Twin Peaks

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Introduction

In February 2013 the Financial Services Board undertook a peer review of South Africa’s progress implementing reforms in respect of inter-agency coordination and regulatory structure. The review was conducted by a team of experts drawn from the Financial Stability Board’s member institutions: Saudi Arabian Monetary Agency, Deutsche Bundesbank and Australian Securities and Investments Commission. The review recognised and welcomed South Africa’s planned move to the twin peaks model of financial regulation (‘twin peaks model’), because it will (i) enhance the significance of market conduct regulation and supervision, which has historically played a less important role than prudential regulation particularly in certain financial industries such as transactional banking and (ii) create a more resilient and stable financial system by improving both prudential and market conduct regulation and (iii) improve the regulatory and supervisory oversight of financial conglomerates.

South Africa’s move to twin peaks was announced in National Treasury’s policy document *A safer financial sector to serve South Africa better* in February 2011. The policy document recognises that to support sustained economic growth and development, South Africa needs a safe and stable financial services sector that is accessible to all and sets out proposals to achieve this. The main proposal, which was adopted by Cabinet in July 2011, is to separate prudential and market conduct regulation and supervision i.e., to shift to the twin peaks model. Implementation of the model is a two-phase process. The first phase involves developing and tabling in Parliament overarching legislation to empower the prudential and market conduct regulators to deliver on their mandates. The second phase comprises of harmonising specific financial sector legislation such as the Banks Act, Long- and Short-term Insurance Acts with overarching legislation and regulator mandates. Expected completion of phase one is 2013/14 while phase two may take a number of years. An overall timeline for implementation has not yet been set.

Current financial regulatory and supervisory framework

The current framework for financial regulation and supervision in South Africa is fairly complex with a number of regulators – see figure 1 for a simplified depiction. The main regulators are Bank Supervision Department (BSD) of the South African Reserve Bank (SARB) and the Financial Services Board (FSB-SA). BSD prudentially regulates and supervises banks and the FSB-SA most non-bank financial institutions as well as securities markets, where it relies on self-regulatory organisations such as the JSE and Strate. The National Credit
Regulator (NCR) regulates the market conduct of all credit providers (banks and non-banks) and the National Consumer Commission (NCC) the market conduct of all consumer goods and services providers as well as banks (other financial services firms have been exempted). To add to the complexity, financial sector regulators are to varying degrees subject to the authority of two government departments. The Department of Trade and Industry oversees the NCR and NCC, while BSD has a direct reporting line to the Minister of Finance on legislative issues and FSB-SA is subject to the general authority of the Minister of Finance.

**Figure 1: Current financial regulatory framework**

<table>
<thead>
<tr>
<th>Prudential regulation</th>
<th>Market Conduct regulation</th>
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<tbody>
<tr>
<td>South African Reserve Bank</td>
<td>Financial Services Board</td>
</tr>
<tr>
<td>Registrar of Banks (aka Office for Banks or Bank Supervision Department)</td>
<td>Registrars of Pension Funds, Friendly Societies, Long-Term Insurance, Short-Term Insurance, Securities Services, Collective Investment Schemes</td>
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<tr>
<td>Banks</td>
<td>Banks</td>
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<tr>
<td>• Some non-banks such as insurance companies</td>
<td>• Banks</td>
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<tr>
<td>• Securities markets (relying on JSE and Strate)</td>
<td>• Non-banks</td>
</tr>
<tr>
<td></td>
<td>• Securities markets (relying on JSE and Strate)</td>
</tr>
<tr>
<td></td>
<td>• Credit providers including banks and non-banks</td>
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</tbody>
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| | |
| | National Credit Regulator |
| | National Consumer Commission |

The future twin peaks regulatory and supervisory framework

The twin peaks model is characterised by separate prudential and market conduct regulators. Since equal weight is given to prudential and market conduct regulation, it is regarded as the optimal way to ensure that consumer protection and market integrity receive sufficient priority and are not routinely presumed to be subservient to prudential concerns.

Market conduct regulation focuses on protecting customers that buy financial products or otherwise entrust funds to financial institutions. Such regulation provides consumer protection by addressing the unequal position of financial institutions relative to their customers. The most vulnerable customers are retail clients who often lack the sophistication and information necessary to protect themselves from fraud, market abuse or ill-informed advice and rely on financial institutions and their representatives to look after their interests. In South Africa this responsibility will be carried out by the Financial Services Board. Apart from protecting consumers, the market conduct regulator will be required to promote confidence in the South African financial system and ensure financial services institutions and markets function well and to high ethical and professional standards.

Of course prudential regulation also seeks to protect consumers, investors and depositors. Prudential regulation is applied to financial institutions such as banks, securities firms and insurance companies to ensure that they are
financially sound and capable of meeting their obligations to customers. Regulators are interested in the health and strength of these financial institutions as the failure of one or more of them could result in a loss in confidence in the safety and soundness of the financial system. In South Africa the prudential regulator will form part of the SARB and will be responsible for both micro- and macro-prudential regulation and supervision. Micro-prudential regulation aims to secure the safety and soundness of individual financial institutions. Macro-prudential regulation seeks to promote the stability of the financial system as a whole. The stability function of the SARB will undertake conglomerate supervision as well as crisis management and resolution.

A simplified depiction of the proposed twin peaks model in South Africa is shown in figure 2.

The overarching regulatory and supervisory principles to be implemented are:

- **transparency** with regard to regulators’ decisions, actions and approaches;
- **comprehensive coverage** of financial services activities and consistent principles and rules for comparable activities;
- **appropriate, intensive and intrusive** supervision;
- **principles- and rules-based** regulation to achieve regulatory outcomes;
- **risk-based and proportional** regulatory and supervisory approaches;
- **pre-emptive and proactive** frameworks that enable regulators to identify and mitigate emerging risks;
- **credible deterrence** in that regulators have and use the authority to enforce adherence to principles and rules; and
- **appropriate alignment with international standards.**
The prudential and market conduct regulators receive their mandates and powers from government policy and legislation enacted by parliament. They are accountable and operationally independent within this mandate. Appropriate governance framework to oversee them will include (i) a regular flow of information, including actual performance against objectives, to the National Treasury; (ii) strategic and annual performance plans as well as annual reports tabled in Parliament through the Minister of Finance; and (iii) regular external audits. The prudential regulator will operate within the SARB and be subject to the SARB’s governance arrangements. The market conduct regulator will be governed by a full-time commissioner and executive management team appointed by the Minister of Finance. Independent audit, remuneration and risk committees will have administrative oversight.

**Issues still to be addressed**

The major issue to be addressed under the twin peaks model is the role of the NCR. Agreement between National Treasury and the Department of Trade and Industry as the disposition of NCR has yet to be reached. Clearly it would be preferable for South Africa to have only one market conduct for financial services. This will ensure consistent market conduct standards in terms of licensing, fit and proper requirements, disclosure, consumer recourse and enforcement across the financial services industry, which will avoid confusing consumers, inviting unintended consequences such as regulatory arbitrage and burdening market participants with unnecessary compliance costs such as different management information and reporting systems for credit versus other financial products.

Medical aid schemes are not addressed in the proposed twin peaks model. Since the management of these schemes require financial expertise and that they are often underwritten and managed within financial conglomerates it would be in the interests of customers to incorporate them.

The Financial Regulatory Reform Steering Committee believes the economic cost of implementing twin peaks will be minimal. However there are concerns that increased requirements for regulated entities in terms of licensing, reporting and funding will increase compliance costs and hence the costs passed on to consumers.

The Twin Peaks approach to financial regulation separates regulatory functions by objectives, thereby allowing each regulator to focus on a single core mandate. Yet the prudential regulation of certain institutions will be allocated to the market conduct regulator (see figure 2). It may be necessary to elaborate why this approach is considered appropriate.

**Conclusion**

The implementation in South Africa of the twin peaks model has two fundamental objectives to (i) strengthen South Africa’s approach to consumer protection and market conduct in financial services and (ii) create a more resilient and stable financial system. Introducing a new model of financial regulation is not a simple task and will require effective planning to ensure risks are managed and effective supervisory oversight remain in place.
throughout the transition. No doubt the Financial Regulatory Reform Steering Committee will develop more
detailed and definitive plan to ensure stakeholder cooperation, coordination and support to achieve a safer
financial sector that serves South African better.

(1) South Africa, as a Financial Stability Board member jurisdiction, has committed to undergoing
periodic peer reviews to assess implementation and effectiveness of international financial standards
and policies.

(2) To be operationally independent regulators and supervisors must be free from both political
interference and regulatory capture by the industry.

(3) The Financial Regulatory Reform Steering Committee comprises of and is co-chaired by senior
officials from the SARB, FSB-SA and National Treasury. It was established in June 2011 to develop the
Twin Peaks financial regulatory framework and subsequently implement the reforms.

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