cover both emerging risks within financial institutions or groups as well as concerns at an industry, market, sector or business-model level.
- **Outcomes-based:** Consumer protection regulation will be primarily outcomes based, requiring financial institutions to comply with both principles- and rules-based regulations, both of which will be legally binding and enforceable.

- **Risk-based and proportional:** In a risk-based supervisory framework, financial institutions that consistently comply with market conduct obligations and deliver TCF outcomes – as monitored by supervisory tools – will attract less market conduct regulatory scrutiny than those who show less regard for fair customer treatment. This principle will require a review of how appropriate the FSB’s current risk-based models are for identifying and managing market conduct risk, as opposed to prudential or financial risk.
- **Pre-emptive and proactive:** The market conduct regulator will need to pre-emptively intervene to prevent or limit material damage that might result in negative customer outcomes. This remedial intervention could be at an institutional, industry or sector level, depending on the risks involved.
- **A credible deterrent to misconduct:** For market conduct regulation to be effective, it is imperative that both consumers and regulated entities are confident that the regulator will detect and take meaningful action against misconduct and unfair customer treatment. Therefore, in order to have a deterrent (as opposed to merely a punitive) effect, the regulatory consequences of material misconduct will be made visible. The market conduct regulator’s proposed enforcement approach is discussed in Chapter 7.
- **Aligned with applicable international standards:** The market conduct regulator will ensure that its frameworks and practices comply, where appropriate, with relevant international standards as established by the international standards to which South Africa subscribes.

5.4 Regulatory and supervisory approach

The market conduct regulator will adopt the following approaches to fulfil its mandates:

Mandate: Promote the fair treatment of financial services customers

The “treating customers fairly” approach

The market conduct regulator will seek to protect and secure fair treatment of financial-services consumers by adopting and enforcing an outcomes-based TCF regulatory and supervisory

approach, which will require regulated firms to deliver specific fairness outcomes for their customers.²³ The six TCF outcomes are:

- Customers are confident they are dealing with firms that put fair treatment of customers at the centre of their culture.
- Products and services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly.
- Customers are given clear information and are kept appropriately informed before, during and after the time of contracting.
- Where customers receive advice, the advice is suitable and takes account of their circumstances.
- Customers are provided with products that perform as firms have led them to expect. The associated service is of an acceptable standard and in accordance with what customers have been led to expect.
- Customers do not face unreasonable post-sale barriers to changing product, switching provider, submitting a claim or making a complaint.

The TCF approach will require regulated financial institutions to consider how they treat customers at all times, from product design and marketing to the advice, point-of-sale and after-sale stages. In particular, financial institutions will need to adopt a TCF culture and governance framework, embedding TCF principles and controls in their leadership, strategy, decision-making, performance-management and reward processes. The market conduct regulator will monitor the efficacy of an institution's TCF governance and controls.

Enhanced effectiveness of the ombud system

Inevitably, even in a comprehensive and rigorous market conduct regulation environment, some instances of abuse will occur. The enforcement mechanisms at the market conduct regulator's disposal are not necessarily appropriate to achieve swift and effective redress for individual customers who have been prejudiced by misconduct. It is essential that such customers have access to simple, effective and independent dispute resolution mechanisms that can secure them a fair outcome when broader consumer protection frameworks have failed.

²³ Further details of the TCF approach are contained in "Treating Customers Fairly Roadmap" and related publications available on the FSB's website at www.fsb.co.za.

The foundations of any ombud system are independence, accessibility, transparency, accountability, integrity, clarity of purpose and effectiveness. Such mechanisms are currently provided by the various ombud schemes contemplated in the Financial Services Ombud Schemes Act (2004). Despite its undeniable successes, the fragmented nature of the current ombud system, with its combination of statutory and voluntary schemes, poses the following actual and potential risks:

- Consumer confusion
- Gaps and overlaps in jurisdiction
- “Forum shopping”²⁴
- Administrative inefficiencies
- Inconsistencies in approach
- Governance challenges
- Doubts regarding the independence of the industry-sponsored voluntary schemes.

A review of the current ombud system is under way to develop recommendations to improve its efficiency and effectiveness while building on the work and expertise of existing bodies. Options being considered for the financial ombud system structure include:

- Continuing the current system of independent offices, but with stronger oversight by the Financial Services Ombud Schemes Council.
- Establishing a merged entity with a single representative governing body under the leadership of an executive officer, while retaining separate ombuds for each sector. In this model the sectoral ombuds would be tasked with dispute resolution and issuing determinations, while governance and operational matters would be centrally coordinated. Regional ombud offices could be built into such a model.

Given their dealings with customer complaints, ombuds are ideally positioned to give the market conduct regulator insight into emerging negative conduct trends and specific unfair business practices. They can also indicate how the market conduct regulatory framework is unfolding, and help to identify gaps in it.

Whatever its eventual structure, the revised ombud system will play an important role in helping the market conduct regulator take pre-emptive action on financial market misconduct.

²⁴ “Forum shopping” refers to complainants or parties to a dispute selecting a forum that they believe will give the most lenient or favourable consideration to their case. As a result, respondents sometimes have to answer to multiple complaints on the same matter, or receive contradictory decisions for similar situations.

Mandate: Promote customers' financial awareness and literacy

Effective consumer protection regulation is necessary to reduce the risks inherent in the information asymmetry between financial institutions and their customers. However, the only way to reduce the asymmetry itself – and so improve customers' bargaining power – is to increase their financial literacy levels.

The market conduct regulator's mandate therefore includes promoting and, together with other role players, developing and implementing a national financial literacy strategy. This will entail coordinated efforts from government, schools, financial institutions, industry associations, employers, trade unions, community organisations and non-governmental organisations. This is a long-term strategy.

Mandate: Protect and enhance financial markets' efficiency and integrity

A regulator that stays abreast of financial market developments is fundamental for protecting investors and ensuring the efficiency, integrity and reputation of financial markets. Disregard for product regulation, improper trading practices, unfair treatment of orders, market manipulation, unfair trading practices, misuse of client assets and fraudulent practices threaten confidence in South Africa's financial markets and, ultimately, the investor protection objective.

Connected to financial market efficiency is the need for the market conduct regulator to ensure transparency, particularly with regards to trade information. The market conduct regulator will assume responsibility for regulating financial markets infrastructure conduct and ensure that the rules regarding transparency provide investor protection.

International standards set by the International Organisation of Securities Commissions will inform the market conduct regulator's regulatory and supervisory approach to South Africa's financial markets. These include principles for enforcing securities regulation, managing collective investment schemes and secondary markets, and using self-regulatory organisations.

The current FSB Directorate of Market Abuse will be incorporated into the new market conduct regulator and will continue to play a key role in ensuring financial market integrity by investigating cases of insider trading, market manipulation and false reporting relating to the affairs of a public company, and taking appropriate enforcement action if necessary.

Financial markets are capable of vastly improving the efficiency, transparency and safety of financial systems. However, they also concentrate systemic risk, so appropriate supervision and oversight is critical. The disruption or malfunctioning of financial markets infrastructure can threaten the viability of other market participants and the stability of the financial system. As explained in Chapter 4, the role the prudential regulator plays in overseeing key financial markets infrastructures will be increased to address the systemic and prudential risks they introduce. Coordinating mechanisms will be put in place between the prudential regulator, the market conduct regulator and the JSE Limited, in its capacity as a self-regulatory organisation.

Mandate: Contribute to the policy objective of financial stability

As outlined in Chapter 1, the National Treasury policy document articulated the following policy priorities for the financial sector:

- Ensure financial stability
- Ensure consumer protection and market conduct
- Expand access through financial inclusion
- Combat financial crime.

Of these, the consumer protection and market conduct priority clearly forms the basis of the market conduct regulator's strategic objective to "protect consumers of financial services and promote confidence in the South African financial system".

However, the market conduct regulator also has an important role to play in supporting the other three policy priorities. This will require the market conduct regulator to consider any potential impact on these objectives when carrying out other components of its mandate. Inevitably, situations will arise where policy priorities and strategic objectives compete. In such cases, the market conduct regulator will have to transparently and proactively engage the prudential regulator, the National Treasury and any other applicable / relevant agencies to manage short- or medium-term trade-offs without compromising on delivering long-term objectives.

Mandate: Contribute to financial inclusion

Financial inclusion means ensuring that all South Africans have adequate access to financial services to enable them to, among other functions, manage their money, save for the future and insure themselves against unforeseen events.

The market conduct regulator will contribute to inclusion by:

- Ensuring responsible financial inclusion by implementing consumer protection regulations.
- Promoting financial capability training to help consumers understand financial products and services, and truly comprehend the financial system, including consumer protection regulations and recourse mechanisms.
- Implementing, supervising and enforcing specific inclusion frameworks, such as the South African microinsurance framework.

5.5 Supervisory tools

The market conduct regulator will rely on a mix of traditional supervisory tools and newer, more innovative tools to fulfil its mandate. The use of supervisory tools will, as appropriate, be consistent with applicable international standards.

Traditional supervisory tools include scheduled and ad hoc site visits, regular compliance and other reporting, ad hoc information requests, and reviews and analyses of independent reports and other information.

New supervisory tools include “mystery shopper” techniques (where anonymous, independent observers pose as customers or potential customers to test the quality of institutions’ interactions with customers), sourcing information from third parties such as intermediaries, suppliers, the media, ombud schemes or consumer bodies in a structured manner, new or existing industry surveys, and revised and enhanced regulatory reporting.

Enhanced reporting requirements

Reporting requirements will need to be comprehensive and rigorous to enable the market conduct regulator to proactively identify industry- and financial-institution-specific conduct risks, and early-warning signs of unfair customer treatment. These reports will include both non-public components, which are to be incorporated as deemed appropriate into existing regulatory returns and compliance reports, and the public disclosure of identified measures.

The market conduct regulator will ensure that public disclosure leads to fair and meaningful comparisons between financial institutions and sectors, and that the necessary prudential safeguards are in place. The reputational effect of meaningful public disclosure will not only be a driver of the “credible deterrence” principle, but also serve as an incentive to deliver positive customer outcomes.

Pre-emptive intervention to mitigate market conduct risks

Occasionally, the market conduct regulator will, after consulting with other stakeholders, be required to intervene pre-emptively to mitigate emerging conduct risks. Possible industry- or sector-level interventions include:

- Engaging industry associations to drive sector-wide communication and, where it is likely to be effective, self-regulation through industry standards or codes of conduct.
- Alerting affected sectors of the regulator’s concerns and expectations regarding an identified risk through specific regulatory guidance.
- Thematic on-site monitoring of institutions to gather information on the extent of a risk or suspected breach of conduct.
- Warning or informing consumers about the financial products or services concerned.
- Tightening regulatory requirements to close identified gaps.

With regard to institution-specific conduct risks, unless the market conduct regulator believes the risks are sufficiently serious to demand immediate formal regulatory action, the likely initial response will be to engage the institution’s senior management to discuss:

- **A course of action to ensure that the identified inappropriate conduct stops.** This could include changes in business processes, changes in product design or the withdrawal of products or promotional material.
- **Redress for customer prejudice already caused.** This could include tracing and communicating with affected or potentially affected customers.
- **Disciplinary or other appropriate action** to be taken by the institution against the individuals responsible for unfair treatment.
- **Training interventions.**

Where an agreement is reached between the market conduct regulator and a financial institution, explicit undertakings and timelines will be established and adherence to them will be closely monitored. Formal regulatory enforcement action will be taken should such an agreement not be honoured, or in cases where the market conduct regulator considers the risk posed to consumers to be so serious or the conduct so unacceptable that an agreed negotiated solution will not be effective.

Product suitability

The extent to which the market conduct regulator should intervene in the design of financial products, if at all, specifically where products or product features are identified as being unfair to consumers or certain categories of consumers, is a topic of debate. Possible interventions range from regulatory preapproval of financial products before they are launched, which is the most intrusive intervention, to compulsory disclosure of key product features, which is the least intrusive intervention. Options between these two extremes include prescribing certain product features for certain target markets and prohibiting (or ordering the withdrawal of) certain products or product features.

The market conduct regulator's legislative and regulatory framework will grant it the authority to draw from a wide range of suitable product interventions, provided these are in accordance with its eight overarching regulatory and supervisory principles, especially the principle of risk-based and proportional regulation.

It should be noted that certain product-specific regulatory frameworks – such as the collective investment schemes' mandate approval requirements, regulations in respect of the demarcation between health insurance and medical schemes, regulation of early termination charge levels in long-term insurance investments, insurance commission regulations and the pending microinsurance framework – already contain varying degrees of product design regulation.

5.6 Summary

- The market conduct regulator's objective will be to protect consumers of financial services and promote confidence in the South African financial system, with specific supporting mandates, including:
 - Promoting the fair treatment of financial services customers

- Protecting and enhancing the efficiency and integrity of South Africa's financial markets
 - Promoting financial awareness and financial literacy among South Africans
 - Contributing to the policy objectives of financial stability, financial inclusion and combating financial crime.
- The market conduct regulator will adhere to the eight overarching regulatory and supervisory principles set out in Chapter 1.
 - Using the abovementioned principles, the market conduct regulator will rely on a mix of traditional supervisory tools and newer, more innovative tools – including enhanced public and non-public reporting requirements, and an appropriate set of product suitability powers – to fulfil its mandates. These tools will be designed to enable pre-emptive mitigation of market conduct risks.

6. Crisis management and resolution

6.1 Introduction

Financial crises are often triggered by specific events or adverse developments in individual institutions or market cycles, which then quickly spread to the rest of the system. It is important to have mechanisms in place to prevent such disruptions and to deal with crises when they occur to reduce the risk to financial stability.

In October 2011, the global forum of regulators known as the Financial Stability Board released *The Key Attributes of Effective Resolution Regimes for Financial Institutions*,²⁵ which was adopted by the G20 in November 2011. As a G20 member, South Africa is committed to strengthening its resolution framework in line with these attributes. This chapter discusses the attributes of an effective resolution framework and proposes areas of improvement for South Africa.

6.2 Objectives and principles of a crisis resolution framework

The objective of financial crisis management is to resolve a severe disruption in the financial system at minimal public cost while containing the negative effects on the real economy. Proactive interventions by resolution authorities are justified if the benefits of reduced systemic risk exceed the possible negative effects of resolution. These effects include fiscal costs, social economic costs, an increase in the moral hazard of supervision, or a loss of competition or confidence in the financial sector.

The Financial Stability Board describes an effective resolution regime as one that resolves stress in financial institutions without severe systemic disruption or exposing taxpayers to loss while protecting vital economic functions.²⁶ A resolution regime is not intended to prevent the failure of financial institutions, nor does it imply that financial institutions will necessarily be supported or bailed out. The guiding principle for intervention is the likelihood of disruption to systemic stability. An effective resolution framework aims to:

- Restore financial stability in a crisis with the least possible loss of value and public cost.

²⁵ Financial Stability Board (2011) "The Key Attributes of Effective Resolution Regimes for Financial Institutions". Available at: http://www.financialstabilityboard.org/publications/r_111104cc.pdf. Basel: Financial Stability Board.

²⁶ Ibid, pg 3.

- Increase the resolvability of systemically significant elements in the financial system, preferably without public support.
- Maintain and restore confidence in the financial system.
- Ensure that key functions in the financial system continue (for example, payment systems, securities settlement, and an essential degree of financial intermediation).
- Prevent loss of value through prompt and appropriate intervention.
- Let losses, where they do occur, be absorbed by appropriate buffers, shareholders and, if necessary, creditors, rather than by retail customers or taxpayers.

To achieve these objectives, an effective resolution framework should allow authorities to intervene in a timely, decisive and coordinated fashion to resolve fragility in the financial system, including the resolution of systemically significant financial institutions that are no longer viable.

6.3 The resolution authority

To facilitate prompt and effective corrective action, the Financial Stability Board advises that each jurisdiction should have a designated resolution authority or authorities, responsible for exercising resolution powers over financial institutions within the scope of the resolution regime.²⁷ The resolution authority should have adequate powers to achieve these functions and operational independence consistent with its statutory responsibilities. It should also have the required expertise, resources and operational capacity to implement resolution measures.

According to the Financial Stability Board, the resolution authority should:

- Pursue financial stability at the least possible loss of value and cost to taxpayers
- Ensure continuity of systemically important financial services
- Protect depositors, policyholders and investors, as applicable
- Avoid unnecessary destruction of value and minimise the overall cost of resolution
- Consider the potential impact of resolution actions on financial stability in other jurisdictions.²⁸

²⁷ Ibid, pg. 5–6.

²⁸ Ibid.

In light of the South African Reserve Bank's financial stability mandate, its responsibility for both micro- and macroprudential supervision, and its role in managing money-market liquidity, it has been identified as the resolution authority in South Africa. However, once taxpayers' money is at risk, decisions to use such money will be taken by the Minister of Finance.

Coordination arrangements

Effective resolution requires coordination among various regulators and stakeholders. The resolution authority will need to decide whether a distressed financial institution or markets infrastructure element poses a systemic risk based on predetermined criteria. This decision will need to occur in consultation with the Minister of Finance.

Because a systemic crisis could result in social costs and, in certain circumstances, require using taxpayer funds, the Minister of Finance will be part of the resolution process. Input from the market conduct regulator could also be relevant in relation to the protection of depositors, policyholders or investors.

Regulated entities will be subject to various regulating authorities' rules and regulations. However, in a crisis, the resolution framework will coordinate these authorities to prevent actions that could affect the efficacy of the resolution process or erode public confidence.

6.4 Scope of the resolution framework

The resolution framework's prime objective is financial stability rather than institutional soundness. Accordingly, not all institutions will fall within the scope of the framework. The criteria used to determine whether an institution, organisation or market falls within the scope of the framework will be based on its contribution to systemic risk, or its systemic significance, at a given point in time. The framework will be designed and applied in a manner that minimises moral hazard, despite the challenges of doing so in a concentrated financial sector.

Systemic significance is the extent to which failure of or disruption in an institution spills over to the rest of the financial system, affecting its stability. For example, in the banking sector, systemic significance is determined according to the following criteria:

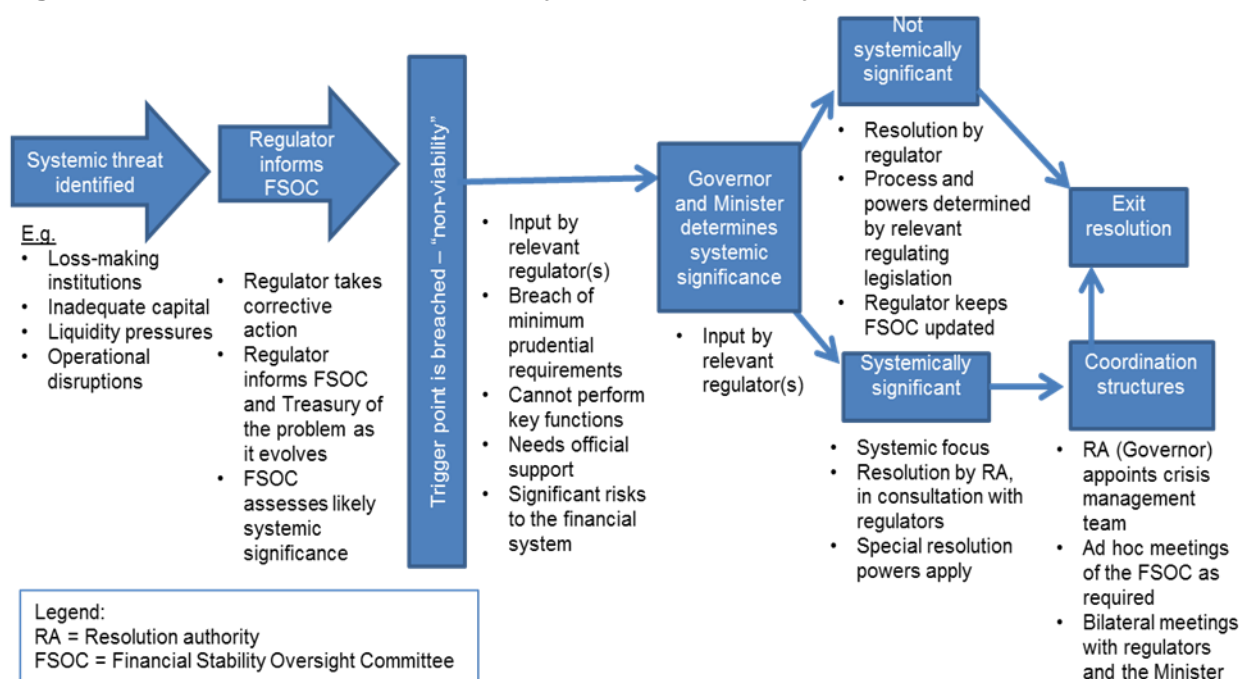
- Size of the institution, market or organisation
- Interlinkages with other financial entities and services
- Degree of substitutability of key functions and financial services

- Complexity of activities
- Magnitude of wealth effects in the event of failure.

The resolution framework will be applied to all elements of the financial system that are systemically significant. Such elements could include non-bank financial institutions, major participants or exposures in financial markets, financial market infrastructure organisations and financial markets themselves.²⁹ Elements that are not systemically significant will be resolved by the prudential or market conduct regulator.

The resolution paths for systemic and non-systemic institutions are shown in Figure 6.1.

Figure 6.1: Resolution framework for systemic and non-systemic institutions



Systemic significance is time-dependent and can vary according to the general degree of confidence in the financial system. South Africa’s regulators and authorities will therefore agree on the criteria and the methodologies applied to determine systemic significance, but will not issue a list of systemic institutions or elements of the financial system.

²⁹ For the remainder of this chapter, “institution” will refer to individual financial institutions, “organisation” will refer to financial infrastructure components or systems, and “financial market” will refer to the buying and selling of various categories of financial instruments.

An important element of an effective resolution regime is that its scope will include the resolution of both individual institutions and the financial groups in which systemically significant institutions operate. The resolution authority will have the right to prevent holding companies of distressed institutions transferring assets to other parts of the financial group. Therefore, the scope of the resolution framework will be from the group holding company downwards.

Trigger for entry into resolution

The trigger for entry into resolution is the point at which an institution is no longer viable or is likely to no longer be viable, and has no reasonable prospect of becoming so, or where a dysfunctional market threatens financial stability. Should the microprudential regulator decide that an entity, organisation or market is non-viable, then the Governor of the South African Reserve Bank will, in consultation with the Minister of Finance, decide whether the entity, organisation or market is systemically significant and, if it is deemed to be so, invoke the resolution process in the interest of financial stability.

The decision regarding the non-viability of a systemically significant institution, organisation or market will be based on the following indicators:

- The entity is no longer able to meet its minimum prudential requirements
- The entity is no longer able to perform its functions or provide key financial services
- The entity cannot function without the central bank's intervention or support
- The entity poses significant risks to the financial system and has failed to adequately address such risks on its own.

These indicators are based on a combination of quantitative and qualitative measures. Should an entry into resolution be triggered, the Bank has some discretion on how to act, and will make its decision based on the severity and nature of the disruption or risk.

Resolution does not constitute a default event. It is aimed at resolving a crisis. If it were to be identified as a default event, the crisis could be exacerbated if default clauses are triggered in contracts among market participants and with counterparties of the distressed institution.

Resolution powers

In its capacity as administrative resolution authority, the Bank will have the power to facilitate prompt corrective action and effective intervention to preserve financial stability. However, the Minister of Finance, as guardian of public funds and with clear political accountability, will always be involved in the resolution process and in deciding on an appropriate course of action. There will be a clear distinction between the powers the Bank can exercise at its discretion, and those that will require consultation with the Minister of Finance.

In terms of the South African Reserve Bank Act, the Bank can conduct a wide range of market transactions and provide liquidity to distressed entities. Liquidity provision will be collateralised to cover the Bank's financial risk and to comply with legal requirements. The Bank will be assigned general powers, in line with the minimum recommendations of the Financial Stability Board and applicable laws, which it will be free to exercise independently except when public funds or government guarantees are involved, which would require a decision by the Minister of Finance. Such general powers could include:

- Removing and replacing an entity's senior management and directors, and recovering money from those responsible (including the recovery of variable remuneration).
- Appointing a curator or administrator to manage an institution or parts of its business.
- Operating and resolving an institution, including terminating contracts, continuing or assigning contracts, purchasing or selling assets, writing down debt and taking any other action necessary to restructure or wind down the institution's operations. These powers could also be used to facilitate a private-sector solution, such as a merger.
- Requiring other companies in the same group (or a successor or acquiring entity) to provide the services offered by an institution in resolution to ensure continuity of service to the public. These services may also be procured from unaffiliated third parties.
- Overriding the rights of an entity's shareholders to restructure and dispose of the institution's business or its liabilities and assets.
- Transferring or selling assets, liabilities, legal rights and obligations, including deposit liabilities and ownership in shares, to a solvent third party.
- Establishing a temporary bridge institution to take over and continue operating certain critical functions and viable operations of the failed or failing institution.
- Establishing a separate asset management vehicle and transferring any non-performing loans or difficult-to-value assets to this vehicle for management and eventual run-down.

- Carrying out bail-in³⁰ within resolution, either by recapitalising the institution providing essential functions, or by capitalising a newly established entity or bridge institution to which these functions have been transferred following closure of the non-viable entity.
- Temporarily suspending the exercise of early termination rights that may otherwise be triggered upon entry of an institution into resolution.
- Imposing a moratorium with a suspension of payments to unsecured creditors and customers, and a stay on creditor actions to attach assets or otherwise collect money or property from the institution while protecting the enforcement of eligible netting and collateral agreements.
- Effecting closure and orderly liquidation of all or part of a failed or failing institution.

Bail-in within resolution

During the recent global financial crisis there were instances where authorities had to recapitalise banks with taxpayers' money, while shareholders and creditors suffered limited or no losses and eventually benefited from the official support. This scenario is commonly known as a bailout. To protect taxpayers from such losses, it is now common for the resolution authority to have the power to carry out a "bail-in" as part of its resolution framework.

The resolution authority's bail-in powers can only be used once an institution has entered the resolution process – after it has become unviable and is likely to be liquidated if left alone. The reason for bailing-in an institution prior to liquidation (that is, as a going concern) is to preserve asset values and those functions critical for financial stability, and to resolve the institution in an orderly manner. The hierarchy of claims will always be respected in a bail-in situation and no equity holder or creditor will be worse off than he or she ultimately would have been in liquidation outside the resolution framework.

In the bail-in process, the resolution authority has the choice to write down the value of debt, or convert debt to equity. In South Africa, bail-in will be conducted by converting debt into common equity. The reason for this is that although bond holders may lose some value at the point of conversion, they have a chance of recovering those losses as the institution recovers. In contrast, writing down the value of debt constitutes permanent, realised losses.

³⁰ "Bail-in" powers enable the resolution authority to write down equity or other instruments of ownership of the distressed firm, as well as unsecured and uninsured creditor claims, in the hierarchy of claims, as would be the case in liquidation. Alternatively, the resolution authority can convert these instruments into equity.

The resolution authority should have the authority to resolve a systemically significant financial group. As such, mechanisms should be in place to recapitalise required entities in the group through bail-in arrangements, even if debt had been issued higher up in the group hierarchy, for example, by the holding company.

Safeguards

In the interest of speed and decisive action, the resolution authority will be able to act under the resolution framework without being subject to approval by shareholders or judicial review. However, safeguards will be built into the legislative framework to protect stakeholders, counterbalance the resolution authority's considerable powers and ensure that the authority remains accountable for its actions during a crisis. These safeguards will:

- Allow shareholders and creditors to seek judicial review of the resolution process after the fact
- Ensure that no creditor of a resolved institution is worse off than it would ultimately have been if the institution had been liquidated outside of the resolution framework
- Ensure that set-off and netting arrangements are respected during the resolution process.

The hierarchy of claims will be respected as far as possible. If there is any divergence from the general principle of equitable treatment of creditors of the same class, the reasons for such divergence will be made available.

Recovery and resolution plans

The Financial Stability Board recommends that all systemically significant institutions should have a recovery and resolution plan to serve as a guide should they become distressed. These plans, also referred to as "living wills", provide a mechanism to improve the resolvability of systemically significant institutions.

The two components of a recovery and resolution plan are:

- A recovery plan, which should serve as a guide to the recovery of a distressed institution under various stress scenarios. The recovery plan applies to the phase before an institution has reached the point of non-viability, when it still has a reasonable prospect of recovery if appropriate measures are taken. A recovery plan should include credible

options to cope with scenarios that address capital shortfalls and liquidity pressures, as well as processes to ensure the timely implementation of recovery options in stress scenarios. The responsibility for devising and executing a recovery plan lies with the institution's senior management.

- A resolution plan, which should guide the resolution authority in using its powers to resolve an institution without severe systemic disruption or exposing taxpayers to loss. The resolution plan should help authorities achieve an orderly resolution and, as such, should complement the resolution framework. The resolution plan should, among other things, identify functions for which continuity is critical, provide suitable options to preserve those functions, articulate data requirements, and identify potential barriers to effective resolution and actions to mitigate such barriers.

The Financial Stability Board further recommends that recovery and resolution plans should be regularly assessed as part of the regulatory and supervisory oversight of systemically important financial institutions. Resolution authorities should also regularly assess the resolvability of systemically significant institutions and evaluate the feasibility of their recovery and resolution plans.

As an interim measure, the Bank Supervision department of the South African Reserve Bank focused on recovery and resolution plans in 2012. Banks were informed of the requirement to develop recovery and resolution plans. The review and assessment of banks' plans will form part of the domestic banking system's regular supervisory programme from 2013 onwards.

6.5 Funding arrangements for resolution

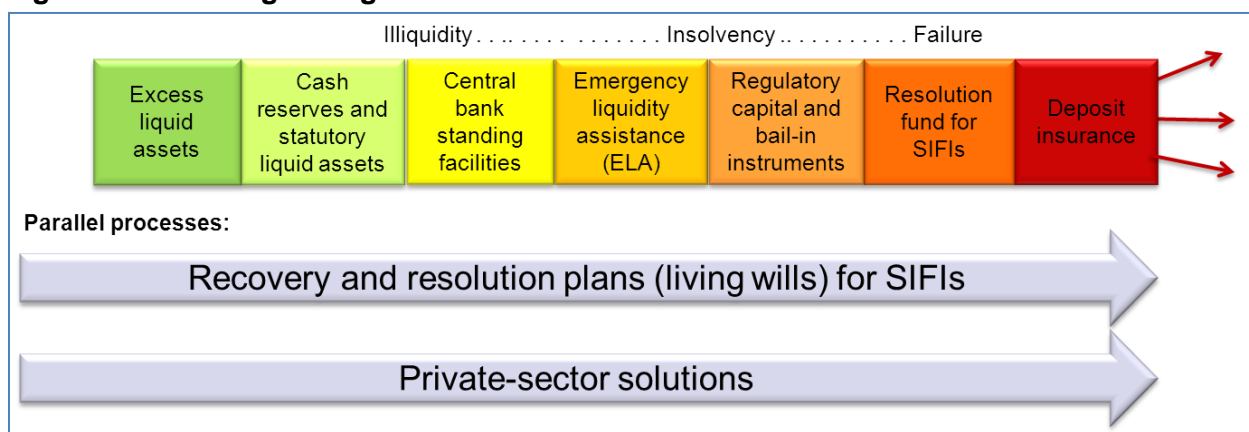
The resolution of any financial disruption of systemic proportions is likely to require funding, either through liquidity or solvency support. While emergency liquidity assistance is normally provided by – and at the discretion of – the central bank, solvency support is provided either by the government (via the National Treasury), a privately funded resolution fund or private-sector investors.

An effective resolution framework aims to avoid using public funds to bail out financial institutions or absorb economic losses. This requires adequate buffers. The Financial Stability Board recommends that countries should establish privately financed deposit insurance or resolution funds, or a funding mechanism to recover resolution costs from industry after the fact.

Deposit insurance and resolution funds serve different purposes. A deposit insurance fund protects (mainly retail) depositors against losses in the event of a bank failure. As such, they can play a critical role in preventing a “run” on a bank. A resolution fund can be used for various purposes, for example, to fund or provide capital for an institution in distress prior to its failure, or to compensate creditors who suffered greater losses than they would have in liquidation. A resolution fund could therefore be established to complement a deposit insurance scheme.

The funding buffers in the resolution process comprise both internal buffers (prudential liquidity and capital requirements) and external buffers (deposit insurance and resolution funds). These buffers are illustrated in Figure 6.2.

Figure 6.2: Funding arrangements for resolution



1. SIFs – systemically important financial institutions

The National Treasury is developing a deposit insurance policy, which will cover retail deposits up to a certain limit. The South African Reserve Bank is expected to establish and administer a resolution fund.

6.6 Cross-border cooperation in resolution

The resolution framework will empower and encourage the resolution authority to cooperate with foreign resolution authorities to achieve a solution. The resolution authority will have authority over local branches of foreign finance institutions and the mandate to support a resolution carried out by a foreign home authority. National laws and regulations will not discriminate against creditors on the basis of their nationality, location or the jurisdiction in which their claims are payable.

Agreements – including those relating to recovery and resolution plans – will ensure information-sharing. The local resolution authority will consider the cross-border effects of its resolution processes, especially in Africa. In this regard, South African regulators and key authorities in countries where South African financial institutions have operations may be required to establish and maintain regional crisis-management groups to enhance preparedness for, and manage the cross-border effects of, a financial crisis affecting a multinational institution. South Africa will also have to participate in crisis-management groups in its capacity as host regulator for international banks.

The key elements of cross-border resolution coordination will be captured in the resolution framework. Such elements will be enabling rather than prescriptive, as the nature and extent of cooperation will depend on the circumstances.

6.7 Exiting the resolution process

An institution cannot be supported or remain in resolution indefinitely. The resolution authority will, within a reasonable time, allow an institution to exit the resolution process. This will be done in any of the following three scenarios:

- The institution recovers and becomes viable on its own, in which case it will be formally declared to be no longer within resolution.
- The institution is dissolved in an orderly manner and its licence is cancelled.
- The institution requires further assistance that goes beyond the powers of the resolution authority, such as capital injections by the National Treasury. Interventions in such cases would be decided on a case-by-case basis between the Governor of the South African Reserve Bank, through the FSOC, and the Minister of Finance.

6.8 Summary

- The South African Reserve Bank is established as a resolution authority as part of its financial stability mandate.
- The resolution framework is based on systemic significance and financial stability considerations, rather than institutional soundness. It includes the resolution of various types of systemically significant financial institutions, financial market infrastructure and financial groups.

- The resolution authority is granted a wide range of powers to enable prompt corrective action, including bail-in powers.
- Safeguards are provided to protect stakeholders and ensure that the resolution authority remains accountable.

7. Enforcement

7.1 Introduction

The design, architecture and legislation of the twin peaks model must also address enforcement – the corrective or sanctioning action by a supervisor or regulator. The proposed principles aim to encourage compliance with the new regulatory regime and effectively combat financial crime. Enforcement will differ slightly between the prudential and market conduct regulator, based on approaches that are most effective for each one.

Effective enforcement of the twin peaks model will combine a number of appropriate approaches tailored to specific cases. Enforcement options will include:

- Summary administrative penalties
- Referral to an administrative enforcement forum
- Referral of matters for criminal prosecution
- Suspension or withdrawal of licences and approvals
- Orders to take or cease particular actions
- Debarment.

7.2 Prudential regulatory environment

The enforcement framework for prudential regulation will initially be based on existing legislation such as the Banks Act (1990) and the Long-Term Insurance Act (1998). Over time, the prudential regulator will include other enforcement tools in the framework where necessary.

The prudential regulator should have the necessary enforcement powers and regulatory tools to act quickly – and to be seen to act quickly – when non-compliance is detected. However, the regulator should remain cognisant of the effect any significant regulatory action will have on confidence in the financial system's stability. Perceptions of regulatory action against a financial institution, especially a bank, could endanger economic value, invoke market panic and cause the public to lose trust in the financial system, possibly resulting in a “run” on the bank, which could lead to a flight of capital.

7.3 Market conduct regulatory environment

The market conduct enforcement process will build on the successes of the FSB Enforcement Committee. It will adjudicate on alleged contraventions and instances of non-compliance. To promote compliance, the market conduct regulator will also run information campaigns about relevant issues.

To pose a credible deterrent, the market conduct regulator will need efficient and visible legal authority to enforce compliance within its regulatory framework, including adequate authority to impose meaningful redress and sanctions for material non-compliance. There are two types of deterrence: “specific deterrence” refers to convincing the transgressor not to repeat the transgression or instance of non-compliance, while “general deterrence” refers to convincing the industry to comply with the law. The market conduct regulator will aim to achieve both.

Given that a greater deterrent effect is achieved when the period between contravention and sanction is short, emphasis will be placed on swift enforcement action. To this end, the regulator will review all existing enforcement structures to identify inefficiencies. The review will consider decriminalising certain contraventions, launching a voluntary disclosure programme, and rationalising judicial or administrative review.

The regulator will adopt a pre-emptive, proactive supervisory approach. This will typically entail agreeing with institutions on remedial action to mitigate identified market conduct risks (as discussed in Chapter 5). However, there will be cases where this approach will not be effective. In such cases, the market conduct regulator will take formal action. The following enforcement options are already available to the current FSB through its Enforcement Committee and other existing legislation:

- Imposing administrative fines and penalties
- Declaring business practices to be undesirable, with authority to order the practices to cease or proceed only in an amended form
- Suspending or withdrawing regulatory licences
- Terminating or withdrawing approval for individuals to act in a certain capacity
- Referral to the National Prosecuting Authority for criminal prosecution of individual wrongdoers, where a statutory or common-law criminal offence is committed.

The market conduct enforcement framework will retain and enhance these powers, increasing enforcement capacity as necessary.

The legislation currently governing the FSB Enforcement Committee stipulates that any matters referred to it, including cases where a settlement is reached, are to be publicised. Publication is also prescribed for other formal enforcement actions, such as withdrawing or suspending a licence. Criminal proceedings, where applicable, are also a matter of public record. This feature will be retained in the market conduct regulator's framework, with the important proviso that the prudential regulator is to be consulted where publication of enforcement actions might introduce systemic risk into the financial system. However, given the regulators' overarching transparency principle, non-disclosure should be the exception rather than the rule, so that the deterrent factor of enforcement is not blunted. The reputational consequences of public disclosure should be an effective deterrent to unfair customer treatment.

7.4 Regulator and adjudicative independence

A credible enforcement system needs an appropriate level of independence and protection on an institutional and financial basis. The twin peaks framework will entrench this independence while upholding the Constitution and the law. With regard to the market conduct regulator's operational structure, appropriate controls will be put in place to ensure that its administrative actions are lawful, reasonable and procedurally fair.

7.5 Cooperation

To avoid a silo-based approach, mechanisms will be put in place to ensure coordinated and strategic enforcement, especially in cases that involve multiple contraventions and undesirable trends. A permanent coordinating enforcement forum representing all relevant regulators – including those outside the twin peaks framework – will be established.

7.6 Combating money laundering and terrorism financing

Enforcing compliance with AML and CFT legislation and regulation has become an important aspect of prudential and market conduct supervision. The Financial Action Task Force, the Basel Core Principles for Effective Banking Supervision, IAIS Insurance Core Principles and the FIC Act all require regulators to fulfil certain responsibilities.³¹

One objective of the FIC Act is to impose certain duties on institutions that might be used for AML/CFT activities. These obligations protect both the stability and safety of financial institutions and the broader financial system.

The FIC is responsible for ensuring that existing national supervisory bodies – currently the South African Reserve Bank for banks and the FSB for the non-banking sector – fulfil their obligations to enforce AML/CFT legislation.

AML/CFT compliance will continue to be supervised as part of regulated institutions' enterprise-wide risk management, since significant reputational risk may arise not only for the institution, but also for the regulators and the financial system, if not effectively performed. Shifting towards the twin peaks model will not require material change to the FIC's mandate or positioning. However, the demarcation of responsibilities between the market conduct regulator and the prudential regulator will require some practical changes to how compliance is supervised. In particular, the obligations imposed on supervisory bodies will need to be allocated appropriately.

The prudential regulator will be responsible for AML/CFT supervision of institutions that fall under its jurisdiction. The market conduct regulator will carry out AML/CFT supervision of those entities not subject to supervision by the prudential regulator. Should AML/CFT concerns come to light in the course of either regulator's supervisory activities, appropriate coordination and information-sharing mechanisms between the FIC and the two regulators will be implemented. Since significant financial crime may also have implications for financial stability, the various regulators will also coordinate with the FSOC. Opportunities to improve coordination and clarify roles between the FIC and the prudential and market conduct regulators will also be identified.

³¹ Financial Action Task Force (2012) Recommendation 26 and 27 of "International Standards on Combating Money Laundering and the Financing of Terrorism and Proliferation". Paris. Pg. 23.

7.7 Summary

- The prudential regulator will have the necessary enforcement powers and regulatory tools to act quickly, and will remain cognisant of the effect any significant regulatory action will have on confidence in the financial system's stability.
- To pose a credible deterrent, the market conduct regulator will have visible legal authority to enforce compliance within its regulatory framework, including the ability to impose meaningful redress and sanctions for material non-compliance.
- The prudential regulator will be responsible for AML/CFT supervision of institutions that fall under its jurisdiction, while the market conduct regulator will carry out AML/CFT supervision of those entities that do not fall under the prudential regulator.

8. Implementation and next steps

Moving towards a twin peaks model of financial regulation will result in the South African Reserve Bank's organisational design changing to encompass the prudential regulator, and the FSB being transformed into a new entity, the market conduct regulator.

The twin peaks model is expected to take place in two phases: the first phase will run during 2013/14 and will involve relevant legislation being developed and tabled in Parliament to enable the regulators to deliver on their revised mandates. This step will include integrating resources and staff who are currently responsible for prudential regulation from the FSB into the Bank.

The second phase, to be implemented over the medium term, will consist of harmonising specific financial sector legislative, regulatory and supervisory systems and frameworks.

The FRRSC is cognisant of the complexity of the reform agenda and the effect it will have on the regulators and the regulated financial sector, and is committed to comprehensive industry and public engagement regarding the contemplated changes. The FRRSC will engage with all interested stakeholders as part of finalising the reform proposals.

Interested parties are encouraged to send written comments on this document, particularly with regards to the "summaries" outlined at the end of Chapters 2 to 7. Comments should be sent to the Head of the FRRSC Secretariat, Mr Unathi Kamlana, via fax to 012 313 4974 or by email to twinpeaks@resbank.co.za. The closing date for comments is 8 March 2013. Comments received will be considered in finalising the legislative proposals.

Abbreviations

AML	Anti-money laundering
CFT	Combating the financing of terrorism
FIC	Financial Intelligence Centre
FIC Act	Financial Intelligence Centre Act (2001)
FRRSC	Financial Regulatory Reform Steering Committee
FSB	Financial Services Board
FSOC	Financial Stability Oversight Committee
G20	Group of 20
IAIS	International Association of Insurance Supervisors
NCR	National Credit Regulator
PASA	Payment Association of South Africa
PFMA	Public Finance Management Act (1999)
SAMOS	South African Multiple Option Settlement
TCF	Treating customers fairly

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