Twin Peaks in South Africa:

RESPONSE AND EXPLANATORY DOCUMENT

Accompanying the Second Draft of the Financial Sector Regulation Bill

December 2014

national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

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Introduction

The first draft of the Financial Sector Regulation (FSR) Bill was published in December 2013. Close to 300 pages of comments were received on the draft Bill, and numerous interactions were held with stakeholders.

This document accompanies the revised second draft of the FSR Bill. It summarises some of the responses to the comments received and explains in more detail the proposals in the second draft of the Bill.

Stakeholders are encouraged to comment on the second draft of the Bill, and written comments will be taken until 2 March 2015. Thereafter a third draft will be tabled in Parliament. Stakeholders will have a further opportunity to comment during the Parliamentary process.

Enacting the FSR Bill is only part of the Twin Peaks reform process, which will be undertaken over a number of years. Other steps to be taken include developing a comprehensive new framework for market conduct. Accompanying this document is the discussion document *Treating Customers Fairly in the Financial Sector: A Market Conduct Policy Framework for South Africa*, which proposes a streamlined market conduct framework. In addition, new prudential requirements will be introduced such as Solvency Assessment and Management for insurers.

Also accompanying this paper is a detailed matrix of all public comments received on the first draft of the FSR Bill and responses to these.

Purpose of this document

This document is a response and explanatory document to explain the underlying purpose and architecture of the Revised (Second) Draft of the Financial Sector Regulation Bill, which seeks to lay the legislative basis for the coming Twin Peaks system of regulating the financial sector. It indicates to what extent public comments on the first draft of the Bill (published in December 2013) have been taken into account, and provides an explanation for the changes and the proposed architecture of the regulatory system.

The Twin Peaks system of regulation

The proposed Twin Peaks system for regulating the financial sector is designed to make the financial sector safer, and to better protect financial customers in South Africa. It gives effect to the government policy paper published in February 2011, entitled *A safer financial sector to serve South*

Africa better[1]. That document, known commonly as the "Red Book", took into account the lessons learnt from the 2008 Global Financial Crisis, assessed the structure and characteristics of South Africa's financial sector for gaps and weaknesses, and set out proposals to reform the regulatory system for the financial sector.

While South Africa's financial sector is generally resilient, it could be delivering better outcomes for customers and the economy. Many customers in the financial sector are not treated fairly, and are often sold products or services that do not deliver value for money, are complex, and do not perform as expected or are not appropriate to their needs.

Twin Peaks is a comprehensive and complete system for regulating the financial sector. It aims to ensure better outcomes for financial customers and the wider economy, by ensuring that customers are treated fairly, that their funds are protected against the risk of institutions failing, and by reducing the risk of using taxpayer funds to protect the economy from systemic failures. Twin Peaks places equal focus on prudential and market conduct supervision by creating dedicated authorities responsible for each of these objectives. It also places a separate focus on financial stability.

A Twin Peaks system also represents a decisive shift away from a fragmented regulatory approach, minimising regulatory arbitrage or forum shopping. It focuses on implementing a more streamlined system of licensing, supervision, enforcement, customer complaints (including ombuds), appeal mechanism (tribunal) and customer advice and education across the financial sector.

Process to date

Following the publication of the Red Book, Cabinet approved the shift to a Twin Peaks system in July 2011, and an interagency Financial Sector Regulatory Reform Steering Committee (FRRSC) was put in place to implement the reform. In approving the shift, Cabinet approved the following principles to guide the reform in the regulation of the financial structure:

Principle 1: Financial service providers must be appropriately licensed or regulated.

Principle 2: There should be a transparent approach to regulation and supervision. *Regulation and supervision should be risk-based, where appropriate, and proportional to the nature, scale and complexity of risks present in a regulated entity and the system as a whole.*

Principle 3: The quality of supervision must be sufficiently intense, intrusive and effective.

Principle 4: Policy and legislation are set by government and the legislature, providing the operational framework for authorities.

Principle 5a: Authorities must operate objectively with integrity and be operationally independent, but must also be accountable for their actions and performance.

Principle 5b: Governance arrangements for authorities and standard-setters must be reviewed, so that boards perform only governance functions. *Where boards exist, they should be involved in governance issues only, and not policy or operational issues.*

Principle 6: Regulations should be of universal applicability and comprehensive in scope in order to reduce regulatory arbitrage.

[1] All documents referred to in this section are available online at http://www.treasury.gov.za/twinpeaks

Principle 7: The legislative framework should allow for a lead authority for every financial institution that is regulated by a multiple set of financial authorities. All authorities involved must strive to coordinate their supervisory activities.

Principle 8: Relevant ministers must ensure that the legislation they administer promotes coordination and reduces the scope for arbitrage.

Principle 9: The regulatory framework must include responsibility for macroprudential supervision.

Principle 10: Special mechanisms are needed to deal with systemically important financial institutions (SIFIs).

Principle 11: Market conduct oversight must be sufficiently strong to complement prudential regulation, particularly in the banking sector. *Market conduct oversight is critical for the financial sector, and complements prudential oversight.*

Principle 12: Financial integrity oversight should be effective to promote confidence in the system.

Principle 13: Authorities should be appropriately funded to enable them to function effectively.

Principle 14: Financial authorities require emergency-type powers to deal with a systemic financial crisis, requiring strong and overriding legislative powers.

Principle 15: All the above principles are reflected in international standards like Basel III and standards set by the International Association of Insurance Supervisors (IAIS) and International Organisation of Securities Commission (IOSCO). To the extent that there are any contradictions or inconsistencies in the above principles, government will take appropriate steps to facilitate greater consistency with international standards, taking into account the public interest.

In February 2013, a detailed follow-up document was published, *Implementing a Twin Peaks model of model of financial regulation in South Africa*. This document, known as the "Roadmap" set out the process going forward, and highlighted important policy choices in the area of prudential and market conduct supervision.

Later that year, in December 2013, Cabinet approved the publication of the Financial Sector Regulation (FSR) Bill to give effect to Twin Peaks, and stakeholders were given until March 2014 to provide comments. Close to 300 pages of comments were received from internal and external stakeholders, and considered in the course of the revision of the legislation. This has culminated in a second draft of the FSR Bill.

The rationale for Twin Peaks

The South African financial system has a number of features that suggest that a Twin Peaks approach to regulation would be best suited. In particular, the South Africa financial sector is **highly interconnected** and dominated by large financial groups, with each group typically comprising at least a bank and insurance company. This small number of large financial groups also leads to **reduced competition**. Many financial institutions **sell complex products with opaque fee structures**, often **prices for services are higher** than they would be if the system was more competitive, and **financial institutions do not necessarily provide services to all South Africans –** wealthier, urban customers tend to get a wider range of more suitable products, while poorer and rural customers may get inappropriate or expensive financial services, or none at all.

The regulatory landscape for the financial services sector is also fragmented, and based on a range of different laws applied at an industry level – for example, legislation for banking, insurance, pensions, collective investment schemes, credit and so on. This has resulted in a 'silo' approach to regulation of the various industries, with different standards and requirements applying to different industries, and allowed for regulatory arbitrage.

The Twin Peaks approach to financial regulation, as proposed in the FSR Bill, is designed to underpin a comprehensive regulatory system with two main aims:

- To strengthen the financial safety and soundness of financial institutions by creating a dedicated Prudential Authority (PA)
- To better protect financial customers and ensure that they are treated fairly by financial institutions by creating a dedicated market conduct authority – the Financial Sector Conduct Authority (FSCA)[2]

Under this model, the Reserve Bank will oversee financial stability, within a policy framework agreed with the Minister of Finance. Recent G20 reforms on dealing with systemically important financial institutions (SIFIs) and 'Too-Big-To-Fail' financial institutions form a critical part of this stability objective, which aims to reduce the likelihood of using tax-payer funds to bail out failing financial institutions.

While the Reserve Bank will be responsible for macroprudential supervision, the PA will focus on microprudential supervision. It will have the important objective of ensuring that individual financial institutions are sound, and can meet their promises to depositors, insurance policy-holders, retirement fund members and investors at all times.

A number of market conduct issues have over time been highlighted in the South African financial sector. The financial sector is a powerful industry, and customers do not typically have the knowledge or power to assess whether they are being treated fairly or to take on the industry on their own when they are not treated fairly. Together with conflicted remuneration and incentive structures, this information asymmetry has led to many poor customer outcomes. Particular problems have been identified in the retail banking (originally through the Banking Enquiry Panel or Jali Panel), credit, insurance, retirement and investment fund industries. In responding to conduct issues, an important lesson learnt is that prudential authorities are not geared to deal with the poor treatment of customers. The global financial crisis further emphasised this point.

A dedicated focus on market conduct in the financial services sector is thus necessary, and this forms the second 'peak' in the Twin Peaks model. The discussion document accompanying this paper, '*Treating Customers Fairly in the Financial Sector: A Market Conduct Policy Framework for South Africa'* gives further detail on challenges with market conduct in South Africa, and a proposed approach to improving market conduct under Twin Peaks.

The Twin Peaks reform is intended to take into account the interconnected nature of the financial sector and the evolution of business models – most financial groups provide an increasingly broad range of products and services under one banner, from transactional services to insurance, credit, investment management, and advice and distribution. Reforms under Twin Peaks will support more consistent and complete supervision and regulation, developing comprehensive market conduct, prudential, and stability regulatory frameworks to be applied across the financial sector as a whole, rather than on an industry basis. This will minimise the potential for regulatory gaps and arbitrage.

[2] The name of the Market Conduct Authority in the first draft of the FSR Bill has been changed to the Financial Sector Conduct Authority (FSCA) in the second draft. The term 'market conduct' was viewed as being limiting and ambiguous

The coming Twin Peaks system of regulation recognises that the two objectives of financial soundness and treating customers fairly are better done by two regulators, dedicated to each objective. This is because the prudential regulator and market conduct regulator often have conflicting objectives when pursuing their respective objectives.

Many countries have chosen a Twin Peaks approach, including Australia, Belgium, the Netherlands, New Zealand and the United Kingdom. However, each has implemented their own unique version of the model. For example, the UK's Prudential Regulatory Authority operates as a subsidiary of the Bank of England and is responsible only for the prudential regulation of systemic institutions like banks, insurers and some asset managers, while the Financial Conduct Authority is responsible for market conduct supervision, both credit and all other financial institutions, and some prudential supervision. The Australian Prudential Regulatory Authority is completely separate from the Reserve Bank of Australia. In Belgium and the Netherlands, account has to be taken of the role of the European Union and the European Central Bank, hence the domestic central bank is responsible for prudential oversight, but not for monetary policy. ,

The South African implementation is also unique, and the proposals contained in FSR Bill reflect specific South African characteristics. These are explained in more detail in this document, which has the following chapters:

- *Chapter 2* gives a brief overview of the **phased approach** to implementing the Twin Peaks system and an overview of the current status in the reform process.
- *Chapter 3* explains the **second draft of the FSR Bill**, explaining at a high level some of the main changes from the first draft.
- *Chapter 4* addresses **financial stability** and systemic supervision.
- *Chapter 5* discusses the main characteristics of **the two new authorities** including provisions related to governance contained in the FSR Bill. It also sets out details of **cooperation and coordination** between the two authorities and the National Credit Regulator.
- *Chapter 6* briefly sets out the proposed approach to **licensing**, including for products and services not yet regulated under specific financial sector laws.
- *Chapter 7* considers in more detail the proposals on the issuing of **standards** by the new authorities. It explains some of the challenges with the existing approach to subordinate legislation, and the proposed standardised system of primary legislation, regulations, standards, interpretation notes and guidance notes under Twin Peaks.
- *Chapter 8* discusses **enforcement**. Provisions have been made to ensure that the authorities have the necessary powers to undertake investigations and take enforcement action if needed.
- *Chapter 9* discusses **ombud schemes arrangements.**
- *Chapter 10* briefly outlines the **next steps** in the implementation process.

The Twin Peaks reform will require the development of deep underlying policy frameworks for prudential and market conduct regulation. The prudential framework in South Africa is highly developed and evolving, in line with international developments - for example with amendments to legislation to implement the Basel III standards in banking, and the Solvency Assessment and Management (SAM) measures in the insurance industry. The discussion document on the market conduct draft policy framework accompanying this document, however, is less-developed globally, and the draft policy document takes a first step toward in developing it significantly in SA. It sets out a strategy for improving market conduct in the financial sector, including a proposed law under which the FSCA will eventually operate – the proposed Conduct of Financial Institutions (CoFI) Act. It is envisaged that this law will ultimately replace existing fragmented market conduct requirements provided for through existing financial sector laws.

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Phased implementation of the Twin Peaks system

A Twin Peaks system will be introduced through a phased approach designed to minimise the risks associated with the change. In the first phase, the Financial Sector Regulation Bill establishes the new regulatory authorities. The development of the underlying frameworks within which the authorities will operate will then take place. This will require substantial legislative reform, and changes are likely to happen over a number of years to ensure that the transition is as smooth as possible.

Current framework

In the current regulatory framework, there are a number of regulatory authorities with responsibility for financial sector regulation, each with substantially different powers and functions.

The Registrar of Banks, part of the Bank Supervision Department in the Reserve Bank, is responsible for the prudential supervision of banks and for performing functions assigned in terms of the Banks Act.

The Financial Services Board (FSB), established in terms of the Financial Services Board Act, is responsible for the prudential and market conduct supervision of all non-bank financial institutions, including insurance companies, pension funds, investment schemes and financial intermediaries. The FSB is structured so that there is a Registrar for each type of industry – i.e. a Registrar for Long-term Insurance, a Registrar for Short-term Insurance, a Registrar for Pension Funds, and so on. The FSB is responsible for 13 different financial sector laws. It reports to the Minister of Finance.

The National Credit Regulator (NCR) supervises all retail credit providers, which includes but is not limited to institutions which provide financial products and services as the main part of their business – in other words, their scope includes clothing and furniture retailers as well as banks and other financial institutions. The NCR is responsible for the implementation of the National Credit Act and focuses on promoting access to credit and the market conduct regulation of retail credit providers in South Africa. It reports to the Minister of Trade and Industry. In addition the Council of Medical Schemes oversees medical aids.

This regulatory landscape, while largely effective, is also fragmented, and has led to gaps in regulatory application in some instances, and allowed for regulatory arbitrage in others. The industry-based approach to regulation, with the myriad of laws for specific types of industries (banking, insurance etc.), has also meant that different standards are applied to financial products or services in different ways, even though those products and services may be similar. Financial groups, which perform a range of different financial activities, are also subject to multiple laws with differing requirements.

Twin Peaks reform process

The Twin Peaks approach aims to significantly streamline and strengthen the regulatory environment. The new system will be implemented in the following broad phases[3]:

Phase 1: setting up the regulatory architecture

a) Two new authorities are created, namely the Financial Sector Conduct Authority (FSCA), and the Prudential Authority (PA). The FSCA will be a stand-alone market conduct authority, while the PA will be an authority established within the Reserve Bank. The FSB and the Bank Supervision Department will cease to exist. It is important to note that these existing regulatory institutions will not merely be 'renamed' under the Twin Peaks system. The new authorities will have clearly defined mandates relating to market conduct and financial soundness respectively, and have broad jurisdiction over the financial sector. The Reserve Bank is given an express mandate for financial stability oversight.

   Existing industry-specific legislation remains in place. However, with the creation of the new authorities, the *responsibility* for the existing Acts will change. For example, the responsible authority for the prudentially-focused provisions of the Banks Act and prudential aspects of the Long-term and Short-term Insurance Acts will shift from the Registrar of Banks and Registrars of Long-term and Short-term Insurance to the Prudential Authority. For most other pieces of legislation, the primary responsibility for the law will shift to the FSCA. The authority responsible for the legislation will also become the licensing authority for financial institutions licensed or authorised in terms of that law[4].

b) The second draft of the FSR Bill progresses the first stage of the Twin Peaks implementation further than what was contemplated in the first draft. The revised Bill gives additional powers to the new authorities, in keeping with their respective objectives. These powers will be in addition to those provided in existing industry-specific financial sector laws (i.e. an "overlay"), and are intended to ensure that the authorities have the required tools to perform effectively in this first phase of their establishment, without being limited by gaps in the existing law.

   The authorities are also empowered to exercise their powers over *all* licensed financial institutions, regardless of which authority is the licensing authority. This will ensure completeness of regulatory coverage.

   To improve consistency in regulation, strong coordination and cooperation requirements have been provided for among relevant regulatory authorities in the financial sector. This includes the PA, FSCA, Reserve Bank, and the NCR.

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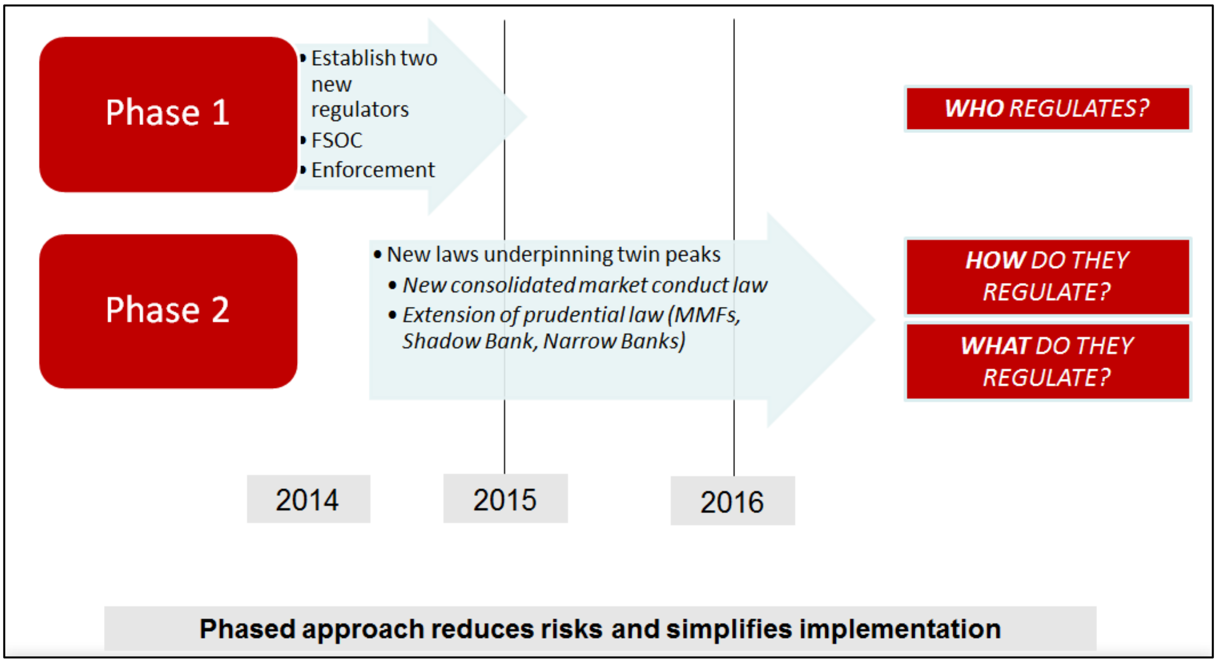
[3] These phases are indicative rather than rigidly defined time periods, and overlap between the phases is expected

[4] The exact details of the changes in responsibility are contained in the consequential amendments to the various laws, which are also released together with the proposed Bill. slightly different approach is taken for the payments system and market infrastructure, explained in further detail further on in the document

Phase 2: Establishing the target framework

The second phase of the reform process is necessarily more far-reaching. In this phase, the legal frameworks for prudential and market conduct regulation will be developed, harmonised and strengthened, including through in some instances repealing industry-specific legislation (especially for market conduct) and introducing new legislation and licensing procedures where necessary. The revised legal framework will be developed to support more effective supervision of the deeply interconnected financial system. Ultimately Twin Peaks regulation is intended to provide a streamlined system of licensing, supervision, enforcement, customer complaints (including ombuds), appeal mechanisms (tribunal) and customer advice and education.

Figure 1: A phased approach to Twin Peaks implementation



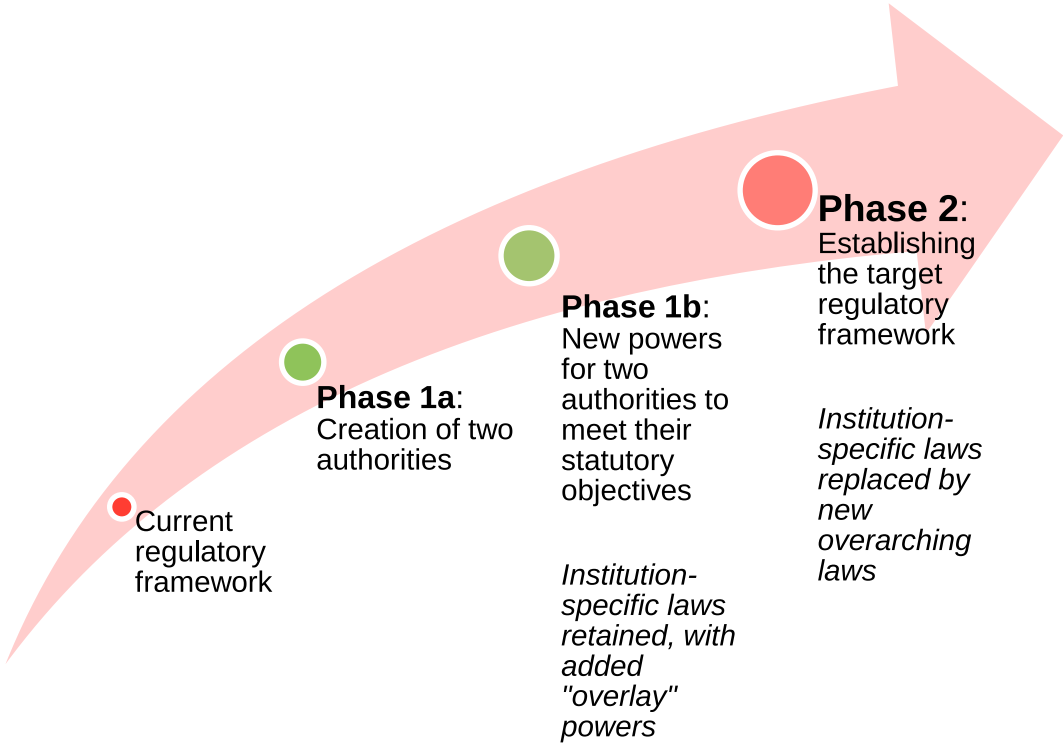
Current status in reform process

The revised FSR Bill published with this paper provides for Phase 1 of the reform process; i.e. it is an intermediate step in creating the final new regulatory framework. In addition to establishing the authorities, it provides them with the powers necessary to supervise institutions and take necessary enforcement action from their first day of operation.

This Bill leaves the underlying industry-specific laws largely intact, while providing an overlay of powers that can be used in addition to powers available in the existing laws, and which can be applied consistently across sectors. To the extent possible, it avoids introducing concepts or structures that might conflict with the envisaged final framework.

Phase 1 will still have material limitations relative to the target framework at the end of Phase 2. For example, it will perpetuate to some extent the current industry-based "silo" approach under existing laws. However, it is believed that the current Bill will nevertheless enable the two authorities to function effectively and to progress a long way towards the final system envisaged.

Figure 2: Current process in Twin Peaks implementation



The discussion document on the proposed market conduct policy framework begins the work of establishing new market conduct legislation envisaged for the target framework in Phase 2.

The future framework

The pillars of effective regulatory oversight can be thought of as:

- Licensing
- Issuing regulatory requirements
- Supervising regulated entities
- Taking enforcement action (including remedial and punitive action) against those who breach the requirements or break the law

A related part of the overall regulatory system is ensuring effective customer recourse mechanisms. South Africa makes use of an ombuds system for external dispute resolution for financial customers where internal complaints mechanisms may not have worked.

Table 1 explains these pillars with reference to the current framework, the intermediate framework that will be implemented in Phase 1 (2015-16) and the long-run target framework that will be implemented over Phase 2 (2016–18).

These pillars are also discussed in further detail in the remaining chapters of this document.

Table 1: The pillars of the regulatory framework

	Current regulatory framework	Intermediate framework Phase 1 (2015)	Target regulatory framework Phase 2 (aim for 2018)
Licensing	Under industry-specific laws (e.g. Banks Act, CISCA)	Provisions in industry-specific laws and existing licenses will be retained but allocated to one authority. This authority, designated as licensing authority, is responsible for overall supervision of the relevant act. The FSR Bill also proposes an overlay of limited additional licencing powers for the new authorities in respect of newly designated products and services, and requires cooperation between authorities for new licenses and withdrawal of or changes to existing licenses	Industry-specific licensing provisions repealed and replaced. Institutions will be required to get a license from the PA and a separate license from the FSCA.
Setting standards and regulatory requirements (subordinate legislation)	Issued through industry-specific laws (e.g. bank regulations, board notices, directives etc)	Existing subordinate legislation (e.g. bank regulations, Regulation 28, Board Notice 80, Policyholder Protection Rules, FAIS General Code) all remain in place and will continue to apply. These will largely be supervised by the relevant licensing authority in Phase 1. The FSCA and PA will be able to issue new prudential or conduct standards under the FSR Act.	The intention is to eventually phase out the broad range of existing subordinate legislation and replace these with standards. This will standardise and streamline the current regulatory environment, where subordinate legislation currently refers to a wide range of instruments (rules, board notices etc). The process followed in issuing these instruments also differs currently, especially regarding consultation and whether they are issued by the Minister or a Registrar. In the target framework, all subordinate legislative requirements issued by the authorities will be issued as standards. These will complement the policy framework established through primary law and Ministerial regulation. The

			role of Ministerial regulations in the financial sector will also be streamlined over time.
Supervision (including collecting information, onsite inspections and investigations)	Through powers provided for in industry -specific laws, and in some instances the FSB Act and Inspections Act.	Retain provisions in industry-specific laws, but provide an overlay of additional supervisory powers in FSR Act. The exceptions are inspections and investigation powers, where the Inspections Act will be repealed and replaced with provisions in the FSR Act.	Provisions in industry-specific law repealed and replaced with provisions in new legislation (e.g. legislation giving effect to new conduct framework)
Administrative actions, including enforcement actions	Through industry-specific laws, FSB Act and Financial Institutions (Protection of Funds) Act.	A comprehensive and expanded suite of administrative and enforcement actions are proposed in the FSR Bill, including the powers to fine institutions, to issue directives, to enter into enforceable undertakings, and so on. Provisions in industry-specific law will largely remain	Provisions in industry laws are repealed.
Customer recourse – ombuds schemes	The Financial Services Ombuds Schemes (FSOS) Act oversees voluntary ombuds for, amongst others, the banking, insurance and credit industries. The FAIS Act and Pension Funds Act establish statutory respective ombuds, also overseen by the FSOS Act.	The FSOS Act will be repealed and provisions made for the enhanced oversight of ombud schemes through the FSR Bill, These include stronger powers for the FSOS Council to consolidate and streamline ombuds arrangements more effectively. The role of a potential “chief ombud” may be explored to compliment these developments. All existing ombuds will remain in place and continue to function	A review of the ombud system will establish the way forward with regard to separate industry-specific ombuds, and the role of voluntary and statutory ombuds. The intention will be to ensure a consolidated approach to alternative dispute resolution in support of the consolidated approach and streamlined system of overall regulation.

3

The Financial Sector Regulation Bill

The second draft of the Financial Sector Regulation Bill responds to stakeholder comments submitted and issues raised during public workshops. Additional sections have been added relating to licensing, standard-setting, enforcement and group supervision, amongst others. This chapter and the subsequent chapters explain the revisions in more detail.

Objectives of the Financial Sector Regulation Bill

The key objective of the FSR Bill is to put in place the architecture of the Twin Peaks regulatory system for the financial sector. The regulatory system aims to be consistent with international best practice and agreed principles in terms of regulatory independence, accountability and effectiveness.

Broadly speaking, a Twin Peaks approach places distinct and separate focus on the safety and soundness of a financial institution, and the manner in which an institution provides financial products or services.

Safety and soundness supervision can be thought of as supervising the *promises* that financial institutions make. Prudential oversight is focused on ensuring that financial institutions are in a financial position to be able to deliver on the financial ‘promises’ they make to customers.

Financial services are services relating to marketing, delivering and trading financial products. These require conduct oversight to ensure that product characteristics are appropriate and properly disclosed, and that the products and services are delivered in a way that is fair and efficient.

The FSR Bill aims to create the two new authorities with the appropriate scope of responsibility, specific mandates, and requisite powers to achieve effective prudential and market conduct oversight. The objectives of the two regulatory authorities are quite distinct, although strong coordination and cooperation between the two authorities is also necessary to ensure their effectiveness. Chapter 5 explains the establishment of the authorities in further detail.

The revised FSR Bill also provides for a dedicated focus on systemic stability oversight, or macro prudential supervision, which is the responsibility of the Reserve Bank. This is explained in further detail in Chapter 4.

Objectives of the second draft

Extensive comments on the first draft of the FSR Bill were received from 24 stakeholders[5], including international and local academics, the legal fraternity, the financial services industry and ordinary South Africans.

The comments were very useful to the drafting process. The second draft of the Bill incorporates these comments where appropriate. A thorough internal process simultaneously reviewed the first draft to identify further improvements.

The second draft is designed to:

- *Improve the legal enforceability of the Bill*. In particular many definitions have been reconsidered, and additional areas have been added to improve legal application. *Address inconsistencies and confusions* associated with the concepts of “mono-regulated” and “dual-regulated” entities. The new version does not distinguish between these two concepts. This is a significant change, which is discussed in more detail below.
- *Clarify the role of other regulators under Twin Peaks*. Many organs of state have a role to play in financial regulation. The role of the National Credit Authority (NCR) was not explicitly explained in the first draft of the Bill. Numerous stakeholders noted that both of these entities were key players in the financial regulatory system, and that their role should be clarified.
- *Better align and clarify the governance arrangements for the new authorities*. Given the importance of each of the authorities, each requires an appropriate system of governance and accountability.
- *Align Reserve Bank powers for systemic oversight with its other responsibilities and provide greater clarity about these powers*. The Reserve Bank will be mandated to maintain, and in the event of a systemic event restore, financial stability. The second draft of the FSR Bill clarifies what powers the Reserve Bank will have and how these may be used in fulfilling this mandate.
- *Provide both authorities with powers in addition to industry-specific law* so they are able to supervise and enforce the law in pursuit of their objectives.
- *Empower both authorities to issue standards* (prudential, conduct and joint standards).
- Introduce a legal framework for regulating and supervising financial conglomerates (from both a prudential and a conduct perspective)

[5] A separate detailed comments matrix accompanies this document. It provides details of all comments received, and Treasury’s response. Commentators were Actuarial Society of South Africa, ASISA, Bakgatla Group, Banking Association of South Africa, The (BASA), Cape Chamber of Commerce and Industry, Competition Commission South Africa, Deloitte, Financial Intelligence Centre (FIC), Financial Intermediaries Association of Southern Africa (FIA), Free Market Foundation (FMF), JSE, Melbourne Law School, MicroFinance South Africa, MMI Holdings Limited, National Housing Finance Corporation, Parliamentary Monitoring Group Subscriber, Promontory, Resolution Policy Working Group, South African Institute of Chartered Accountants (SAICA), South African Insurance Association (SAIA), Standard Bank South Africa, STRATE, Voluntary Ombudsman Schemes and the World Bank.

Changes in the second draft of the Bill

Name of the authorities

The name of the Market Conduct Authority in the first draft of the FSR Bill has been changed to the Financial Sector Conduct Authority (FSCA) in the second draft. The term 'market conduct' was viewed as being limiting and ambiguous.

Defining the 'peaks'

The concepts of mono and dual regulation are no longer used. Many comments on the first draft of the Bill indicated that these terms were not clearly defined, and that there was a general lack of clarity on how the distinction would be made and how responsibilities would be allocated between the two authorities.

The approach mooted in the revised draft of the Bill no longer makes use of these terms. Instead, the scope of oversight of the two authorities is clearly set out in terms of their respective objectives. The Prudential Authority will be responsible for supervising the safety and soundness of financial institutions that provide financial products, market infrastructures or payment systems, and the FSCA will supervise the conduct of business of all financial institutions (providers of financial products, financial services, market infrastructures and payment systems), and the integrity of the financial markets.

Financial institutions providing financial products require **prudential** oversight, focused on promoting institutional safety and soundness, so that the institutions are able to deliver on the financial promises they make, i.e. they will be able to meet their financial obligations to their customers.

The Bill sets out a list of financial products which the PA will supervise from a prudential perspective. In addition, it allows for the Minister of Finance to add to the list by designating a new financial product through regulation.

There is a very close relationship between microprudential and macroprudential oversight – an individual institution becoming insolvent could pose risks to the stability of the entire financial system. Similarly, certain market infrastructures, such as exchanges, clearing houses, and settlement systems are also seen as critical to stability. In some cases (e.g. central counterparties to derivatives transactions), market infrastructures provide a product, but in others it is unclear whether they provide a product or a service. Regardless, **market infrastructures** are now widely regarded as warranting prudential oversight at a microprudential level.

Financial services include providing advice about financial products (e.g. advising pensioners how and where to invest their life savings), distributing products (marketing, selling, etc.), dealing in products (e.g. trading equities, trading debt instruments, etc.), operating a market (e.g. a stock exchange), administering and providing supporting services (record-keeping, investment platform administration, valuations, etc.), custody of titles to products etc., and so on. Financial institutions providing financial services require **conduct** oversight to ensure that product characteristics are appropriate, are properly disclosed, and that the products and services are delivered in a way that is fair and efficient.

The Bill provides a list of financial services which will be supervised and regulated from a conduct perspective by the FSCA. Any additions to the list of financial products overseen by the PA will imply an increase in the scope of regulation of the FSCA as it supervises services related to that product. In addition, the Minister of Finance may directly add to the list of financial services by designating a new financial service through regulation.

Regulation will also apply to participants in the national payments system, and this is explained further on in this chapter.

Licensing and supervision in Phase 1

In the final, target framework, all financial institutions will be issued with one license from the FCSA for financial services, and may be required to also hold a separate license from the Prudential Authority if they provide financial products, market infrastructures or payment systems that are to be prudentially regulated. However, rebuilding the licensing framework to eventually result in two separate licenses will be a significant exercise with inherent risks that must be managed carefully.

The FSR Bill therefore does not make major changes to licensing provisions at this stage of the reform process. However, some intermediate steps towards the final model are taken:

- Licensing remains under current industry-specific laws and all current licenses and licensing provisions will remain in place. The new authorities will be designated as licensing authority for specific existing licenses and for overseeing that industry-specific Acts are complied with. The PA will be the licensing authority for the Banks Act and the two Insurance Acts. The FSCA will be the licensing authority for most of the other financial sector laws (see Table 2 below).
- Regardless of which authority holds the license, *both* authorities will be able to fully apply regulation, supervision and enforcement activities on the financial institution. The section below on delinking powers from licensing explains this in more detail.
- The NCR remains responsible for licenses issued under the National Credit Act

The FSR Bill also provides an overlay of additional licensing powers to those provided in existing industry law. These are intended to provide for instances where a new financial product or service may be designated by the Minister of Finance, and needs to be licensed accordingly. Any new licenses issued by either authority in Phase 1 – both for existing and for newly designated products or services – will need to be done in concurrence with the other authority.

Delinking powers from licenses

In Phase 1 of the Twin Peaks process, both authorities will have the ability, following engagement with the other authority, to issue and supervise standards over all financial institutions, regardless of which authority issues the license. The way in which this is achieved in the second draft of the FSR Bill is by defining **financial institutions**, to include financial product providers, financial service providers, a market infrastructure, a payment system operator, and any institution required to be licensed under a financial sector law. The powers granted to each authority may be exercised with respect to **all** financial institutions.

Thus the PA will be able to impose prudential requirements on, for example, collective investment schemes, even though the FSCA is the licensing authority in Phase 1. Similarly, the FSCA will be able to apply conduct requirements for banks and insurers, even though they will be licensed by the PA.

The authorities will also have the power to delegate certain functions. Thus, for example, the PA will have prudential responsibility for insurers. The PA will need to license and set the prudential requirements for insurers, issued as prudential standards. It may, however, under an MoU, delegate the supervision and enforcement of these requirements for smaller companies to the FSCA. The licensing authority will in most cases also be responsible for existing subordinate legislation issued under the Acts they are responsible for, but may similarly delegate supervision thereof [6].

Table 2: Licensing and supervision of existing laws in Phase 1

Entities regulated under the:	Licencing authority	Subordinate legislation	Supervision and enforcement
Banks Act **Cooperative Banks Act** **Mutual Banks Act** **Dedicated Banks Bill**	Prudential Authority	**Existing subordinate legislation:** -Responsibility of licensing authority[7] **New standards may be issued under FSR Bill:** - Prudential standards issued by PA - Conduct standards issued by FSCA	PA supervises and enforces requirements of legislation where it is the licensing authority, and requirements of standards and subordinate legislation it issues.
Insurance Acts **Long-term Insurance Act** **Short-term Insurance Act**			
Pension Funds Act	Financial Sector Conduct Authority		FSCA supervises and enforces requirements of legislation where it is licensing authority, and requirements of standards and subordinate legislation it issues.
Financial Advisory and Intermediary Services Act			
Collective Investment Schemes Control Act			
Friendly Societies Act			
Financial Markets Act			
Credit Rating Services Act			
National Credit Act	National Credit Regulator	Standards issued by the PA and FSCA will apply to entities licensed by the NCR. Standards will be issued in consultation	The NCR remains responsible for supervising and enforcing the NCA PA & FSCA supervise and enforce requirements of standards, subordinate legislation they issue.

Financial Market Infrastructures

The placement of the appropriate regulator for financial market infrastructure (FMI) and the allocation of responsibility for implementing and administering the sectoral law i.e. the Financial Markets Act ("FMA") and the National Payment Systems Act ("NPS Act") has highlighted

[6] In the particular case of the Policyholder Protection Rules issued in terms of the Long-term Insurance Act however, it is worthwhile noticing that the FSCA is designated as the responsible authority for the rules

[7] As noted a slightly different approach is followed for the Policyholder Protection Rules in particular

challenges in understanding how the various types of market infrastructure and the application of the respective sectoral law would be integrated into the FSR, including:

- that there is a distinct difference in terms of how an infrastructure under the NPS Act and a market infrastructure under the FMA are treated
- payment systems are not included as market infrastructure in the FSR Bill
- the FMA is not within the ambit of Reserve Bank oversight, and
- the self-regulatory model (SRO) in the payment system that sets it apart from how it applies to the SRO model for market infrastructure under the FMA

The proposed framework is designed to provide a flexible regulatory structure in which both regulators (the PA and the FSCA) are responsible for regulating and supervising FMI, and play a role in assisting the Reserve Bank in exercising its functions relating to financial institutions. The overall proposal is presented in the table below:

Table 3: Regulation of FMI

Financial Market Infrastructure	Exchange	CSD	Clearing House	CCP	Trade Repository	NPS
Sectoral law	Financial Markets Act					NPS Act
Licensing authority	FSCA					SARB
Supervision of sectoral law	Primarily FSCA, also PA for licensing					SARB
Setting and supervision of standards	PA and FSCA, for respective standards					PA and FSCA
Enforcement of sectoral law	Primarily FSCA, also PA for licensing					SARB

Oversight role of the Reserve Bank

The Reserve Bank has an overarching role in terms oversight of market infrastructure and payment systems. This oversight function does not compromise on the jurisdiction of the FSCA, who remains the regulator responsible for executing the FMA, as it is not contemplated that the Reserve Bank is a financial sector regulator in terms of the FSR Bill. The oversight responsibility extends to regularly assessing South Africa's observance of principles and standards set by such international standard setting bodies as the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO).

Discussions around expanding the role of the Reserve Bank in terms of exercising powers (i.e. supervision and rule-making) over financial institutions and the possibility that this could be done through the PA have culminated in the inclusion of Reserve Bank stability standards (through the PA) in fulfilling its function of stability oversight. This proposal gives some flexibility, though not in terms of who may exercise those powers, as it is the financial sector regulators that must exercise their powers to ensure that these standards are enforced.

Licensing

While the licencing authority will issue the licence, it must seek the concurrence of the other regulator in order to give effect to "dual-licencing".

Standards and enforcement

The FSCA remains the financial sector regulator primarily responsible for administering the FMA, although the PA may make and enforce prudential standards with respect to the safety and soundness of these financial institutions. This approach ensures that each regulator has a responsibility to monitor compliance with the financial sector law in order to achieve their respective objectives. There are strong coordination and co-operation mechanisms built into the framework to ensure that the authorities work together as a seamlessly as possible.

The responsibility of the payment system remains the responsibility of the Reserve Bank under the NPS Act. (The NPS Act is not a financial sector law in terms of the FSR Bill). However the FSCA and PA may make and issue standards with regards to payment system operators and participants in the payment system, which, to protect the stability of the system, must be issued jointly with the Reserve Bank.

Powers for authorities provided in second draft of FSR Bill

The revised FSR Bill provides a number of powers for the PA and FSCA. This will enable the authorities to regulate, supervise and take enforcement action against all financial institutions over which they each have jurisdiction, from their first day of operation. These powers are in addition to existing powers in industry-specific laws, and are intended to ensure that the authorities are not limited by any gaps in existing legislation.

The Bill also provides that any legislative instruments issued by the authorities through provisions in the Bill, will be subject to a rigorous consultation process before being issued, and will be subject to the provisions of the Promotion of Administrative Justice Act (PAJA). The authorities will also be required to put in place and maintain effective arrangements for taking administrative action, to ensure that they are consistent with the provisions of the FSR Bill, PAJA and the requirements of the other financial sector laws. Such arrangements must include adopting administrative action procedures, and may include the establishment of an administrative action committee and other measures.

To further support regulatory transparency, consistency and accountability, the authorities will each publish a summary of their adopted administrative actions procedures.

Licensing

As explained above, while licensing will remain under the existing industry-specific laws during the first phase of the Twin Peaks reform process, the FSR Bill does includes a chapter on licensing. This deals with the licensing of financial products andor services that may not be initially defined in the Financial Sector Regulation Bill. In addition, the FSR Act will itself be used as the relevant law for licensing holding companies of financial conglomerates and provides related powers for regulation and supervision of financial conglomerates. Some additional powers are also provided, for example to vary a license or require additional information, which are intended to apply in addition to institution-specific licensing requirements. Further detail on licensing in the Twin Peaks system is set out in Chapter 6.

Standards

The power to issue prudential and conduct standards is a central pillar of the second draft of the FSR Bill. The expectation is that current prudential and conduct subordinate legislation will migrate to standards over time, and that new subordinate legislation issued will be issued as standards.

Standards are regulatory instruments. Comments on the first draft of the FSR Bill highlighted the importance of empowering the authorities to issue such instruments independently. It is common practise globally for complex requirements, such as the capital adequacy standards and solvency standards, to be issued as standards by regulatory authorities. The advantage of standards is that they can be written as a combination of principles and rules-based documents as appropriate, and support the approach that these are a minimum benchmark. The fact that they are issued by a regulatory authority as subordinate legislation, rather than legislated by a government department, also means that they can be modified relatively easily as needed, subject to transparent consultation processes providing for rapid-response regulatory interventions as they emerge.

The Bill sets out examples of topics for which standards might be issued.

Some areas may require both prudential and conduct standards, with requirements on institutions differing from the perspective of each authority's mandate – for e.g. fit and proper standards. Where it is sensible however, joint standards may be issued to minimise duplication.

The Bill also requires the National Treasury to maintain a public register of all current laws, standards and other regulatory documents.

Further detail on this power and a list of topics for which standards may be issued, is set out in Chapter 7.

Information Gathering and Onsite Inspections

To align with international norms, the term "on-site inspection" will be used to define what is currently understood as an "on-site visit" or other routine supervisory activity. Similarly, the term "investigation" is used in the FSR Bill to refer to what is defined and understood as an "inspection" in current law – in other words, action over and above routine supervisory activity, where a breach of law may be suspected.

The Bill provides for the authorities to access necessary information from regulated institutions. This information can be in whatever form the authority requires, and information requests may be made by the authorities whenever required – both routinely and on an ad-hoc basis.

This is supported by the right of the authorities to verify compliance with regulatory requirements and generally carry out its supervisory functions, including through on-site inspections. As set out in the Bill, routine inspections do not require the authority to have any suspicion of wrongdoing to inspect the institutions.

These powers are not new to the regulatory authorities, and for the most part are a familiar feature of financial sector laws, but are now centralised, harmonised and strengthened in the FSR Bill.

Investigations

When material wrongdoing is suspected, the nature of the interaction between the authority and the institution changes. The authority can then move into investigation mode. The powers of investigation are stronger than that of inspection, but they also generally need to be carried out with the legal backing of a warrant.

These powers provided for are for the most part a familiar feature of financial sector laws, but are now centralised, harmonised and strengthened in the FSR Bill.

Enforcement powers

If the authority detects a breach of a financial sector law, including of a prudential or conduct standard, it can choose to take remedial or punitive action. The FSR Bill provides the power to issue directives, enforceable undertakings, interdicts, debarment orders, and to impose administrative penalties.

These powers are not new to the regulatory authorities, and for the most part are a familiar feature of financial sector laws, but are now centralised, harmonised and strengthened in the FSR Bill. These are discussed in more detail in chapter 8.

2014 Financial Sector Assessment Program

In line with G20 Leaders agreement, the International Monetary Fund (IMF) conducted its Financial Sector Assessment Programme (FSAP) on the South African financial system this year. The FSAP is is a comprehensive and in-depth analysis of a country's financial sector, and is conducted on G20 member countries approximately every five years. . The 2014. FSAP (which coincidentally is also published today by the IMF)focused on three key areas: risks and vulnerabilities; stress testing resiliency; and structural reform to enhance resiliency.

The IMF found that the South African financial sector has a high level of compliance to international standards and best practice and that the greatest risks to financial sector stability flow from the real economy and not the other way around.

South Africa boasts a generally well-regulated and well-capitalised financial and banking sector, which was a significant contributory factor explaining South Africa's resilience during the 2008 global financial crisis. However, without ongoing reform, South Africa is now at risk of falling behind G20 peers. The IMF found that the South African regulatory environment needs to accelerate reforms to address new threats from shadow banking and the risk posed by systemically important financial institutions (SIFIs), particularly within the context of a concentrated financial sector. In addition the IMF recognised the need for policymakers to balance competition with stability objectives.

The IMF supports the shift to a "Twin Peaks" approach to financial sector regulation as a necessary step towards increased coordination, while highlighting that it needs to be carefully planned and sequenced. Among its recommendations were the following:

Regulatory architecture:

Break down existing silos and enhance group-wide supervision to manage credit, concentration, interconnected, and cross-border risks; conduct system-wide stress tests on a regular basis. Twin Peaks should assist with this.

Systemic risk:

Reduce systemic liquidity risk including introducing deposit insurance and a more stable wholesale funding framework.

The full findings and recommendations of the FSAP report will be studied and further considered in finalising the FSR Bill before it is tabled in Parliament. The FSAP is available on the IMF website.

4

Financial Stability

Recent experience has highlighted the need for a flexible approach to dealing with possible threats to financial stability. The Bill has been designed in such a way as to provide the necessary flexibility to the Reserve Bank, as guardian of financial stability, to act in a manner that it sees appropriate, while retaining accountability and transparency. At all times the Reserve Bank must act in a manner consistent with international norms and benchmarks, and take actions that minimise immediate and future risks to the taxpayer.

Changes from the previous draft

There are material changes in the Bill with respect to financial stability oversight. Since the Reserve Bank has been assigned primary responsibility for systemic stability, it is important that it also has the necessary powers to fulfil its responsibilities. The second draft of the FSR Bill allows the Reserve Bank to:

- Monitor the financial system for potential systemic risks.
- Designate SIFIs according to a clearly set out process, including consideration of:
  - the size of the institution involved;
  - the complexity of the institution and its business affairs;
  - the interconnectedness of the institution with other financial institutions within and outside of South Africa;
  - whether there are readily available substitutes for the financial products and financial services that the institution provides
  - any advice provided by the Financial Stability Oversight Committee (FSOC)
- In consultation with the PA, set enhanced prudential standards for SIFIs, such as those relating to:
  - Capital
  - Leverage
  - Liquidity
  - Organisational structure
  - Recovery & Resolution Plans (RRPs)

- Risk management arrangements

The Bill also provides that no SIFI can be put into administration, curatorship or business rescue without the Reserve Bank's approval.

Designation of Systemically Important Financial Institutions

During the first consultation phase, concerns were raised about the process relating to the designation of SIFIs. Stakeholders highlighted that there should be a clear and transparent process. Moreover, concerns were raised about the implications of such a designation.

Following discussions, it is proposed that the Governor is responsible for the designation of SIFIs, taking into consideration the matters listed above. However, the designation as a SIFI **only** means that there is enhanced regulatory oversight (e.g. more frequent onsite inspections, more stringent capital adequacy requirements and closer supervision of recovery and resolution plans). SIFI designation is therefore a regulatory issue, and **does not** guarantee fiscal support in the event of distress. Extending fiscal support to a financial institution (whether a SIFI or not) in distress is solely a decision for the Minister of Finance and government to make.

While prudential standards for SIFIs will be set by Reserve Bank, the PA will be responsible for supervision of these standards.

Financial Stability Oversight Committee (FSOC)

Comments had indicated that the intended role of this committee in the first draft of the Bill was not clear. Certain commentators thought that the FSOC was an additional authority, and that it had its own powers independent of the other authorities. In light of these comments, the FSOC has been redesigned in the second draft to be a more collaborative forum allowing relevant authorities in the financial sector to share views on systemic stability. The membership is now more balanced and decisions are made on a consensus basis.

The FSOC will play an advisory role to the Reserve Bank to support it in fulfilling its financial stability mandate. One of the key areas of consultation is that the Governor may not designate a SIFI without first considering any advice from the FSOC.

Systemic events

The definition of 'systemic' in the first draft of the Bill was cumbersome and confusing. The use of the terms 'systemic failure' and 'financial crisis' was also not clearly delineated. The revised Bill refines the concepts of financial stability and systemic events. These concepts need to be clear, as a systemic event and the *risk* of a systemic event occurring, will be the trigger for much stronger intervention powers for the Reserve Bank in fulfilling its mandate of overseeing financial stability.

The revised FSR Bill defines the concepts of financial stability, systemic events and systemic risk:

Financial stability	There is said to be "financial stability" if payment systems, settlement systems and financial institutions generally provide financial products and financial services without interruption and are capable of continuing to do so; and there is general confidence in their ability to continue to do so.
Systemic event	Means an event or circumstance where: • a financial institution, or a group of financial institutions, cannot provide financial products or financial services that they have contractually undertaken to provide; or • there is a general failure in confidence of financial customers in the ability of one or more financial institutions to continue to provide financial products or services; to an extent that may reasonably be expected to have a substantial adverse effect on the financial system and economic activity in the Republic, irrespective of the event or circumstance occurring or arising inside or outside the Republic
Systemic risk	Means the risk that a systemic event will occur

The key risk of a sudden lack of confidence in the financial system is addressed, even if the lack of confidence does not have an underlying cause – put another way, even if an institution is sound, a sudden lack of confidence in that institution's ability to meet its obligations may actually trigger its collapse.

Managing systemic events

Recent experience has proven that the South African authorities have substantial existing powers to manage potentially systemic events. The Bill now provides explicit statutory mechanisms to manage events and possible events (for example, identifying events that would cause systemic disruption if they occurred).

The role of the Reserve Bank is to monitor systemic risks, take appropriate steps to limit the occurrence of systemic events.. Moreover, there is a statutory obligation on members of the FSOC to report systemic risks, and an obligation on the Reserve Bank to investigate those risks. If a systemic event occurs, the focus of the Reserve Bank shifts to managing the impact.

If a systemic event occurs or is imminent, the Reserve Bank must inform the Minister and propose actions; if there is an impact on the public finances, such action must take place with the approval of the Minister.

Systemic events and imminent systemic events also empower the Reserve Bank to give directions to other authorities (PA, FSCA and NCR).

Financial conglomerate (group) supervision

International standard-setters require that regulation and supervision should be applicable on financial groups or conglomerates, as well as on an individual basis to the entities within a financial group. This is only possible in a very limited way under current industry-specific laws in South Africa, and was not adequately provided for in the first draft of the FSR Bill.

The revised Bill defines financial conglomerates, and allows for the authorities to regulate and supervise such groups in their entirety, rather than only at a holding company level or similar.

A financial conglomerate is defined as a group of companies that comprises:

a) one or more eligible financial institutions;
b) the holding companies, including any controlling companies, of an eligible financial institution;
c) their related persons or inter-related persons, including persons located or incorporated outside of the Republic; and
d) their associates as identified in the International Financial Reporting Standards issued by the International Accounting Standards Board or a successor body

An eligible financial institution includes:

a) a financial institution licensed or required to be licensed as a bank in terms of the Banks Act;
b) a financial institution licensed or required to be licensed as a long-term insurer in terms of the Long-term Insurance Act or a short-term insurer in terms of the Short-term Insurance Act;
c) a market infrastructure;
d) a financial institution prescribed in Regulations

5

The Two Authorities

Twin Peaks creates two financial sector authorities – the Prudential Authority and Financial Sector Conduct Authority. Clear governance mechanisms for both have been created. The PA will be established within the Reserve Bank, and so will rely on the Reserve Bank for governance, resourcing, facilities and staffing. It will be headed by a Deputy Governor of the Reserve Bank, and overseen by a committee that includes the Governor. The FSCA will be a stand-alone institution, managed by an Executive Committee comprising a Commissioner and Deputy Commissioners, with independent governance committees for matters such as audit, remuneration and risk. Substantial new co-operation, co-ordination and collaboration requirements are imposed on both the PA and the FSCA, and also on related regulatory bodies such as the National Credit Regulator.

Key characteristics

The objective of the Prudential Authority is to promote and enhance the safety and soundness of financial institutions that provide financial products, market infrastructures and payment systems, to–

- protect financial customers, including depositors and policyholders, against the risk that those financial institutions may fail to meet their obligations; and
- assist in maintaining financial stability.

The objective of the Financial Sector Conduct Authority is to protect financial customers by–

- ensuring that financial institutions treat financial customers fairly;
- enhancing the efficiency and integrity of the financial system; and
- providing financial customers and potential financial customers with financial education programs, and otherwise promoting financial literacy and financial capability.

The objective of prudential oversight is couched in terms of the safety and soundness of financial institutions that provide financial products. Note that safety and soundness focuses on the financial strength and prudential management of the institution itself – i.e. on the capacity to deliver on its promises, not on the *nature* of those promises (i.e. whether they are fair or appropriate). Product suitability and whether or not the product matches the promises made and expectations created is a matter for conduct regulation.

Thus the FSCA focuses on the fairness, efficiency and integrity of services related to the provision of financial products. The FSCA looks at the way in which financial products are sold, represented, administered and traded.

Under Twin Peaks, the authorities have distinct mandates and objectives to ensure that conduct and prudential supervision are given equal attention. Ultimately, if both authorities are successful in fulfilling their objectives, it results in customers of financial products and services being better protected against unfulfilled and misrepresented promises. Both authorities should also support the South African Reserve Bank in fulfilling its financial stability mandate.

Governance arrangements

The law makes it clear that both authorities are operationally independent in the sense that they are not subject to direction, other than as provided for in the Act. This requirement, coupled with the way in which members of the authorities are appointed and dismissed, the statutory protection afforded to staff of the authorities (provided they do not act in bad faith), and the way in which they are funded, aligns with international best practice for operational independence.

The PA will be responsible for determining its own resource requirements, and funding them through industry levies. More generally, resources such as facilities, accommodation, and seconded staff will be provided by the Reserve Bank. This is a deliberate design feature of the South African model and is arguably no less independent than the current arrangements for banking prudential supervision.

While the aim is to align the governance structures of the PA and the FSCA, there are distinct differences between the two that require divergences in their governance arrangements.

The governing body of the PA (the Oversight Committee) is functionally similar to a conventional non-executive board, in which the only full-time member is the CEO. However, certain powers may not be delegated from the Oversight Committee to the CEO. These include:

- Oversight of management and administration;
- Adopting the supervisory strategy;
- Appointing members of committees that are required and giving directions regarding the conduct of the work of those committees;
- Adopting the administrative action policies of the PA (how they will deal with administrative decisions);

This list is meant to define the parameters of the non-executive Oversight Committee, to ensure the operational independence of the PA within the Reserve Bank, mindful of the possibility of regulatory tensions between PA and Reserve Bank in fulfilling their respective functions.

The FSCA’s governing body (the Executive Committee), in contrast, is comprised of full-time executive members. Such a body is likely (and at times required) to take on additional roles, in particular those relating to the strategic direction and policies of the organisation. The list of non-delegable functions that of the Executive Committee includes:

- Oversight, management and administration;
- Entering into memoranda of understanding;
- Delegating powers to the Prudential Authority or the National Credit Regulator;

- Making conduct standards, and amendments to them;
- Adopting the supervisory strategy;
- Adopting estimates of expenditure and levy proposals;
- Adopting the administrative action procedures;
- Appointing members of committees required and giving directions regarding the conduct of the work of those committees;
- Granting, issuing, varying, suspending or cancelling a licence;

Co-operation, co-ordination, collaboration, consultation and consistency

The two authorities must work in close cooperation in fulfilling their obligations. The FSR Bill sets out a clear process of consultation and coordination, and the requirement for the authorities to draw up memoranda of understanding with each other, which will cover:

- How they will comply with their duties to co-operate and collaborate with each other, including in relation to
  - making standards;
  - licensing;
  - inspections;
  - investigations;
  - enforcement actions;
  - information sharing;
  - other regulatory and supervisory action; and
  - representation at international organisations;

- Delegations of powers and duties between them;
- How they will co-ordinate the performance of their functions in terms of the Financial Intelligence Centre Act;
- How differences between them are to be resolved

The FSR Bill also continues to provide for the Council of Financial Regulators, a platform for regulators involved in the financial sector to consult on matters of common interest, raise issues and risks, and coordinate actions where necessary. In addition to the PA and FSCA, it includes representation from the National Treasury, Department of Trade and Industry, Department of Health, the Reserve Bank, NCR and Council for Medical Schemes. Other regulators and organs of state can be invited to join the Council.

In particular, a Ministeral forum and a forum for financial inclusion have been created to embed deeper coordination.

The role of the National Credit Regulator in the Twin Peaks system

The National Credit Regulator is a crucial part of the overall financial regulatory system in South Africa. Many comments on the first draft of the FSR Bill identified the importance of describing the role of the NCR within the Twin Peaks system being implemented.

Coordination between the authorities and the NCR will be key to the success of the Twin Peaks system, and is provided for in the FSR Bill.

The role of the NCR has become particularly important during recent years, with an increase in unsecured lending and a rise in the granting of reckless credit, particularly to vulnerable communities. Overindebtedness puts strain on society in a number of ways – most importantly, vulnerable households are particularly at risk from unscrupulous lenders. Cabinet has approved a range of steps to address overindebtedness in South Africa[8].

Collaboration conduct, prudential and stability matters are important, as actions taken by each of the authorities (FSCA, PA, Reserve Bank, NCR) in pursuing their respective objectives, may have knock-on effects on the other authorities. The Bill makes provision for a number of ways for the FSCA, PA and the NCR to work together. This includes the requirement for the PA, FSCA, and NCR to enter into memoranda of understanding that will cover issues including the delegations of powers and duties, and how they will co-operate and collaborate in relation to:

- making standards or other legislative instruments
- licensing
- inspections
- investigations
- enforcement actions
- information sharing
- other regulatory and supervisory action
- representation at international organisations

Importantly, the Bill is very clear in distinguishing between general cooperation and coordination on the one hand, and “acquiescence” on the other, that could compromise a authority’s ability to act against wrong-doers. For example, while an authority should consult the other authorities before taking enforcement action against a financial institution, this authority cannot – and should not - be prevented from taking such action.

Given their importance to systemic stability, it is proposed that the NCR be a full member of the Financial Stability Oversight Committee (see Chapter 4). This provides them with an important role in both monitoring financial stability issues, and in ensuring that any actions that may have financial stability issues are undertaken in a collaborative and co-operative way. It will also be a member of the Council of Financial Regulators.

[8] A joint statement issued by the Department of Trade and Industry and National Treasury is available here: http://www.treasury.gov.za/comm_media/press/2013/20131212%20-%20Household%20overindebtedness.pdf

6

Licensing

There will be minimal changes to licensing requirements and procedures in the first phase of the reform process. Licensing requirements set by the relevant industry-specific laws (e.g. the Banks Act, the two Insurance Acts, Pension Funds Act, FAIS Act) will remain in place. Responsibility for licensing under the current Acts will be allocated to one of the two new authorities, and this authority will be responsible for licenses issued under the Act and supervising requirements of the Act.

New licences and renewal, termination or variations of existing licences will require the licencing authority to seek the input of the other authority. Provisions are also made in the FSR Bill to allow the PA or FSCA to license financial products and services that are newly designated as such under the FSR Bill, rather than through an existing law.

As set out in preceding chapters, there will be minimal changes to existing licenses, licensing requirements and procedures in the first phase of the reform process. In the future target framework, financial institutions will receive one license from the conduct authority if they provide financial services, and a separate license from the prudential authority if they provide financial products[9].

The licensing reforms necessary to establish this new licensing framework will be consulted on comprehensively. The intention is to streamline licensing significantly. Currently, financial institutions are licensed according to industry-specific law, with varying standards applying and with the same institution often having to hold multiple licenses.

Licensing provisions in the FSR Bill (phase 1)

The FSR Bill does not introduce significant changes to the current licensing regime, but begins to put in place some of the elements of the new licensing regime in the target regulatory framework.

- **Existing licences:** Responsibility for licensing under the current industry-specific acts is allocated to one of the new authorities. This authority will be responsible for the license issued

[9] In practice, all financial institutions will be licensed by the FSCA while only those that provide financial products as defined in the FSR Bill will require a second license from the PA.

under the Act. The Prudential Authority will be responsible for licensing under the Banks Act, the Long Term Insurance Act and the Short Term Insurance Act. All licenses issued under these Acts will be overseen by the Prudential Authority and any new licenses applied for will be granted by the Prudential Authority. The same applies to the FSCA, which will have responsibility for licenses under the remaining Acts, as set out in the Table 2 in chapter 2. As also noted, a slightly different process is followed for FMIs and the national payment system.

This means that financial institutions that are already licensed (by the FSB and/or the Reserve Bank), will not have to apply for a new license in this phase. The only change is that their licenses will now be issued overseen by a new authority.

However, the FSR Bill does allow for the new authorities to vary a license, in consultation with the other authority.

- **New licenses:** These will be granted under existing industry-specific law by the relevant licensing authority. However, close collaboration is required between the two authorities, to ensure that both authorities agree with the issuing of a new license. The collaboration is necessary as both authorities will have the ability to impose standards on and supervise a financial institution once it is licensed.

  Collaboration in licensing arrangements will also remain in place in the final target framework, to avoid instances where the Prudential Authority grants a license to a financial institution that the FSCA refuses a license to, and vice versa.

  The MoU established between the PA and the FSCA will set out details regarding collaboration on licensing.

- **License renewals in Phase 1:** The process for license renewals in Phase 1 will be similar to the process for issuing ew licenses.

A new licensing regime (phase 2)

The target framework will see the legislative environment streamlined, and the multiple industry-specific laws replaced by overarching prudential and market conduct legislation. Licensing will therefore be streamlined and financial institutions will hold one license from the PA and one from the FSCA.

Importantly, as the industry-specific laws will no longer apply, financial institutions in the target framework will not be licensed on an institutional basis. This will reduce the number of licenses that a single institution will hold.

The envisaged new prudential and market conduct legislation will set out licensing procedures that each authority will follow. While each authority will issue its own license, there will be close collaboration in the licensing process between the authorities, so that institutions are not granted a license by one authority without the concurrence of the other.

As explained in Chapter 2, financial institutions that are product providers, or operate a payment system (excluding the Reserve Bank) or market infrastructure, will be licensed by the PA, while all financial institutions – including product and service providers – will be licensed by the FSCA.

The forthcoming discussion document *"Treating Customers Fairly: A Market Conduct Policy Framework for the Financial Services Sector"* sets out an initial proposed licensing approach for the FSCA, which will license entities according to the type of activity they perform, the product the activity is linked to, and the customers it intends providing the product or service to.

Transfer process for licensing under the target framework

Licenses issued and held in the first phase of the Twin Peaks reform process, will need to be gradually replaced in Phase 2. This will be through new legislation that will be introduced, and according to a process that will be clearly communicated to and consulted with industry.

7

Standards

Effective regulatory authorities need to have the appropriate powers to set standards. The FSR Bill introduces new standard-making powers, which will allow the two authorities to set requirements for financial institutions. For example, the PA will be empowered to set standards for capital, liquidity and leverage and the FSCA will be empowered to set standards for product design and information disclosure, advice and other activities that help financial customers access good-value products and services that better suit their needs. The authorities must coordinate their actions as far as possible when setting standards, and where standards overlap, the two authorities may set standards jointly. There must also be public consultation before standards are issued.

In line with international best practice, the two new authorities will need to be equipped with the appropriate 'tools' – that is, licencing, supervision, and rule-making powers – with which to carry out their regulatory and supervisory duties from their first day of operation. The industry-specific laws that will continue to apply once the FSR Bill is enacted in the first phase of the reform process, will give the authorities certain existing regulatory, supervisory and enforcement powers. However, to ensure that the authorities are not hampered by any gaps in the existing legislation, the FSR Bill also proposes that the authorities be empowered to issue standards on industry directly through this law.

As set out in the licensing section, once a financial institution is licensed, regardless of which authority the license is issued and overseen by, both the PA and FSCA are able to impose standards on the entity. This will ensure full scope of regulatory coverage once the new authorities have been established.

So for example in retail banking, there are currently minimal conduct of business requirements in the Banks Act. Even though the Banks Act will remain in place, and banks will be licensed and overseen by the PA, the FSCA will be able to issue conduct standards on retail banks

One of the International Organization of Securities Commissions (IOSCO) Principles is that an authority "should be operationally independent and accountable in the exercise of its functions and powers." The FSR Bill therefore allows the authorities to issue standards independently – that is, without needing to obtain ministerial approval. This provides for the required independence of the regulatory authorities on the one hand. To balance this independence, the authorities will operate within the approved policy framework laid out in the Bill and strong provisions are also made to ensure transparency and accountability.

Consultation

To ensure transparency and fairness, a clearly defined consultation process is set out for the authorities to follow before standards may be issued. Certain matters have much broader implications and bring with them public interest issues, and the need to consult authorities outside of the ambit of the two authorities before issuing standards. For example, change of ownership above a threshold may require the input of the Competition Commission, and may also have additional public interest issues.

Consistency

Standards would in essence have a similar status to the current rules, board notices, and other subordinate legislation issued under various industry-specific laws by the FSB and Reserve Bank.

The creation of standards as a regulatory instrument is therefore also intended to make the subordinate legislative environment more consistent. Due to the range of industry-specific laws, different processes are followed when issuing these instruments under different laws, and the legal standing of these instruments may not always be the same. It is envisaged that the range of subordinate legislation currently applying to financial institutions will ultimately be replaced by standards. As a first step toward streamlining the subordinate legislative environment, the National Treasury will be required to maintain a public register of all subordinate legislation, including new standards and existing instruments.

Prudential and conduct standards

The authorities may make standards which include, but are not limited to, the list presented below:

Prudential Authority	Financial Sector Conduct Authority
• financial soundness requirements • fit and proper person requirements for financial institutions and key persons • governance of financial institutions • risk management arrangements • internal control arrangements • outsourcing and insourcing by financial institutions • data management • disclosure and reporting requirements for financial institutions, including requirements in relation to financial statements, accounting and auditing • the provision of reports and information • outsourcing and insourcing arrangements • custody, separation and protection of financial products and funds	• fit and proper person requirements for financial institutions and key persons • governance of financial institutions • risk management and compliance arrangements • internal control arrangements • standards of business conduct for financial institutions, including for their agents, employees, financial institution representatives, or persons whom they have mandated to perform an activity or to whom they have outsourced an activity • promotion, marketing, distribution of or access to financial products, financial services, market infrastructures or payment systems • disclosure including in relation to the format and timing of those disclosures

• operational ability (including the adequacy and appropriateness of resources, including human resources, technical resources, and financial resources) of, or available to financial institutions • amalgamations, mergers, transfers, acquisitions or disposals • business continuity and disaster recovery plans • recovery and resolution.	• giving advice, recommendations or guidance to financial customers • ensuring that financial products or financial services are suitable customer circumstances, financial situation, financial product experience and objectives • standards for financial products or financial services, including in relation to the design, pricing and valuation thereof and the applied methodologies • standards for price formation, orderly trading and transparency, for financial institutions operating a market infrastructure or payment system • standards for prospectuses of listed securities • standards for contracts • remuneration, rewards and incentives in relation to the provision of financial products, financial services, market infrastructures or payment systems, including remuneration payable to persons that promote, market, distribute or provide access to financial products • the execution of transactions by agents, employees or financial institution representatives, or financial customers or persons to whom they have outsourced an activity • preventing abusive market practices • the responsibility of financial institutions for the acts and omissions of their agents, employees, financial institution representatives, or persons to whom they have outsourced an activity • record keeping by financial institutions • disclosure and reporting requirements for financial institutions • the provision of reports and information • outsourcing and insourcing arrangements • custody, separation and protection of financial products and funds

Joint standards

There are areas where both authorities have an interest and where similar topics may therefore be addressed in both prudential and conduct standards, but from the perspective of each authority's mandate – for example, governance or fit and proper standards.

In some of these cases, where **both** authorities have similar requirements, issuing standards jointly would reduce administrative burden and duplication. For example, in the case of an insurer, it would be unlikely that the PA would prescribe different governance requirements to those of the FSCA, and so the two authorities could issue joint standards in this regard. However, where for example an insurer also provides advice, the FSCA may set fit and proper standards for those carrying out or overseeing that activity, in addition to fit and proper standards the PA may set for the insurer's directors or other key persons.

While the FSR Bill sets out the concept of joint standards, the procedure to be followed by the authorities in issuing such standards will be set out in the MoU between the two authorities. The authorities are also required to consult with one another prior to issuing any standards.

It is reminded that standards set by either the PA or FSCA relating to the payment system are proposed to be made as joint standards with the Reserve Bank.

Delegating supervision of standards

The Prudential Authority will have the requisite powers to set prudential standards. Similarly, the FSCA will set appropriate conduct standards for financial institutions. The provision for joint standards will ensure that the authorities will collaborate closely to avoid duplication of efforts where necessary. However, given that the authorities will both be regulating the same institutions, another manner in which to ensure administrative efficiencies is through delegation of supervision of standards.

This means that, for example, the prudential authority can set prudential standards, but delegate the supervision of these standards to the FSCA for a certain group of financial institutions. The FSCA will be able supervise adherence to these standards in the course of its normal supervision of the entity.

8

Enforcement and appeals

Clear, transparent, fair enforcement mechanisms are a crucial part of an effective financial regulatory system. A Financial Services Tribunal is established to support fair administrative action and enforcement by the authorities.

In addition to reforming the *structure* of the financial regulatory landscape, the Twin Peaks reform process also aims to strengthen and improve the *nature* of regulation, supervision, and enforcement. The new authorities will be more proactive and intrusive in their supervision, and more principles-based in taking action where necessary.

The new legislation is intended to support this change in approach. The FSR Bill makes the necessary provisions regarding administrative actions to ensure that the authorities will be able to act decisively where necessary, at times on the basis of judgement rather than a formal "breach" of a specific rule. It is anticipated that in the next phase of the reform process, the introduction of overarching market conduct and prudential frameworks will further build on this approach.

However, it is also important to fulfil the general Constitutional principle that a single person or authority should not play multiple roles – that is, setting the rules, enforcing the rules and executing those rules.

In drafting the legislation, both an 'internal model' and an 'external model' were considered in relation to administrative and enforcement action. In the internal model, administrative actions are taken by the authority (i.e. internally), and are only subject to appeal or review. In the external model, administrative actions are referred to an external body.

In South Africa, different regulatory authorities have taken different approaches. For example, competition law arguably proposes an external system. In that system, the Competition Commission does investigative work and then refers the matter to the Competition Tribunal for a decision. The South African Revenue Service arguably follows an internal model – SARS determines any penalties to be paid from non-compliance, and levies them.

To date, the Financial Services Board has had a hybrid internal/external model. In instances where the FSB is of the view that a penalty is the appropriate sanction, decisions are referred to the Enforcement Committee, but this committee is inside the FSB (in the sense that it reports to the Board of the FSB) and so has no independent legal personality.

The FSR Bill follows an internal model, but establishes the Financial Services Tribunal to fulfil the role of independent arbiter to challenge administrative actions – i.e. actions that are taken internally by the authorities in terms of the legislation, regulations and rules. While the authorities may take an administrative action on its own, all administrative action are appealable to the Tribunal and reviewable to the Courts.

Administrative actions – procedures and committees

While the FSR Bill follows an internal model for administrative action, it also ensures transparency regarding these actions. The Bill therefore requires the authorities to adopt written administrative action procedures regarding the administrative actions that they may take, to promote a fair and consistent approach to administrative action.

The authorities may also establish an administrative actions committee (this could be an expanded version of the FSB's current Enforcement Committee) which could advise the authority on appropriate action in particularly complex cases and to which the authorities may delegate the imposition of administrative sanctions.[10] Such committees will include independent persons such as senior advocates, attorneys or retired judges.

Another important check and balance is that all administrative action is subject to the constitutional protections afforded through the Promotion of Administrative Justice Act (PAJA).

Enforcement actions

If the authority detects a breach of a financial sector law, including of a prudential or conduct standard, it faces a range of decisions. It can choose to remediate the situation, including by issuing directives, entering into enforceable undertakings, declaring practices as undesirable, or applying to court for appropriate orders. The aim of remediation is to rectify the breach and ensure it does not recur.

The regulator can also impose administrative penalties, or there may be criminal prosecutions instituted in relation to offences in terms of the FSR Bill or a financial sector law. Fines or imprisonment relate to offences.

The powers related to remedial and penalty actions are explained in further detail below.

Directives

Provisions in the FSR Bill are intended to ensure that the powers of the authorities to issue directives are consistent for all licensed financial institutions. Importantly, the Bill provides the PA with directive powers for financial institutions licensed by the FSCA and vice versa.

[10] Administrative actions should be performed in a manner that is fair and transparent, and in line with the organisation's policy and procedures for administrative action. Given that not only enforcement action impacts financial institutions, but indeed most forms of administrative action, authorities must develop a consistent approach to all of their actions, and all such actions may go through the Administrative Actions Committee.

Enforceable Undertakings

Enforceable undertakings (EUs) are a new instrument for most sectors, although they have been introduced in the Financial Services Board Act recently.

The key to an EU is that it provides the regulator with broad remedial powers under an agreement with the transgressor. EU's typically involve detailed steps for correcting a flaw in a process or system used by the financial institution, and/or compensation for affected customers. In the event that a financial institution fails to meet the agreed terms of the EU, the regulator may:

- impose an administrative penalty
- apply to a Court for an order directing that person to comply with the terms of the undertaking, or any other order the Court considers appropriate
- in the case of a licensed financial institution, suspend or withdraw the licence of the financial institution.

Details of an EU are generally made public as a deterrent to others.

Court orders

A financial sector regulator may institute proceedings in the High Court having jurisdiction in order to:

- compel a financial institution to comply with a financial sector law;
- compel a financial institution to cease contravening a financial sector law;
- compel a financial institution to comply with a lawful request, directive or instruction made, issued or given by the financial sector regulator in terms of a financial sector law;
- obtain a declaratory order relating to any financial sector law or the business of a financial institution;
- prevent the concealment, removal, dissipation or destruction of assets or evidence thereof by a financial institution;
- seize and remove the assets of a financial institution for safe custody pending the exercising of any other legal remedy that may be available to the financial sector regulator.

Debarment Orders

Debarment orders are a remedial response where the regulator wishes to protect certain groups or all customers of financial products or services from certain individuals. The regulator must first determine that a person has

- contravened a financial sector law, a regulator's directive, or an enforceable undertaking;
- attempted, conspired with or aided, abetted, induced, incited, instigated, instructed or commanded, counselled or procured another person to contravene a financial sector law; or
- contravened or failed to comply with a law of a foreign country that corresponds to a financial sector law.

The regulator may then make an order debarring the person for a specified period from:

- providing financial products or financial services, providing a specified category or sub-category of financial product or financial service; or providing a financial product or financial service to a specified category or sub-category of financial customer;
- acting as a key person or a financial institution representative of a financial institution;

- being involved in the management of a financial product provider or a financial services provider; or
- being involved in the provision of a specified financial product or a specified financial service.

Administrative Penalties

If a financial sector regulator is satisfied, on a balance of probabilities, that a person has contravened, or has failed to comply with a provision of a financial sector law, the regulator may impose an administrative penalty in respect of the contravention.

Financial Services Tribunal

Enforcement and other administrative actions may be taken on appeal to the Financial Services Tribunal. Members of the Tribunal are appointed by the Minister of Finance.

The Tribunal may make any of the following orders in an appeal against a decision of a decision-maker:

- an order confirming the decision and dismissing the appeal
- an order remitting the decision to the decision-maker for reconsideration in accordance with the directions of the Tribunal
- an order setting aside or varying the decision and substituting the decision of the Tribunal
- any other incidental order

The Tribunal may also make an order that a party to the appeal pay some or all of the costs incurred by the other party. An order by the Tribunal has legal force, and may be enforced as if it were issued in civil proceedings in a division of the High Court within whose area of jurisdiction the Tribunal held its sitting.

9

Financial Services Ombud Schemes

Twin Peaks aims to introduce a consistent and consolidated approach to financial sector regulation to achieve, amongst others, better protection for financial customers. This includes ensuring efficient and effective customer recourse mechanisms, such an ombuds, which should follow equal standards so customers can be sure of the level of protection and assistance they will receive.

Dispute resolution is a fundamental component of a financial services sector that meets the needs of customers. It includes both the internal complaints mechanisms of financial institutions, and an impartial, external mechanism that is able to resolve customer complaints and disputes if internal resolution is not achieved

The Financial Services Ombud Schemes (FSOS) Act was introduced in South Africa in 2004 to govern the external dispute resolution system for financial services in South Africa. The Act establishes the FSOS Council to govern ombud schemes, and report to the Minister of Finance. The Act oversees both statutory and voluntary ombud schemes – that is, schemes established in terms of legislation or schemes established through an industry initiative respectively.

The Ombuds for Long Term Insurance was the first to be established in 1984, followed by the Ombuds for Banking Services in 1997, the Pension Funds Adjudicator (PFA) and Ombuds for Short Term Insurance in 1998, the FAIS Ombud in 2002, the Credit Ombuds in 2004 and the JSE Ombuds in 2007. The FAIS ombuds acts as the statutory ombud where no other ombuds have jurisdiction.

The PFA and FAIS Ombuds are statutory schemes, while the rest are voluntary schemes created by their respective industries.

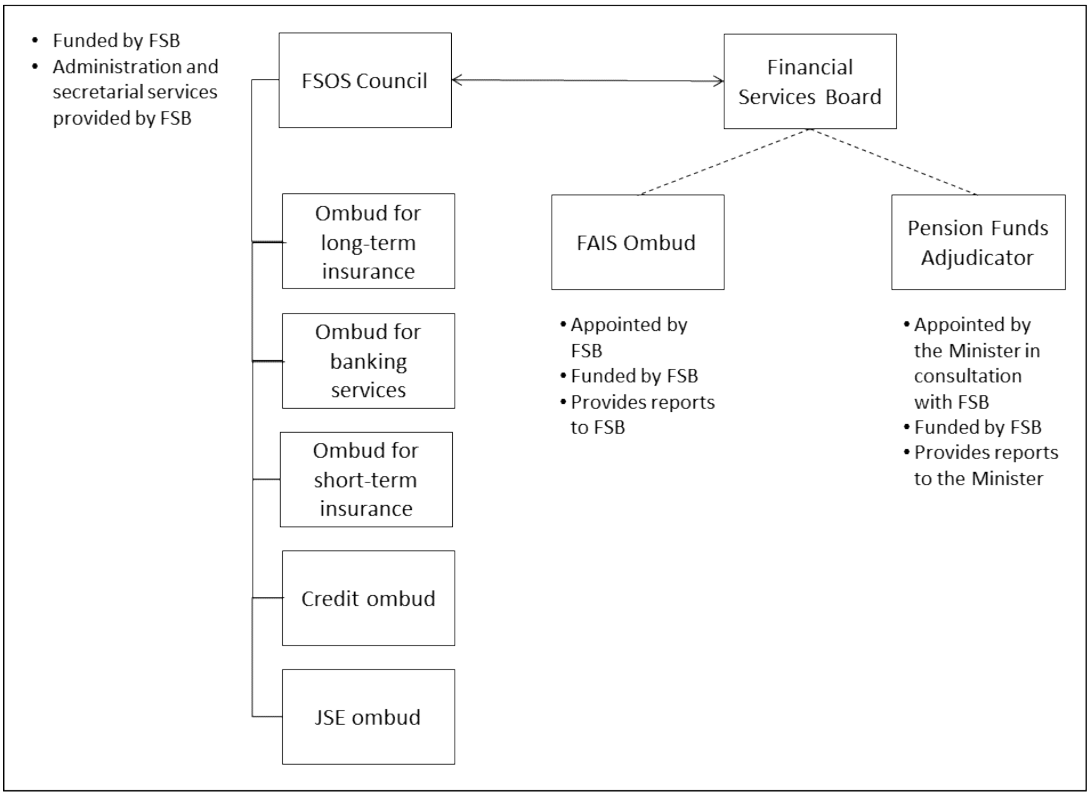
The FSOS Council was established under the FSOS Act to:

- Consider and grant, or refuse, an application for recognition of voluntary ombud schemes;
- Monitor compliance with the FSOS Act by a recognised scheme;

- Promote co-operation and co-ordination of the activities of an ombud of a recognised scheme, the PFA, the FAIS Ombud (also the statutory or default Ombud), including informing and educating clients about available resolution forums;
- After consultation with the relevant ombud, develop and promote best practices for complaint resolution by the recognised scheme;
- Ensure that the independence and impartiality of an ombud are not affected when the FSOS Council performs its functions; and
- Perform such other functions as the Minister, after consultation with the Financial Services Board, may direct to achieve the objects of the FSOS Act.

South Africa's current ombuds schemes architecture can be set out as follows:

Figure 3: The ombuds system in South Africa



A feature of the current ombuds system set out above is the role and involvement of the FSB in the ombuds scheme. The statutory ombuds – the PFA and the FAIS Ombud – are funded through levies collected by the FSB. This is provided for in terms of the Pension Funds Act and FAIS Act. The FSB also provides administrative and secretarial support to the FSOS Council itself.

While the FSOS Act made strides toward consolidation of ombuds, by putting in place an overarching coordinating body overseeing the ombuds system, the role of the FSOS Council has not necessarily been that of a strong independent oversight body. Schemes have typically operated independently and implemented differing approaches to dispute resolution. The range of ombud schemes, as set out in the figure above, are also all directly accessible by customers, and this proliferation of ombud schemes and points of access in an increasingly interconnected financial sector has resulted in customer confusion regarding the correct channel to approach with a complaint.

The Twin Peaks reform of the financial regulatory environment, including the dissolving of the Board of the Financial Stability Board in Phase 1, necessitates changes to the FSOS Act and the operation of the ombud system. The reforms and the replacement of the FSB with the FSCA present an opportunity to improve and refine the ombuds arrangements.

A unified external dispute resolution system in a consolidated Twin Peaks framework

In line with the aim of Twin Peaks reform to consolidate regulatory provisions for the financial sector as far as possible, the revised FSR Bill proposes to repeal the FSOS Act, and instead integrate the provisions in the FSOS Act into the FSR Bill itself. Doing so allows for the close alignment of the ombud scheme system in South Africa to the evolving Twin Peaks regulatory system, in keeping with a unified regulatory approach. In addition, the provisions aim to strengthen the role of the FSOC Council and begin implementing a uniform and consistent approach to external dispute resolution in the financial sector, across all sub-sectors.

The FSR Bill therefore proposes the following:

- Establishing the FSOS Council as a statutory body that will establish a single point of entry into the ombud system
- Making it compulsory for financial institutions to belong to an ombud scheme
- Requiring all voluntary ombuds to be registered with the FSOS Council
- Strengthening the mechanisms for the FSOS Council to provide and oversee a consistent framework for external dispute resolution mechanisms (both voluntary and statutory) across the financial services industry

The benefits and drawbacks of statutory versus voluntary ombuds is a common topic of debate regarding external dispute resolution channels. Customers have expressed doubt as to the independence of voluntary ombuds that are appointed and funded by the very institutions against whom they must consider a complaint. Statutory ombuds are perceived as having greater independence and autonomy and hence more likely to assist a customer than voluntary schemes. However, voluntary ombuds are not without benefit; they are typically easier to establish as they are backed by industry support, and may have better resource capabilities as they are industry funded. For now, all current ombuds schemes will remain in place. What will be a key focus of the strengthened FSOS Council in this first phase of consolidation of the ombuds system will be to ensure equivalent standards and consistent approaches to dispute resolution across the financial services sector, to ensure consistent fair treatment and access for financial customers. The debate regarding the split between voluntary and statutory ombuds is likely to continue as the Twin Peaks system is implemented.

An important question for public consultation is whether the approach taken in the Bill is sufficient for an effective ombuds system in the financial sector. Though not proposed in the Bill, public comments on a centralised ombuds system will be considered as an alternative approach to achieving harmonisation than what is currently proposed by way of a stronger ombud council. This could include the option of establishing an office of chief ombud for the financial sector to oversee the entire ombud system, working with sub-sector ombuds (both statuatory and voluntary) as part of a restructured FSOS. The Treasury will consult with current ombuds on this, and other, options for consideration for the final Bill.

Improvements to the ombuds system are discussed in further detail in the market conduct framework discussion document accompanying this document.

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Next steps

Comments are invited on the revised draft of the FSR Bill and will be taken until 2 March 2015. Public workshops will be held during this consultation period. Once comments have been received and considered, Cabinet will be requested to consider the bill for tabling in Parliament, in the first half of 2015.

The Reserve Bank and the FSB have already begun planning for establishment of the PA and FSCA, including the required movement of staff and other resources, so that the process is as smooth as possible.

The PA and FSCA will operate within the existing industry-specific law and the framework of the FSR Bill once enacted. Work is concurrently underway to establish the prudential and market conduct policy frameworks for the new authorities. The discussion document, *Treating Customers Fairly in the Financial Sector: A Market Conduct Policy Framework for South Africa*, released with this document and the FSR Bill, is the first step in the process for a revised market conduct framework. Comments have been invited on this document, and engagements with stakeholders will also be arranged during the comment period.

The funding mechanism for the two authorities will be included in a special Money Bill that will be issued for public comment in early 2015.

It is anticipated that the reform of the current industry-specific law will take place over 2016 – 2018.